FS Regulatory Brief

How the SEC's Custody Rule Impacts Private Fund Advisers

Introduction

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or "the Act") and rules recently adopted by the Securities and Exchange Commission (SEC), many advisers to private funds will need to register with the SEC as investment advisers and come into compliance with the Investment Advisers Act by March 31, 2012. The impact of registration will be significant and will require that many firms implement changes to their controls, staffing, recordkeeping, and disclosures to fund investors, and establish new compliance programs. One of the more significant rules under the regulatory framework is the so-called "Custody Rule" (Rule 206(4)-2 under the Investment Advisers Act).

This FS Regulatory Brief describes the Custody Rule and some considerations for private fund advisers as they prepare to register with the SEC. It complements our earlier *A Closer Look* pieces describing the impact of Dodd-Frank on asset managers, including *SEC Adopts Final Rule for Investment Adviser Registration* (July 2011) and *Impact on Advisers to Private Equity Funds* (May 2011).

The Custody Rule: An overview

The Custody Rule is intended to provide protections for client cash or securities held on their behalf by investment advisers. In 2009, following a series of fraud cases in which advisers either misappropriated client assets or misrepresented the dollar value of those assets in reports to clients, the SEC revised the Custody Rule to provide new requirements intended to further strengthen protections; decrease the likelihood of customer assets being misappropriated, lost, misused, or subject to advisers' financial reverses; and increase chances for earlier detection of fraudulent activity.

When a registered adviser has "custody" of client cash or securities, the Custody Rule subjects the adviser to the following requirements, unless an exemption is available:

- The adviser must undergo an annual surprise examination by an independent public accountant to verify client assets.
- The adviser must have the qualified custodian maintaining client cash and securities send account statements directly to the advisory clients.
- Unless client assets are maintained by an independent custodian (i.e., a custodian that is not the adviser itself or a related person), the adviser must obtain a report on the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB).

The Custody Rule broadly states "it is a fraudulent, deceptive, or manipulative act" for registered advisers to have custody unless the adviser meets the requirements of the Custody Rule.

What is "custody"?

The Custody Rule defines "custody" as "holding, directly or indirectly, client cash or securities, or having any authority to obtain possession of them" in connection with advisory services. The SEC defines having custody to include:

> (i) Possession of client cash or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;

(ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client cash or securities maintained with a custodian upon your instruction to the custodian; and

(iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client cash or securities.

The Custody Rule presumes that an adviser has constructive custody when a related party acts as a general partner, managing member, or similar role for a pooled investment vehicle.

Investment advisers to private funds are likely to be deemed to have custody because the adviser or a related party of the adviser is in a position of authority with respect to the investments and/or fund either through actual possession, ownership, or another business arrangement. As such, private fund advisers are often deemed to have custody even though the adviser may not have physical custody of cash or securities.[1]

In addition, an adviser will be deemed to have custody if it has the ability to make withdrawals to pay advisory fees.[2] If the ability to withdraw the advisory fee is the only reason an adviser is deemed to have custody, the adviser does not have to undergo the annual surprise examination. In this circumstance, an adviser still must ensure that its compliance program adequately addresses the fee deduction process, as discussed below.

Key requirements of the Custody Rule

The key requirements of the Custody Rule are summarized below.

Use of a qualified custodian. The Custody Rule requires that all client cash and securities managed by the registered adviser, including collateral that is made up of cash or securities, be held by a "qualified custodian" in a separate account under the client/fund name. The Custody Rule defines a qualified custodian as a bank that has its deposits insured by the Federal Deposit Insurance Corporation (FDIC), an SEC-registered broker-dealer, a futures commission merchant registered with the Commodity Futures Trading Commission (CFTC), or a foreign financial institution.

Recognizing that not all securities may easily be placed with a custodian, the SEC provided relief for certain securities that meet the definition of a "privately offered security." The Custody Rule defines privately offered securities as securities that are (1) acquired in a non-public offering from the issuer; (2) uncertificated, with ownership only recorded on the issuer's register or by the transfer agent; and (3) not freely transferable without the consent of the issuer or other holders.

Pooled investment vehicles may not use the privately offered securities relief unless the adviser satisfies the audit exemption (described below). In other words, unless an adviser meets the audit exemption, all securities in a pooled investment vehicle must be held by a qualified custodian.

Historically, many advisers to private funds, particularly private equity funds, may have only held cash at a qualified custodian. Under the Custody Rule, however, all client cash and securities, other than those described above, must be placed with a qualified custodian.

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[1] While the Custody Rule governs cash and securities, an adviser should take care to implement a control environment that addresses all types of client assets under management.

[2] As described in this Regulatory Brief, if an adviser collects more than $1,200 of fees six months or more in advance, the adviser must include with Form ADV Part 2 an independently audited balance sheet for the most recent fiscal year and disclose any material financial condition that may impair the ability to meet contractual client commitments.

Qualified custodian account statements. The adviser must send notice to clients when a custody account is opened or information regarding the account changes. Additionally, the adviser must have a reasonable belief that the qualified custodian sends quarterly account statements directly to clients that include all transactions during the quarter and ending balances of cash and holdings.

The SEC recently clarified that for pooled investment vehicles (which include private equity or hedge funds), the statement sent by the qualified custodian should be a statement of cash and securities held by the fund and transactions by the fund, and must be sent to all investors in the fund. Note, however, the SEC provided an exemption for pooled investment vehicles that are audited (as described below).

Compliance date. Upon registration, the adviser should have a reasonable belief that the qualified custodian will send statements for the next quarter end.

Surprise examination. When an adviser has direct or constructive custody, the adviser must engage an independent public accountant to examine client accounts through confirmation and other testing on a surprise date annually. The independent accountant must confirm cash and securities and investor balances on a sample basis. The accountant's report of the examination (on Form ADV-E) must be submitted electronically to the SEC within 120 days of the surprise examination date, and will be made available publicly on the SEC website. The surprise examination is not required for pooled investment vehicles that meet the audit exemption (described below).

Compliance date. Upon registration, the first examination must occur within six months. Examinations must be repeated once each calendar year thereafter.

Internal controls report. If a related party of the adviser acts as a qualified custodian, the adviser must obtain an internal controls report (such as a Type II SAS 70 report, AT 101 report, etc.) from the custodian.

Advisers to pooled investment vehicles should assess whether a related party acts as a custodian. For example, private equity advisers that use banks that they own or control to hold cash or securities should assess if the qualified custodian is a "related person" as defined in the Custody Rule, which may necessitate receiving an internal controls report. Note that pooled investment vehicles that meet the audit exemption (as described below) must still comply with this requirement.

Compliance date. Upon registration, a controls report must be received within six months. Reports must be received once each calendar year thereafter.

The "audit exemption." The SEC provides an exemption from several of these requirements for advisers to pooled investment vehicles that are subject to an annual financial statement audit by an independent public accountant,[3] and that distribute the audited financial statements (prepared in accordance with US generally accepted accounting principles [GAAP]) to the pool's investors.

Advisers that meet the "audit exemption" are deemed to have satisfied the annual surprise examination requirement.[4] Additionally, an adviser to a pooled investment vehicle that distributes to its investors audited financial statements is not required to have a reasonable belief that a qualified custodian delivers account statements to investors. If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule.

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[3] To qualify for the exemption, the audit must be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.

[4] An adviser that relies on the annual audit provision must nonetheless undergo an annual surprise examination of non-pooled investment vehicle assets of which it has custody.

Upon registration with the SEC, the adviser must have a "reasonable belief" that the audit exemption will be met for the current fiscal year. As such, upon registration, to avoid the notice and statement delivery requirement and the surprise examination requirement, the adviser must have a reasonable belief that it will meet the audit exemption. Meeting the audit exemption requirement also allows the adviser to use the privately offered securities relief.

When assessing whether it may use the audit exemption, an adviser should consider the following factors:

Auditor independence. The accountant performing the audit must be independent from the adviser under SEC standards, a stricter form of independence than the American Institute of Certified Public Accountants (AICPA) standards that many unregistered advisers and their accountants operated under in the past.

Auditor credentials. The accountant must be registered with and subject to inspection by the PCAOB for the adviser to rely on the accountant's opinion for purposes of the audit exemption.

Timing. The adviser should have a reasonable belief that the audit will be completed and delivered to investors annually within 120 days of each pooled investment vehicle's fiscal year end. In a no-action letter and related frequently-asked questions, the SEC noted that if more than 10 percent of a pooled investment vehicle's net assets are invested in an unrelated pooled investment vehicle, the audit may be completed and delivered within 180 days of the fiscal year end.

Principles and standards. To meet the audit exemption, the financial statements must be prepared under US generally accepted auditing standards ("US GAAS"). For those pools audited under other auditing standards, a dual opinion referencing US GAAS and the other standard may be issued. The financial statements must also be prepared under US GAAP.

Non-US pools may have financial statements prepared in accordance with accounting standards other than US GAAP so long as they contain information substantially similar to statements prepared in accordance with US GAAP, with any material differences reconciled to US GAAP. This reconciliation only needs to be delivered to US investors.

Liquidation audits. To rely on the audit exemption, the adviser must obtain a final audit of the pooled investment vehicle upon liquidation. Often, private equity funds may significantly wrap up their operations before final liquidation. In these cases, advisers should be mindful of the need to continue conducting annual audits and obtain a final liquidation audit.

In addition to reviewing if each pooled investment vehicle meets the audit exemption, registering advisers should take care that all investors within a pool subject to the Custody Rule receive financial statements. Historically, many private equity advisers have not subjected certain co-invest entities or employee pool investment vehicles to audits.

Disclosures concerning custody. Registered advisers are required to provide information about their custody practices in their registration form (Form ADV). Part 1, Item 7 of Form ADV asks the adviser to identify all qualified custodians used, including broker-dealers. Item 9 requires the adviser to disclose the accountants used for the audit exemption, surprise examination, and internal controls report. Item 9 also requires the adviser to report:

1. Whether the adviser or a related person has custody of client assets;
2. The total US dollar amount of those assets, as well as the number of clients for whose accounts the adviser or its related person has custody;
3. If any pooled investment vehicle advised by the adviser is audited, and whether the qualified custodians send account statements to investors; and
4. Whether the adviser serves as a qualified custodian for the adviser's clients.

Depending on the responses to these questions, the adviser may be required to provide additional information on Schedule D regarding these various matters.

Additionally, advisers with discretionary authority or custody of client cash or securities must disclose on Form ADV Part 2 any material financial condition that may impair the ability to meet contractual commitments to the clients. If an adviser collects more than $1,200 of fees six months or more in advance, the adviser must include with Form ADV Part 2 an independently audited balance sheet for the most recent fiscal year and disclose any material financial condition that may impair the ability to meet contractual client commitments.

As described above, if an adviser needs to have a surprise examination performed, the adviser must submit Form ADV-E electronically. This form identifies the independent accountant who will be performing the surprise examination. Upon completion of the exam, the independent accountant must file the surprise examination report electronically as well.

Action points for advisers registering with the SEC

Given the importance of the Custody Rule as a key investor protection rule under the Adviser's Act, advisers that are registering with the SEC should take care to ensure that they are meeting its requirements. The SEC has focused considerable attention on the Custody Rule in recent examinations.

Advisers should consider taking the following steps to prepare for registration with the SEC and compliance with the Custody Rule:

1. Identify each investment adviser required to register;
2. For each registered adviser, identify all assets under management;
3. Distinguish which cash and securities are managed within pooled investment vehicles and which are managed within individual accounts;
4. Determine if any cash and securities are maintained at the registered adviser or related party acting as the qualified custodian;
5. Determine if any related party custodians meet the definition of "operational independence" from the adviser;
6. Inventory all securities and determine those that will not meet the definition of privately offered securities;[5]
7. Ensure those securities not meeting the privately offered securities definition are maintained with a qualified custodian;
8. For those accounts not meeting the audit exemption, ensure the qualified custodians are prepared to send quarterly statements;
9. For those accounts not meeting the audit exemption, engage an independent public accountant to perform a surprise examination;
10. Determine and document if there is a "reasonable belief" that the audit exemption will be met for each pooled investment vehicle;
11. Review the books and records provisions related to custody in Investment Advisers Act Rule 204-2 for compliance;
12. Develop policies and procedures to incorporate SEC recommendations on compliance controls and testing (described below); and
13. Review Form ADV disclosures for accuracy and consistency.

Developing effective compliance policies and procedures and controls

The "Compliance Rule" under the Advisers Act (Rule 206(4)-7) requires that registered advisers adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its

[5] Private equity structures typically include various blocker and special purpose vehicle (SPV) entities. Advisers should carefully assess if these entities meet the definition of a "security" that needs to be in compliance with the Custody Rule or if the entities are privately offered securities. Additionally, advisers will need to look through each entity layer to the ultimate portfolio company when assessing the Custody Rule.

rules. The SEC has stated that these policies and procedures must address, among other things, the safeguarding of client assets from conversion or inappropriate use by advisory personnel:

> "Compliance with rule 206(4)-7 requires an adviser with custody to adopt controls over access to client assets that are reasonably designed to prevent misappropriation or misuse of client assets, develop systems or procedures to assure prompt detection of any misuse, and take appropriate action if any misuse does occur."[6]

The SEC suggests that advisers with custody of client assets should consider the value of instituting the following policies and procedures as part of their compliance programs:

- Conducting background and credit checks on employees of the investment adviser who will have access (or could acquire access) to client assets, to determine whether it would be appropriate for those employees to have such access;
- Requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;
- Limiting the number of employees who are permitted to interact with custodians with respect to client assets, and rotating them on a periodic basis;
- If the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected;
- Requiring that problems be brought to the immediate attention of management and the adviser's chief compliance officer (CCO);
- Prohibiting employees from acquiring custody of assets by prohibiting them from becoming trustees for client assets or obtaining powers of attorney for clients separate from the advisory firm; and
- Ensuring that the adviser's CCO has access to sufficient information on these matters to enforce the adviser's policies and procedures.

The SEC also suggests that the CCO periodically test the effectiveness of the firm's controls by, for example:

- Periodically reconciling client account balances at the adviser with the custodian's records of client transactions and holdings.
- Comparing, on a sample basis, client addresses obtained from the clients' qualified custodians with client addresses maintained by the adviser to look for inconsistencies or patterns that suggest possible manipulation of address information.

In addition, the SEC suggests that advisers that have custody as a result of their authority to deduct advisory fees directly from client accounts held at a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of the advisory contract (which would violate the contract and which could constitute fraud under the Advisers Act). The SEC suggests that examples of such policies are:

- Periodic testing on a sample basis of fee calculations for client accounts, to determine their accuracy;
- Testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and
- Segregating duties between those personnel responsible for processing billing invoices or listings of fees due from clients and those personnel responsible for reviewing the invoices

[6] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2968 (Dec. 30, 2009)

and listings for accuracy, as well as those employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.

The SEC notes that advisers should tailor their procedures to the nature of their firm and its particular risks. As an example, the SEC states that advisers to pooled investment vehicles should consider whether their procedures should cover investor accounts in the pool to prevent an employee from misappropriating assets from the pool by processing false investor withdrawals.

In addition to the SEC's recommendations, advisers might consider the following additional controls as part of an overall robust control environment:

1. Periodically assess the adviser's securities in each entity or portfolio company structure for accuracy of the certificates and proper placement with qualified custodians;
2. Ensure that current privately offered securities have not changed status under the definition in the Custody Rule;
3. Ensure that policies and procedures address expenses and ensure proper allocation of expenses to each pooled investment vehicle and/or accounts, especially related to diligence on new deals and acquisitions;
4. Examine limited partnership agreements and investment advisory contracts when calculating expenses and waterfalls;
5. Prohibit commingling of assets;
6. Send all certificates directly to the qualified custodian and have policies and procedures on inadvertently receiving assets under custody;
7. Perform periodic oversight of the qualified custodian, including obtaining controls reports, on-site reviews, and reconciliations; and
8. Ensure that all employees with responsibility for custody controls are adequately trained and understand their obligations.

Additional information

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