

New SEC Guidance on Application of Custody Rule to SPVs and Escrow Accounts

July 8, 2014

The Securities and Exchange Commission (SEC) recently issued a guidance update (Update) on Rule 206(4)-2 of the Investment Advisers Act of 1940 (Custody Rule), which regulates the custody practices of registered investment advisers for client funds and securities.^[1] This Update clarified the application of the Custody Rule to (i) special investment vehicles used by a pooled investment vehicle client when making investments and (ii) escrow accounts used by a pooled investment vehicle client when selling its interest in a portfolio company. Both are issues that the SEC has identified in examinations of registered investment advisers and in inquiries received from the industry.

Special Purpose Vehicles

Investment advisers frequently use special purpose vehicles (SPVs) to facilitate investments by one or more pooled investment vehicle clients. According to prior SEC guidance, if the investment adviser is relying on the "audit provision" of the Custody Rule,^[2] the investment adviser could either: (i) treat each SPV as a separate client (in which case it would be required to separately comply with the financial statement distribution requirement with respect to the SPV and, accordingly, distribute audited financial statements of the SPV to beneficial owners of the pooled investment vehicles invested in the SPV); or (ii) treat the assets of each SPV as assets of the pooled investment vehicles invested in it (in which case it would not be required to comply separately with the financial statement distribution requirement with respect to the SPV, but instead would be required to include the SPV's assets within the pools' respective audited financials).^[3]

The Update clarified when an investment adviser relying on the audit provision is permitted to treat an SPV's assets as assets of the pooled investment vehicle clients invested in it, and when it is required to treat the SPV as a separate client. The Update provides that, if the SPV has no owners other than the investment adviser, the investment adviser's related persons or pooled investment vehicle clients that are controlled by the adviser or its related persons, then the investment adviser may treat the SPV's assets as assets of the pooled investment vehicle clients. If, however, the SPV has third-party owners, then the investment adviser must treat the SPV as a separate client.

Escrow Accounts

The Update also addressed the Custody Rule's application to escrow accounts used to hold proceeds from the sale or merger of a portfolio company owned by an investment adviser's pooled investment vehicle clients as well as third parties. As part of the transaction, the pooled investment vehicle clients and third-party owners commonly appoint a "sellers' representative" to act on their behalf and maintain their joint escrow account under the representative's name. These practices, however, may run afoul of the Custody Rule, as the rule requires client funds to be maintained either in a separate account for each client under that client's name or in accounts containing only the funds and securities of the investment adviser's clients under the investment adviser's name as agent or trustee.

In response to inquiries from investment advisers, the SEC confirmed in the Update that it would not object if an investment adviser maintains client funds in an escrow account with other client and non-client assets, if: (i) the client is a pooled investment vehicle that relies on the audit provision and includes the portion of the escrow attributable to it in its financial statements; (ii) the escrow account is maintained in connection with the sale or merger of a portfolio company owned by the client (e.g., for indemnification or to adjust the purchase price); (iii) the escrow account contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (iv) the escrow account exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (v) the escrow account is maintained at a qualified custodian; and (vi) the sellers' representative is contractually obligated to promptly distribute the funds remaining in the escrow account at the end of the escrow period based on a predetermined formula to the sellers, including the pooled investment vehicle clients.

Registered investment advisers should note that the SEC has highlighted compliance with the Custody Rule as an examination priority.^[4] If you have any questions concerning the foregoing, please feel free to contact your regular Proskauer lawyer or any of the lawyers listed in this alert.

^[1] The Update was issued by the SEC's Division of Investment Management. A copy can be found [here](#).

^[2] The Custody Rule generally requires a registered investment adviser to maintain client funds and securities with a qualified custodian. It also imposes additional client notice, account statement delivery and surprise audit requirements. A registered investment adviser to a pooled investment vehicle, however, may rely on the audit provision under part (b)(4) of the Custody Rule and be exempt from these additional requirements if, among other things, audited financial statements of the pool are distributed to all of the pool's beneficial owners within 120 days (or 180 days, in the case of a fund-of-funds) of each year-end.

^[3] Please see Section II.F of the SEC's adopting release for the Custody Rule, which can be found [here](#).

^[4] The SEC's examination priorities for 2014 can be found [here](#).

Related Professionals

- **Amanda H. Nussbaum**

Partner

- **Scott S. Jones**

Partner

- **Charles (Chip) Parsons**

Partner

- **Jamie E. Poindexter**

Partner

- **Marc A. Persily**

Partner

- **Ira G. Bogner**

Managing Partner

- **Sarah K. Cherry**

Partner

- **Bruce L. Lieb**

- **Nigel van Zyl**

Partner

- **Michael R. Suppappola**

Partner

- **Arnold P. May**

Partner

- **Timothy W. Mungovan**

Chairman of the Firm

- **Mary B. Kuusisto**

Partner

- **Malcolm B. Nicholls III**

Partner

- **David W. Tegeler**

- **Howard J. Beber**

Partner

- **Robin A. Painter**
- **Christopher M. Wells**
- **Stephen T. Mears**
Partner