

August 2014

Americas' FS Regulatory CoE

Regulatory Alert #14-04

New SEC Guidance on Custody Rules Offers Mixed News for Private Fund Advisers

May Result in Certain SPVs Requiring Separate Audits or Surprise Exams but May Make It Easier for Escrow Accounts to Comply With Custody Rule

The U.S. Securities and Exchange Commission (SEC) staff recently issued [guidance](#)¹ that offers both good news and bad news to private fund advisers seeking to comply with the “custody rule”² regarding special purpose vehicles (SPVs) and escrow accounts. The guidance specifically applies to:

- SPVs used by pooled investment vehicle (PIV) clients (e.g., hedge funds, private equity funds and real estate funds) to make investments (investment SPVs), and
- Escrow accounts used by PIV clients when selling interests in portfolio companies (escrows).

“The new guidance may prove to be a mixed bag for private fund advisers,” stated **John Russo**, Audit partner with KPMG. “For PIV clients, they frequently use investment SPVs to facilitate investments and use escrow accounts in connection with sale transactions.

“The guidance offers fund advisers relief in terms of the time and resources needed to comply with the custody rule for escrow accounts used by PIV clients, but may complicate compliance with the investment SPV requirements,” he observed. “Care will have to be taken to assess each situation individually in order to ensure that fund advisers maintain compliance with the SEC’s requirements. This is particularly important in light of the fact that the SEC has made compliance with the custody rule one of its [2014 examination priorities](#).”

Americas' FS Regulatory CoE Contacts:

[Pam Martin](#)
Managing Director
Americas' CoE

[Jim Low](#)
Partner, FS Audit

[Hugh Kelly](#)
Principal, FS Regulatory

Key Contacts:

[Chad Gazillo](#)
Partner, FS Audit

[John Russo](#)
Partner, FS Audit

Quick Links

[SEC IM Guidance
Update](#)

[National Examination
Priorities for 2014](#)



[Contact Us/
Subscribe](#)

¹ See SEC IM Guidance Update No. 2014-07 *Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows*

² See Rule 206(4)-2 of the Investment Advisers Act of 1940

Keeping Clients' Assets Safe

Rule 206(4)-2 of the Investment Advisers Act of 1940 (the Act), or the custody rule, requires registered investment advisers who have “custody” of client assets to take steps to guard against the misuse or misappropriation of the clients’ funds and securities. For example, registered investment advisers generally are required to maintain client funds and securities with a qualified custodian (e.g., a bank or broker-dealer). The rule also imposes additional client notice, account statement delivery and surprise examination requirements.

Private funds, and private equity funds in particular, often have found it challenging to comply with the SEC’s custody rule. In 2013, the SEC [announced](#) that approximately one-third of firms it examined had custody rule-related deficiencies. The SEC’s new guidance hopes to bring some welcome relief to private fund managers.

Impact on Investment SPVs

Under the Act’s “audit provision,”³ an adviser to private funds is exempt from the custody rule’s notice, account statement and independent verification requirements if, among other things:

- The fund is subject to audit at least annually by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB), and
- Audited financial statements⁴ are distributed to the fund’s beneficial owners within 120 days of the end of the fund’s fiscal year (or 180 days in the case of a fund of funds).

Many private funds use SPVs to facilitate investments in securities of private companies or real estate. It’s possible that this SPV structure creates other PIVs that may be subject to the custody rule to the extent that the SPVs are controlled by the investment adviser. To comply with the custody rule, an investment adviser can either:

- **Treat each SPV as a *separate client*:** In this case, the investment adviser is required to (1) obtain a surprise examination or (2) comply with the financial statement distribution requirement by distributing audited financial statements of the SPV **to each beneficial owner** of the top-tier PIV.
- **Treat the assets of each SPV as *assets of the pooled investment vehicles invested in it*:** In this case, the assets of the SPV may be treated as assets of the PIV as long as: (1) such assets are considered within the scope of the PIVs financial statement audit,

and (2) the SPV has no other owners other than the adviser, the adviser's related persons⁵ or PIVs controlled by the adviser or its related person.

The SEC made an important clarification in the guidance that certain investment funds may not be able to rely on the audit provision of the custody rule even though they have characteristics of an SPV. Specifically, the SEC clarified that when third parties⁶ invest directly in an investment fund, the custody rule's SPV provision is generally not applicable and the investment fund should be treated as a separate client. In that case, the custody rule requires, among other things, that the investment adviser comply separately with the audited financial statements distribution requirements with respect to the investment fund.

KPMG observation: "We believe that the SEC's position on investment SPVs may result in more audits or surprise examinations of the SPV entities," said **Chad Gazzillo**, Audit partner with KPMG. "Some advisers in the industry took the view that under certain circumstances, the assets of an SPV could be included in the scope of the audits of the SPV's parent pooled investment vehicles, even if a third party was also invested directly in the SPV as long as that third party was also indirectly invested in the SPV through one of the parent PIVs.

"That no longer appears to be the case under the SEC's guidance," he observed. "Accordingly, private fund advisers should review whether separate audits are required to be performed and delivered to investors for any SPVs in which their funds hold interests."

³ See Rule 206(4)-2(b)(4) of the Act

⁴ The financial statements must be prepared in accordance with U.S. GAAP, with some exceptions for non-U.S. funds and non-U.S. advisers, and meet with requirements of U.S. generally accepted auditing standards (U.S. GAAS). See Custody Rule FAQ VI.5.

⁵ "Related person" means any person, directly or indirectly, controlling or controlled by [the adviser], and any person that is under common control with [the adviser]. Advisers Act Rule 206(4)-2(d)(7).

⁶ Third parties include owners other than the adviser, the adviser's related person(s), or pooled investment vehicles controlled by the adviser or the adviser's related person(s), or PIVs controlled by the adviser or the adviser's related person(s).

Impact on Escrow Accounts

The SEC's guidance may also make it easier for investment advisers who employ escrow accounts to comply with the custody rule. Escrow accounts often are used in connection with the sale of a portfolio company that is owned by one or more PIVs. The escrow account may

be owned by the adviser's PIV clients and other third-party sellers who are not clients of the adviser.

Typically, a percentage of the sale proceeds are retained in an escrow account in the event indemnification or an adjustment to the sale price of a portfolio company is required. The funds remaining in the account are distributed to the sellers (including the adviser's PIV clients and other non-client owners of the portfolio company) after a specified period of time based on an agreed-upon formula.

As part of the transaction, a "sellers' representative" typically is appointed by the adviser's PIV clients and third-party owners to act on their behalves and maintain a joint escrow account under the representative's name. However, in order to comply with the custody rule, investment advisers are required to maintain funds and securities with a qualified custodian:

- 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** that are maintained in the **adviser's name** as agent or trustee for clients.

Thus, post-sale escrow accounts that contain co-mingled assets—money potentially owed to the fund as well as to other sellers **not related** to the fund—technically may violate the custody rule requirements. Accordingly, to comply with the custody rule, investment advisers would have to create separate escrow accounts for each client.

The SEC's guidance offers relief by permitting investment advisers to commingle client and non-client assets in a single escrow account in the name of the seller's representative, provided that the following six conditions are met:

1. The client is a PIV that relies upon the audit provision and includes the portion of the escrow account attributable to the PIV in its financial statements.
 - **Note:** A PIV that is not relying on the audit provision may not be able to take advantage of this relief.
2. The escrow account is maintained in connection with the sale or merger of a portfolio company owned by the client.
3. The escrow account funds are in the amount agreed upon by the buyer and seller of the portfolio company.
4. The escrow account is temporary and exists only for as long as the time agreed upon by the buyer and seller.
5. The escrow account is maintained at a qualified custodian.

6. The seller's representative is contractually obligated to promptly distribute the funds remaining in the escrow account (based upon a predetermined formula) to the sellers, including PIV clients, at the end of the escrow period.

KPMG observation: "The guidance provides private fund managers with a blueprint to avoid incurring costs for setting up separate escrow accounts for each fund—for example, in a club deal⁷—when certain investments are sold," noted Russo. "In light of the SEC's guidance, private fund managers may want to reconsider how they structure escrow arrangements in connection with the sales of their portfolio companies."

⁷ A group of unrelated PIVs and investors that jointly make an investment.

How KPMG Can Help You

For more information on the SEC's guidance, or to discuss how this development may impact you and your firm, please contact:

The Americas' FS Regulatory Center of Excellence:



Pam Martin
Managing Director
202-533-3070
pamelamartin@kpmg.com

One of the following KPMG professionals leading the firm's efforts with regard to this guidance:

Chad B. Gazzillo
Audit Partner
267-256-2687
cgazzillo@kpmg.com

John V. Russo
Audit Partner
212-954-2623
jrusso@kpmg.com

About KPMG's Americas' FS Regulatory Center of Excellence

KPMG's Americas' FS Regulatory Center of Excellence (CoE) is based in Washington, D.C., and comprised of key industry practitioners and regulatory advisers from across KPMG's global network of member firms. These individuals work with engagement teams and clients to provide insights into the implications of regulatory changes, distill the impact of regulatory developments on clients' businesses and advise how to adapt clients' business models to better thrive in this dynamic environment. Articles and publications of the Americas' FS Regulatory CoE are available through KPMG's [Global CoE website](#).

[Privacy](#) | [Legal](#)

You have received this message from KPMG LLP. If you wish to unsubscribe from Americas' FS Regulatory CoE, please [click here](#). If you wish to unsubscribe from all Center of Excellence communications, please [click here](#). If you wish to unsubscribe from all KPMG communications, please [click here](#).

KPMG LLP, 3 Chestnut Ridge Road, Montvale, NJ 07645

© 2014 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. NDPPS 296693

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.