

Private Equity Alert

SEC Issues Guidance Update With Respect to Privately Offered Securities Under the Custody Rule

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The SEC has released new guidance (the Guidance)¹ with respect to Rule 206(4)-2 under the Investment Advisers Act (the Custody Rule). The Guidance provides relief to private fund sponsors by expanding the coverage of the “privately offered securities” exception in the Custody Rule to certain certificated, privately offered securities. Subject to the conditions set forth in the Guidance, registered investment advisers to private funds that have financial statements prepared in accordance with the generally accepted accounting principles (GAAP) and that are audited at least annually will no longer need to arrange for a qualified custodian to hold custody of certificated “privately offered securities.” As stated in further detail below, such relief was previously only available to certain uncertificated privately offered securities.

Privately Offered Securities Exception and the Custody Rule

The Custody Rule requires a registered investment adviser that has or is deemed to have custody of client assets to maintain such assets with a qualified custodian. The SEC has advised that a private fund adviser that is affiliated with the general partner of the fund is generally deemed to have custody of the fund’s assets, and, therefore, the fund’s assets must be held by a qualified custodian. However, under the “privately offered securities” exception, uncertificated, book-entry, privately offered securities held by a private fund that undergoes an annual audit in accordance with GAAP are not required to be held by the qualified custodian. “Privately offered securities” under the Custody Rule include securities that are (a) acquired from the issuer in a transaction, or series of transactions, that does not involve a public offering, (b) uncertificated, and (c) transferable only with the prior consent of the issuer or the holders of the outstanding securities of the issuer.

Relief for Certificated Securities

In the Guidance, the SEC stated that although a security evidenced by a private stock certificate does not technically meet the Custody Rule’s definition of “privately offered security” because of the existence of a certificate (*i.e.*, “certificated” limited liability company interests that were obtained through a private placement), it will not object if a registered

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investment adviser does not maintain private stock certificates with a qualified custodian subject to the following requirements:

- *Annual Audit:* The private fund prepares financial statements in accordance with GAAP, which are audited at least annually, and otherwise complies with the “audit” exception² in the Custody Rule.
- *Transferability Only With Consent:* The certificate can be used to effect a transfer or facilitate a change in beneficial ownership of the security only with the consent of the issuer or holders of the outstanding securities of the issuer.
- *Recorded on Books and Records:* Ownership of the security is recorded on the books of the issuer or its transfer agent.
- *Legends Restricting Transfer:* The certificate contains appropriate legends restricting transfer.
- *Appropriate Safeguards:* The certificate is appropriately safeguarded by the investment adviser and can be replaced upon loss or destruction. Private fund sponsors should amend their compliance policies and procedures, if necessary, to ensure appropriate safeguards are implemented.

Please do not hesitate to contact us with any questions.

1 Available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf>

2 The “audit” exception in the Custody Rules requires that (i) the fund’s audited financial statements are prepared in accordance with GAAP, (ii) the statements are delivered to all investors within 120 days of the end of the fund’s fiscal year (or 180 days in the case of a fund of funds), (iii) the audit is performed by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB, and (iv) the fund is subject to an audit upon liquidation.

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