

Investment Management Alert

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Custody Concerns for Investment Advisers as Loan Agents

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On December 20, 2018, the staff of the Division of Investment Management (the “Staff”) of the Securities and Exchange Commission (SEC) issued conditional no-action relief to Madison Capital Funding LLC (“Madison”),¹ clarifying guidance with respect to Section 206(4) of the Investment Advisers Act of 1940 (the “Advisers Act”) and Rule 206(4)-2 thereunder (the “Custody Rule”),² for investment advisers that also act as administrative agents for loan syndicates that are made up, at least in part, of its advisory clients.

Background

Madison is an SEC-registered investment adviser that is in the business of providing nonbank senior loans to middle-market companies. Madison organizes loan syndicates, which generally include Madison, its affiliates, and other bank and nonbank lenders, as well as institutional and sophisticated investors. Loan syndicates may include Madison’s advisory clients. Madison often acts as administrative agent on behalf of the loan syndicate pursuant to a credit agreement. It establishes a single bank account in its own name as agent for the loan syndicate participants (the “Agency Account”) to facilitate the movement of cash among the various participants and borrowers. Madison, however, has no authority to determine how the cash is used, allocated or disbursed, and it applies the terms of the credit agreement in its capacity as the administrative agent.

¹ The Staff’s no-action letter is available at <https://www.sec.gov/investment/madison-capital-funding-122018-206-4>.

² The Custody Rule requires that, in the case of an adviser with custody of client assets, the following requirements be met: (1) a qualified custodian must maintain such funds or securities (i) in a separate account for each client under that client’s name or (ii) in accounts that contain only the investment adviser’s clients’ funds and securities under the adviser’s name as agent for the client; and (2) the adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends account statements to its clients at least quarterly. An adviser may be deemed to have custody of client assets if it “holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them in connection with advisory services, or has any authority to obtain possession of them, in connection with advisory services [it] provide[s] to clients. . . .” Moreover, custody includes “any arrangement . . . under which [an adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian”

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Because Madison had the ability to access the funds in the Agency Account, which included funds of its clients, it was concerned that it would be deemed to have custody. Moreover, since the Agency Accounts commingled all loan syndicate participants' funds (including some of its advisory clients), this would run afoul of the Custody Rule's requirements to maintain custody funds in a separate account for each client under that client's name or in accounts that contain only the adviser's clients' funds under the adviser's name as agent for the client. Lastly, the bank custodian did not send quarterly account statements to each participant in the loan syndicate, as also required under the Custody Rule.

Conditional No-Action Relief

The SEC granted conditional no-action relief to Madison, subject to several conditions, including:

1. The Agency Account will be maintained with a "qualified custodian," as defined under the Custody Rule.
2. Only the assets of the loan syndicate participants will be put in the Agency Account.
3. No cash will be deposited in or withdrawn from the Agency Account, except pursuant to the credit agreements with the loan syndicates.
4. Madison will receive payments from loan syndicate participants only as agent for the loan syndicate participants.
5. In addition to disclosing on its Form ADV Part 1A the advisory client assets over which Madison has custody and each qualified custodian therefore, Madison will also disclose in Form ADV Part 2A its custody of the assets in the Agency Account and that the account commingles advisory clients and third-party assets.
6. Madison will develop and implement controls for its administrative agent services that are designed to ensure that (i) assets of the loan syndicate participants are safeguarded from loss or misappropriation, (ii) the assets in the Agency Account are distributed in accordance with the credit agreements with the loan syndicates, and (iii) the administrative agent services are being operated in a manner consistent with the credit agreements (the "Control Objectives").
7. Madison will obtain a written internal control report prepared by an independent public accountant ("Control Attestation"), no less frequently than once each calendar year, meeting the following requirements:
 1. The Control Attestation must include an opinion of the accountant as to whether controls have been placed in operation as of a specific date and are suitably designed and operating effectively to meet the Control Objectives.
 2. The accountant must verify that the assets in the Agency Account are reconciled to a custodian other than Madison or a related person.
 3. The accountant must be registered with, and subject to regular inspection as of the commencement of the relationship by, the Public Company Accounting Oversight Board.
8. Madison will promptly seek to resolve any control issues identified in the Control Attestation.

9. Madison will include the annual Control Attestation, including any qualified opinion, as part of its books and records under the Custody Rule.
10. If the accountant issues a qualified opinion with respect to any Control Attestation, Madison will promptly notify its advisory clients that are loan syndicate participants and inform them of the issues that resulted in such qualified opinion and how the issues will be avoided going forward.
11. Madison will detail the controls developed and implemented to ensure that the Control Objectives are achieved, as well as the Control Attestation process, in its policies and procedures.

Notably, the Staff specifically stated that third parties are permitted to rely on Madison's no-action letter to the extent that their facts and circumstances are substantially similar to Madison's. This should come as welcome guidance for other investment advisers acting as administrative agents for loan syndicates. The above guidance relates only to the use of a related party as agent. If the agent were not related to the investment adviser and would not have authority or control over the disbursements from the agent account, the investment adviser may not be deemed to have "custody" under the Custody Rule, and the above requirements would not apply.