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Private Equity Alert

SEC Issues Guidance on the Application of the Custody Rule To Special Purpose Vehicles and Escrow Accounts

By David Wohl and Venera Ziegler

In response to inquiries from registered investment advisers and issues raised by the SEC's Office of Compliance Inspections and Examinations, the Staff of the Division of Investment Management of the SEC (the "Staff") recently issued guidance regarding the application of Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Custody Rule"), to situations when advisers to pooled investment vehicles ("Funds") utilize: (i) special purpose vehicles when making investments ("SPVs"); and (ii) escrow accounts when selling interests in portfolio companies.

SPVs and the Audit Exception

In its guidance, the Staff noted that it has previously stated that when seeking to comply with the provisions of the Custody Rule with respect to SPVs, an investment adviser generally can either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the Fund(s) of which it has custody indirectly. If the adviser is relying on the audit exception[1] of the Custody Rule and treats the SPV as a separate client, the adviser must comply separately with the Custody Rule's audited financial statement distribution requirements and distribute the audited financial statements of the SPV to the investors of the Fund(s) that own the SPV. If, however, the adviser is relying on the audit exception and treats the SPV's assets as assets of the Fund(s) of which it has custody indirectly, such assets must be considered within the scope of the financial statement audit of the Fund(s).

The Staff stated that it was often asked whether an adviser relying on the audit exception may choose to treat the assets of the SPV as assets of its Fund client(s) of which the adviser or the adviser's related person(s) has custody indirectly in the following scenarios: (i) when a single Fund forms an SPV to make a single investment; (ii) when multiple Funds form an SPV to make a single investment; and (iii) when one or more Funds form an SPV to make multiple investments. *The Staff stated that, in those scenarios, it would not object if an adviser relying on the audit exception treats the assets of the SPV as assets of the Fund(s) of which the adviser or the adviser's related person(s) has custody indirectly so long as the assets of the SPV are considered within the scope of the Fund's (or Funds') audits and the SPV has no owners other than the adviser, the adviser's related person(s) or Fund clients controlled by the adviser or the adviser's related person(s).*

Weil News

- Weil's Private Equity practice was ranked #1 in Global Private Equity Announced Deals by Bloomberg with $32.2 billion in transactions in the first quarter of 2014
- Weil advised Grupo Corporativo Ono's principal shareholders, Providence Equity Partners, CCMP, Thomas H Lee and Quadrangle, on the €7.2 billion sale of Ono to Vodafone
- Weil advised Berkshire Partners and National Vision Inc., the leading independent retailer of eyeglasses and contact lenses, in the sale of National Vision to KKR
- Weil advised aPriori Capital Partners, a new independent advisory firm, in its spin-off from Credit Suisse and its management of DLJ Merchant Banking Partners
- Weil advised Baring Private Equity Asia in connection with the $3 billion take private of Giant Interactive Group, China's leading online game developer and operator

However, the Staff stated that in situations where the SPV is owned by an adviser's Funds as well as third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related person(s), an adviser relying on the audit exception should treat the SPV as a separate client for purposes of the Custody Rule. *Therefore, in the situation where an SPV has third party co-investors or other investors that are not controlled by the adviser, the SPV will have to undergo a separate audit in order to comply with the audit exception of the Custody Rule.*

Escrow Accounts

The Staff stated that it often receives questions from Fund advisers with respect to the application of the Custody Rule to escrow accounts that typically are used for a limited period of time in connection with the sale of a portfolio company ("Escrow Accounts"). The focus of these inquiries commonly concerns the sale of a portfolio company owned by one or more of the adviser's Funds and other persons that are not clients of the adviser. As part of the sale, sellers often appoint a "sellers' representative" to act on their behalf with respect to a portion of the sale proceeds held in an Escrow Account following the closing of the sale.

The Custody Rule requires a registered investment adviser to maintain funds and securities over which it has custody with a qualified custodian in a separate account for each client in the client's name, or in accounts that contain only the adviser's clients' funds and securities that are maintained in the adviser's name as agent or trustee for the clients. The assets in an Escrow Account often belong to both the adviser's Funds and other sellers that are not advisory clients and are typically maintained in the name of the sellers' representative. In this situation, advisers have argued that the protections of these joint Escrow Accounts for their Funds (and investors) are similar to separate Escrow Accounts or Escrow Accounts with only clients' assets and that creating multiple Escrow Accounts to fully comply with the Custody Rule would not significantly change the protections and risks.

In the guidance, the Staff stated that it would not object if an adviser maintains Fund assets in an Escrow Account with other client and non-client assets, provided that: (i) the client is a Fund that relies on the audit exception and includes the portion of the Escrow Account attributable to the Fund in its financial statements; (ii) the Escrow Account is in connection with the sale or merger of a portfolio company owned by the Fund (i.e., for indemnification or to adjust the purchase price); (iii) the Escrow Account contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (iv) the Escrow Account exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (v) the Escrow Account is maintained at a qualified custodian; and (vi) the sellers' representative is contractually obligated to promptly distribute the money remaining in the Escrow Account at the end of the escrow period on a predetermined formula to the sellers, including the Fund clients of the adviser.

1. Rule 206(4)-2(b)(4) generally excepts an adviser to a Fund from complying with the client notice, account statement delivery and surprise examination provisions of the Custody Rule to the extent the Fund's financial statements are prepared in accordance with generally accepted accounting principles, are subject to an audit by a PCAOB-registered accountant and the adviser distributes the audited financial statements to investors within 120 days of the Fund's fiscal year end.

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