

Compliance with Advisers Act Rule 206(4)-2: Combined Financial Statements - What You Need to Know

November 4, 2020

Rule 206(4)-2, referred to as the “Custody Rule”, is regarded as an integral component of the Investment Advisers Act of 1940. The rule requires advisers that have custody of client securities or funds to implement a set of controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers’ financial reverses. Historically, investment advisers have employed paragraph (b)(4) of the Custody Rule, the audit exception, which exempts the adviser from complying with paragraphs (a)(2) and (a)(3) and deems the adviser in compliance with paragraph (a)(4). The account of a limited partnership, limited liability company, or another type of pooled investment vehicle (PIV), is deemed to be in compliance with paragraph (a)(4) if the pooled investment vehicle is subject to audit at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners, members, or other beneficial owners within 120 days of the end of its fiscal year.

On October 23, 2020, the Chief Accountant’s Office of the Division of Investment Management released a “Dear CFO Letter” that provides guidance on the use of combined financial statements to comply with the Custody Rule. Historically, some investment advisers have issued combined financial statements for commonly controlled entities to satisfy the Custody Rule. In their letter, the SEC stated that they do not believe an investment adviser can prepare combined financial statements for multiple pooled investment vehicles solely based on common management. In determining whether an investment adviser using combined financial statements can rely on the audit exception, the SEC recommends that investment advisers consider the following factors:

- Each pooled investment vehicle (PIV) has the same management.

- There is clear evidence of legal ownership of each investment individually with each PIV or there are contractual agreements which clearly show the assignment of investments held on a combined basis to each PIV.
- Investments and investment gains and losses, including income and expenses, are allocated pro rata to each PIV.
- Each PIV has the same management fee and performance fee structure (e.g., allocations work on a combined basis, calculated based on one hurdle on the combined basis, including combined fair values and contributions/distributions).
- The financial highlights are the same for each PIV.
- The combined financial statements will:
 - Present a statement of changes for each PIV separately and a combined aggregate total.
 - Provide clear disclosure of each PIV's pro rata percentage ownership of the combined basis, total commitments of each PIV, and aggregated commitments on a combined basis.

Additional considerations for investment advisers using combined financial statements include the differing rights of limited partners, members, or other beneficial owners over time and whether they would impact the financial reporting presentation on a combined basis. It is also recommended that the investment adviser evaluate whether an individual investor could reasonably interpret the information presented on a combined basis to the investor's ownership in a specific PIV.

For additional information, refer to the SEC's "[Dear CFO Letter](#)." And if you have any questions about this recent SEC guidance and how it may impact you, please contact [Ed Thorp](#), [Jack Whitaker](#) or your Anchin Relationship Partner.