SEC Issues Guidance on Application of Custody Rules to Special Purpose Vehicles and Escrows

Introduction

The Division of Investment Management of the Securities and Exchange Commission (the SEC) recently 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. Specifically, the SEC's guidance focused on the application of the Custody Rule with respect to special purpose vehicles utilized for making investments (SPVs) and escrow accounts utilized when selling interests in portfolio companies. This guidance will be of interest to private equity fund managers, and other private fund managers that may periodically utilize SPVs in pursuing their investment programs, provided in each case that the manager is registered as an investment adviser with the SEC.

The Custody Rule and Special Purpose Vehicles

With respect to treatment of SPVs with respect to compliance with the Custody Rule, the SEC previously stated that an investment adviser could either (1) treat the SPV as a separate client (whereby the investment adviser would have custody of the assets of the SPV) or (2) rely on the audit exemption[1] of the Custody Rule (the "audit exemption") and treat the SPV's assets as assets of the funds of which it has indirect custody. Generally, if an investment adviser opts to treat the SPV as a separate client, the Custody Rule requires that the investment adviser separately comply with the audited financial statements distribution requirements (i.e., by separately auditing the SPV and distributing the financial statements to fund investors). If an investment adviser opts to rely on the audit provision and treat the SPV's assets as assets of a fund, such assets must be considered within the scope of such fund's financial statement audit.

The SEC's recent guidance focused on how an investment adviser that relies on the audit exemption can comply with the requirements of the Custody Rule in four common scenarios: (1) an SPV that holds one investment, whose sole beneficial owner is a single fund managed by the investment adviser; (2) an SPV that holds one investment, whose sole beneficial owners are multiple affiliated funds managed by the investment adviser; (3) an SPV that holds multiple investments, whose sole beneficial owners are multiple affiliated funds managed by the investment adviser; and (4) an SPV that holds one or more investments, whose beneficial owners include a fund managed by the investment adviser and other unaffiliated parties.

The SEC clarified that if (a) an SPV is owned by one or more affiliated funds managed by the investment adviser and (b) the SPV is within the scope of the funds' financial statement audit(s) (i.e., scenarios (1), (2) and (3) described above), then the investment adviser may treat the assets of the SPV as assets of the fund(s) to comply with the Custody Rule. However, with respect to an SPV owned by one fund managed by the investment adviser and unaffiliated third parties (i.e., scenario (4) described above), the SEC noted that an investment adviser relying on the audit exemption should treat the SPV as a separate client for purposes of the Custody Rule. As a result, in this scenario, the investment adviser must separately comply with the Custody Rule's audited financial statement distribution requirements (among other requirements) with respect to such SPV. In light of this new guidance, we recommend that private fund managers reconsider whether separate audits should be obtained for one or more of the SPVs in which their funds hold interests.

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[1] If a fund is audited by an independent public accountant, the financial statements are distributed to investors and certain other requirements are met, the adviser is exempt from certain requirements of the Custody Rule, including the need to have a surprise exam to verify the proper custody of assets.

The SEC's guidance leaves unanswered several key questions with respect to SPVs that have often been raised by, and discussed with, the SEC during examinations, including:

1. What does it mean for an SPV to be "within the scope of a fund's audit"?

2. Under what circumstances is an SPV a "client" of the investment adviser?[2]

3. In a "club deal" among the funds of various advisers, which adviser must take responsibility for satisfying the Custody Rule?

4. If an adviser does not rely on the audit exemption, how can that adviser comply with the Custody Rule with respect to the SPVs held by its funds?

5. Does the guidance in scenario (4) apply if a fund makes an investment through an alternative investment vehicle owned in whole or in part by some or all of the fund's limited partners and/or the fund?

The Custody Rule and Escrow Accounts

In connection with the certain sales of portfolio companies by private equity funds, an escrow account is created to hold a portion of the proceeds of the sale, in case there is an indemnification claim or purchase price adjustment. The sellers (which may include both a fund advised by a registered adviser and unaffiliated sellers) appoint a "sellers' representative" to act on their behalf with respect to the sale proceeds held in escrow. The custody rule requires a registered investment adviser to maintain funds and securities over which it has custody with a qualified custodian in a separate account for each client in the client's name, or in accounts that contain only the adviser's clients' funds and securities that are maintained in the adviser's name as agent or trustee for the clients. The funds in an escrow account often belong to both the adviser's pooled investment vehicle clients and other sellers that are not advisory clients and are typically maintained in the name of the sellers' representative. In its guidance, the SEC clarified that an investment adviser would be in compliance with the Custody Rule if the investment adviser maintained client funds in an escrow account with other client and non-client assets and the funds were held in the name of the sellers' representative so long as:

1. The client is a fund that relies on the audit exemption and includes the portion of the escrow account attributable to the fund in its financial statements;

2. The escrow account is utilized in connection with the sale or merger of a portfolio company owned by the client (i.e., for indemnification or purchase price adjustment purposes);

3. The escrow account contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and sellers;

4. The escrow account exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers;

5. The escrow account is maintained at a qualified custodian; and

[2] With respect to the second question, the SEC sidestepped this issue by noting that for purposes of its guidance, it was assuming that the SPV was a client (and whether an SPV is actually a client of the investment adviser is based on the facts and circumstances surrounding the SPV).

6. The sellers' representative is contractually obligated to promptly distribute the funds remaining in the escrow account at the end of the escrow period, based on a predetermined formula to the sellers (including the fund client).

In light of this guidance, private equity firms will want to arrange the sales of their portfolio companies and related contractual provisions in a manner designed to satisfy the requirements of the new guidance.[3]

The full text of the IM Guidance Update is available here.

[3] In particular, firms will need to change the practice in certain jurisdictions of having non-qualified custodians (such as law firms) hold escrow proceeds. Also, while not specifically addressed in the guidance, we believe it is reasonable to take the position that the buyer of a portfolio company is not responsible for the custody of assets held in escrow. Finally, as above, the guidance does not address how advisers that do not rely on the audit exemption satisfy the Custody Rule in connection with an escrow.