The Case for a Custodian

CUSTODY SERVICES

With the right custodian and other service providers in place, a fund can create an environment conducive to attracting additional investors, helping it achieve fundraising goals.

Introduction

The Custody Rule under the Investment Advisers Act of 1940[1] requires that registered investment advisors' client funds and securities be maintained with a qualified custodian. Choosing the right custodian is one of the most crucial decisions that a fund manager makes. Putting control of the fund's assets in the hands of a qualified custodian increases transparency and helps mitigate the risk of fraud.

In this paper, we discuss the important roles that qualified custodians and other service providers serve for fund management. At the time of fund startup there is often significant focus on minimizing costs. What can be lost when weighing costs and benefits is the value that reputable service providers can offer the fund. With the right custodian and other service providers in place, funds can create an environment conducive to attracting additional investors, helping funds achieve their fundraising goals.

A Proliferation of Ponzi Schemes

Most people have heard of Charles Ponzi, for whom the "Ponzi scheme" was named, and Bernie Madoff, who defrauded thousands of investors of approximately $17.5 billion. A Ponzi scheme is a fraudulent investment system where the operator generates returns for earlier investors with money invested by later investors, rather than from legitimate business activities or profits from financial trading.

Private investment fund managers sometimes have to contend with the negative perceptions caused by Madoff and others. While these schemes are not the norm, the few high-profile cases have the potential to tarnish an entire sector that by-and-large offers legitimate investment opportunities.

Since Madoff's arrest in 2008, Ponzi schemes have increasingly grabbed headlines. According to Ponzitracker.com, a website that tracks the occurrences of Ponzi schemes, 277 schemes were uncovered between 2012 and 2015, totaling approximately $8.3 billion.[2]

It was in this atmosphere that the Securities and Exchange Commission amended the Custody Rule to strengthen controls over the custody of client assets and to encourage the use of independent custodians. The SEC expressed its belief that the changes to the Custody Rule, which became effective in March 2010, would increase investors' confidence in registered investment advisors. "In particular, increased investor

between 2012-2015

277 PONZI SCHEMES were uncovered

TOTALING APPROXIMATELY

$8.3billion

Source: Ponzitracker.com

confidence could lead to more efficient allocation of investor assets, which could result in an increase in the assets under management of investment advisers and, depending on how those assets are invested, a potential increase in the availability of capital."[3]

Choosing the Custodian

Under the Custody Rule, a registered investment advisor must maintain client funds and securities with a qualified custodian. The advisor must have a reasonable belief, after due inquiry, that the qualified custodian sends account statements *directly* to clients. In the adopting release to the 2010 amendments, the SEC expressed its belief that this requirement would increase advisory clients' confidence: Because clients would receive two statements, one from the advisor and one from the independent custodian, advisors would be deterred from engaging in fraudulent activities, and clients would be able to detect any unauthorized activity in their accounts.[4]

Advisors to private funds that are pooled investment vehicles must maintain the fund's cash and securities with a qualified custodian. Advisors that meet certain requirements, however, are excepted from the investor statement delivery requirement if they have the pooled investment vehicle audited and distribute the audited financial statements to the fund's investors. While this exception may be an efficient option for advisors who qualify, annual audited financial statements do not have the immediacy or transparency of monthly or quarterly statements sent to investors by the custodian.

The fund-level statements sent to investors by the custodian provide investors a window into the transactions engaged in by the fund manager.

THE CUSTODIAN'S DUTIES

01 Receives Cash
The custodian receives cash from new investors from the fund administrator.

02 Invests Cash
The custodian invests the cash at the direction of the fund manager.

03 Receives & Holds Assets
Once invested, the custodian receives and holds the assets (or representation of the assets) on behalf of the fund.

04 Receives Income
When the asset pays dividends, principal and interest, or makes redemptions, the custodian receives the income.

05 Distributes Income & Assets
At the direction of the fund manager, the custodian distributes cash or assets for fund administration expenses, investor redemptions, liquidations, etc.

06 Issues Statements
The custodian issues periodic fund-level statements to the fund manager and investors.

At the direction of the fund manager, the custodian invests the fund's cash, holds the investments in custody and distributes the income from the investments. See the illustration below.

The custodian issues a fund-level statement to the fund's investors, showing the above activity:

SAMPLE FUND-LEVEL STATEMENT

MILLENNIUM TRUST COMPANY

For the Account of: **TEST CAPITAL FUND**
October 1, 2017 - December 31, 2017

Recent Activity:	
New Subscriptions	+$75,000,000
Investment: ABC Private Debt Instrument	-$35,000,000
Investment: XYZ Private Equity Holding	-$40,000,000
Redemptions	-$10,000,000
Expenses: Fund Accountant	-$100,000
Holdings:	
DEF Private Equity Holding	$75,000,000
HIJ Real Estate Holding	$60,000,000
ABC Private Debt Holding	$35,000,000
XYZ Private Equity Holding	$40,000,000
Cash Balance	$19,000,000

Even if you are not a registered investment advisor required to comply with the Custody Rule, engaging an independent custodian for your fund's assets can help increase investor confidence by offering more transparency and accountability.

While most banks and registered broker-dealers meet the definition of "qualified custodian" under the Custody Rule, not all such institutions are willing to custody alternative assets, such as private equity or debt, marketplace loans or real estate-related securities. Millennium Trust Company specializes in the custody of alternative investments.

Choosing Other Service Providers

Fund Administrator

Institutional investors are increasingly requiring funds to engage a third-party fund administrator to verify values and trading positions.

The fund administrator calculates the net asset value (NAV), or the value of the fund's assets minus the value of its liabilities, which is done daily for mutual funds, monthly for most hedge funds, and quarterly for most private equity funds. The administrator also typically performs cash reconciliations, maintains the fund's books and records, onboards new investors, and processes subscriptions and redemptions.

Fund Attorney

Fund managers should look for law firms or attorneys that understand the fund's investing strategies and goals. The attorney will advise on the appropriate structure for the fund based on that understanding, and will draft the organizational documents (e.g., partnership agreement for a limited partnership, operating agreement for a limited liability company) and other documents necessary to form and operate the fund. The attorney will also be a key player in drafting the offering or private placement memorandum describing the terms of the investment, minimum investor requirements, risk factors, investment manager details, and the strategy to be employed by the fund. The fund manager also will likely require ongoing legal guidance with respect to regulatory compliance, ERISA and tax law.

Fund Accountant

The fund accountant is important both at fund startup and throughout the life of the fund. In many cases, the fund accountant will work closely with the fund manager and the attorney to determine the appropriate tax structure of the fund, including whether to structure the fund as a partnership, LLC or trust, and where to register the fund (i.e. domestic or offshore).

Fund Auditor

The Custody Rule contains complex provisions with respect to "surprise examinations" and annual audited financial statements. The fund's attorney and accountant can assist the fund manager in determining the applicability of those requirements. The auditing firm must be registered with the Public Company Accounting Oversight Board (PCAOB).

Conclusion

This paper offers insights into the importance of choosing the right service providers—including a custodian—to provide transparency for your investors, which can increase investor confidence and can help you grow. In fact, the SEC amended the Custody Rule in part to encourage the use of independent custodians. And qualified custodians provide an invaluable service at a relatively nominal cost.

Private fund managers that implement best practices from the start of the fund – and choose reputable service providers that have experience in the world of private funds – can build trust with the fund's investors. A custodian with relevant expertise and a respected reputation may provide a valuable layer of transparency to the fund conducive to attracting investors, helping the fund grow.

References

1. 17 CFR 275.206(4)-2.
2. Ponzitracker.com.
3. Securities and Exchange Commission, Adopting Release No. IA-2968 at p.75, December 30, 2009.
4. Id, at p. 80.

CASE STUDY: INSTITUTIONAL-QUALITY INFRASTRUCTURE AIDS GROWTH

Once investors understand a fund's investment strategy, they focus on the nuts and bolts of operational due diligence. Millennium Trust recently helped a fund client put institutional-quality infrastructure in place at inception, which helped position the fund for growth.

The Challenge

A leader in the emerging category of digital finance investing, the fund wanted to focus on performance and investment choice, so it needed a qualified custodian that could provide institutional-quality infrastructure to meet the operational due diligence standards of increasingly sophisticated and demanding investors.

The Solution

After comparing the relative value propositions of several custodians, this client implemented Millennium's fund custody solution. As the value and complexity of their business grew, it chose to expand its relationship with Millennium because of positive experiences and ability to accommodate complex operations.

The Results

Over the years, the scalability of Millennium's solutions has helped this client build relationships with institutions, single and multi-family offices, independent asset managers, and insurance companies, that are interested in consumer, small business, real estate, and other sectors of the digital finance marketplace. Putting institutional-quality infrastructure in place at inception was a best practice that helped the fund address lender and investor concerns and positioned it for growth.