

January 9, 2019

## SEC Provides Custody Rule No-Action Letter Concerning Adviser's Administrative Services Loan Syndication Business

On December 20, 2018, the SEC staff issued a [no-action letter](#) to Madison Capital Funding LLC (“Madison”), a registered investment adviser, concerning the administrative agent services Madison performs for its loan syndication business, which includes commingling advisory client assets with non-client assets in a single account (the “Agency Account”). The SEC staff agreed not to recommend enforcement action under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the “Custody Rule”), notwithstanding the facts that Madison’s use of the Agency Account did not comply with Custody Rule provisions 206(4)-2(a)(1) and 206(4)-2(a)(3).<sup>1</sup> However, the no-action position required that Madison satisfy various conditions set forth in the no-action letter.

**Background.** Madison is a lender to middle-market companies through loan syndicates organized by Madison, for which Madison serves as administrative agent. The loan syndicate participants include Madison, other bank and non-bank lenders and various institutional and other sophisticated investors. On behalf of a loan syndicate, and pursuant to terms set forth in the credit agreement, each participating lender appoints Madison as the administrative agent to take action on its behalf as set forth in the credit agreement and, more generally, to exercise powers either expressly delegated to Madison under the credit agreement or incidental to the agreement. Madison established the Agency Account with a bank that is a “qualified custodian” under the Custody Rule, and Madison uses the Agency Account to move cash to and from the lenders and the borrowers for all of the loan syndicates.

In addition to its loan syndication business, Madison provides investment advisory services to private investment funds and separately managed accounts for institutional investors. Loan syndicate participants may include Madison’s advisory clients (“Advisory Clients”) and other persons that are not Advisory Clients, including Madison or an affiliate.

In its incoming letter, Madison stated that it likely would be deemed to have “custody” of the assets in the Agency Account, including assets of Advisory Clients, because, as the administrative agent to the loan syndicates, Madison is authorized to obtain the cash in the Agency Account, including cash that belongs to Advisory Clients. Consequently, Madison is required to satisfy the Custody Rule’s requirements, including Rule 206(4)-2(a)(1) and Rule 206(4)-2(a)(3).

**The No-Action Letter.** The incoming letter stated that the Agency Accounts do not meet the requirements of Rule 206(4)-2(a)(1) because they commingle funds of Madison’s investment advisory clients with those of non-clients (the other loan syndicate participants). The SEC staff accepted the representations in Madison’s incoming letter to the effect that, if Madison conducted its administrative agent services in a manner that satisfied the eleven requirements listed in the Appendix to this Client Alert, the client protections provided to Advisory Clients by Rule 206(4)-2(a)(1) would not be materially affected. The internal control report conditions listed in the Appendix are similar to the requirements specified in Rule 206(4)-2(a)(6), which ordinarily apply when an investment adviser or a related person is deemed to maintain custody of advisory clients’ funds or securities.

With respect to Madison’s inability to satisfy Rule 206(4)-2(a)(3)’s account-statement requirement, the SEC staff accepted Madison’s argument that, while it may be possible for the custodian of the Agency Account to send quarterly loan syndicate account statements in accordance with Rule 206(4)-2(a)(3) to Advisory Clients, the statements would not be useful to Advisory Clients because the loan syndicate account contains assets belonging both to Advisory Clients and

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<sup>1</sup> Rule 206(4)-2(a)(1) generally requires that an investment adviser rely upon a qualified custodian to maintain the accounts of advisory clients, as well as specifying how the adviser must designate and structure those accounts. Rule 206(4)-2(a)(3) generally requires an adviser to have a reasonable basis, after due inquiry, for believing that a qualified custodian sends an account statement, at least quarterly, to each of the adviser’s clients for which the qualified custodian maintains client funds or securities.

assets belonging to other parties invested in multiple loan syndications. Instead, Madison represented, and the SEC staff accepted, that Madison has a reasonable belief, upon due inquiry, in accordance with Rule 206(4)-2(a)(3), that each Advisory Client would continue to receive quarterly account statements from the Advisory Client's own qualified custodian, and that these account statements would contain the Advisory Client's information regarding individual portfolio holdings and cash, as well as individual interests in any loan syndicate and cash received therefrom. The SEC staff accepted Madison's assertion that these account statements communicate to Advisory Clients the information needed to monitor their assets. (Note that this condition would not be applicable to advisers that do not cause qualified custodians to send account statements directly to private fund investors in reliance on the "audit exemption" with respect to fund clients).

Separately, in a footnote to the no-action letter, the SEC staff stated that it is "willing to entertain other no-action requests where investment advisers serving as administrative agents have similarly taken or propose to take steps to minimize the risk that client funds or securities could be lost or withdrawn or misappropriated by the investment adviser."

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Please contact your regular Ropes & Gray attorney for additional information or any questions about how the issues described in this Alert may impact your operations.

## Appendix

### Madison Capital Funding LLC No-Action Letter Conditions

1. The Agency Account will be maintained with a “qualified custodian” as defined in the Custody Rule.
2. Only the assets of loan syndicate participants will be placed in the Agency Account.
3. No cash will be deposited in or withdrawn from the Agency Account except pursuant to the credit agreements for the loan syndicates.
4. Madison will receive payments from loan syndicate participants or underlying obligors only as agent for the loan syndicate participants (and such payments would not be a part of Madison’s estate in bankruptcy).
5. In addition to disclosing on its Form ADV Part 1A the advisory client assets over which Madison has custody and each qualified custodian with which such assets are maintained, Madison will provide disclosure in its Form ADV Part 2A to reflect its custody of the assets in the Agency Account and that the account commingles advisory client and third-party assets.
6. Madison will develop and implement controls for its administrative agent services which include controls that are designed and implemented to ensure that: (i) the assets of the loan syndicate participants are safeguarded from loss or misappropriation, (ii) the assets in the Agency Account are distributed in a timely manner, accurately and completely and in accordance with the applicable credit agreements; and (iii) the administrative agent services are, and the Agency Account is being operated in a manner that is, consistent with the credit agreements for the relevant loans (“Control Objectives”).
7. Madison will obtain a written internal control report (“Control Attestation”), no less frequently than once each calendar year, prepared by an independent public accountant:
  - a. The internal control report 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 are operating effectively during the year to meet the Control Objectives;
  - b. The accountant must verify that the assets in the Agency Account are reconciled to a custodian other than Madison or a related person; and
  - c. The accountant must be 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 Public Company Accounting Oversight Board in accordance with its rules.
8. Madison will promptly seek to resolve any control activity exceptions identified in the Control Attestation on the part of Madison and/or its employees to comply with or fully implement the controls to meet the Control Objectives.
9. Madison will include the annual Control Attestation, including any qualified opinion, as part of its books and records under Rule 204-2 under the Advisers Act.
10. If the accountant issues a qualified opinion with respect to any Control Attestation, Madison will promptly notify its clients that are loan syndicate participants and inform them of the issue(s) that resulted in such qualified opinion and how such issue(s) 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 adopted, implemented, and subject to, annual review under Rule 206(4)-7 of the Advisers Act.