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Custody

# SEC Temporarily Permits Hedge Fund Managers to Avoid Surprise Examination Requirement with Audits by Auditors That Are Registered with, but Not Subject to Inspection by, the PCAOB

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By Joe Story, *Hedge Fund Law Report*

In late 2009, the SEC adopted amendments to Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940, as amended (Advisers Act). (The Hedge Fund Law Report has analyzed the implications of the amended Custody Rule for, among other things, compliance policies and procedures; the balance of power between hedge fund managers and accountants; structuring of managed accounts; internal control reporting; and hedge fund liquidations.) As amended, the Custody Rule creates a general rule that is bad for hedge fund managers, an exception to the general rule that is good for hedge fund managers, and parameters for applying the exception that are ambiguous for hedge fund managers. In brief, the general rule is that any investment adviser deemed to have custody of client securities or assets – and most hedge fund managers would have deemed custody within the Custody Rule's broad definition of custody – is required to undergo an annual surprise examination conducted by an independent public accountant. The exception is that advisers to pooled investment vehicles (such as hedge funds) are excepted from the surprise examination requirement if their funds are audited annually in accordance with GAAP by "an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules." Advisers Act Rule 206(4)-2(b)(4)(ii). The exemption also requires a hedge fund to distribute its audited financial statements to investors within 120 days (180 days for funds of funds) of the fund's fiscal year-end.

The ambiguity in application of the exception is essentially as follows: A hedge fund manager is only excepted from the surprise examination requirement if the independent public accountant that it retains to perform annual audits of its funds is (1) registered with the PCAOB and (2) subject to regular inspection by the PCAOB (3) as of the commencement of the professional engagement period and (4) as of each calendar year-end. But many of the independent public accountants that routinely audit hedge funds are not subject to regular inspection by the PCAOB, and it is not yet clear what "as of the commencement of the professional engagement period" will mean for purposes of the Custody Rule. In other words, many independent public accountants would not satisfy the second and third elements of the test for eligibility to provide annual audits that can except a hedge fund manager from the surprise examination

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requirement. Therefore, to avoid the surprise examination requirement, many hedge fund managers would have to replace their current auditors with auditors that are subject to "regular inspection" by the PCAOB. Only auditors to public companies currently are subject to regular inspection by the PCAOB. In many cases, such public company auditors are larger and more expensive, and have less institutional knowledge (and in some cases less industry knowledge), than auditors focused specifically on the hedge fund industry. In short, absent relief and clarification, the Custody Rule would require many hedge fund managers to replace their funds' current auditors, which in turn could: raise funds' costs; increase the length of audits; increase the time of hedge fund manager personnel and other manager resources committed to annual audits; diminish or eliminate the value of institutional knowledge; and sever by regulation professional engagements that in many cases have been long-standing and mutually productive.

Fortunately, in an October 12, 2010 no-action letter to the law firm Seward & Kissel LLP (Seward Letter), the Staff of the SEC's Division of Investment Management provided such relief and clarification. This article further describes the legal, accounting and operational problems created by the Custody Rule, and the relief offered by the Seward Letter with respect to those problems.

## Regular Inspection by the PCAOB

As indicated, the Custody Rule contains two obstacles that can prevent many independent public accountants from performing annual hedge fund audits that can except the manager of the hedge fund under audit from the surprise examination requirement. The first obstacle is that the independent public accountant must be subject to regular inspection by the PCAOB. Many of the independent public accountants that audit hedge funds are registered with the PCAOB, but are not subject to regular inspection by the PCAOB. This is because many hedge funds are audited by independent public accountants that also audit broker-dealers, and independent public accountants that audit broker-dealers are required to be registered with the PCAOB, but are not required to be subject to regular inspection by the PCAOB. In turn, this is because following passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Section 17(e) of the Securities Exchange Act of 1934 requires registered broker-dealers to annually file with the SEC certain financial statements that are certified by a PCAOB-registered accountant. However, Section 17(e) does not require that the accountant that certifies the relevant financial statements be subject to regular inspection by the PCAOB.

## Dodd-Frank Section 982

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) amends Title I of Sarbanes-Oxley to authorize the PCAOB to establish a regular inspection program for auditors of broker-dealers. Once the PCAOB establishes such a regular inspection program for auditors of broker-dealers, many auditors of hedge funds will satisfy the "subject to regular inspection by the PCAOB" requirement because many auditors of hedge funds are also auditors of broker-dealers. However, there is a timing problem: Sarbanes-Oxley Section 107(b) requires SEC approval prior to effectiveness of any rule of the PCAOB, and any such SEC approval would require a public notice and comment period. Therefore, until such a public notice and comment period has been completed, and SEC approval has been given, a PCAOB rule providing for regular inspection of auditors of broker-dealers will not be effective. That could take months, and in the meantime, many auditors of hedge funds will not be "subject to regular

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inspection by the PCAOB" – that is, will remain ineligible to provide annual audits that can except hedge fund managers from the surprise examination requirement. For a broadly analogous timing issue inherent in Dodd-Frank, and the potential regulatory arbitrage it creates, see "Does Dodd-Frank Enable Certain Hedge Fund Managers to Elect Between Registration with the SEC and CFTC?," Hedge Fund Law Report, Vol. 3, No. 39 (Oct. 8, 2010).

## "As of the Commencement of the Professional Engagement Period"

Even after effectiveness of the PCAOB rule establishing a regular inspection program for auditors of broker-dealers – and, by extension, for many auditors of hedge funds – many auditors of hedge funds still may not be able to represent that they were subject to regular PCAOB inspections "as of the commencement of the professional engagement period." That is, whether or not a hedge fund auditor will be able to represent that it was subject to regular inspections as of the commencement of the professional engagement period will depend on how the PCAOB rule defines "commencement" and "professional engagement period"; when the rule becomes effective and whether that effective date is retroactive; and whether the rule contains a "grandfather" provision. For example, assume that a hedge fund manager launched in mid-2005, immediately engaged an independent public accountant to audit its funds and has retained the same accountant until today; that accountant focuses exclusively on hedge funds and broker-dealers, does not audit public companies and thus is not subject to regular inspection by the PCAOB. Absent a grandfather provision or retroactive effective date in the PCAOB rule, and assuming that for purposes of the PCAOB rule, a professional engagement period commences upon execution of an engagement letter, the auditor would not be able to represent that it was subject to regular inspection by the PCAOB as of the commencement of the professional engagement period. This is the second obstacle that can prevent many independent public accountants from performing annual hedge fund audits that can except the manager of the hedge fund under audit from the surprise examination requirement.

## Seward Letter

The Seward Letter addresses and offers relief from both obstacles. Specifically, the Seward Letter indicates that the Staff of the Division of Investment Management would not recommend enforcement action to the SEC under Advisers Act Section 206(4) or Rule 206(4)-2 thereunder against a hedge fund manager that engages an auditor to audit its funds in connection with the annual audit exception to the surprise examination requirement, so long as the following four conditions are met:

1. The auditor also audits a broker or a dealer;
2. The auditor was engaged to audit the financial statements of one or more of the hedge funds for the most recently completed fiscal year;
3. The auditor was registered with the PCAOB and engaged to audit the financial statements of a broker or a dealer on July 21, 2010 [the date of passage of Dodd-Frank] and is registered with the PCAOB and engaged to audit the financial statements of a broker or a dealer as of the issuance of audited financial statements used to satisfy the annual audit exception to the surprise examination requirement; and

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4. The hedge fund manager provides written notification to each investor in each hedge fund prior to the distribution of the financial statements that the hedge fund's auditor is not subject to regular inspection by the PCAOB.

While the Seward Letter does not explicitly provide insight into the rationale behind the various requirements, presumably, the intent of the first and third requirements is to ensure that any auditor that avails itself of the relief in the letter is PCAOB-registered at relevant times and did not register with the PCAOB solely to take advantage of the relief. Similarly, the rationale behind the second requirement may be to limit the relief to established professional engagements. Finally, the rationale for the fourth requirement appears to be classic disclosure and investor protection. Also, it should be noted that any notification to investors stating that the hedge fund's auditor is not subject to regular inspection by the PCAOB may also offer context and qualification, for example, notes to the effect that: it is not uncommon for auditors of hedge funds not to be subject to regular inspection by the PCAOB; even though the auditor is not subject to regular inspection by the PCAOB, it still must comply with Generally Accepted Auditing Standards and other professional standards; and the auditor may become subject to regular inspection by the PCAOB under the terms of a forthcoming rule.

## Timing

The Seward Letter states that it only applies to financial statements issued prior to the earlier of: (1) the adoption of rules concerning the inspection of auditors of brokers and dealers by the PCAOB; or (2) July 21, 2011.

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