The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC Staff Issues No-Action Relief on Funds' Custody of Loan Interests

[33091]

February 5, 2021 TO: ICI Members
Investment Company Directors
ICI Global Members
Accounting/Treasurers Committee
Fixed-Income Advisory Committee
Investment Advisers Committee
SEC Rules Committee
Securities Operations Advisory Committee
Small Funds Committee SUBJECTS: Audit and Attest
Compliance
Fixed Income Securities
Fund Accounting & Financial Reporting
Investment Advisers
Operations
Portfolio Oversight RE: SEC Staff Issues No-Action Relief on Funds' Custody of Loan Interests

The staff of the Securities and Exchange Commission's Division of Investment Management recently issued no-action relief regarding fund self-custody of certain uncertificated loan interests under Section 17(f) of the Investment Company Act of 1940 and Rule 17f-2 thereunder.[1] As explained further below, the staff 's letter provides no-action relief to the requesting registered investment companies and series ("funds") and their directors or officers from the vaulting, access, notification, and verification requirements for self-custody if the funds maintain those loan interests in the manner described in the letter.

Description of Uncertificated Loan Interests and Documentation

The letter explains that the funds invest in term or delayed draw corporate loans (not collateralized loan obligations) that are originated, negotiated, and structured by one or more primary lenders, typically consisting of banks, insurance companies or other financial institutions. The terms of the loans are governed by a credit agreement.

When a fund invests, loan interests are not transferred to the fund until the completion of a multi-step settlement process. The fund, however, does not receive a securities certificate or other tangible token of ownership that could be custodied with its custodian. Instead, loan interests are reflected on the records that are maintained on behalf of the loan

borrower, typically by an administrative agent, for the purpose of identifying owners of all loan interests and the principal amount of the loan attributable to each.

In their incoming letter,[2] the funds reason that while the loan documents together evidence that the fund has purchased a particular loan interest, possession of those documents would be of no value to a purchaser or other purported transferee. Rather, a transfer by a fund to such a subsequent transferee would be effected by following the multi-step settlement process discussed above.

Description of Fund Custody Practices for Loan Interests

The incoming letter explains that the funds' custody practice has been to maintain the loan documents with the fund's custodian for safekeeping, using a "sealed envelope safekeeping letter agreement." The custodian, however, does not verify the contents of the sealed envelope, reconcile it with the funds' books and records, or provide other services with respect to the bank debt agreements. Due to the volume of transactions and frequency of refinancings and paydowns, which can occur daily, it has become extremely burdensome to maintain copies of the loan documents and amendments with the funds' custodians. Furthermore, many custodians have become reluctant to safekeep paper documents like loan documents.

Request for Relief

The funds have been unable to comply with the strict terms of Rule 17f-2 because the rule assumes physical possession of underlying certificates.[3] The funds request relief to cease providing the loan documents to their custodian for safekeeping, while noting their view that keeping their loan documents sealed envelope for safekeeping "do[es] little to further the purposes underlying Section 17(f)."

The funds offer alternative means of satisfying the vaulting, access, notification, and verification requirements of Rule 17f-2, including implementing a series of internal controls procedures and conducting annual audits.[4]

Staff No-action Relief

The staff letter explains that each fund currently is subject to an annual audit during which the independent public accountant confirms all of the fund's investments, including its investments in loan interests, and reconciles the loan interests to the fund's account records. The independent auditor relies on controls testing as reported in the Service Organization Controls Report (SOC 1) on the adviser's fund accounting system and controls around trade authorization, trade confirmation, position reconciliation, cost roll-forward, and the systematic calculation of realized gains and losses.

Based the funds' facts and representations, particularly the representations that the funds are complying with audit requirements, the staff concludes that it would not recommend enforcement action under Section 17(f) or Rule 17f-2 if the funds maintain custody of loan interests 2 in the manner, and subject to the representations, described in the incoming letter.

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endnotes

[1] SEC Staff No-Action Letter (Jan. 13, 2021), *available at* https://www.sec.gov/investment/klgates-011321-rule17f.

[2] The incoming letter is *available at* https://www.sec.gov/divisions/investment/noaction/2021/klgates-incoming-letter-011321.pdf.

[3] Rule 17f-2 permits a fund to "self-custody," or have access to securities and other investments maintained by a bank, if certain conditions are met including, among others, (i) limited access by no more than five fund personnel to the investments, subject to a board resolution; (ii) strict procedures for depositing or withdrawing investments; and (iii) verification by an independent public account at least three times during each fiscal year, at least two of which are chosen by the accountant without prior notice to the fund.

[4] See incoming letter at 5-7. The incoming letter explains why an annual audit is sufficient, and why two additional "surprise" audits should not be necessary. By granting the no-action relief, the SEC staff implicitly agrees. The staff notes in the no-action letter, however, that it is not taking any view regarding Rule 206(4)-2 under the Investment Advisers Act of 1940 and its application to, among other instruments, privately offered securities.
