

A large, stylized hourglass graphic is positioned on the left side of the cover. The top bulb is filled with a dark teal liquid, which is spilling over the rim and creating ripples on the surface below. The bottom bulb is empty. The background is a light teal color with a white diagonal stripe running from the top right to the bottom left.

# The US Private Equity Fund Compliance Guide

How to register and maintain an active and effective compliance program under the Investment Advisers Act of 1940

## Executive Summary

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# 13

## Custody

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### Introduction

The Securities and Exchange Commission (SEC) regulates the custody of funds and securities of a client of a registered investment adviser by generally requiring that they be held by a 'qualified custodian,' generally a bank or broker-dealer. The SEC amended the Investment Advisers Act of 1940 (the 'Advisers Act') Rule 206(4)-2, its custody rule applicable to registered investment advisers (the 'Custody Rule'), in late 2009, significantly increasing the protections the rule provides for advisory clients.<sup>1</sup> Because those amendments took effect on March 12, 2010, this chapter describes the requirements of the Custody Rule only in its amended form, without touching on earlier versions of the rule. While the following discussion provides a general discussion of the rule's provisions, it focuses on issues of particular interest to the managers of private equity funds.

### Definition of 'custody'

An understanding of the Custody Rule begins with a discussion of the rule's broad definition of the term 'custody.' In ordinary parlance a person is considered to have custody if he holds an asset in his possession. Except in the limited case of mutual fund shares and certain uncertificated securities discussed below, the Custody Rule forbids a registered investment adviser to hold custody of client funds or securities.<sup>2</sup> However, the fact that a registered adviser does not hold physical custody of client funds or securities does not mean that the adviser does not have custody for purposes of the rule. Instead, the rule's definition of custody keys off the power of an adviser – or its 'related persons' – to control the disposition of client assets for the potential benefit of the adviser or its related persons.<sup>3</sup> Indeed, it is the possession of that kind of power, in addition to actual possession of client funds or securities, that triggers the application of the Custody Rule's requirements.

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<sup>1</sup> Advisers Act Release No. 2968 (December 30, 2009), published in the Federal Register (Vol. 75 at p. 1457) on January 11, 2010 (the 'Amending Release'). At the same time the SEC published an interpretive release for independent public accountants providing direction with respect to the independent verification and internal control reports required by amended Rule 206(4)-2, Advisers Act Release No. 2969 (December 30, 2009), also published in the Federal Register (Vol. 75 at p. 1492) on January 11, 2010 (the 'Accounting Interpretive Release'). Answers to many questions about the Custody Rule and its application, including many of the issues treated in the footnotes in this chapter, can be found in *Staff Responses to Questions About the Custody Rule* at [http://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](http://www.sec.gov/divisions/investment/custody_faq_030510.htm).

<sup>2</sup> The Custody Rule does not apply to client assets that are not funds or securities. It does, however, apply to a registered adviser's custody of funds or securities even if the advisory relationship is uncompensated. Under the Custody Rule swap transaction collateral must also be held at a qualified custodian pursuant to arrangements that meet all requirements described in this chapter.

<sup>3</sup> The definition of 'custody' (in paragraph (d)(2) of the Custody Rule) is as follows: 'Custody means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. An individual has custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes: *(continued)*

## Section II: Policies

Thus, while custody for purposes of the Custody Rule does not arise from mere possession of the power to buy and sell securities for a client pursuant to a grant of discretionary investment management authority,<sup>4</sup> custody is deemed present for purposes of the rule when the adviser or one of its related persons (that is, a natural person or entity controlled, controlled by or under common control with the same adviser<sup>5</sup>) has the 'direct or indirect authority' (regardless of whether exercise of that authority would be improper) to 'obtain possession' of client funds or securities in connection with the adviser's provision of investment advisory services. Of particular importance in the context of the management of private equity funds, the definition of custody specifically includes possession by an adviser or its related person of the kind of legal ownership or capacity to access funds and securities that is held by a general partner of a limited partnership or the managing member of a limited liability company. As a result, managers of private equity funds will almost always be deemed to have custody of the funds' assets because either the manager or one of its related persons will occupy that kind of position of authority with respect to the fund vehicle.<sup>6</sup>

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- (i) Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly, but in any case within three business days of receiving them;
  - (ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and
  - (iii) 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 you or your supervised person legal ownership of or access to client funds or securities.'

<sup>4</sup> An adviser is also not deemed to have custody as a result of having been granted the power to transfer assets between accounts at the qualified custodians holding client assets or to instruct a qualified custodian to distribute assets to the client pursuant to authority granted by the client.

<sup>5</sup> Custody Rule paragraph (d)(7). 'Control' is defined paragraph (d)(1) as follows:

'Control means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. Control includes:

- (i) Each of your firm's officers, partners or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control your firm;
- (ii) A person is presumed to control a corporation if the person:
  - (A) Directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or
  - (B) Has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities;
- (iii) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership;
- (iv) A person is presumed to control a limited liability company if the person:
  - (A) Directly or indirectly has the right to vote 25 percent or more of a class of the interests of the limited liability company;
  - (B) Has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the limited liability company; or
  - (C) Is an elected manager of the limited liability company; or
- (v) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.'

<sup>6</sup> No explicit SEC guidance is available with regard to whether a registered adviser is deemed to have custody when a control person of the adviser or one of its employees serves as a director or officer of a pooled investment vehicle organized as a corporation. However, in our experience SEC examiners have taken the position that custody exists in those circumstances, at least when the director or officer appears to have a control relationship with the pooled investment vehicle.

## Custody

### The audited fund exception

With regard to direct account management arrangements with a particular client, for instance, in some co-investment arrangements, managers or advisers should also note that custody is deemed present when the manager has been granted the authority in the applicable advisory agreement to determine and instruct the client's qualified custodian to pay management or performance fees directly to the manager or its affiliate (albeit custody for this reason alone subjects a registered adviser to fewer requirements, as is discussed below). Custody in this sense can be avoided if the client or an independent third party (such as a qualified custodian of the client's assets that is not a related person of the adviser) calculates and makes the payment to the manager.

Once custody for purposes of the Custody Rule is determined to be present, the Custody Rule imposes a variety of requirements. However, it is important to note that most of the requirements described below do not apply to a manager of a 'pooled investment vehicle' (including private equity funds and hedge funds) if the fund vehicle in question is audited annually, and upon liquidation, by an independent public accountant<sup>7</sup> registered with, and subject to inspection by, the Public Company Accounting Oversight Board (PCAOB) and the report is provided to the fund's investors or their independent representatives (described below) within 120 days of the close of the fund's fiscal year (in the case of a liquidation audit, 'promptly after completion of the audit'). Fund of fund audit reports may be provided with 180 days of the close of the fund of fund's fiscal year. This exception is referred to below as the 'audited fund exception.'<sup>8</sup> If interests in the fund in question are held by another fund that is a related person of the fund in which investors hold interests, the financial statements must be sent to the investors in the investing fund; among other situations, this requirement applies to master-feeder arrangements and certain special purpose investment vehicles.

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<sup>7</sup> A public accountant that meets the applicable requirements can be independent even if the accountant also audits the books of the adviser.

<sup>8</sup> There is no minimum number of investors required to utilize the audited fund exception, with the result that the exception may be used even in the case of a single-investor vehicle; however, the audited fund exception is not available with respect to a client that is not a pooled investor vehicle, even if the client co-invests alongside an audited pooled vehicle.

The accountant's examination must be conducted in accordance with US generally accepted auditing standards, and the report must generally comply with US generally accepted auditing principles (GAAP), provided that an adviser with its principal place of business outside the United States may arrange for the provision of audited statements under another set of accounting principles with respect to a pooled investment vehicle organized offshore (with a reconciliation to US GAAP provided to US investors). Registered advisers whose operations are altogether offshore need not comply with the custody rule with respect to offshore funds even if those funds have US investors.

The SEC staff has made it clear in the Staff Responses that a fund adviser's failure to comply with audited fund exception – including a failure to deliver the required financial statements within the specified time period – disqualifies the adviser from relying on otherwise applicable exemptions. However, the SEC staff has stated that it will not recommend enforcement action if an adviser reasonably believed that a pooled investment vehicle's audited financial statements would be distributed within the required time frame, but failed to have them distributed in time under 'certain unforeseeable circumstances.'

If the accountant conducting the examination is not registered with, and subject to examination by, the PCAOB when the accountant is retained or the audit commences, the audited fund exception will nonetheless be deemed satisfied if the accountant attains that status before the audit is issued.

### Requirements when custody is present

#### To hold client funds and securities with a 'qualified custodian'

The requirements applicable to advisers with custody are as follows (with special notations relating to the circumstances applicable to the typical manager of private equity funds):

Advisers must arrange for their clients' funds and securities to be held with a 'qualified custodian' (either a US bank, broker-dealer, futures commission merchant or a foreign financial institution that customarily holds financial assets for its customer and keeps its advisory clients' assets in customer accounts that are segregated from its proprietary assets), either under the client's name or under the name of the adviser as agent or trustee for its clients, and to notify its clients of the custody arrangement (except that the client notification requirement does not apply when the audited fund exception is applicable).<sup>9</sup> The qualified custodian must hold the assets entrusted to it in an account that is segregated from its proprietary assets.<sup>10</sup> Except as described in the next two paragraphs, this requirement to arrange to hold client funds or securities with a qualified custodian applies to a private equity fund manager even if the manager complies with the audited fund exception.<sup>11</sup>

The requirement to hold client funds and securities at a qualified custodian is subject to strictly limited exceptions. First, the qualified custodian for mutual fund shares (that is, shares of open-end investment companies registered under the Investment Company Act of 1940) may be the mutual fund's transfer agent. Importantly, this exception applies in the case of publicly offered money market funds, in which a private equity fund may invest its cash assets.<sup>12</sup>

Second, an adviser is not required to arrange for its qualified custodian to hold uncertificated, privately offered securities that are transferable only with the permission of the issuer of the securities.<sup>13</sup> In the case of a pooled investment vehicle such as a private equity fund, the Custody Rule also requires that the vehicle comply with audited fund exception in order for the vehicle's manager to be permitted to hold uncertificated securities in

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<sup>9</sup> Notice is required only at the inception of a qualified custodian arrangement, and not when assets are transferred between qualified custodians pursuant to powers granted to the adviser.

<sup>10</sup> Compliance with the segregation requirement is generally not problematic in the case of US qualified custodians, but should be contractually specified in the case of assets held with a foreign custodian, with respect to which segregation requirements may not be imposed as a matter of course.

<sup>11</sup> An adviser that inadvertently receives a check made out to client not only is deemed to have custody, but violates the Custody Rule unless the adviser returns the check to the client within three business days (see Custody Rule paragraph (d)(2)(i)). This restriction does not apply to checks drawn by a client and made payable to a third party. However, the SEC staff has taken the position that it will not recommend enforcement action if an adviser inadvertently receives tax refunds, class action settlement proceeds, dividends and certain other items and forwards them to the client within five business days, subject to the requirement that the adviser maintain appropriate records.

<sup>12</sup> If a mutual fund's transfer agent is a related person of the investment adviser, the transfer agent must comply with the internal control report and surprise examination requirements discussed below.

<sup>13</sup> If the adviser's client is not a pooled investment vehicle over which the adviser or one of its related persons has powers that confer custody as defined in the Custody Rule, the adviser may avoid an attribution of custody of a privately offered security if the client must sign the subscription agreement for that security and the adviser has no authority to transfer or redeem the security without client consent.

## Custody

### To obtain an annual internal control report

its own custody rather than in the custody of a qualified custodian.<sup>14</sup> It is important to note that this exception explicitly does not apply to certificated securities, such as those held by a private equity fund in many portfolio companies.<sup>15</sup> However, it may be possible for private equity managers to obviate this issue by requiring or persuading their funds' portfolio companies to provide that their portfolio companies' securities (or at least those held by private equity funds) will be uncertificated.

If a registered adviser or one of its related persons serves as the qualified custodian for the adviser's client assets, the adviser or its related person custodian is required to obtain an annual internal control report from an independent accountant registered with, and subject to examination by, the PCAOB as to whether controls have been placed in operation by that qualified custodian that are suitably designed and operate effectively to meet control objectives relating to custodial services. This requirement would apply to a manager of a private equity fund only in the unusual case in which the manager was affiliated with a broker-dealer or a bank that served as the fund's qualified custodian. The first internal control report must be obtained within six months after March 12, 2010, which was the effective date of the amendments to the Custody Rule that require such reports (or, if later, within six months of the adviser's becoming registered).<sup>16</sup> If a surprise examination of the kind described below is required (which would not be the case with respect to a private equity fund that complied with the audited fund exception), the first internal control report must be obtained prior to the first surprise examination. The accountant rendering an internal control report must also verify that the funds and securities in the account are reconciled to a custodian other than the adviser or its related person.

### Additional requirements

When the audited fund exception does not apply or is not available, the Custody Rule imposes the following additional requirements upon registered investment advisers with respect to the client assets over which they hold custody:

- The adviser must have a reasonable basis for believing, after due inquiry, that the qualified custodian for the client assets sends statements directly to the client (or the client's 'independent representative') at least quarterly, detailing the holdings in the client's account and transactions during the applicable period. If the client is a pooled investment vehicle and the requirements of the audited fund exception are not met, the account statements must be sent to the fund's investors (including investors in a related fund if the client investment vehicle is held through other funds in which investors invest). The account statements sent with respect to such a pooled investment vehicle

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<sup>14</sup> If the audited fund exception is not available to a pooled investment vehicle – with the result that the vehicle's adviser must arrange to hold uncertificated securities whose transfer is restricted by their issuer at a qualified custodian – the adviser may satisfy the holding requirement by arranging for the applicable subscription agreement to be held by a qualified custodian or for a qualified custodian to serve as the pooled vehicle's nominee.

<sup>15</sup> The SEC staff has refused to expand the kinds of securities that may be held by a pooled investment vehicle's manager to certificated securities that are subject to equivalent restrictions on transfer, on the grounds that the SEC itself had explicitly considered and rejected that possibility.

<sup>16</sup> The required internal control report need not address the effectiveness of controls prior to March 12, 2010.

## Section II: Policies

must relate to the assets of the pool as a whole, not a slice of those assets attributable to a particular investor's interest in the pool, and should provide investors with information necessary to respond to accountant confirmation requests with regard to deposits and withdrawals. If the adviser chooses to send its own statements as well, it must include in the transmittal a notice urging the client to compare its account statements with those provided by the custodian.

An independent representative is a person that: (i) acts for the investment adviser's client (or, in the case of a pooled investment vehicle, investors in the vehicle) and by law or contract is required to act in the best interests of the client (or investor); (ii) does not control, is not controlled by and is not under common control with the adviser; and (iii) does not have, and has not had within the preceding two years, a material business relationship with the adviser.<sup>17</sup>

- Except in the case of advisers that have custody only because of their ability to calculate and withdraw advisory fees directly from the qualified custodian,<sup>18</sup> a registered adviser generally must enter into a written agreement for an independent accountant to conduct an annual surprise examination (at a time chosen by the accountant that is irregular from year to year) of all accounts of which the adviser or one of its related persons has custody.<sup>19</sup> If the qualified custodian is the adviser or one of its related persons, the accountant performing such an examination must be registered with, and subject to examination by, the PCAOB. Advisers subject to the surprise examination requirement must enter into an agreement with an independent accountant for the first examination to commence by December 31, 2010 (or, if later, within six months of the adviser becoming registered). In the case of an adviser that is subject to the internal control report requirement, however (because the adviser or one of its related persons serves as the qualified custodian for client assets), the internal control report must be obtained before the first surprise examination, with the examination commencing within six months after the internal control report is obtained.

The surprise examination requirement does not apply if an adviser is deemed to have custody only because the qualified custodian is a related person of the adviser and the adviser has determined (in a documented decision that is available for examination by the SEC) that the related person qualified custodian is 'operationally independent' of the adviser in the manner specified in the Custody Rule.<sup>20</sup>

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<sup>17</sup> While the Custody Rule does not as such impose a requirement that an adviser obtain the client's consent to the appointment of an independent representative, the SEC staff has noted that an adviser's fiduciary duties, the client's contract with the adviser or a limited partnership agreement may require client consent and that '[a]ppointment of a representative without consent of the client suggests that the representative may be controlled by the adviser and is not truly independent.'

<sup>18</sup> If the qualified custodian is a related person of the adviser, this exception applies only if the qualified custodian is operationally independent, as further described below.

<sup>19</sup> In the case of a pooled investment vehicle that does not qualify for the audited fund exception, the accountant's procedures should include obtaining investor confirmation of deposits and withdrawals, and the statements sent by the qualified custodian should provide investors with the information necessary to respond to the requested confirmation.

<sup>20</sup> Custody Rule paragraph (b)(6). Custody Rule paragraph (d)(5) defines 'operationally independent' as follows: '[F]or purposes of paragraph (b)(6) of this section, a related person is presumed not be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person: (i) client assets in the

*(continued)*

## Custody

The agreement governing the required surprise examination must require the examining accountant to file a certificate on Form ADV-E with the SEC within 120 days of the completion of the examination, reporting that the accountant has conducted the examination and its extent. If the accountant finds material discrepancies in the course of the examination, it must advise the SEC of the discrepancies within one business day. In addition, if the accountant resigns, is dismissed or either is removed from or removes itself from reappointment, the agreement must require the accountant to file a statement with the SEC on Form ADV-E within four business days, giving the date of the relevant event and containing an explanation of any problems relating to examination scope or procedure that contributed to the accountant's dismissal or removal.

### Additional compliance considerations

Separate recordkeeping and disclosure requirements relating to a registered adviser's custody practices are described elsewhere in this guide. The SEC emphasized in its release promulgating the 2009 amendments to the Custody Rule that registered advisers should 'consider the value of instituting' a number of compliance practices and procedures relating to custody. It is appropriate to note the following suggestions here:

- Background checks for employees with access (or potential access) to client assets.
- Require the authorization of more than one person before assets can be moved within, or transferred or withdrawn from, a client account, and before effecting changes in account ownership information.
- Limit the number of employees who are permitted to interact with qualified custodians and rotate those employees periodically.
- If the adviser or a related person is the qualified custodian, segregate the duties of advisory personnel from those of custodial personnel.
- Establish procedures to ascertain that the qualified custodian sends the required reports to clients.
- Establish procedures to assure that a qualified custodian remains operationally independent from the adviser (if the operationally independent exception from the surprise audit examination requirement is utilized).
- Establish procedures regulating the circumstances under which advisory employees may be deemed to acquire custody.
- Establish appropriate supervisory and testing procedures.
- Establish appropriate procedures to determine and assess the payment of client fees.

As can be seen from the descriptions in this chapter, the Custody Rule imposes a substantial and effective regime to protect client assets. Registered advisers should ensure that they comply with the rule, in the knowledge that their compliance will be closely examined by the SEC staff when it examines the adviser's operations. □

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custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to[,] client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.'

**Compliance checks:**

- An adviser is considered to have custody of client funds and securities if it or one of its related persons is the general partner of a limited partnership or the managing member of a limited liability company. Custody may also be present if an adviser controls a fund organized as a corporation.
- If custody is present, funds and securities generally must be held by a 'qualified custodian' – that is, a US bank, broker-dealer, futures commission merchant or a foreign financial institution – that customarily holds financial assets segregated from its proprietary assets.
- If custody is present, most other custody requirements applicable to private funds are satisfied if the fund has an annual audit by a PCAOB-registered independent public accountant with the report provided to investors within 120 days of close of fund's fiscal year and upon liquidation.
- Uncertificated privately offered securities transferable only with permission of the issuer generally do not have to be held by a 'qualified custodian.'
- If the audited fund exception is not available, an annual surprise audit is generally required.
- If the qualified custodian is a 'related person' to the adviser, the custodian must undergo an annual internal control audit by a PCAOB-registered independent public accountant.

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