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Custody

Avoiding Common Pitfalls Under the Custody Rule: Custody Determination, Auditor Independence and Liquidation Audits (Part Two of Two)

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The crux of Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act), commonly referred to as the "custody rule," is the protection of client and investor assets, with each of the rule's provisions designed to support this mandate. For example, the rule requires that the audit firm engaged to verify a client's funds and securities – either through a "surprise audit" of the client's account or the annual audit of the financial statements of a pooled investment vehicle (PIV) – qualify as an "independent public accountant." This concept of independence – defined through SEC rules as well as professional guidelines applicable to audit professionals – adds a level of integrity to the audit process and is aimed at providing a layer of comfort to the SEC, the adviser's clients and fund investors. Ensuring that the auditor meets both sets of independence requirements is not always easy, particularly for advisers that are part of a larger organization.

Auditor independence is one of several areas where an adviser can run afoul of the custody rule. In this second installment of a two-part series, we review the auditor-independence requirement and discuss two additional hazards that may result in non-compliance with the custody rule: failing to realize when the adviser has custody and liquidation audits. The first article detailed options for fund managers to comply with the rule; discussed the frequency with which custody is reviewed during SEC examinations; and identified common weaknesses relating to inadvertent custody, as well as preparation and delivery of audited financial statements (AFS).

For a discussion of SEC enforcement actions and corresponding penalties involving violations of the custody rule, see "Failure by Investment Advisers to Ensure Accurate Client Billing May Lead to SEC Enforcement Action and Penalties" (Feb. 2, 2017); "Repeat Custody Rule Offenders Face Severe SEC Sanctions" (Dec. 10, 2015); and "SEC Sanctions Two Private Fund Managers for Custody Rule Violations, Including Imposing Statutory Bars on Their Chief Compliance Officers" (Nov. 8, 2013).

Trap 4: Failure by an Adviser to Realize It Has Custody

How the SEC Defines Custody

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Investment advisers seeking to register with the SEC must file a completed Form ADV with the agency and thereafter annually amend the form within 90 days of the adviser's fiscal year-end. Item 9 in Part 1 of Form ADV requires advisers to disclose whether the adviser or any related person has custody of advisory clients' cash or bank accounts and securities.

Many hedge fund managers were first required to register with the SEC in 2012, after the Dodd-Frank Act repealed Section 203(b)(3) of the Advisers Act (often referred to as the private adviser exemption). Upon registering with the SEC, these advisers became subject to the panoply of rules under the Advisers Act, including the custody rule.

In the beginning, many advisers struggled with some of the concepts within the custody rule. "It can be counterintuitive for an adviser to conclude that it has custody, as defined in the rule, over client assets," explained Dechert partner David Vaughan, "because in the vast majority of cases, the adviser doesn't have physical custody, as the client's assets are being held with a custodian." Additionally, many advisers, as a matter of best practice, assign cash control rights to a fund's administrator (*e.g.*, to pay invoices), and therefore cannot move money out of a fund's bank accounts.

Within the custody rule, the SEC provided three examples of when an adviser has custody of a client's funds and securities, including:

> any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

As a result, advisers to private funds formed as limited partnerships or limited liability companies almost always have custody of the PIV's funds and securities in light of the fact that the adviser or one of its affiliates is typically appointed as the general partner or managing member of the fund, clarified Vaughan.

The analysis can be more complex in the offshore fund context when the fund is structured as a company and maintains a board of directors with a majority of independent directors. "In many cases, however, the conclusion is drawn that the adviser has custody in the offshore fund context as well," Vaughan noted. "For example, it may be determined that the inherent authority of the inside director(s) is sufficient such that the adviser would be viewed as having the authority or would otherwise be permitted to withdraw client funds or securities upon its instruction to the custodian. Alternatively, the offshore fund may feed into a master fund where the adviser has (or is deemed to have) custody, which would also result in the adviser having custody at the offshore feeder fund level."

"In a master-feeder fund structure, concluding that the adviser has custody for the offshore feeder fund generally does not materially alter the adviser's existing practices," noted Tram Nguyen, a partner at Paul Hastings. Most advisers are already holding assets with a qualified custodian (with the exception of certain privately offered securities), she added, and institutional investors generally consider it a best business practice and good governance tool to have the fund audited.

"Advisers to private funds, therefore, usually accept the notion that in the vast majority of cases, the SEC considers them to have custody of the funds' cash and securities," observed Ropes & Gray partner Joel Wattenbarger. "When it comes to completing Item 9 on Part 1 of Form ADV, these advisers generally take the approach that they or one of their related persons have custody," he noted.

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"It can be a more complex analysis," Wattenbarger added, "to determine whether the adviser has custody over assets held in separately managed accounts. This analysis can depend on fairly fine points about the details of the authority that the adviser has over the account, such as the adviser's ability to open new custodial accounts and move assets out of client accounts." See "How Can Hedge Fund Managers Structure Managed Accounts to Remain Outside the Purview of the Amended Custody Rule's Surprise Examination Requirement?" (Feb. 4, 2010).

Special Purpose Vehicles

In June 2014, the SEC issued a guidance update on "Private Funds and the Application of the Custody Rule to Special Purposes Vehicles and Escrows" (SPV Guidance). See "How Does the Custody Rule Apply to Special Purpose Vehicles Used by Private Equity Funds to Purchase, and Escrow Accounts Used to Sell, Portfolio Companies?" (Jul. 24, 2014). Hedge fund managers often use special purpose vehicle (SPV) structures when making investments to address tax or regulatory issues, explained Nguyen, and the SPV is generally structured as a corporate entity, limited partnership or limited liability company, with the adviser or an affiliate acting as the general partner or managing member, respectively, in the latter two cases.

Prior to the issuance of the SPV Guidance by the SEC, members of the industry struggled with whether they had to conduct a separate custody analysis at the SPV level, Nguyen explained. In most cases, a custody analysis at the SPV level would have resulted in the adviser being deemed to have custody of the assets within the SPV in light of the adviser's (or its affiliate's) legal ownership interest in the entity or other ability to access the underlying assets – raising the question of whether the adviser now had to conduct a separate audit at both the fund and SPV level.

"The SPV Guidance provides that the adviser does not have to conduct a separate audit at the SPV level, provided that the assets of the SPV are considered within the scope of the PIV financial statement audit and the SPV has no owners other than the adviser, the adviser's related person or PIVs that are controlled by the adviser or the adviser's related persons," Nguyen observed.

While the SPV Guidance was generally well received by advisers to private funds, Nguyen advised that custody of the SPV is likely to be raised by the SEC staff during examinations. "It is not intuitive for most advisers to understand that they have custody at the SPV level. The SEC is likely to scrutinize the SPV structure to ensure that it fits within the SPV Guidance," she added.

Trap 5: Auditor Independence

Independence Requirements

Audits of PIVs that are performed with the intention of meeting the "audit exception" (Section (b)(4) of Rule 206(4)-2) must be conducted 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 in accordance with its rules." An independent public accountant is further defined in Section (d)(4) of the rule to mean a public accountant that meets the standards of independence described in Rule 2-01(b) and (c) of Regulation S-X (SEC Audit Independence Rules).

The SEC Audit Independence Rules are stricter than the independence requirements set forth in the professional guidelines for accountants, Vaughan explained. "In the private fund context,

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issues with independence may arise when the adviser (or its affiliate) hires the audit firm (or an affiliate of the audit firm) to provide consulting services," added Mark Gurevich, a partner at Ropes & Gray.

"The challenge with the SEC Audit Independence Rules is that they will not always render a black-and-white answer as to whether a particular relationship or provision of a service by the audit firm gives rise to an independence issue," explained Wattenbarger. "Generally speaking, however, any time the adviser (or one of its affiliates) engages its audit firm to provide consulting services, it raises a red flag that should be further investigated to determine if the auditor is still able to meet the independence requirements under the SEC Audit Independence Rules and professional guidelines," Gurevich continued.

Complications With Auditor Independence

Issues with respect to auditor independence tend to arise in two contexts, noted Vaughan. The first is in the private equity space. In circumstances where the private equity fund maintains a controlling position in a portfolio company, the portfolio company is likely to be considered an affiliated entity of the adviser for purposes of the SEC Audit Independence Rules. As a result, if a portfolio company engages the same firm that is auditing the adviser's private funds, the auditor may no longer meet the standard for independence. It is important for the private equity manager to be aware of any existing consulting arrangements that portfolio companies may have, as well as review and approve any new consulting relationships to ensure that the use of consultants by the fund's portfolio companies does not prevent the adviser from engaging the auditor of its choice to audit its funds.

"The other circumstance where independence issues occasionally arise," Vaughan explained, "concerns advisers to private funds that are part of large financial institutions. Due to the number of affiliated entities that may engage consultants, the adviser may find that its options for selecting an auditor are quite limited." For hedge fund managers that are independent firms, however, the independence issue tends to be less of a concern, provided that the manager does not engage its auditing firm to provide consulting services.

Managing Auditor Independence

"When it comes to recognizing that the fund's auditor may not in fact meet the independence requirements of the SEC rules, this issue is more likely to be raised by the audit firm, as opposed to by the SEC," Vaughan observed. Auditors test for independence on an annual basis, and they occasionally identify conflicts that were not previously flagged as part of the analysis.

When this happens, the auditor will determine if it can meet the independence requirements under the SEC Audit Independence Rules and the professional guidelines. If not, the auditor may need to resign. The auditor may also conduct a look-back analysis to determine if it met the independence requirements when conducting prior audits of the adviser's funds.

As a matter of best practice, Vaughan recommended that advisers request the auditor to include a representation within the auditor engagement letter that the auditor meets the independence standards under both the professional guidelines and SEC Audit Independence Rules. This representation should be repeated on an annual basis, well in advance of commencement of the audit so that in the event the auditor can no longer make the representation, the adviser has sufficient time to engage a new auditor and still be able to comply with the 120-day deadline to deliver AFS to the PIV's investors.

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Trap 6: Liquidation and Initial Audits

Another aspect of the audit exception that is occasionally overlooked by advisers concerns the liquidation audit. "Advisers to PIVs that elect to rely upon the audit exception are required to obtain a final audit of the pool's financial statements and distribute those statements to investors promptly upon completion of the audit," explained Nicholas Batinich, a partner at ACA Compliance Group. "From a business perspective, this provision baffles certain advisers that contend that the cost outweighs the benefits of obtaining a liquidation audit."

When an adviser is winding down a fund, it is generally trying to do so as swiftly as possible. Consequently, advisers and some investors may view the liquidation audit as an unnecessary expense. "Unfortunately," Batinich explained, "this is a requirement that cannot be waived, even at the behest of investors, for advisers utilizing the audit exception for compliance with the custody rule."

For more on fund liquidations, see our two-part series on winding down funds: "How Managers Make the Decision and Communicate It to Investors and Service Providers" (Mar. 2, 2017); and "Navigating Illiquid Assets, Unanticipated Windfalls and Fees and Expenses During Liquidation" (Mar. 16, 2017).

A related issue of which advisers need to be aware concerns the audit of newly launched funds. "Advisers that intend to rely upon the audit exception need to ensure that the interim period of time from when the fund is launched through its first fiscal year-end is also audited," noted Batinich.

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