IM Guidance Update

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PRIVATE FUNDS AND THE APPLICATION OF THE CUSTODY RULE TO SPECIAL PURPOSE VEHICLES AND ESCROWS

The Dodd-Frank Act required the registration of many investment advisers to hedge funds, private equity funds, and other private pooled investment vehicles ("pooled investment vehicles"), which significantly increased the population of investment advisers to these vehicles registered with the Commission.[1] The Division receives inquiries, and the Commission's Office of Compliance Inspections and Examinations has identified issues in examinations, regarding how the Advisers Act custody rule, Rule 206(4)-2, applies[2] when advisers to pooled investment vehicles, particularly private equity funds, utilize: (1) special purpose vehicles when making investments ("Investment SPVs"); and (2) escrow accounts when selling interests in portfolio companies.

Investment Special Purpose Vehicles

The Commission acknowledged in the custody rule adopting release ("Custody Rule Release")[3] that investment advisers to pooled investment vehicles may from time to time use Investment SPVs to facilitate investments in certain securities by one or more pooled investment vehicles that the advisers manage. These Investment SPVs typically are controlled[4] by the investment adviser or the adviser's related person(s)[5] who often serve as general partners of limited partnerships (or managing members of limited liability companies, or persons who hold comparable positions for another type of pooled investment vehicle).

The Commission stated in the Custody Rule Release that to comply with new section 206(4)-2(c) of the custody rule, "Delivery to Related Person," an investment adviser could either treat the Investment SPV as a separate client, in which case the adviser will have custody of the Investment SPV's assets, or treat the Investment SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly.[6] If the adviser is relying on the audit provision[7] and treats the Investment SPV as a separate client, the custody rule requires the adviser to comply separately with the custody rule's audited financial statement distribution requirements.[8] Accordingly, such advisers should distribute the audited financial statements of the Investment SPV to the beneficial owners

of the pooled investment vehicles that own the Investment SPV. If, however, the adviser is relying on the audit provision and treats the Investment SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the scope of the pooled investment vehicles' financial statement audit.[9]

The focus of inquiries regarding Investment SPVs commonly revolve around how the Commission's guidance applies to an investment adviser to pooled investment vehicles that rely on the audit provision, when such investment adviser utilizes Investment SPVs in a number of different scenarios. In particular, advisers inquire when an adviser may treat the assets owned by an Investment SPV as assets of pooled investment vehicle clients of which the adviser has custody indirectly and therefore include such assets within the scope of pooled investment vehicles' financial statement audits. The scenarios below are illustrative of the inquiries the Division is receiving with respect to the custody rule and Investment SPVs.[10] The Division's response follows each scenario.

1) **Scenario:** For legal, tax, regulatory or other similar purposes, an adviser to a pooled investment vehicle client utilizes a limited liability company ("LLC"), trust, partnership, corporation or other similar vehicle to purchase a single investment on behalf of the pooled investment vehicle client ("single purpose vehicle"). The pooled investment vehicle client invests a portion of its capital in the single purpose vehicle, which in turn invests in a single investment. The single purpose vehicle has no owners other than the adviser, the adviser's related person(s) or the pooled investment vehicle client that is controlled by the adviser or the adviser's related person(s). Advisers have asked whether an adviser relying on the audit provision may choose to treat the assets of the single purpose vehicle as assets of the pooled investment vehicle client of which the adviser or the adviser's related person(s) has custody indirectly for purposes of the custody rule.

   Response: As discussed in the Custody Rule Release, an adviser relying on the audit provision may treat the assets of the single purpose vehicle as assets of the pooled investment vehicle client of which the adviser or the adviser's related person(s) has custody indirectly so long as: (a) the assets of the single purpose vehicle are considered within the scope of the pooled investment vehicle client's financial statement audit; and (b) the single purpose vehicle has no owners other than the adviser, the adviser's related person(s) or the pooled investment vehicle client that is controlled by the adviser or the adviser's related person(s).

2) **Scenario:** For legal, tax, regulatory or other similar purposes, an adviser to multiple pooled investment vehicle clients utilizes a LLC, trust, partnership, corporation or other similar vehicle to purchase a single investment on behalf of multiple pooled

investment vehicle clients ("multi-fund single purpose vehicle"). The pooled investment vehicle clients invest in the multi-fund single purpose vehicle, which in turn invests in a single investment. The multi-fund single purpose vehicle has no owners other than the adviser, the adviser's related person(s) or pooled investment vehicle clients controlled by the adviser or the adviser's related person(s). Advisers have asked whether an adviser relying on the audit provision may choose to treat the assets of the multi-fund single purpose vehicle as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly for purposes of the custody rule.

Response: The Division would not object if an adviser relying on the audit provision treats the assets of the multi-fund single purpose vehicle as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly so long as: (a) the assets of the multi-fund single purpose vehicle are considered within the scope of the pooled investment vehicle clients' financial statement audits; and (b) the multi-fund single purpose vehicle has no owners other than the adviser, the adviser's related person(s) or pooled investment vehicle clients that are controlled by the adviser or the adviser's related person(s).

3) **Scenario:** For legal, tax, regulatory or other similar purposes, an adviser to one or more pooled investment vehicle clients utilizes a LLC, trust, partnership, corporation or other similar vehicle to purchase multiple investments on behalf of the one or more pooled investment vehicle clients ("multi-purpose vehicle"). The pooled investment vehicle clients invest in the multi-purpose vehicle, which in turn invests in more than one investment. The multi-purpose vehicle has no owners other than the adviser, the adviser's related person(s) or pooled investment vehicle clients controlled by the adviser or the adviser's related person(s). Advisers have asked whether an adviser relying on the audit provision may choose to treat the assets of the multi-purpose vehicle as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly for purposes of the custody rule.

Response: The Division would not object if an adviser relying on the audit provision treats the assets of the multi-purpose vehicle as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly so long as: (a) the assets of the multi-purpose vehicle are considered within the scope of the pooled investment vehicles' financial statement audits; and (b) the multi-purpose vehicle has no owners other than the adviser, the adviser's related person(s) or pooled investment vehicle clients controlled by the adviser or the adviser's related person(s).

4) **Scenario:** For legal, tax, regulatory or other similar purposes, an adviser to one or more pooled investment vehicle clients utilizes a LLC, trust, partnership, corporation or other similar vehicle to purchase one or more investments on behalf of the one or more pooled investment vehicle clients and third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related person(s) ("investment fund"). The pooled investment vehicle clients and third parties invest in the investment fund, which in turn invests in one or more investments. The investment fund has third-party owners, such as pooled investment vehicles controlled by other advisers or persons that are not the adviser, the adviser's related person(s) or pooled investment vehicles controlled by the adviser. Advisers have asked whether an adviser relying on the audit provision may choose to treat the assets of the investment fund as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly for purposes of the custody rule.

   Response: Generally, the Division believes that an adviser relying on the audit provision should treat the assets of the investment fund as a separate client for purposes of the custody rule. While the investment fund may exhibit certain characteristics of an Investment SPV, it has owners other than the adviser, the adviser's related person(s) or pooled investment vehicles controlled by the adviser or the adviser's related person(s). Therefore, the investment fund should be treated as a separate client for purposes of the custody rule. In that case, the custody rule requires, among other things, the adviser to comply separately with the custody rule's audited financial statement distribution[11] requirements with respect to the investment fund.

Escrow Accounts

The Division receives inquiries from advisers to pooled investment vehicles with respect to the application of the Advisers Act custody rule to escrow accounts that typically are used for a limited period of time in connection with the sale of a portfolio company owned by one or more pooled investment vehicles ("Escrows").

The focus of inquiries regarding Escrows commonly revolves around a circumstance involving the sale of a portfolio company owned by one or more pooled investment vehicles (typically private equity funds) advised by a registered investment adviser and other persons that are not clients of the adviser. As part of the sale or merger,[12] the Division understands that the sellers (including the adviser's pooled investment vehicle client(s) and other non-client owners of the portfolio company) often appoint a "sellers' representative"[13] to act on their behalf with respect to a portion of the sale proceeds held in an Escrow following the closing of the sale or merger.[14] The purpose of an

Escrow is to hold a percentage of sale proceeds to be used in the event of indemnification or an adjustment to the sale price of a portfolio company included in the terms of the purchase or merger agreement between the sellers and buyer. An Escrow typically exists for a limited period of time and the funds remaining after such time are distributed on a predetermined formula to the sellers, including the adviser's pooled investment vehicle clients.

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.[15] The funds in an Escrow 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. Under these circumstances, advisers assert that the primary protections of these joint Escrows for their clients (and pooled investment vehicle investors) are similar in material respects to separate Escrows or Escrows with only clients' funds and that creating multiple Escrows to fully comply with the custody rule would not significantly change the protections and risks. For example, advisers have stated that for these pooled investment vehicle clients, the portion of the Escrow attributable to the pooled investment vehicle would be included in its financial statements and within the scope of the audit. Advisers also note that, while the Escrows have a limited duration, exist for a narrow purpose and have a small percentage of the sale proceeds, the cost to establish and maintain several Escrows in the names of various pooled investment vehicle clients and unrelated investors would be significant, a cost some of which would be borne by pooled investment vehicle investors.

The Division would not object if an adviser maintains client funds in an Escrow with other client and non-client assets, provided that: (1) the client is a pooled investment vehicle that relies on the audit provision and includes the portion of the Escrow attributable to the pooled investment vehicle in its financial statements; (2) the Escrow is in connection with the sale or merger of a portfolio company owned by the client (i.e., for indemnification or to adjust the purchase price); (3) the Escrow contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (4) the Escrow 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 is maintained at a qualified custodian; and (6) the sellers' representative is contractually obligated to promptly distribute the funds remaining in the Escrow at the end of the escrow period on a predetermined formula to the sellers,[16] including the pooled investment vehicle clients.

Endnotes

1 The Dodd-Frank Act eliminated the private adviser exemption from investment adviser registration, which was available to investment advisers that, among other things, had fewer than 15 clients with each pooled investment vehicle counting as a single client. As of May 1, 2014, 37.8% of all registered investment advisers advise at least one private fund.

2 Typically, an adviser to a pooled investment vehicle has custody of the pool's assets because the adviser or a related person(s) serves as the general partner of a limited partnership or in a comparable position of the pool. Under the rule, custody includes 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 the adviser or its supervised person legal ownership or access to client funds or securities.

3 *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2968 (Dec. 30, 2009) at Section II.F, available at http://www.sec.gov/rules/final/2009/ia-2968.pdf.

4 Advisers Act Rule 206(4)-2(d)(1) (defining "control" for purposes of the custody rule).

5 "Related person" means any person, directly or indirectly, controlling or controlled by [the adviser], and any person that is under common control with [the adviser]. Advisers Act Rule 206(4)-2(d)(7).

6 Advisers Act Rule 206(4)-2(c) states that sending an account statement under paragraph (a)(5) of the custody rule or distributing audited financial statements under paragraph (b)(4) shall not satisfy the requirements of the custody rule if such account statements or financial statements are sent solely to limited partners (or members or other beneficial owners) that themselves are limited partnerships (or limited liability companies, or another type of pooled investment vehicle) and are the adviser's related persons.

7 Advisers Act Rule 206(4)-2(b)(4) (the "audit provision") requires, among other things, the pooled investment vehicle to be subject to audit at least annually by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board, and for the audited financial statements to be distributed to all beneficial owners of the pool within 120 days

of the pool's fiscal year-end. An adviser to a pooled investment vehicle that does not rely on the audit provision must, among other things, obtain an independent verification of the pooled investment vehicle's funds and securities and have a reasonable basis for believing that the qualified custodian sends quarterly account statements to each limited partner (or member or other beneficial owner). Advisers Act Rule 206(4)-2(a)(2)-(5).

8 Custody Rule Release at Section II.F.

9 Custody Rule Release at Section II.F.

10 In each of the four scenarios discussed in this guidance, the adviser has determined that the single purpose vehicle, the multi-fund single purpose vehicle, the multi-purpose vehicle and the investment fund (each as defined below) are investment advisory clients and the Division has accepted these assumptions for purposes of this guidance. Whether an entity is an investment advisory client will depend on the particular facts and circumstances, which this guidance is not specifically addressing.

11 Advisers Act Rule 206(4)-2(b)(4) and (c).

12 The transaction typically takes the form of a sale of portfolio company stock or assets or a merger.

13 The sellers' representative is often appointed in a purchase agreement or in an ancillary document by the sellers.

14 The Division understands that the sellers' representative is often the investment adviser or an affiliate and the Escrow is typically held in the name of the sellers' representative.

15 Advisers Act Rule 206(4)-2(a)(1).

16 The Division anticipates that this contractual obligation will be referenced in the escrow agreement.

This *IM Guidance Update* summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This *IM Guidance Update* is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this *IM Guidance Update*.

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