

CLIENT UPDATE

SEC STAFF PROVIDES RELIEF UNDER THE CUSTODY RULE WITH RESPECT TO RESTRICTED STOCK CERTIFICATES HELD BY PRIVATE FUNDS

NEW YORK

Michael P. Harrell
mpharrell@debevoise.com

WASHINGTON, D.C.

Kenneth J. Berman
kjberman@debevoise.com

Gregory T. Larkin

gtlarkin@debevoise.com

Among the many issues that private fund sponsors face with respect to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”) is the cost of maintaining with a qualified custodian “paper” stock certificates that are not readily transferable. On August 1, 2013, the Division of Investment Management of the Securities and Exchange Commission (the “SEC Staff”) issued an important IM Guidance Update¹ that provides relief to private fund sponsors with respect to this issue. Private fund sponsors should adopt policies and procedures to ensure that any certificated, privately-offered securities that are not maintained with a qualified custodian in reliance on the new IM Guidance Update are appropriately safeguarded.

THE PRIVATELY-OFFERED SECURITIES EXEMPTION

Under Rule 206(4)-2(a)(1), if a registered investment adviser has “custody” of the cash and securities of its clients, it is required to maintain those cash and securities of clients with a qualified custodian (generally, a bank or a broker-dealer).

¹ IM Guidance Update, No. 2013-04 (Aug. 2013), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf>

Rule 206(4)-2(b)(2) (the “Privately-Offered Securities Exception”) provides an exception from this requirement for certain uncertificated, privately-offered securities that are held by private funds that undergo an annual audit in accordance with Rule 206(4)-2(b)(4) (the “Annual Audit Exception”).²

Until the recent IM Guidance Update, however, the Privately-Offered Securities Exception has not been available where a certificate or other evidence of the security was issued, even if the certificate was non-transferable and, therefore, presented a minimal risk of misappropriation. In the IM Guidance Update, the SEC Staff effectively expanded the Privately-Offered Securities Exception to also include certain certificated, privately-offered securities.³

THE NEW RELIEF

The relief provided by the IM Guidance Update is available to a private fund sponsor if:

- *Subject to an Annual Audit.* The private fund is subject to an audit in accordance with Annual Audit Exception.⁴
- *Non-Transferable.* The certificate (or other evidence) of the security can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer.
- *Recorded on Books of Issuer.* Ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client.
- *Legend Restricting Transfer.* The certificate contains a legend restricting transfer.
- *Appropriate Safeguards.* The certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

² The Privately-Offered Securities Exception requires that the security is (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. (Note: the Privately-Offered Securities Exception is also available to investment advisers with respect to clients that are not pooled investment vehicles.)

³ The SEC Staff also took the position that securities that are evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty to be “privately offered securities” under Privately-Offered Securities Exception.

⁴ The Annual Audit Exception requires that (i) the fund’s audited financial statements are prepared in accordance with U.S. GAAP, (ii) the statements are delivered to all investors within 120 days of the end of the fund’s fiscal year (or 180 days in the case of a fund of funds), (iii) the audit is performed by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB, and (iv) the fund is subject to an audit upon liquidation.

The first three conditions closely track the requirements of the Privately-Offered Securities Exception and the fourth condition reflects the SEC Staff's understanding of common practice.

NEXT STEPS

Private fund sponsors should adopt policies and procedures to ensure that any certificated, privately-offered securities that are not maintained with a qualified custodian, as permitted by the IM Guidance Update, are appropriately safeguarded. These policies and procedures may include requiring that such certificates are held in a safe, a safety deposit box or a locked file cabinet or in another arrangement where access is appropriately limited.

OPEN ISSUES

The IM Guidance Update does not address some of the other significant issues that private fund sponsors face under the Custody Rule, including the requirement that uncertificated, privately-offered securities be maintained with a qualified custodian if the private fund is not subject to annual audit under U.S. GAAP. However, the new guidance does reflect an important first step on the part of the SEC Staff in dealing with unnecessary burdens imposed on private fund sponsors by Advisers Act registration.

* * *

Please do not hesitate to contact us with any questions.

August 6, 2013