

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

ASSET MANAGEMENT **INSIGHTS**

FOR ADVISERS ACTING AS AGENTS TO LOAN SYNDICATION, ADDITIONAL PROCEDURES UNDER THE CUSTODY RULE ARE EXPECTED

By Dale Thompson

The SEC recently provided no-action relief¹ to Madison Capital Funding LLC ("Madison") in connection with administrative agent services it performs for its loan syndication business. The relief imposes additional procedures for compliance with the requirements of Rule 206(4)-2 under the Investment Advisers Act (the "Custody Rule").

Madison is a middle-market lender, loan syndicator and administrative agent, and it also provides investment advisory services to private investment funds and separately managed accounts for institutional investors ("Advisory Clients"). In its role as administrative agent, Madison established a single bank account ("Agency Account") with a U.S. bank. The Agency Account is used to facilitate the movement of cash to and from the lenders and the borrowers for all participants in the loan syndicates ("Loan Syndicate Participants") that Madison acts as agent. However, the Agency Account was opened by and in the name of Madison as agent for the Loan Syndicate Participants, thereby, resulting in the commingling of cash in the Agency Account among several loan syndicates and Loan Syndicate Participants, including participants that are not Advisory Clients ("Third Parties").

Since Madison, an SEC-registered adviser, is deemed to having custody over the funds in the Agency Account, the Agency Account arrangement violated the requirements of Rule 206(4)-2 under the Custody Rule, specifically paragraph (a)(1) thereunder which require:

- ▶ that an adviser maintain the funds in a separate account of a qualified custodian for each client under that client's name; or
- ▶ that the accounts contain only the clients' funds under the adviser's name as agent or trustee for the clients.

Further, Madison sought relief with respect to paragraph (a)(3) under the Custody Rule, which requires the distribution of account statements, at least quarterly, to the Loan Syndicate Participants.



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¹ <https://www.sec.gov/investment/madison-capital-funding-122018-206-4>

The SEC granted relief to Madison for the above violations provided that:

- ▶ The Agency Account will be maintained with a Qualified Custodian, as defined in the Custody Rule².
- ▶ Only the assets of Loan Syndicate Participants will be placed in the Agency Account.
- ▶ No cash will be deposited in or withdrawn from the Agency Account except pursuant to the credit agreements for the Loan Syndicates.
- ▶ Madison receives 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).
- ▶ 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 assets of Third Parties.
- ▶ Madison develop and implement controls for its administrative agent services which include controls that are designed and implemented to ensure that:
 - the assets of the Loan Syndicate Participants are safeguarded from loss or misappropriation;
 - the assets in the Agency Account are distributed in a timely manner, accurately and completely, and in accordance with the applicable credit agreements; and
 - 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").
- ▶ Madison 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 must include an opinion of the Accountant as to whether controls have been placed in operation as of a specific date, 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 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.
- ▶ Madison 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.
- ▶ 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.
- ▶ Madison details 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 Investment Advisers Act.

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In addition to the above requirements, an adviser must continue to comply with the other requirements of the Custody Rule, including a requirement for a separate Surprise Examination that must be performed and reported on.

² See 206(4)-2(d)(6) under the Custody Rule

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