SEC Releases Guidance with respect to Privately Offered Securities and the Custody Rule

Overview and Background

Late last week, the Division of Investment Management of the U.S. Securities and Exchange Commission (the "SEC") released an IM Guidance Update with respect to the custody rule, Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended. The guidance addresses the question of whether instruments evidencing a private fund's ownership of certain privately issued securities, including non-transferable stock certificates or "certificated" limited liability company interests that were obtained through a private placement ("private security certificates"), meet the definition of "privately offered securities" under the Custody Rule and thus are *not* required to be held with a qualified custodian. Subject to certain conditions set forth below, the SEC clarified that such private security certificates *do not* have to be maintained with a qualified custodian.

Private Security Certificates Materially Similar to "Privately Offered Securities"

Under the Custody Rule "privately offered securities" include securities that are: (A) acquired from the issuer in a transaction, or series of transactions, that does not involve a public offering; (B) uncertificated; and (C) transferable only with the prior consent of the issuer or the holders of the outstanding securities of the issuer. The SEC noted that private security certificates do not technically meet the definition of "privately offered securities" under the Custody Rule because such securities are represented by certificates. However, investment advisers, through letters and inquiries, have argued that maintaining private security certificates at a qualified custodian does not provide meaningful protection to investors in private funds and adds substantial costs typically paid by fund investors.

Compliance with the Custody Rule

Based on the arguments set forth by investment advisers, the SEC confirmed that it would not object if an investment adviser did not maintain private security certificates with a qualified custodian, so long as certain other conditions are met:

1. The adviser's client is a pooled investment vehicle subject to financial statement audits in accordance with the Custody Rule;[1]

2. The certificate can be used to effect a transfer or facilitate a change in beneficial ownership of the security only with the consent of the issuer or holders of the outstanding securities of the issuer;

3. Ownership of the security is recorded on the books of the issuer (or its transfer agent);

4. The private security certificate contains appropriate legends restricting transfers; and

5. The private security certificate is appropriately held by the investment adviser and can be replaced upon loss or destruction.[2]

[1] The "audit exemption" in the Custody Rules generally requires that the private fund be subject to an audit at least annually by a PCAOB-registered and inspected independent public accountant and that all such audited financial statements are distributed annual to all beneficial owners of the private fund within 120 days of the fiscal year end (or 180 days in the case of funds-of-funds).

Implications for Private Fund Sponsors

In light of the SEC's guidance, private equity fund managers and other registered investment advisers maintaining private security certificates with third-party custodians may wish to reconsider their existing custody arrangements with respect to such securities. While the SEC's guidance may be helpful for sponsors of funds holdings private security certificates, it is important to note that the SEC did not remove the issuer consent requirements (see #2 above). Therefore, to the extent a private security certificate does not require an issuer to consent to a transfer, it must still be held by a qualified custodian. In addition, the SEC's new guidance does not change the custody rule analysis for uncertificated securities, which may include, amongst other things, partnership interests, LLC interests, and derivatives positions held pursuant to ISDA master agreements.[3]

Please contact your usual Ropes & Gray attorney if you have any questions with respect to the Custody Rule or the SEC's recent guidance.

[2] Registered investment advisers should have compliance policies and procedures in place that reasonably address the safeguarding of client assets from conversion or other inappropriate use by advisory personnel.

[3] For example, while the SEC clarified that partnership agreements, subscription agreements and LLC agreements are not certificates under the Custody Rule, the securities represented by such documents are "privately offered securities" provided they meet the other elements of Rule 206(4)-2(b)(2) (which includes the "issuer consent requirement"). Similarly, the SEC considers securities that are evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty to be "privately offered securities" under the Custody Rule.