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SEC Issues Guidance to Private Funds Regarding the Application of the Custody Rule to Special Purpose Vehicles and Escrow Accounts

On June 26, 2014, the SEC's Division of Investment Management issued guidance¹ regarding how Rule 206(4)-2 of the Investment Advisers Act of 1940 (commonly referred to as the "Custody Rule") applies when investment advisers to pooled investment vehicles (including private funds such as private equity funds and hedge funds) utilize (i) special purpose vehicles to make investments ("Investment SPVs") and (ii) escrow accounts to sell portfolio companies.

Investment Special Purpose Vehicles

The guidance provides that where an investment adviser to a private fund uses an Investment SPV to purchase any of:

- i. a single investment on behalf of the private fund ("single purpose vehicle");
- ii. a single investment on behalf of multiple private funds ("multi-fund single purpose vehicle"); or
- iii. multiple investments on behalf of one or more private funds ("multi-purpose vehicle"),

the investment adviser, relying on the "audit provision" of the Custody Rule, may treat the assets of any such vehicle as assets of the private fund(s) of which the investment adviser or the investment adviser's "related person(s)" (as defined in Rule 206(4)-2(d)(7)²) has custody indirectly, and the Investment SPV need not be separately audited so long as:

- a. the assets of the single purpose vehicle, multi-fund single purpose vehicle or multi-purpose vehicle, as the case may be, are within the scope of the private fund's financial statement audit; and

¹ See, <http://www.sec.gov/investment/im-guidance-2014-07.pdf>

² The definition of "related person" in the Custody Rule is different than the definition of "related person" on Form ADV. For purposes of the Custody Rule, related person includes any person that controls the adviser. "Control" means the power to direct the management or policies of a person. Whether a particular manager would be a related person and therefore permitted to invest in the Investment SPV consistent with the staff guidance would depend on the facts and circumstances.

- b. the single purpose vehicle, multi-fund single purpose vehicle or multi-purpose vehicle, as the case may be, has no owners other than the investment adviser, the investment adviser's related person(s) or the private fund(s) controlled by the investment adviser or the investment adviser's related person(s).³

However, where an investment adviser uses an Investment SPV to purchase one or more investments on behalf of private fund(s) and third parties that are not private fund clients of the investment adviser or the investment adviser's related person(s), the Investment SPV must be treated as a separate client for purposes of the Custody Rule, and, therefore, if the investment adviser is relying on the audit provision of the Custody Rule, that Investment SPV should be separately audited and copies of the audited financial statements must be distributed to the beneficial owners of the private fund(s) that own the Investment SPV. For example, under this guidance an Investment SPV in which co-investors participate directly or in which portfolio company management participate in a profit sharing program could require a separate audit.

Escrow Accounts

The SEC also provided guidance for investment advisers to private funds with respect to the application of the Custody Rule to escrow accounts that typically are used for a limited period of time in connection with the sale of a portfolio company owned by one or more private funds advised by a registered investment adviser and other persons that are not clients of the investment adviser ("Escrows"). As part of the sale or merger, sellers (including the investment adviser's private fund(s) and other non-client owners of the portfolio company) often appoint a "sellers' representative" to act on their behalf with respect to a portion of the sale proceeds held in an Escrow following the closing of the sale or merger.

The guidance states that an investment adviser may maintain client funds in an Escrow with other client and non-client assets without violating the Custody Rule, provided that:

- i. the client is a private fund that relies on the audit provision and includes the portion of the Escrow attributable to the private fund in its financial statements;
- ii. the Escrow is 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);

³ Alternatively, pursuant to the Custody Rule's Adopting Release, an investment adviser may rely on the audit provision of the Custody Rule and treat each Investment 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 Investment SPV and, accordingly, distribute audited financial statements of the Investment SPV to the beneficial owners of the private funds invested in the SPV).

- iii. the Escrow 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 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 is maintained at a qualified custodian pursuant to the Custody Rule; and
- vi. sellers' representative is contractually obligated to promptly distribute the funds remaining in the Escrow at the end of the escrow period to the sellers, including the private fund client(s), based on a predetermined formula.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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