

CLIENT UPDATE

SEC STAFF RAISES IMPORTANT CUSTODY RULE COMPLIANCE ISSUES FOR PRIVATE FUND SPONSORS

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The Office of Compliance Inspections and Examinations of the Securities and Exchange Commission (the “SEC”) recently released a risk alert concerning “widespread and varied non-compliance with elements of” Rule 206(4)-2 under the Investment Advisers Act of 1940 (the “Custody Rule”) that have been observed in the SEC’s National Examination Program (“NEP”).¹

The NEP alert identifies several compliance issues that are relevant for private fund sponsors. Private fund sponsors should expect SEC examiners to review their custody arrangements in detail. Thus, they should carefully review their compliance with the Custody Rule.

This client update focuses on the issues raised in the NEP alert relating to the “Annual Audit Approach” (defined below), which is used by most private fund sponsors to comply with the Custody Rule. The NEP alert also addresses common deficiencies observed outside of the private fund context that are not covered in this client update. Private fund sponsors with separately managed accounts or that do not follow the Annual Audit Approach should also review the issues raised in the NEP alert relating to the surprise examination and other requirements of the Custody Rule.

¹ Office of Compliance Inspections and Examinations, Significant Deficiencies Involving Adviser Custody and Safety of Client Assets, National Exam Program Risk Alert: Volume III, Issue 1 (Mar. 4, 2013), available at <http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>.

BACKGROUND

The safety of client assets has always been a major priority of the SEC. The Custody Rule contains a number of conditions that are designed to prevent the loss of client assets from theft or fraud. The NEP recently identified the safety of client assets and compliance with the Custody Rule as one of its top priorities for its 2013 examination program.²

Among other things, the Custody Rule requires an investment adviser who has “custody” of client assets to (i) maintain the client assets with a “qualified custodian” (such as a bank or broker-dealer) (the “Qualified Custodian Requirement”), (ii) have a reasonable belief that the qualified custodian is sending quarterly account statements to the clients (the “Quarterly Account Statement Requirement”) and (iii) undergo a surprise examination by an independent accountant (the “Surprise Examination Requirement”). Alternatively, an investment adviser may avoid the Quarterly Account Statement Requirement and the Surprise Examination Requirement with respect to a pooled investment vehicle by arranging for an annual audit of such vehicle that satisfies certain conditions and distributing the vehicle’s audited financial statements to investors within 120 days of the vehicle’s year end (or 180 days in the case of a fund of funds) (the “Annual Audit Approach”).³

The NEP alert contains a reminder that an investment adviser is considered to have “custody” for purposes of the Custody Rule if, among other things, the adviser or a related person serves as the general partner of, or holds a comparable position with, a pooled investment vehicle. Therefore, a private fund sponsor generally is considered to have “custody” of the assets of not only its main funds, but also certain co-investment vehicles, feeder vehicles (including employee vehicles) and special purpose vehicles formed for the purpose of making investments in one or more portfolio investments.

DEFICIENCIES IDENTIFIED BY THE SEC RELEVANT TO PRIVATE FUND SPONSORS

The NEP alert identifies a number of areas of non-compliance that may be particularly relevant to private fund sponsors. The most significant relate to failures to comply with the conditions of the Annual Audit Approach.

² For more information, please see our Client Update: SEC Enforcement Action Targets Advisers to Private Equity Funds (March 15, 2013), available at <http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=ca38874-183e-43bb-a8d8-866764a5b24a>.

³ For more information on the Custody Rule, please see our Client Update: How the SEC’s New Custody Requirements Change the Ground Rules for Registered Investment Advisers (January 5, 2010), available at <http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=d9666c13-358c-4e86-b1b2-11b1177353ff>.

- The accountant conducting the audit was not both (i) “independent” under Regulation S-X and (ii) registered with, and subject to inspection by, the Public Company Accounting Oversight Board (the “PCAOB”).
- The audited financial statements of the fund were not prepared in accordance with U.S. GAAP. The staff noted that financial statements prepared on a federal income tax basis or in accordance with auditing standards other than U.S. GAAP generally would not be sufficient.
- Under certain circumstances, non-U.S. sponsors and non-U.S. funds may be able to prepare the financial statements in accordance with accounting standards other than U.S. GAAP. However, the staff observed instances where financial statements prepared in accordance with International Financial Reporting Standards (“IFRS”) did not contain information substantially similar to statements prepared in accordance with U.S. GAAP as required by the staff guidance (*e.g.*, the Schedule of Investments or Financial Highlights were omitted, or were included but labeled as unaudited).
- The adviser received qualified audit opinions due to the fact that (i) the organizational expenses had been improperly amortized rather than expensed as incurred or (ii) the adviser could not substantiate fair valuations of fund investments. Qualified opinions do not satisfy the conditions of the Annual Audit Approach.
- The adviser failed to distribute the audited financial statements to *all* fund investors, including feeder fund investors. The staff noted that offering to make the financial statements available upon request is not sufficient to satisfy the conditions of the Annual Audit Approach.
- The adviser failed to arrange for the performance of a final audit upon the liquidation of the fund.
- The adviser obtained investor approval to waive the annual audit of the fund but did not satisfy the Surprise Examination Requirement and the Quarterly Account Statement Requirement.

In addition, advisers following the Annual Audit Approach must still satisfy the Qualified Custodian Requirement. The SEC staff noted that some advisers had held client assets in an account in the adviser’s name (but not as agent or trustee for the client) or had commingled client, proprietary and employee assets into one account. In addition, the SEC staff noted that maintaining certificates of securities in a bank safe deposit box would not satisfy this requirement.

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Private fund sponsors should carefully review their compliance policies with their legal counsel and accountants to ensure that none of these issues are applicable. Please do not hesitate to contact us with any questions.

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