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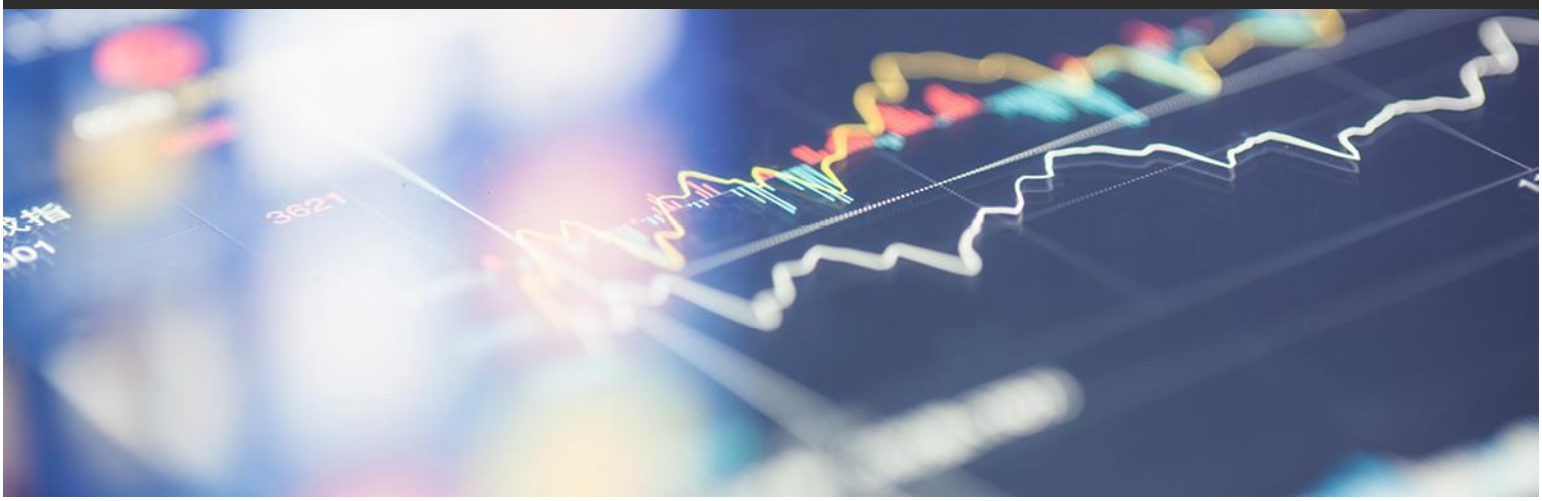
Alert | Investment Management



February 2021

SEC Staff Issues No-Action Relief for Custody of Certain Loan Interests Under the Investment Company Act

On Jan. 13, 2021, the Division of Investment Management staff (Staff) of the Securities and Exchange Commission (Commission) issued a no-action letter advising that it would not recommend enforcement action to the Commission under Section 17(f) of the Investment Company Act of 1940 (1940 Act), and paragraphs (b)-(f) of Rule 17f-2 thereunder, if certain registered management investment companies or series thereof (Funds), or their directors or officers, if the Funds, acting as self-custodians, maintain certain Loan Interests (as defined below) without strict compliance with paragraphs (b)-(e) of Rule 17f-2.

Background

Section 17(f) of the 1940 Act generally requires a registered investment company to maintain its securities and similar investments in the custody of a bank, a member of a national securities exchange, or to self-custody such assets subject to any rules prescribed by the Commission. Rule 17f-2 under the 1940 Act sets forth the conditions under which a fund may act as a self-custodian, a number of which some view as burdensome. For example, the rule requires that: (1) fund investments (with limited exception) must be deposited in the safekeeping of a bank (often referred to as the "vaulting requirement," which assumes certification or physical possession); (2) the fund's board must designate no more than five "authorized persons" for the fund and adopt a resolution permitting access to the fund's investments only by two persons acting together; (3) any person depositing or withdrawing investments from the depository or

ordering their withdrawal and delivery from the safekeeping of the fund or other company must sign a specific notation; and (4) investments maintained by a fund must be verified by complete examination by an independent public accountant retained by the fund at least three times during the fiscal year, at least two of which must be on a "surprise" basis.

Loan Interests

The letter relates to term or delayed draw corporate loans (Loans) 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 typically set out in a credit agreement between the primary lenders, the borrower and the administrative agent that administers the Loans on behalf of the lending syndicate. Pursuant to the specific terms and subject to the conditions in the credit agreement, primary lenders may sell interests in a Loan (Loan Interests) to third parties, including the Funds. The Funds do not receive any securities certificate or other tangible evidence of ownership that could be custodied with its custodian or, that if endorsed and delivered to a subsequent purchaser or other third party, could be used by that third party to evidence its own right to a Fund's Loan Interest. Settlement of purchases of Loan Interests involve a number of steps, and various documents are executed in connection with the settlement process (Loan Documents). As the Funds point out in the request, possession of the Loan Documents would be of no value to a purchaser or other purported transferee of a Fund's Loan Interests. Instead, the Loan Interests are reflected on the records that are maintained on behalf of the borrower under the Loan (the administrative agent) for the purpose of identifying the owners of all Loan Interests and the principal amount of the Loan attributable to each.

The Funds had been providing the Loan Documents to their custodian for safekeeping under Section 17(f), but that posed a number of challenges. In particular, the Funds suggested that the common practice of "sealed envelope" document safekeeping by fund custodians does little to further the purposes underlying Section 17(f), at least with respect to Loan Documents. Accordingly, the Funds sought to discontinue delivering Loan Documents to their custodians and instead rely on Rule 17f-2, but with a number of modifications to address the particular attributes of this particular asset class.

Relief

Drawing from prior staff no-action relief, the Funds proposed the following in lieu of the rule's requirements:

- Only a limited number of authorized personnel of the Funds would provide instructions to the Funds' custodian and the administrative agents;
- Passwords or other appropriate security procedures would be used to ensure that only properly authorized persons can transmit such instructions;
- The Funds would reconcile settled Loan Interests to the records of the administrative agents on a regular basis (i.e., at least monthly);
- Loan Interests would be titled or recorded at the administrative agents in the name of a Fund (not in the name of the Fund's investment adviser);
- Neither the Funds nor their investment advisers would be affiliated with the administrative agents; and
- Each Fund would adopt policies and procedures reasonably designed to prevent violation of the above conditions, as part of the Fund's compliance program under 1940 Act Rule 38a-1.

In lieu of the rule's verification requirement, each Fund would be subject to an annual audit during which the Fund's 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 incoming letter noted that a single annual audit, such as that normally performed for mutual funds, provides sufficient custody protections to investors in pooled investment vehicles under Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act). In the letter, the Staff specifically noted the incoming letter's representation that the Funds are complying with annual audit requirements. This letter reflects the continuing interest in investments and trading in loans by non-banks that in turn continues to raise interesting regulatory questions under the 1940 Act and the Advisers Act.

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