To Our Clients and Friends

Memorandum

SEC Staff Grants Custody Rule No-Action Relief to Investment Adviser Acting as Administrative Agent

On December 20, 2018, the staff (the "Staff") of the Securities and Exchange Commission ("SEC") granted conditional no-action relief to Madison Capital Funding LLC ("Madison"), an investment adviser registered with the SEC, from certain requirements under Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") in connection with Madison's administrative agent services for its loan syndication business.[1] This memorandum provides a summary of the relief granted.

The Custody Rule

The Custody Rule imposes certain requirements on registered investment advisers with custody of client funds or securities. "Custody" is defined to include actual custody (i.e., physically holding client funds or securities), as well as constructive custody (i.e., having authority to obtain possession of them, such as having a general power of attorney or serving as the general partner of a pooled investment vehicle client).[2] The definition also provides that an investment adviser has custody if its related person has custody of client funds or securities in connection with advisory services the adviser provides to clients.[3]

Among other things, the Custody Rule requires an investment adviser with actual or constructive custody to maintain client funds and securities with a qualified custodian (defined to include, in general, banks, registered broker-dealers, and registered futures commission merchants),[4] either in a separate account for each client, under that client's name, or in accounts that contain only the adviser's clients' funds and securities, under the adviser's name as agent or trustee for the clients.[5] As a result, an investment adviser is not permitted to commingle client funds and securities with those of third parties that are not clients (the "Commingling Provision"). In addition, the Custody Rule requires an investment adviser with custody to have a reasonable basis, after due inquiry, for believing that the qualified custodian sends a quarterly account statement to each client, identifying the amounts of funds and securities and setting

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1 Madison Capital Funding LLC, SEC No-Action Letter (Dec. 20, 2018).

2 Advisers Act Rule 206(4)-2(d)(2).

3 *Id*. "Related person" is defined to mean "any person, directly or indirectly, controlling or controlled by [the adviser], and any person that is under common control with [the adviser]." Advisers Act Rule 206(4)-2(d)(7).

4 Advisers Act Rule 206(4)-2(d)(6).

5 Advisers Act Rule 206(4)-2(a)(1).

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forth all transactions during the period (the "Account Statement Provision").[6] If an adviser's clients are pooled investment vehicles that prepare and distribute annual audited financial statements, the adviser is not required to comply with the Account Statement Provision with respect to such clients (the "Audited Pool Exception").[7]

Madison's Loan Syndication Business

According to the incoming letter (the "Incoming Letter"),[8] Madison provides advisory services to private investment funds and separately managed accounts ("Advisory Clients"). Madison also operates a loan syndication business and acts as a non-bank lender that provides senior loans to middle market companies. For a majority of the senior loans that Madison provides, it organizes a loan syndicate (a "Loan Syndicate") and serves as the administrative agent to the Loan Syndicate.[9] Participants in a Loan Syndicate ("Loan Syndicate Participants") may include Advisory Clients, as well as other individuals and/or entities that are not Advisory Clients ("Third Parties"). As the administrative agent, Madison establishes a single bank account (the "Agency Account") with a qualified custodian to facilitate the movement of cash to and from the Loan Syndicate Participants and the borrowers. Funds related to the Loan Syndicates are not held in separate accounts or sub-accounts for each Loan Syndicate Participant under that participant's name. As a result, assets of Advisory Clients and Third Parties are commingled in the Agency Account. Under each Loan Syndicate's credit agreement, Madison is required to follow negotiated guidelines or formulas regarding cash movement; Madison has no authority to determine how the assets in the Agency Account are used, allocated, or disbursed. The qualified custodian of the Agency Account does not send account statements to the Loan Syndicate Participants.

The Incoming Letter states that in connection with its advisory business, Madison would be deemed to have custody of the assets of the Advisory Clients for which it serves as the general partner or managing member, as applicable, and/or for which it has the authority to withdraw funds from a separately managed account pursuant to an investment advisory agreement. The Incoming Letter also states that Madison is likely to be deemed to have custody of the assets in the Agency Account, which includes Advisory Client assets, because it serves as the administrative agent to the Loan Syndicates and has access to, and authority to obtain the cash in, the Agency Account.

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6 Advisers Act Rule 206(4)-2(a)(3).

7 Advisers Act Rule 206(4)-2(b)(4). The Audited Pool Exception provides, among other requirements, that audited financial statements must be distributed to all investors in the pooled investment vehicle within 120 days of the end of its fiscal year. In addition, audited financial statements must be prepared upon liquidation of the pooled investment vehicle and distributed promptly after the completion of the liquidation audit. *Id*.

8 Madison Capital Funding LLC, Incoming Letter (Dec. 17, 2018).

9 Although the Incoming Letter indicates that Madison acted as the administrative agent for all of its Loan Syndicates, it also describes the loan syndication industry generally, and states that an affiliate of a non-bank lender can often serve as the administrative agent. Because the definition of "custody" provides that an investment adviser has custody if a related person has custody of client funds or securities in connection with services the adviser provides to clients, the issues Madison faced would have existed even if a related person, and not Madison, had acted as the administrative agent to the Loan Syndicates.

The Request for Relief

The Commingling Provision

The Incoming Letter requests relief from the application of the Commingling Provision with respect to the Agency Account. Because assets of Advisory Clients and Third Parties were commingled in the Agency Account, Madison was not in compliance with the Commingling Provision. Madison argued that to comply with the Commingling Provision with respect to the Agency Account would be highly unusual, if not unprecedented, in the loan syndication industry, and that it would be burdensome on the borrower (because they expect to make a single payment to all lenders, as opposed to multiple payments to different lenders) and Madison (because it would need to spend additional resources checking for and correcting errors related to maintaining additional accounts). Madison also argued that the operational efficiency provided by the Agency Account is vital to its ability to compete with other non-bank lenders for lending business.

In support of its request for relief from the Commingling Provision, Madison highlighted the rationale behind the prohibition on commingling: to protect client assets from unlawful activities or financial reverses, including insolvency, of the adviser. Madison noted that due to provisions incorporated into the form credit agreements for syndicated loans, the assets in the Agency Account would not be available to creditors of Madison in the event of its bankruptcy, and that the only remaining risk would be fraud, which is a risk inherent in any investment, and not specific to the Agency Account.

The Account Statement Provision

The Incoming Letter also requests relief from the application of the Account Statement Provision with respect to the Agency Account. Because the Agency Account's qualified custodian did not send account statements to Loan Syndicate Participants, including Advisory Client participants, Madison was not in compliance with the Account Statement Provision.[10]

In support of its request for relief from the Account Statement Provision, Madison argued that Agency Account statements would not be meaningful to Advisory Clients because Advisory Clients would not be able to identify their own holdings in the Agency Account from the statements, and would not be able to accurately use or decipher the information contained in the statements. Madison also noted that Advisory Clients that are not eligible for the Audited Pool Exception receive account statements from the qualified custodian with whom such Advisory Clients' funds and securities are custodied, and that these statements provide those Advisory Clients with the relevant information needed to monitor their assets.

The Conditions for Relief

In its response to the Incoming Letter, the Staff stated that it would not recommend enforcement action under Section 206(4) of the Advisers Act, and the Commingling Provision and Account Statement Provision of the Custody Rule, against Madison for its activities as administrative agent and investment adviser, subject to the following eleven conditions.

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[10] Because the Custody Rule does not require distribution of quarterly account statements to clients that qualify for the Audited Pool Exception, the Incoming Letter only requests relief from the Account Statement Provision with respect to Madison's clients that do not qualify for the Audited Pool Exception.

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.[11]

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 ("Accountant"):

    - The internal control report will 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;

    - The Accountant will verify that the assets in the Agency account are reconciled to a custodian other than Madison or a related person; and

    - The Accountant will 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.

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[11] The Form ADV disclosure that Madison proposed to the Staff was several paragraphs long. It included a detailed description of Madison's loan syndication business, an explanation of the Custody Rule issues posed by the Agency Account, and a citation to the no-action letter.

10. If the Accountant issues a qualified opinion with respect to any Control Attestation, Madison will promptly notify Advisory 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.

Conclusion

The Incoming Letter suggests that the issues described above are not unique to Madison, and that other registered advisers that use a single agency account in connection with loan syndications are also violating the Custody Rule with respect to such accounts. These issues can exist even where an affiliate of a registered adviser, rather than the adviser itself, acts as the administrative agent to a loan syndicate in which the adviser's clients participate. Investment advisers that act as administrative agents to loan syndicates (either directly or through an affiliate) should consider whether the issues described above are applicable to them.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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