

Client Update

SEC Staff Provides No-Action Relief from Custody Rule for Principals-Only Funds

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On March 23rd, the Division of Investment Management of the Securities and Exchange Commission (the “SEC Staff”) issued a no-action letter addressing the applicability of certain provisions of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the “Custody Rule”) to private investment funds whose investors consist solely of the fund manager’s “Principals” and their spouses and minor children (“Principals-Only Funds”).¹ In particular, the no-action letter permits an investment adviser to a Principals-Only Fund to forgo subjecting the fund to either an annual audit or a surprise examination that would otherwise be required by the Custody Rule.

Private fund sponsors may want to consider whether they manage any Principal-Only Funds that they treat as clients for purposes of the Custody Rule. We note, however, that given the restrictive definition of “Principals,” the no-action relief will likely not apply to most employee or “friends-and-family” funds.

THE CUSTODY RULE

Under the Custody Rule, a private fund sponsor is generally deemed to have custody of the assets of the private fund it manages because it, or an affiliate, serves as the fund’s general partner. As a result, the private fund sponsor must either:

- Be subject to an annual surprise examination by an independent accountant to verify the fund’s assets and have a reasonable basis for believing the qualified custodian holding the assets of the fund is sending quarterly account statements to the investors; or

¹ 16th Amendment Advisors LLC, SEC Staff No-Action Letter (March 23, 2015), available at <http://www.sec.gov/divisions/investment/noaction/2015/16th-amendment-advisors-032315.htm>.

- Arrange for the fund's year-end financial statements to be (i) prepared in accordance with U.S. generally accepted accounting principles and audited by an independent accountant registered with, and inspected by, the Public Company Accounting Oversight Board and (ii) distributed to all of its investors within 120 days after the end of its fiscal year.

THE NO-ACTION LETTER AND ITS UTILITY

The no-action letter would permit a registered investment adviser to avoid either of these requirements for a private investment fund whose investors consist solely of:

- Individuals who (a) have plenary access to information (either statutory, contractual or some combination of the two) concerning the management of the investment adviser, the fund and the fund's general partner (or equivalent), (b) are listed as "control persons" in Schedule A to Form ADV because of their status as the investment adviser's officers or directors with executive responsibility (or having a similar status or function) and (c) have a material ownership in the investment adviser ("Principals"); and
- The Principals' spouses and minor children, as well as investment vehicles established for the individual or joint benefit of the Principals, their spouses or minor children.

Because the relief is limited to funds whose investors consist solely of Principals and their immediate family members, it is unlikely to apply to most employee investment vehicles or "friends-and-family" funds. For example, the relief would not apply to a fund whose investors include "knowledgeable employees" (as defined under the Investment Company Act of 1940) who are not executive officers or who do not have material ownership interest in the investment adviser. In addition, family members beyond spouses and minor children are not covered.

The utility of the no-action relief may be limited in other respects. For example, it does not provide relief from the requirement that an investment adviser maintain the fund's cash and portfolio securities with a qualified custodian. The no-action letter also does not address whether the fund's privately offered securities need to be maintained with a qualified custodian, since the exceptions for privately offered securities would require that the fund be subject to an annual audit in compliance with the Custody Rule.²

² See our Client Update: SEC Staff Provides Relief Under the Custody Rule With Respect to Restricted Stock Certificates Held by Private Funds (August 6, 2013), available at

It is worth noting that the no-action letter states that the requesting firm had already determined that the Principals-Only Funds at issue were clients for purposes of the Advisers Act. The Custody Rule only applies to assets of the adviser's clients. The SEC Staff appears to have left open the possibility that, based on the particular facts and circumstances, a Principals-Only Fund or, for that matter, certain other types of employee and family investment vehicles may not be clients and thus may not be subject to the Custody Rule.

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Please do not hesitate to contact us with any questions.

<http://www.debevoise.com/insights/publications/2013/08/sec-staff-provides-relief-under-the-custody-rule>.