

Alerts & Publications

Key Contacts

PDF



McAllister Jimbo

Los Angeles

D: +1-213-430-8087



SEC Issues Guidance on Application of Custody Rule to SPVs & Escrows

July 9, 2014

Related Practices

Securities Enforcement
Regulatory & Government Affairs

Rule 206(4)-2 under the Investment Advisers Act of 1940, or the custody rule, requires registered investment advisers who have “custody” of client assets to take specific measures to protect those assets from loss. The Staff of the Securities and Exchange Commission’s Division of Investment Management (“Staff”) recently provided guidance on how the custody rule applies to registered advisers to private funds when such advisers use special purpose vehicles for making investments (“Investment SPVs”) and escrow accounts when selling interests in portfolio companies (“Escrows”). The guidance, which is available [here](#), will particularly be of interest to private equity fund advisers because of the common use of Investment SPVs and Escrows within their industry.

Investment Special Purpose Vehicles

Under Rule 206(4)-2(b)(4) (the “audit provision”), an adviser to private funds is exempt from the custody rule’s notice and independent verification requirements if, among other things, its fund is subject to audit at least annually by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB and audited financial statements are distributed to the fund’s beneficial owners within 120 days of the end of the fund’s fiscal year. For Investment SPVs, the SEC has stated that an adviser may (1) treat the Investment SPV as a separate client, in which case the adviser has custody of the Investment SPV’s assets, or (2) treat the Investment SPV’s assets as assets of the fund(s) of which it has custody indirectly. If the adviser is relying on the audit provision

and treats the Investment SPV as a separate client, the adviser must separately comply with the audited financial statement distribution requirements by separately auditing the Investment SPV and distributing financial statements to fund investors. If an adviser relying on the audit provision decides to treat the Investment SPV's assets as assets of a fund(s), such assets must be considered within the scope of the fund's financial statement audit.

In its guidance, the Staff presented four scenarios and responses to help clarify how an adviser relying on the audit provision may treat the assets of an Investment SPV while remaining in compliance with the custody rule. The first three scenarios address treatment of the assets of an:

- Investment SPV created to purchase a single investment on behalf of a single fund managed by the adviser (single purpose vehicle);
- Investment SPV created to purchase a single investment on behalf of multiple affiliated funds managed by the adviser (multi-fund single purpose vehicle); and
- Investment SPV created to purchase multiple investments on behalf of one or multiple affiliated funds managed by the adviser (multi-purpose vehicle).

With respect to each of these scenarios, the Staff stated that an adviser relying on the audit provision could treat the assets of such Investment SPVs as assets of the fund(s) so long as: (1) the assets of such vehicles are considered within the scope of the fund(s)'s financial statement audits and (2) such vehicles have no owners other than the adviser, its related person(s), or funds that are controlled by the adviser or its related person(s).

The Staff came to a different conclusion in the fourth scenario, wherein an SPV holds one or more investments on behalf of the adviser's fund(s) and third parties that are not controlled by the adviser or its related person(s) ("investment fund"). The Staff stated that an adviser relying on the audit provision should treat the assets of such "investment fund" as a separate client for purposes of the custody rule. The Staff distinguished between Investment SPVs and investment funds because an investment fund, unlike an Investment SPV, has unaffiliated third-party owners. Consequently, an adviser to an investment fund must separately comply with the audited financial statement distribution requirements by separately auditing the Investment fund and distributing financial statements to fund investors.

Based on this guidance, advisers should review whether separate audits are required for any SPVs in which their funds hold interests.

Escrow Accounts

Rule 206(4)-2(a)(1) requires registered investment advisers to designate a qualified custodian to maintain client funds and securities over which the adviser has custody, either in a separate account for each client under that client's name or in accounts that contain only clients' funds and securities,

under the adviser's name as agent to trustee for the clients. However, in connection with the sale of a portfolio company owned by a fund, an adviser may hold a portion of the sale proceeds in an Escrow following the close of the sale or merger, in case of a purchase price adjustment or indemnification claim. The Escrow may contain multiple clients' assets, as well as non-client assets. As a result, advisers have asked whether they are required to create separate Escrows for each client in order to comply with the custody rule.

In response, the Staff explained that an adviser could maintain client funds in an Escrow with other client and non-client assets, in the name of the seller's representative, provided that the following six conditions are met:

- The client is a fund that relies on the audit provision and includes the portion of the Escrow attributable to the fund in its financial statements;
- The Escrow is in connection with the sale or merger of a portfolio company owned by the client (i.e., for indemnification or to adjust the purchase price);
- The Escrow contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers;
- The Escrow exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers;
- The Escrow is maintained at a qualified custodian; and
- The sellers' representative is contractually obligated to promptly distribute the funds remaining in the Escrow at the end of the escrow period on a predetermined formula to the sellers,[2] including the fund clients.

In light of the guidance, advisers should ensure that their Escrows meet the enumerated conditions.

O'Melveny & Myers is available to advise investment advisers about compliance with the custody rule and, in particular, reviewing SPV structures for compliance with the audit provision. For questions, please contact Heather Traeger at (202) 383-5232 or Mcallister Jimbo at (202) 383-5299.

[1] Custody is defined as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." Under the rule, an adviser has custody if the adviser or a related person in any capacity has legal ownership of or access to client funds or securities.

[2] The Division anticipates that this contractual obligation will be referenced in the escrow agreement.

This memorandum is a summary for general information and discussion only and may be considered an advertisement for certain purposes. It is not a full analysis of the matters presented, may not be relied upon as legal advice, and does not purport to represent the views of our clients or the Firm. Heather Traeger, an O'Melveny partner licensed to practice law

in the District of Columbia and Texas, and McAllister Jimbo, an O'Melveny associate licensed to practice law in California, contributed to the content of this newsletter. The views expressed in this newsletter are the views of the authors except as otherwise noted.

Portions of this communication may contain attorney advertising. Prior results do not guarantee a similar outcome. Please direct all inquiries regarding New York's Rules of Professional Conduct to O'Melveny & Myers LLP, Times Square Tower, 7 Times Square, New York, NY, 10036, Phone:+1-212-326-2000. © 2014 O'Melveny & Myers LLP. All Rights Reserved.

Quick links +

Subscribe

' ! \$ #

[Disclaimer](#) | [Privacy Policy](#) | [Contact Us](#) | [Employee Portal](#)
Attorney Advertising © 2019 O'Melveny & Myers LLP. All Rights Reserved.