Legal Insight

K&L GATES

www.klgates.com

March 15, 2013

Practice Group:

Private Equity

Investment Management, Hedge Funds and Alternative Investments

SEC Issues Risk Alert on Custody Rule, Reinforcing Its Message to Registered Investment Advisers in Its Examination Priorities for 2013

By Beth R. Kramer and Paulo J. Marnoto

On March 4, 2013, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert identifying "significant deficiencies" by registered investment advisers in compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"), which is designed to protect investors against misappropriation or other misuse of client assets.[1] The SEC reported custody-related issues were observed in about one-third of registered investment advisers recently examined as part of the SEC's National Exam Program. The SEC grouped these deficiencies into four categories: (1) failure by the adviser to recognize that it has "custody" as defined under the Custody Rule, (2) failure to comply with the "qualified custodian" requirements, (3) failure to comply with the rule's surprise audit requirement, and (4) failure to comply with the audit approach exception to the "surprise audit" requirement for pooled investment vehicles. All registered investment advisers, including newly registered investment advisers to private funds, who have custody of client assets are required to comply with the Custody Rule.

One of the areas of failure the staff noted was that some advisers have failed to recognize that they are deemed to have custody where the adviser acts as the general partner of a limited partnership or in a similar position with respect to a pooled investment vehicle. In addition to this typical private investment fund structure, the Custody Rule also applies where the adviser serves as the general partner or in a similar role with respect to a vehicle through which investors participate in a single co-investment opportunity, even where the vehicle is used merely to facilitate structuring the investment or where the co-investors have made an independent investment decision to participate in such co-investment. In such circumstances, the adviser is required to comply with the surprise audit requirement or provide annual audited financial statements to the investors of the vehicle even if the vehicle holds a single portfolio company investment. Private equity fund advisers may want to consider whether their existing arrangements comply with the Custody Rule, and whether the governing documents of their pooled investment vehicles and co-investment arrangements provide for how the fees and expenses of the qualified custodian and the costs of a surprise audit or preparation of audited financial statements will be borne by the participants of such vehicles.

[1] On March 4, 2013, the SEC's Office of Investor Education and Advocacy also issued an Investor Bulletin to inform investors of the requirements under the Custody Rule.

SEC Issues Risk Alert on Custody Rule, Reinforcing Its Message to Registered Investment Advisers in Its Examination Priorities for 2013

The Custody Rule requires an adviser to (subject to certain exceptions, including one that applies when the private fund's financial statements are audited):

- Retain a "qualified custodian"[2] to maintain client assets in a separate account under the client's name or in accounts that contain only the assets of the adviser's clients and under the adviser's name as agent or trustee for such clients;
- Notify the client as to how the client's assets are held;
- Ensure that the client receives quarterly account statements with details of transactions in the account; and
- Undergo an audit of the account by an independent public accountant to verify the client's assets.

The OCIE staff noted various deficiencies with some advisers who prepared audited financial statements with respect to pooled investment vehicles, including the following failures:

- The public accountant retained to conduct the financial statement audit was not "independent" under Regulation S-X or not registered with the Public Company Accounting Oversight Board;
- Audited financial statements were not prepared in accordance with US GAAP; the audit itself was not conducted in accordance with US GAAP; or the adviser could not substantiate fair valuations, which resulted in the independent public accountant's inability to issue an unqualified opinion;
- The adviser could not demonstrate that the audited financial statements were distributed to *all* investors in the pooled investment vehicle;
- Audited financial statements were not provided within 120 days of the private fund's fiscal year end (or 180 days for funds of funds); and
- A final audit was not performed upon liquidation of a pooled investment vehicle.

The SEC staff has required advisers with such deficiencies to take immediate remedial measures, including revisions to their compliance procedures and even changes to business practices where necessary, and in certain cases the staff has referred such advisers for enforcement action.

The Risk Alert in many ways reinforces OCIE's previous message in its recently published examination priorities, which informed investors and registered investment advisers about areas that the staff will focus on as perceived to have heightened risk. These priorities are set by the staff and are intended to be aligned with the SEC's mission to improve compliance, prevent fraud, inform policy, and monitor firm-wide systemic risk. Although the examination priorities memorandum

[2] Under Rule 206(4)-2(d)(6), a "qualified custodian" includes certain banks, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions.

addresses issues across the securities market, we have focused below on those priorities most relevant to private equity and other private fund advisers.[3]

The examination priorities noted in the memorandum are consistent with those in the SEC's published letter to newly registered private fund advisers in October 2012, in which the SEC announced its intent to launch a coordinated examination initiative "designed to establish a meaningful presence" with these advisers ("Presence Exams"). This initiative will run over the next two years and consist of three phases:

- **Engagement**—OCIE staff will conduct an outreach initiative to inform new registrants about their obligations under the Investment Advisers Act.
- **Examination**—OCIE staff will focus on perceived higher-risk areas of the business and operations of those private fund advisers selected for examination. The SEC aims to examine a "substantial percentage" of private fund advisers, and noted that it will prioritize exams of these advisers where the staff's analytics indicate higher risks to investors relative to the rest of the registrants, or where there are indicia of fraud or other serious wrongdoing.
- **Reporting**—OCIE staff will report its observations to the SEC and the public, including common practices identified in the higher-risk focus areas, industry trends and significant issues, with the intent of encouraging private fund advisers to review and improve their compliance programs in these areas.

The examination phase of the Presence Exams may include a review of one or more of the following areas that the staff perceives to be "higher-risk" with respect to the particular registrant:

Safety of Client Assets. The staff may review a private fund adviser's compliance with the Custody Rule by examining the adviser's compliance policies, procedures and business practices with respect to the custody of client assets, the adequacy of audits of private funds, and the effectiveness of policies and procedures to protect those assets. In light of the SEC's Risk Alert discussed above, advisers should expect the staff to devote significant attention to the adviser's compliance policies and procedures in this area.

Conflicts of Interest. The staff may review compensation arrangements and any potential conflicts of interest they present, such as undisclosed fees or solicitation arrangements, referrals, certain client servicing fees and portfolio company fees. Among other measures, fund documents and related disclosure should clearly describe expenses that will be borne by a fund (as opposed to the adviser) and how the adviser allocates third-party fees and expenses (such as broken deal expenses) among multiple investment vehicles. Careful consideration should also be given to whether the adviser's disclosure materials adequately disclose the types of fees the adviser may charge to a fund's portfolio company and whether any portion of those fees may be retained by the adviser. The staff may also review investment allocation policies for potential conflicts of interest, such as conflicts arising out of the allocation of an investment opportunity among side-by-side investment vehicles or

[3] The priorities set forth in the National Exam Program Examination Priorities memorandum dated February 21, 2013 are not exhaustive. The staff indicated that it will conduct additional examinations in 2013 focused on risks, issues and policy matters that are not addressed in the memorandum.

where the adviser manages several different investment vehicles with potentially overlapping strategies. In particular, allocation arrangements in which one investment vehicle is perceived as supporting deal flow for another more profitable investment vehicle could be subject to heightened scrutiny on examination.

Marketing/Performance. The staff may evaluate the accuracy of performance information in marketing materials and related disclosures and compliance with record keeping requirements under the Investment Advisers Act.

Valuation. The staff may review valuation policies and procedures, including a comparison of the disclosed methodology for valuing illiquid or difficult to value investments against actual valuations, the method for calculating management and performance fees, and allocation of expenses to private funds.

The staff has also noted that it may review policies to ensure compliance with the SEC's recently adopted "pay to play" rule designed to prevent advisers from obtaining business from government entities in return for political contributions.

Private fund advisers should consider reviewing their compliance policies, procedures and actual business practices in light of these priorities and the significant risk of enforcement that could result from a perceived deficiency in one or more of these priority areas.

Authors:

Beth R. Kramer
beth.kramer@klgates.com
+1.212.536.4024

Paulo J. Marnoto
paul.marnoto@klgates.com
+1.617.261.3245

SEC Issues Risk Alert on Custody Rule, Reinforcing Its Message to Registered Investment Advisers in Its Examination Priorities for 2013