CLIENT UPDATE

TREATMENT OF SPVS AND M&A ESCROW ACCOUNTS UNDER THE ADVISERS ACT CUSTODY RULE

WASHINGTON, D.C.
Kenneth J. Berman
kjberman@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

NEW YORK
Michael P. Harrell
mpharrell@debevoise.com

Kevin M. Schmidt
kmschmidt@debevoise.com

Jaime Doninger Schechter
jdschechter@debevoise.com

HONG KONG
Andrew M. Ostrognai
amostrognai@debevoise.com

The treatment of special purposes vehicles ("SPVs") used to facilitate investments in portfolio companies has presented issues under Rule 206(4)-2 under the U.S. Investment Advisers Act of 1940 (the "Custody Rule") since the current version of the Custody Rule was adopted in December 2009. Private fund managers often subject their funds to an annual audit in accordance with the "Annual Audit Approach" to avoid certain burdensome provisions of the Custody Rule, including a "surprise" examination by an independent accountant.[1] One question has been the circumstances under which the SPV should be separately audited from the main fund for purposes of the Annual Audit Approach.

The Division of Investment Management of the U.S. Securities and Exchange Commission (the "SEC Staff") recently published a new IM Guidance Update[2] that addresses this audit question. The IM Guidance Update also provides guidance on the use of an escrow account in connection with the sale of a portfolio company that holds sales proceeds owed to non-clients.

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1 The "Annual Audit Approach" under Rule 206(4)-2(b)(4) requires that a private fund or other pooled investment vehicle (i) be subject to an annual audit by an independent public account that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board; (ii) distribute its audited financial statements prepared in accordance with U.S. GAAP to its investors within 120 days of the end of its fiscal year; and (iii) undergo a liquidation audit and distribute the financial statements promptly after the completion of such audit.

2 IM Guidance Update, No. 2014-07 (June 2014), *available at* http://www.sec.gov/investment/im-guidance-2014-07.pdf.

SPVS UNDER THE ANNUAL AUDIT APPROACH

The SEC Staff identified four categories of SPVs commonly used by private funds:

- an SPV used by a single fund for a single investment;
- an SPV used by multiple related funds for a single investment;
- an SPV used by one or more related funds for multiple investments; and
- an SPV used by one or more related funds and one or more third-party investors for one or more investments.

The IM Guidance Update states that the first three categories of SPVs would not be required to be subject to a separate audit if:

- the assets of the SPV are considered within the scope of the fund's audit; and
- the SPV has no owners other than (i) funds managed by the fund manager and its related persons, (ii) the fund manager and (ii) the fund manager's related persons (e.g., related general partners).

In the case of an SPV that includes one or more third-party investors, the IM Guidance Update states that a fund manager that relies on the Annual Audit Approach, and is deemed to have custody of the SPV's assets, should treat the SPV as a separate client for purposes of the Custody Rule because its owners include persons other than the fund manager, the funds that it manages and related persons of the fund manager. Thus, in order for a fund manager that is deemed to have custody of the SPV's assets to rely on the Annual Audit Approach, the SPV should be separately audited and its financial statements distributed to investors. Presumably, this guidance would not apply to the managers of third-party funds that hold interests in the SPV if those managers do not have custody of the SPV's assets.[3]

ESCROW ACCOUNTS WITH NON-CLIENT ASSETS

The SEC Staff also provided guidance on the use of escrow accounts for a limited period of time in connection with the sale of a fund portfolio company. As part of the sale or merger, the sellers (including the fund manager's clients and other non-client owners of

[3] An investment adviser is considered to have "custody" for purposes of the Custody Rule if it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. "Custody" includes, among other things, situations where the investment adviser has legal ownership of or access to client funds or securities, such as where it acts as a general partner of a limited partnership.

the portfolio company) often appoint the fund manager as the "sellers' representative" to act on their behalf with respect to a portion of the sale proceeds that may be held in an escrow account following the closing of the transaction in connection with contingent indemnification or other payment obligations to the buyer. Questions had been raised whether these arrangements are inconsistent with the provision of the Custody Rule that requires that client assets be maintained either in a separate account for each client in the client's name or in an account that contains only the fund manager's clients' assets under the name of the fund manager as agent or trustee for the clients.

The SEC Staff agreed that it is not necessary to establish separate escrow accounts for the fund manager's clients if the escrow arrangement meets certain conditions:

- the fund manager's client is a fund that follows the Annual Audit Approach (and the applicable portion of the escrow account is included in its audited financial statements);
- the escrow account is formed in connection with the sale or merger of a portfolio company owned by the fund;
- the escrow account contains an amount of money (and exists for a period of time) that is agreed upon as part of a *bona fide* negotiation between the buyer and sellers;
- the escrow account is maintained at a qualified custodian; and
- the sellers' representative is contractually obligated to promptly distribute the funds remaining in the escrow account at the end of the escrow period on a predetermined formula to the sellers.

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Please do not hesitate to contact us with any questions.

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