

# Client Alert

Current Issues Relevant to Our Clients

August 20, 2013

## SEC Issues Relief Regarding Private Stock Certificates Under Advisers Act Custody Rule

*The staff of the Securities and Exchange Commission (“SEC”) recently announced that it would not require advisers of private investment funds to hold non-transferable stock certificates or certificated LLC interests obtained in a private placement with a “qualified custodian” under the Investment Advisers Act of 1940 (the “Advisers Act”) custody rule. To rely on this relief, private fund advisers must comply with certain conditions, described below. The relief is likely of the most interest to private funds of funds, private equity funds and similar funds that themselves invest in privately-offered securities. The SEC guidance is available [here](#).*

### The Custody Rule and Exception for Certain Privately Issued Securities

Advisers Act Rule 206(4)-2 provides that it is a fraudulent, deceptive, or manipulative act, practice or course of business for an SEC-registered adviser to have “custody” of client funds or securities unless a qualified custodian maintains those funds and securities in a separate account for each client under that client’s name or in accounts that only contain the adviser’s client’s funds and securities under the adviser’s name as agent or trustee for the clients. A “qualified custodian” is generally an FDIC-insured bank or savings association, a registered broker-dealer, a registered futures commission merchant or certain foreign financial institutions that customarily hold financial assets for customers. A private fund adviser typically has custody of the fund’s assets because it or a related entity serves as general partner of a limited partnership, managing member of an LLC, trustee of a trust, or comparable position for another type of pooled investment vehicle.

The custody rule also requires that registered advisers that have custody of client funds or securities either contract with an independent accountant to subject itself to a surprise annual examination or engage an independent public accountant to conduct an annual audit of the private fund and deliver audited financial statements to all beneficial owners within 120 days after the end of its fiscal year.

The custody rule provides an exception from the qualified custodian requirement for certain privately offered securities held in pooled investment vehicles provided that the pooled investment vehicle is audited by an independent public account that is registered with and

subject to regular inspection by the Public Company Accounting Oversight Board (“PCAOB”) in accordance with the rule. “Privately offered securities” are generally *uncertificated* securities acquired from the issuer in a transaction not involving any public offering that are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. Because *certificated* private securities do not technically fall within this definition, the rule requires an adviser to maintain certificated securities with a qualified custodian.

### SEC Relief

The recent SEC guidance provides that the SEC Division of Investment Management would not object if an adviser does not maintain non-transferable stock certificates or certificated LLC interests obtained in a private placement (“private stock certificates”) with a qualified custodian, provided that:

- the client is a pooled investment vehicle that is subject to a financial statement audit in accordance with Advisers Act Rule 206(4)-2(b)(4);
- the private stock certificate can only be used to effect a transfer or 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 private stock certificate contains a legend restricting transfer; and

- the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

The guidance also reminds advisers that it is the staff's position that a partnership agreement, subscription agreement or LLC agreement that is not itself a certificate under paragraph (b)(2)(B) of the custody rule, and the securities these documents represent meet the definition of "privately offered securities" under the custody rule if they otherwise fall within the terms of the exception. In addition the guidance also notes that it is the staff's position that securities evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty are "privately offered securities" eligible for the exception.

### For More Information

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