

SEC Provides Guidance on SPVs and Escrows Under the Custody Rule

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In June 2014, the Securities and Exchange Commission (the “SEC”) issued a guidance update (the “Update”) on the application of the custody rule¹ of the Investment Advisers Act of 1940 (the “Custody Rule”) to special purpose vehicles (“SPVs”) and escrow accounts.²

Investment Special Purpose Vehicles

Investment advisers form SPVs to facilitate investments in certain securities by one or more pooled investment vehicles managed by the adviser. These SPVs typically are controlled by the investment adviser (or the adviser’s related person), who often serves as a general partner of limited partnerships or holds comparable positions for other types of pooled investment vehicles. The SEC’s 2009 Custody Rule adopting release³ provided that to comply with section 206(4)-2(c) of the Custody Rule, “Delivery to Related Person,” an investment adviser could either (i) treat the SPV as a separate client (in which case the adviser will be deemed to have “custody” of the SPV assets) or (ii) treat the SPV’s assets as assets of the pooled investment vehicles of which the adviser has custody indirectly. The Update provides guidance through a series of examples as to when an adviser must treat the SPV as a separate client, which, as described further below, would require the adviser to obtain a separate audit of the SPV.

If the adviser treats the SPV as a separate client and relies on the “audit provision” of the Custody Rule,⁴ the adviser will be required to separately comply with the financial statement distribution requirement with respect to the SPV. Consequently, the adviser must obtain an audit of the SPV and deliver audited financial statements of the SPV to the beneficial owners of the pooled investment vehicle invested in the SPV.

On the other hand, if the adviser relies on the audit provision and treats the SPV’s assets as assets of the pooled investment vehicles of which the adviser has custody indirectly, the adviser does not need to separately comply with the financial statement distribution requirement as to the SPV. Instead, the adviser would treat the SPV’s assets as assets of the pooled investment vehicle and would include the SPV’s assets in the audited financial statements of the pooled investment vehicle.

The Update clarified when an adviser relying on the audit provision must treat the SPV as a separate client as opposed to treating the assets of the SPV as assets of the pooled investment vehicle clients. According to the Update, the adviser must treat the SPV as a separate client when the SPV has third-party owners. When the SPV has no owners other than the adviser, the adviser’s related persons, or one or more pooled investment

1 Rule 206(4)-2

2 The full text of the Update is available [here](#).

3 The SEC adopted certain amendments to the Custody Rule in 2009 and simultaneously issued an adopting release, which is available [here](#).

4 The audit provision exempts advisers from certain requirements of the Custody Rule, provided that the adviser, among other things, delivers audited financial statements of the pooled investment vehicle within 120 days of the end of each year, or 180 days for a fund of funds.

vehicle clients controlled by the adviser or the adviser's related persons (even if the SPV is used for multiple investments or has multiple owners), the adviser is not required to treat the SPV as a separate client and may instead treat the SPV's assets as assets of the pooled investment vehicle clients.

Escrow Accounts

The Update also clarified the application of the Custody Rule to escrow accounts used in connection with the sale of a portfolio company owned by one or more pooled investment vehicles ("Escrows"). Escrows are often used for a limited period of time to hold proceeds from the sale or merger of a portfolio company owned by an investment adviser's pooled investment vehicle clients and third parties. Typically, a "sellers' representative" will be appointed to act on behalf of the sellers with respect to a portion of the sale proceeds held in escrow to cover indemnification claims, purchase price adjustments or other adjustments.

The Custody Rule requires a registered investment adviser to maintain funds and securities over which it has custody with a qualified custodian in a separate account for each client in such client's name, or in accounts that contain only the adviser's clients' funds and securities maintained in the adviser's name as agent or trustee for the clients. Because the funds in an Escrow typically belong to both the adviser's pooled investment vehicle clients and third-party sellers, and are typically maintained by the sellers' representative instead of in the adviser's name as agent or trustee for the adviser's clients, such Escrows may run afoul of the Custody Rule.

The Update clarified that, provided certain requirements are met, the SEC will not object to the use of Escrows containing client funds and other client and non-client assets. Such Escrows are acceptable if: (i) the client is a pooled investment vehicle that relies on the audit provision and includes the portion of the Escrow attributable to the pooled investment vehicle in its financial statements; (ii) the Escrow is in connection with the sale or merger of a portfolio company owned by the client; (iii) the Escrow contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (iv) the Escrow exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (v) the Escrow is maintained at a qualified custodian; and (vi) the sellers' representative is contractually obligated to promptly distribute the remaining Escrow funds at the end of the escrow period on a predetermined formula to the sellers, including the pooled investment vehicle clients.

Overall, the Update provides additional clarity with respect to SPVs and some relief with respect to Escrows. If you have any questions regarding the Update or the application of the Custody Rule, please do not hesitate to contact your regular Skadden attorney or Anastasia Rockas.