PUBLICATIONS

New Custody Rule FAQs

SRZ Private Funds Regulatory Update

May 2020

On March 30 and April 2, 2020, the U.S. Securities and Exchange Commission's Division of Investment Management released two pieces of guidance, in the form of frequently-asked-questions, regarding issues relating to Rule 206(4)-2 ("Custody Rule") that relate to COVID-19 delays. The guidance addressed two specific challenges for advisers: surprise examination delays and unintended possession of physical certificates. Managers looking to rely on this SEC staff guidance should confirm that they satisfy the technical conditions underlying each FAQ.

Surprise Examinations. The March 30, 2020 FAQ addresses delays in receiving a "surprise audit" under the Custody Rule and it specifically states that the SEC staff would not recommend an enforcement action for a late surprise audit if the adviser reasonably believed that the independent public accountant would complete its surprise examination and file the required Form ADV-E within 120 days after the date chosen by the independent public accountant but — due to disruptions related to COVID-19 — the accountant was unable to complete; provided, however, that the accountant files its Form ADV-E no more than 45 days after the original due date.

Privately Offered Securities. The April 2, 2020 FAQ was posed on behalf of an adviser holding, on behalf of its clients, privately issued, certificated securities which could not be held by a qualified custodian because the adviser's custodian was no longer accepting physical certificates due to circumstances related to COVID-19. In the FAQ, the adviser stated that it could not identify other qualified custodians to hold these certificates and

could not readily convert them into an uncertificated format to meet the privately offered securities exemption in the Custody Rule. The SEC staff indicated that it would not recommend an enforcement action so long as:

- A transfer or a change in beneficial ownership of the security can only be effected with the prior consent of the issuer or holders of the outstanding securities of the issuer;
- Ownership of the security is recorded on the books of the issuer or its transfer agent (or similar) in the name of the client;
- There is a legend restricting transfer on the certificate;
- The adviser appropriately safeguards the certificates and they can be replaced upon loss or destruction; and
- The adviser makes and keeps a record of the custodian's closure.

The new FAQ is very similar to Custody Rule guidance[1] on certificated securities that was published in 2013, but the 2013 guidance is limited to clients that are pooled investment vehicles subject to an annual financial statement audit; this FAQ removes that limitation but requires that an adviser make and keep a record of the custodian's closure. In addition, this relief is only effective while, due to COVID-19, the physical certificates cannot be held by a qualified custodian or be converted to comply with the privately offered securities exemption.

This article appeared in the May 2020 edition of *SRZ's Private Funds Regulatory Update.* To read the full *Update,* click here.

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[1] Securities and Exchange Commission, Division of Investment Management, Guidance Update: Privately Offered Securities under the Investment Advisers Act Custody Rule (August 2013), available here.

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