

# SEC Issues New Custody Guidance to Private Fund Managers

**August 9, 2013**

The Securities and Exchange Commission recently issued an IM Guidance Update (the Interpretative Letter) setting forth new interpretative guidance under the Investment Advisers Act of 1940 (as amended, the Advisers Act) to registered investment advisers with respect to custody requirements for privately issued stock certificates. Subject to certain conditions set forth in the Interpretative Letter, the SEC has provided relief to advisers that do not wish to engage a qualified custodian to custody certain privately issued, non-transferrable stock certificates.

## Background

Under Rule 206(4)-2 of the Advisers Act (the Custody Rule), SEC-registered investment advisers are deemed to have "custody" of client assets if the adviser or a related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. Accordingly, the general partner of a private fund generally is deemed to have custody of the private fund's assets because it is deemed to have legal ownership and/or access to the private fund's cash and securities.

Among other requirements, a registered investment adviser with custody of private fund assets must either subject itself to a surprise annual examination by an independent public accountant (the Surprise Examination Approach)[\[1\]](#) or, alternatively, engage an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board to conduct an annual audit of the private fund and deliver audited financial statements to all limited partners or other beneficial owners within 120 days of the end of its fiscal year (or 180 days with respect to any "fund of funds") (the Annual Audit Approach).

In addition, the Custody Rule requires that a registered investment adviser that has custody of client funds or securities maintain such funds or securities with a qualified custodian (e.g., a bank, savings association, or registered broker-dealer). The Custody Rule does not require private fund advisers that rely on the Annual Audit Approach to custody certain privately offered securities with a qualified custodian so long as such securities are (i) acquired from the issuer in a transaction not involving any public offering, (ii) *uncertificated (with ownership 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 (the Private Security Exemption). Advisers that rely on the Surprise Examination Approach cannot rely on the Private Security Exemption.

### New Interpretative Guidance

Subject to the conditions set forth in the Interpretative Letter, the SEC is issuing relief to private fund advisers that use the Annual Audit Approach and do not wish to engage a qualified custodian to hold privately issued, non-transferrable stock certificates, notwithstanding that such securities are not "uncertificated" for purposes of the Private Security Exemption.

The Interpretative Letter sets forth five conditions to relying on the relief: (1) the client is a pooled investment vehicle that is subject to the Annual Audit Approach; (2) the private stock certificate 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; (3) ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client; (4) the private stock certificate contains a legend restricting transfer; and (5) the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

Importantly, the Interpretative Letter also confirms that the SEC considers securities evidenced solely by "partnership agreements, subscription agreements and LLC agreements," as well as "ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty," to be "uncertificated" for purposes of the Private Security Exemption.

### Analysis

The Interpretative Letter provides much needed relief to SEC-registered private fund advisers who previously engaged costly qualified custodians to custody privately offered stock certificates. Nevertheless, advisers should carefully consider the five conditions set forth in the Interpretative Letter prior to terminating any existing custody arrangements with a qualified custodian.

Advisers should also specifically note that private stock certificates that are transferrable without the prior consent of the issuer or holders of the outstanding securities of the issuer are not eligible for the relief. In some circumstances, this condition may significantly limit a private fund adviser's ability to rely on the interpretative relief.

[Read a copy of the Interpretative Letter.](#)

[1] Advisers using the Surprise Examination Approach also must provide certain notices regarding custody arrangements to limited partners and have a reasonable basis, after due inquiry, for believing that a qualified custodian send account statements to each limited partner quarterly. Advisers using the Annual Audit Approach do not need to comply with these additional requirements.

#### [Related Professionals](#)

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- **Michael R. Suppappola**  
Partner
- **Amanda H. Nussbaum**  
Partner
- **Scott S. Jones**  
Partner
- **Charles (Chip) Parsons**  
Partner
- **Jamiel E. Poindexter**  
Partner
- **Marc A. Persily**  
Partner
- **Ira G. Bogner**  
Managing Partner

- **Sarah K. Cherry**

Partner

- **Bruce L. Lieb**

- **Nigel van Zyl**

Partner

- **Arnold P. May**

Partner

- **Mary B. Kuusisto**

Partner

- **Malcolm B. Nicholls III**

Partner

- **Howard J. Beber**

Partner

- **Robin A. Painter**

- **Christopher M. Wells**

- **Stephen T. Mears**

Partner