

Investment Adviser Custody of Privately Offered Securities under Dodd-Frank

A Collaboration By:



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Primarily as a result of the Bernie Madoff scandal, Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), has been amended in recent years and has been subject to ever changing, complex U.S. Securities and Exchange Commission (“SEC”) guidance. As a result, a significant amount of confusion exists among registered investment advisers (“RIAs”) regarding their compliance with the requirements of the Custody Rule. Indeed, many RIAs are unaware that they are not in compliance with the requirements of the Custody Rule. One of the most difficult areas for compliance with the Custody Rule involves the custody of privately offered securities (“Privately Offered Securities”).

Despite industry confusion about compliance with the Custody Rule, the SEC has recently gone on the record to state that compliance with the Custody Rule will be area of significant focus for the SEC’s upcoming RIA examinations. This article is designed to provide a quick overview of the Custody Rule, including its requirements for Privately Offered Securities and some proactive steps RIAs should take to ensure their compliance with the requirements of the Custody Rule.

Overview of the Custody Rule

The Custody Rule sets forth specific requirements for RIAs that have “custody” of client securities or funds (“Client Assets”). Custody is defined by the Custody Rule as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.” An RIA is deemed to have custody if it: (1) has actual possession or control of Client Assets, even if temporary, unless the Client Assets were received inadvertently and were returned within three business days; (2) has an arrangement by which the RIA has the authority to withdraw funds from the account (including the ability to withdraw advisory fees); or (3) acts in a capacity that gives the RIA legal ownership of or access to the Client Assets (including, as a result of the RIA’s position as the general partner to a limited partnership or other similar position). RIAs are also deemed to have custody if any of their related persons (i.e., persons that control, are controlled by or under common control with the RIA) have custody of Client Assets.

If an RIA has custody of Client Assets, the Custody Rule requires, among other things, (1) that the Client Assets be held by a “qualified custodian” (i.e., a bank, trust company, savings association, registered broker-dealer or registered futures commission merchant); (2) the RIA to send notice to clients when an account is established with a qualified custodian on their behalf; (3) that the RIA have a reasonable basis for believing that the qualified custodian sends quarterly account statements to the client;

CUSTODY RULE

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(4) that the RIA undergo an annual surprise examination by an independent accountant in order to verify client assets; and (5) unless the Client Assets are maintained by an independent custodian, that the RIA obtain an annual written report on the internal controls of the custodian from an independent accounting firm.

Custody Rule Requirements for Privately Offered Securities

As stated above, one of the most difficult areas for compliance with the Custody Rule involves the custody of Privately Offered Securities. Privately Offered Securities that (1) are not certificated and are registered only on the books of the issuer or its transfer agent in the name of the client and (2) require the prior consent of the issuer or other holders for their transfer are exempt from the requirements of the Custody Rule. However, not all Privately Offered Securities meet those criteria, as some Privately Offered Securities are certificated and evidenced by, for example, non-transferable stock certificates or certificated limited liability company interests that were obtained in a private placement ("Private Stock Certificates"). These Private Stock Certificates would not fall under the exemption for Privately Offered Securities discussed above and thus may be subject to the requirements of the Custody Rule.

Private Funds

The SEC has recently issued guidance that makes an exception to the Custody Rule's requirements for RIAs to audited private investment funds ("Funds") with respect to custody of certain Private Stock Certificates. The SEC has stated that RIAs do not have to maintain such Private Stock Certificates with a qualified custodian provided that each of the following requirements is met:

- (1) the client is a Fund subject to an annual audit by an independent public accountant and audited financial statements are distributed annually to investors;*
- (2) the Private Stock Certificates can only be used to effect a transfer or change in the beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer;*
- (3) ownership of the security is recorded on the books of the issuer (or its transfer agent) in the name of the client;*
- (4) the Private Stock Certificate contains a legend restricting transfer; and*
- (5) the Private Stock Certificate is appropriately safeguarded by the RIA and can be replaced upon loss or destruction.*

GUIDANCE

The SEC has recently issued guidance that makes an exception to the Custody Rule's requirements for RIAs to audited Funds with respect to custody of certain Private Stock Certificates.

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If an RIA advises an audited Fund that does not comply with each of the foregoing specific requirements, the relief provided by the SEC guidance is unavailable and each Private Stock Certificate must be maintained with a qualified custodian. Furthermore, the SEC relief discussed above is not available with respect to unaudited Funds. Therefore, if any of the RIA's Fund clients are not subject to an annual audit, then each Private Stock Certificate held by such Fund must be maintained with a qualified custodian.

Separately Managed Accounts

RIAs that advise separately managed accounts also face issues with respect to Custody Rule compliance that may not be immediately apparent. In particular, many RIAs do not realize that each of the RIA's separately managed account clients must also comply with the Custody Rule's requirements. RIAs should keep this in mind, especially with respect to any Privately Offered Securities held by such separately managed account clients.

Ensuring Compliance with the Custody Rule

While compliance with the Custody Rule is complex, RIAs will not be able to use that excuse with the SEC during their upcoming examinations. RIAs who may have issues related to the custody of their Privately Offered Securities, including Private Stock Certificates, should consult with legal counsel or a qualified custodian that is well acquainted with the Custody Rule's requirements to avoid having any such issues being discovered by a regulator during an examination, which could lead to a costly enforcement action.

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Scott Foster has been providing institutional alternative asset custody since 2008. Scott has focused on self-directed IRA and pooled investment vehicle custody with hedge funds, private equity and debt, venture capital, fund of funds, family offices and RIAs.



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