

Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors



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Custody Rule Update: Guidance for SPVs and Escrows

The Division of Investment Management of the Securities and Exchange Commission (the “SEC”) provided an Investment Management Guidance Update (the “Update”) regarding the Custody Rule (Rule 206(4)-2) under the Investment Advisers Act of 1940, as amended (the “Custody Rule”). The focus of the Update centered around two issues that arise on a regular basis in adviser examinations.

1. Special purpose vehicles (“SPVs”) used when making investments.
2. Escrow accounts when selling interest in portfolio companies.

SPVs

An adviser can treat an SPV as a distinct client in which the adviser would have custody of the assets or the adviser can treat the assets of the SPV as the assets of the client or fund vehicles of which it has custody indirectly. The adviser is deemed to have custody of the assets under both situations. If the adviser chooses to treat the SPV as a separate client they will be required to perform a separate audit of the SPV and distribute those separate audited financial statements to their investors to satisfy the distribution requirements of the Custody Rule. If the adviser chooses to treat the SPV’s assets as assets of a fund, and will rely on the audit provision to comply with the Custody Rule, the assets must be included within the scope of the fund’s audited financial statements.

The Update provides some clarity based on common scenarios for advisers that utilize the audit provision to satisfy the Custody Rule. The SEC provided the following scenarios based on inquiries made by investment advisers:

1. The SPV holds one investment of which the sole beneficial owner is a single fund managed by the investment adviser.
2. The SPV holds one investment of which the sole beneficial owners are multiple affiliated funds managed by the investment adviser.
3. The SPV that holds multiple investments of which the sole beneficial owners are multiple affiliated funds managed by the investment adviser.
4. The SPV that holds one or more investments of which the beneficial owners include a fund managed by the investment adviser and other unaffiliated parties.

The SEC’s response indicates that for an SPV owned by an adviser fund or affiliated fund, where the assets of the SPV are within the scope of the fund’s financial statement audit, the adviser may consider the assets of the SPV as assets of the fund to comply with the Custody Rule (Scenarios 1, 2 and 3). Where the SPV holds one or more investments managed by the adviser and another unaffiliated party, the SEC noted that the SPV is a separate client and would therefore need separate audited financial statements to comply with the Custody Rule (scenario 4).

Escrow

The SEC also received inquiries about escrow accounts, that are typically used for limited periods of time, in connection with the sale of portfolio companies owned by one or more funds.

Where the sale involves sellers who are not clients of the adviser and for which a “sellers’ representative” has been appointed to act on behalf of all sellers, including with respect to funds held in an escrow account, the SEC stated that it would not object to such a scenario under the Custody Rule so long as:

1. The client is a pooled investment vehicle that relies on the audit provision of the Custody Rule and includes the client’s share of the amounts held in escrow in the pooled investment vehicle’s financial statements.
2. The escrow was created in connection with the sale or merger of a portfolio company owned by the client.
3. The escrow account contains money that was agreed to between the buyer and sellers as part of a bona fide negotiation.
4. The time period the escrow exists was agreed upon as part of a bona fide negotiation.
5. The escrow account is maintained with a qualified custodian.
6. The sellers’ representative is contractually required to promptly distribute the funds to the sellers at the end of the escrow period, based on a predetermined formula.

Given the current guidance, investment advisers should consider reviewing their current structures to determine whether they continue to comply with the Custody Rule.

You can find the full SEC Division of Investment Management Guidance Update at: <http://www.sec.gov/investment/im-guidance-2014-07.pdf>

For more information, please contact your Anchin Financial Services Relationship Partner at 212.840.3456.

Jeffrey I. Rosenthal, CPA Jeffrey.Rosenthal@anchin.com Partner-In-Charge	Peter L. Berlant, CPA Peter.Berlant@anchin.com Associate Partner-In-Charge	Jeffrey J. Bowden Jeffrey.Bowden@anchin.com Principal
James Burns, CPA James.Burns@anchin.com Partner	Michael Mazzola, CPA Michael.Mazzola@anchin.com Partner	Marc G. Goldberg, CPA Marc.Goldberg@anchin.com Partner
Mitchell Rosenthal, CPA Mitchell.Rosenthal@anchin.com Partner	Craig F. Silberberg, CPA Craig.Silberberg@anchin.com Partner	E. George Teixeira, CPA George.Teixeira@anchin.com Partner
Edward F. Thorp, CPA Edward.Thorp@anchin.com Partner		



Anchin, Block & Anchin LLP
Accountants and Advisors
1375 Broadway, New York, NY 10018
212.840.3456 • www.anchin.com