

Privately Offered Securities under the Investment Advisers Act Custody Rule

The Dodd-Frank Act, which resulted in the registration of many investment advisers to hedge, private equity, and other private pooled investment vehicles, significantly increased the population of investment advisers to these vehicles registered with the Commission.¹ The Division receives inquiries from advisers to pooled investment vehicles with respect to the Advisers Act custody rule, Rule 206(4)-2, regarding whether the rule requires advisers to audited pooled investment vehicles to maintain with a qualified custodian certain instruments evidencing the pool's ownership of certain privately issued securities—namely, non-transferable stock certificates or “certificated” LLC interests²—that were obtained in a private placement (“private stock certificates”).³ The focus of these inquiries commonly involves whether these securities meet the custody rule's definition of “privately offered security,” and therefore would *not* have to be held at a qualified custodian.⁴

Although a security evidenced by a private stock certificate does not technically meet the custody rule's definition of “privately offered security” because of the existence of a “certificate,” advisers contend that such securities are similar in all material respects to a privately offered security because the client's ownership interest in the security is not impacted by the existence (or lack thereof) of the certificate.⁵ In addition, advisers note that ownership of these securities is recorded on the books of the issuer or its transfer agent in the name of the pooled investment vehicle and the certificate cannot be used to effect a change in beneficial ownership of the security for which the private stock certificate is issued. Advisers also note that a private stock certificate can be replaced by the issuer if lost or destroyed because ownership is recorded on the books of the issuer.

Advisers assert that beyond the substantial investor protections provided by the financial statement audits, maintaining private stock certificates at a qualified custodian does not provide meaningful protection to investors in pooled investment vehicles.⁶ An auditor conducting an audit of a pooled investment vehicle's financial statements in accordance with generally accepted auditing standards performs substantive procedures to verify the existence of the pool's investments,⁷ including securities that are privately issued, regardless of whether the private stock certificates are held at a qualified custodian.⁸ Moreover, advisers have informed the Division that maintaining private stock certificates



at a qualified custodian can add substantial costs, which are typically borne by investors in pooled investment vehicles as an expense paid by such vehicles.

The Division would not object if an adviser does not maintain private stock certificates with a qualified custodian, provided that (1) the client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the custody rule;⁹ (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.¹⁰

Endnotes

- 1 The Dodd-Frank Act eliminated the private adviser exemption from investment adviser registration, which was available to investment advisers that had fewer than 15 clients with each pooled investment vehicle counting as a single client.
- 2 Partnership agreements, subscription agreements and LLC agreements are not certificates under Rule 206(4)-2(b)(2)(B) and the securities represented by such documents are privately offered securities provided they meet the other elements of Rule 206(4)-2(b)(2). See Release No. IA-2176, Custody of Funds or Securities of Clients by Investment Advisers, Section II.B (September 25, 2003), *available at* <http://www.sec.gov/rules/final/ia-2176.htm>. In addition, the Division considers 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 Rule 206(4)-2(b)(2).
- 3 Paragraph (a)(1) of the custody rule states that it is a fraudulent, deceptive or manipulative act, practice or course of business for an adviser to have custody of client funds or securities unless a qualified custodian maintains those funds and securities in a separate account for each client under that client's name or in accounts that contain only the adviser's clients' funds and securities, under the adviser's name as agent or trustee for the clients. The rule defines "qualified custodian" as a bank or savings association, a registered broker-dealer, a registered futures commission merchant or a foreign financial institution that customarily holds financial assets for its customers. Rule 206(4)-2(d)(6). Typically, an adviser to a pooled investment vehicle has custody of the pool's assets because the adviser or a related person serves as the general partner of a limited partnership or in a comparable position of the pool. Under the rule, custody includes any capacity (such as general partner of a limited partnership, managing member of a limited

liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised person legal ownership or access to client funds or securities. Rule 206(4)-2(d)(2)(iii).

- 4 The custody rule provides an exception from the requirement to maintain securities at a qualified custodian for certain privately issued securities (“privately offered securities”) for an adviser to a pooled investment vehicle, provided the pool’s financial statements are audited by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (“PCAOB”). Rule 206(4)-(2)(b)(2). This exception for privately offered securities is not available to advisers to pooled investment vehicles that are not audited in accordance with paragraph (b)(4) of the custody rule. “Privately offered securities” are defined as securities that are: (A) acquired from the issuer in a transaction or chain of transactions not involving a public offering; (B) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (C) transferable only with the prior consent of the issuer or holders of the outstanding securities of the issuer.
- 5 Issuers provide “certificates” to investors, including private fund investors, for various reasons including state law requirements or investor demand.
- 6 Under the custody rule, investors in pooled investment vehicles are protected by controls that are designed to protect their assets from being lost, misused or misappropriated by either an annual audit of the pool’s financial statements (with delivery of financial statements to pool investors) or an annual surprise examination of the pool’s funds or securities (with delivery of the pool’s custodial account statements at least quarterly to pool investors). Rule 206(4)-2(b)(4); Rule 206(4)-2(a)(1).
- 7 In addition to verifying the existence of a pooled investment vehicle’s investments, the financial statement audit also addresses additional matters important to pool investors, such as tests of valuations of pool investments, income, operating expenses, and, if applicable, incentive fees and allocations that accrue to the adviser.
- 8 See, for example, AU-C Section 500, *Audit Evidence* and paragraph .21 of AU Section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. If a qualified custodian does not hold a pool’s investments, examples of the types of substantive procedures an auditor may perform to verify the existence of a pool’s investments include, among others, confirmation with the issuer of a security or with the counterparty to a derivative, confirmation of settled transactions with a broker-dealer or counterparty, confirmation of unsettled transactions with a broker-dealer or counterparty, physical inspection of a security or derivative contract, reading executed partnership or similar agreements, inspecting underlying agreements and other forms of supporting documentation (e.g., for amounts reported, evidence that would preclude the sales treatment of a transfer, and

unrecorded repurchase agreements), inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period, performing analytical procedures, etc.

- 9 Rule 206(4)-2(b)(4), the audit provision, requires the pooled investment vehicle to be subject to audit at least annually by a PCAOB-registered and subject to inspection independent public accountant, and for the audited financial statements to be distributed annually to all beneficial owners of the pool within 120 days of the end of the pool's fiscal year. For unaudited pooled investment vehicles and other clients, a significant benefit of the requirement to maintain funds and securities with a qualified custodian is to allow the assets to be included on account statements that the qualified custodian provides to clients (or investors in the case of a pooled investment vehicle) so the clients (or investors) can monitor transactions and holdings in their (or the pool's) account. Advisers relying on the audit provision of the custody rule for pooled investment vehicles, which provides alternative investor protections including, as discussed above, the audit's substantive procedures regarding the existence and ownership of the pool's securities, are not required to have a reasonable belief that the qualified custodian sends the pool's account statements to investors.
- 10 Registered investment advisers should have compliance policies and procedures reasonably designed to address the safeguarding of client assets from conversion or inappropriate use by advisory personnel. See Release No. IA-2204, Compliance Programs of Investment Companies and Investment Advisers (December 17, 2003), *available at* <http://www.sec.gov/rules/final/ia-2204.htm>.

This IM Guidance Update summarizes the Commission staff's views regarding various requirements of the Investment Company Act of 1940 and/or the Investment Advisers Act of 1940. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This IM Guidance Update is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this IM Guidance Update.

The Investment Management Division works to:

- ▲ protect investors
- ▲ promote informed investment decisions and
- ▲ facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

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