

CLIENT MEMORANDUM

SEC Staff Provides Relief on Custody of Privately Offered Securities

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The SEC's Division of Investment Management, in response to requests from registered investment advisers, has issued guidance that allows advisers to pooled investment vehicles to hold certificates for privately offered securities themselves instead of with qualified custodians.¹

Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule") regulates custody activities of registered investment advisers. The Custody Rule generally requires an adviser that is deemed to have custody² under that Rule to maintain client funds or securities with a "qualified custodian."³

¹ Division of Investment Management [IM Guidance Update – Custody of Privately Offered Securities](http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf), August 2013 No. 2013-4. <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf>.

² Most advisers to private funds, by virtue of their capacity as general partner, managing member or a comparable position at the fund, or by their relationship to such persons, are deemed to have custody under the Custody Rule.

³ "Qualified custodians" include banks and savings associations, registered broker-dealers, registered futures commission merchants and foreign financial institutions that keep advisory clients' assets in customer accounts segregated from their proprietary assets.

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However, the Custody Rule does not require “privately offered securities” to be maintained with a qualified custodian. Privately offered securities are defined in the Custody Rule as securities which are: (a) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (b) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (c) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. To rely on this exemption, advisers to pooled investment vehicles must also distribute audited financial statements of the vehicle to investors within 120 days of each fiscal year - end.

Many advisers to pooled investment vehicles receive certificates from issuers in connection with investments in private securities offerings, particularly in the context of private equity investments. Since these securities are “certificated,” the exemption in the Custody Rule on its face is not available and the advisers must arrange for qualified custodians to hold those certificates.

The Division of Investment Management, noting the arguments of advisers that certificated private securities are similar in all material respects to uncertificated privately offered securities under the Rule and that the costs of maintaining certificates at qualified custodians are typically borne by pool investors, has determined to provide relief from the requirement that certificated private securities be held at qualified custodians provided that:

- the client is a pooled investment vehicle subject to a financial statement audit in accordance with the Custody Rule;
- the certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer;
- ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client;
- the certificate contains a legend restricting transfer; and
- the certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction. The Division emphasized that the adviser should also have procedures reasonably designed to safeguard the certificates.

The guidance also confirmed that (i) partnership agreements, subscription agreements and LLC agreements are not certificates under the Custody Rule and the securities represented by such documents are privately offered securities, provided they meet the other elements for privately offered securities, and (ii) securities that are evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty may be treated as privately offered securities under the Custody Rule.

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If you have any questions concerning the matters described in this memorandum, please contact Martin R. Miller (212-728-8690, mmiller@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com) or the Willkie attorney with whom you regularly work.

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