

SEC Grants Hedge Fund Auditors Limited Relief from Inspection Requirements

By Kay A. Gordon and Kenneth G. Juster of K&L Gates LLP

Introduction

On October 12, 2010, the Securities and Exchange Commission (the "SEC") staff granted no-action relief under Section 206(4) of the Investment Advisers Act of 1940, as amended (the "Advisers Act") and Rule 206(4)-2 thereunder (the "Custody Rule")^[1] to allow advisers to private funds to continue to use their current auditors to satisfy the Annual Audit Provision (defined below) in the case that these auditors are not currently subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB"). Absent this relief, the use of such auditors would potentially subject fund advisers to the application of the surprise audit requirement under the Custody Rule. This relief expires upon adoption of rules concerning the inspection of auditors of broker-dealers by the PCAOB or July 21, 2011, whichever date is earlier.

Background

Under the Custody Rule, each investment adviser that is deemed to have "custody" of clients' securities or funds must implement a set of controls designed to protect those assets from loss, misuse or misappropriation. Most investment advisers to limited partnerships, limited liability companies and other types of pooled vehicles (collectively, "private funds") are deemed to have custody of such private funds' assets, and therefore must comply with the Custody Rule. Advisers with custody of client funds or securities must generally undergo an annual surprise audit of such assets by an independent public accountant.^[2] However, in recognition of the fact that a surprise examination would be duplicative of the annual financial statement audit and would not materially benefit investors, the SEC exempted advisers to private funds from the annual surprise audit requirement, provided that such private funds are subject to annual audits that meet certain specified conditions (the "Annual Audit Provision").^[3]

Notably, the private fund's annual audit must be conducted by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.^[4] Many private funds are audited by independent public accountants that also act as auditors to broker-dealers, and are required to be registered with the PCAOB,^[5] but may not be currently subject to inspection by the PCAOB. Therefore, audits performed by such auditors do not satisfy Rule 206(4)-2(b)(4)(ii), and may not be relied upon by advisers seeking to avoid the surprise audit requirement.

The Dodd-Frank Wall Street Reform and Consumer Protection Act attempts to address this problem through Section 982 of the Act ("Section 982"), which amends Title I of the Sarbanes-Oxley Act to provide the PCAOB with the authority to establish a regular inspection program for auditors of broker-dealers.^[6] However, the rules implementing Section 982 will only be adopted and effective following the SEC approval of such rules (including public notice and comment periods) as required under Sarbanes-Oxley Act

Section 107(b). Accordingly, to comply with the Annual Audit Provision, advisers to private funds would be required to replace their current auditors unless and until such auditors become subject to PCAOB inspections even if such auditors are registered with the PCAOB.

No-Action Relief

In recognition of the disruption to the adviser and additional cost to investors that would result from requiring advisers to private funds to change auditors, the SEC staff has granted no-action relief under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder to permit such advisers to continue to use their current auditors to satisfy the Annual Audit Provision, subject to the following conditions:

- the auditor was engaged to audit the financial statements of one or more of the private funds for the most recently completed fiscal year;
- the auditor was registered with the PCAOB and engaged to audit the financial statements of a broker or dealer on July 21, 2010 and is registered with the PCAOB and engaged to audit the financial statements of a broker or dealer as of the issuance of audited financial statements used to satisfy the Annual Audit Provision; and
- the adviser provides written notification to each investor in each private fund prior to the distribution of the financial statements that the private fund's auditor is not subject to regular inspection by the PCAOB.^[7]

This relief is granted only with respect to financial statements issued prior to the adoption of rules concerning the inspection of auditors of broker-dealers by the PCAOB on July 21, 2011, whichever date is earlier. The relief is expected to serve as a useful interim measure to ensure continuity of private funds' relationships with their auditors where such continuity would have been otherwise unnecessarily interrupted because of the timing of the rulemaking agenda.

Kay A. Gordon, Partner, kay.gordon@klgates.com

Ms. Gordon practices in the firm's New York office and concentrates her work in the Investment Management practice, with a particular emphasis on hedge funds, private equity funds and compliance-related matters involving registered advisers and broker-dealers. She also advises clients on a broad range of securities and regulatory matters as well as a variety of financial instruments and transactions, including managed accounts, credit facilities, joint ventures and derivative instruments. She also represents clients in investigations by the SEC and other regulators.

Kenneth G. Juster, Associate, ken.juster@klgates.com

Mr. Juster is an associate in the investment management group, resident in the Boston office. He focuses his practice on advising clients in the financial services industry, including private domestic and offshore investment funds, broker-dealers, investment advisers and registered funds. Mr. Juster advises clients on SEC and FINRA regulatory requirements, Investment Company Act, Investment Advisers Act, Exchange Act and SRO compliance

issues, including Section 28(e) "soft dollar" compliance, development of supervisory procedures and overall compliance reviews. He counsels broker-dealers, advisers and fund clients in connection with their prime brokerage arrangements, Master Repurchase Agreements and other derivatives-related transactions. Mr. Juster also advises clients with respect to transactional matters, including the structuring and distribution of equity securities, hedge funds, private equity funds and funds of funds.

K&L Gates LLP

[K&L Gates](#) represents leading global corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. Our practice is robustly a full market practice at once regional, national and international in scope, and it is cutting edge, complex, and dynamic. In 2009, our revenues exceeded \$1 billion and, as stated in the July 2010 issue of the UK publication *Legal Business*, the firm "has further cemented its position as the Global 100's fastest growing firm."

Notes:

^[1] Seward & Kissell LLP, SEC No-Action Letter (pub. avail. Oct. 12, 2010) (the "Letter").

^[2] Rule 206(4)-2(a)(4).

^[3] Rule 206(4)-2(b)(4). The exemption applies to a private fund that is subject to audit:

1. At least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year;
2. 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 PCAOB in accordance with its rules; and
3. Upon liquidation and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) promptly after the completion of such audit.

^[4] Rule 206(4)-2(b)(4)(ii).

^[5] Following the passage of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), Section 17(e) of the Securities Exchange Act of 1934 provides that every registered broker or dealer shall annually file with the SEC certain financial statements that are certified by a firm that is registered with the PCAOB.

^[6] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 982.

^[7] See the Letter.

Material in this work is for general educational purposes only, and should not be construed as legal advice or legal opinion on any specific facts or circumstances. For legal advice, please consult your personal lawyer or other appropriate professional. Reprinted with permission from K&L Gates LLP.