Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What Madison Capital Ruling Means For Investment Advisers

By **J. Paul Forrester and Adam Kanter**
January 25, 2019, 3:37 PM EST


J. Paul Forrester


Adam Kanter

On Dec. 20, 2018, the staff of the Division of Investment Management of the U.S. Securities and Exchange Commission granted conditional no-action relief to Madison Capital under Section 206(4) of the Investment Advisers Act of 1940, as amended, and Rule 206(4)-2, known as the custody rule, thereunder for administrative agents under syndicated loans that also act (or that have affiliates that also act) as investment advisers for pooled investment vehicles, or separately managed accounts that are also lenders under such syndicated loans.

Background

In late 2016 or early 2017, in the course of a routine examination of a registered investment adviser, or RIA, and to the surprise of many industry participants,[1] the SEC's Division of Investment Management staff took the position that RIAs that trade loans and other assets (including derivatives) on behalf of separately managed accounts that do not settle "delivery versus payment," or DVP, have "custody" of client assets under the Advisers Act (due to their imputed ability to access client assets), and therefore must comply with the requirements of the custody rule, including the custody rule's four central safekeeping requirements:

1. Maintaining client assets with a "qualified custodian" in a separate account in each client's name or in an omnibus account that contains only client assets;

2. Providing certain notices to clients;

3. Having a reasonable basis, formed after due inquiry, that the qualified custodian sends account statements to clients on at least a quarterly basis; and

4. Engaging an independent public accountant to conduct an annual surprise examination to verify the existence of client assets.

The staff's position concerning this deemed "custody" for non-DVP accounts was most recently formalized in an IM Guidance Update issued in February 2017.

Madison Capital's Request

As an RIA and active middle market loan originator and lender, Madison Capital stated that it often acts as an administrative agent for loans that are syndicated to other bank and nonbank lenders, including pooled investment vehicles and separately managed accounts for which the administrative agent or an affiliate that is an RIA may act as an investment adviser. Based on the administrative agent's ability to access the assets of the loan syndicate on an other-than-DVP basis, it would be viewed as having "custody" under the staff's position noted above, triggering the application of the custody rule.[2]

Madison Capital was concerned that because it, in its capacity as administrative agent, typically established a single bank account for all participants in a loan syndicate, the arrangement would fail to comply with requirement (1) above (because, although the account was established with a qualified custodian, it did not solely contain client assets), and with requirement (3) above (because the bank custodian did not send quarterly account statements to each participant in the loan syndicate), and requested that the SEC agree not to recommend that the SEC take action if the RIA failed to comply with these requirements of the custody rule.

The SEC's Conditional Relief

The staff granted conditional relief to Madison Capital from these requirements under the custody rule, subject to the following requirements:

1. The administrative agent will establish and maintain a single bank account with a "qualified custodian", as defined in the custody rule.

2. Only the assets of the participants in the syndicated loan 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 Capital 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 Capital's estate in bankruptcy).

5. In addition to disclosing on its Form ADV Part 1A the advisory client assets over which Madison Capital has custody, and each qualified custodian with which such assets are maintained, Madison Capital 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 Capital will develop and implement controls for its administrative agent services which include controls that are designed and implemented to ensure that: (1) the assets of the loan syndicate participants are safeguarded from loss or misappropriation; (2) the assets in the agency account are distributed in a timely manner, accurately and completely, and in accordance with the applicable credit agreements; and (3) 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.

7. Madison Capital will obtain a written internal control report no less frequently than once each calendar year, prepared by an independent public accountant:

- 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;

- The accountant must verify that the assets in the agency account are reconciled to a custodian other than Madison Capital or a related person; and

- 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 Capital will promptly seek to resolve any control activity exceptions identified in the control attestation on the part of Madison Capital and/or its employees to comply with or fully implement the controls to meet the control objectives.

9. Madison Capital 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 Capital 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 Capital 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.

The SEC Division of Investment Management staff noted that Madison Capital had also represented that it will comply with all other requirements under the custody rule, which would include, for example, the requirement to undergo an annual surprise examination by an independent public account (or, for pooled investment vehicles, to prepare and distribute annual audited financial statements to investors).

Possible Consequences

Consistent with general practice of the Division of Investment Management, third parties are permitted to rely on Madison Capital's no-action letter, to the extent that their facts and circumstances are substantially similar to those described in the letter. However, the staff also stated that it would be willing to entertain other no-action requests where RIAs serving as administrative agents have taken or propose to take other steps to minimize the risk that client funds or securities could be lost or withdrawn or misappropriated by the RIA.

Of course, other things being equal, we expect that RIAs may choose to avoid the custody rule's requirements altogether (and even the alternative requirements of the Madison Capital relief) by using third-party administrative agents that are not controlled by the RIA. That said, it remains unclear what degree of oversight an RIA can exercise over a third-party administrative agent without triggering application of the custody rule — a possibility specifically called out by the staff in the letter.

Moreover, for RIAs that opt to comply with the custody rule and rely on the Madison Capital relief, they will need to assess the potential additional costs of the required control attestation, and may also need to consider whether and how these costs should be borne by the RIA, advisory clients that are loan syndicate participants, or all loan syndicate participants (and whether additional disclosure would need to be provided depending on the answer).

While it remains possible that another RIA could approach the SEC staff with an alternative proposal for safeguarding client assets, the current partial government shutdown means that even a start to that process won't be happening any time soon.

J. Paul Forrester and Adam D. Kanter are partners at Mayer Brown LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] The Loan Syndication and Trading Association has drawn attention to this issue (see: https://www.lsta.org/news-and-resources/news/bank-loan-trades-and-custody-of-client-assets) and has held events to discuss this issue (see: http://www.lsta.org/events-and-education/webcast-replays/event-details/2017-07-11-custody-challenges-for-loan-trading#presentations (membership/registration required)), and the LSTA's general counsel has written about it for an industry publication (see: http://www.leveragedloan.com/guest-analysis-lstas-ganz-weighs-leveraged-loan-trading-custody/).

[2] The staff also noted that even in circumstances where an RIA uses an unaffiliated third party as administrative agent, depending on the degree of control over that third party exercised by the RIA, the RIA may still be deemed to have "custody."