

July 22, 2019

Via Electronic Filing

Mr. Paul Cellupica, Esquire
Deputy Director and Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE Washington, DC 20549

Re: Custody Rule and Trading Controls Relating to Bank Loans

Dear Mr. Cellupica:

The Loan Syndications and Trading Association (“LSTA”)¹ appreciates the invitation from the Staff of the Securities and Exchange Commission (“the “Commission”) for industry engagement on Rule 206(4)-2 under the Investment Advisers Act of 1940 (the “Custody Rule”) as set forth in your letter of March 12, 2019 (“Letter”).

As a threshold matter, the LSTA appreciates and supports the investor protection goals of the Custody Rule. However, recent guidance regarding the Custody Rule relating to instruments that do not settle on a delivery-versus-payment (“DVP”) basis² has caused confusion, as LSTA’s members understood until relatively recently that investing in bank loans as authorized by clients would constitute “authorized trading” and thus would fall outside the definition of “custody” under the Rule.³

¹ The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trade of commercial loans. The 350 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

² The term “DVP” broadly refers to a securities settlement mechanism in which cash is delivered only upon the corresponding delivery of securities.

³ See *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2176 (September 25, 2003)(adviser’s authority to issue instructions to a broker-dealer or custodian to effect or settle trades does not constitute “custody”); Cf. *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority*, IM Guidance Update (Feb. 2017) (stating that one method for avoiding inadvertent custody is to ensure that the adviser’s trading authority is limited to “delivery versus payment” transactions, and indicating that the guidance provided was intended to address “custody arising from authority that goes beyond such arrangements.”).

In the Letter, the Division of Investment Management asks a number of questions designed to elicit information regarding the trading and settlement process for non-DVP instruments, as well as the controls around such processes that serve to mitigate the risk of loss or misappropriation of a client's assets. In an effort to assist the Staff in assessing these risks as they relate to bank loans, we explain below the process by which bank loan interests ("Loan Interests") trade and settle and the extensive documentation that tracks this process. We also address the substantial controls and independent checks in place to prevent loss and misappropriation of client assets, including the critical role played by the client's custodian in the process. We believe that investment advisers that invest and trade in a manner consistent with these protocols, which are standard in the industry, should not be deemed to have "custody" of client assets as defined in the Custody Rule, as the additional regulatory requirements associated therewith would impose additional costs without corresponding benefit to clients.

I. Trading and Settlement Process for Bank Loans

A. The Role of Various Parties in the Process

Bank loans are originated, negotiated, and structured by arranging banks and allocated to and purchased by a syndicate of lenders consisting of commercial banks, thrift institutions, insurance companies, finance companies or other financial institutions and provide critical financing to U.S. companies (each a "Borrower") for a variety of business purposes. Allocations of bank loans are further sub-allocated by asset managers to individual clients, and such "Loan Interests" are available for sale in the secondary market. Typically, one of the syndicate banks administers the bank loan on behalf of the syndicate and is referred to as the agent bank or administrative agent ("Administrative Agent"). The Administrative Agent is responsible for, among other things, maintaining the list of lenders.⁴

Once the allocations have been given to the syndicate of lenders, syndicated Loan Interests trade in the secondary market with dealer desks at large underwriting banks (each, an "Executing Broker"). Purchases of Loan Interests are typically structured as assignments, in which the assignee becomes a lender of record. These assignments settle on a non-DVP basis. After the agreement setting out the terms and conditions of the loan between the borrower and the arranging banks ("Credit Agreement") has been executed, the transfer of the Loan Interests is legally effected through a formal written assignment and assumption agreement between the seller/assignor ("Seller") and the buyer/assignee ("Buyer") and settles through a settlement platform.

The Borrower (if the Buyer is new to the loan and not affiliated with an existing lender of record) and the Administrative Agent must consent in writing to each assignment. Before a new lender is added to the approved list, the Administrative Agent must conduct a rigorous "Know your Customer" due diligence process to confirm the identity of the Buyer, which includes, among other things, review of Form W-9s, confirmation of applicable wire instructions and proof of the relationship between the investment adviser and the Buyer/client.⁵

⁴ Some banks reserve the right to delegate some or all of their administrative responsibilities as agent bank to non-bank affiliates.

⁵ After approval, the lender may participate in a bank loan transaction by completing the necessary Trade Documentation, as defined below. All potential lenders, including those that are advised by an affiliate of the Administrative Agent, are subject to the same due diligence process and qualification standards.

Loan Interests are not certificated; rather, ownership is recorded on the books of the Administrative Agent. Payment for an assigned Loan Interest is made only after all applicable documentation has been executed and approved, as more fully described below.

B. Documentation of the Process

Documentation relating to the transfer of Loan Interests is extensive and incorporates the participation of several parties independent of the investment adviser placing the order. Each Loan Interest transaction is documented in the form of (i) a trade ticket, (ii) a trade confirmation, (iii) an assignment and assumption agreement, and (iv) a funding memorandum (collectively, the “Trade Documentation”):

- First, a *trade ticket* is generated by an electronic settlement platform, based upon trade details submitted by the Executing Broker to the settlement platform that memorialize the Executing Broker’s understanding of the transaction. The trade ticket includes the identity of the Buyer, the Seller, the Borrower and the Administrative Agent, the trade date, the amount of Loan Interests being transferred, the purchase price, and the assignment fee (if any).
- Second, a *trade confirmation* is generated by the settlement platform, memorializing the agreed upon terms of the transaction (*i.e.*, the Borrower, the amount of Loan Interests being transferred to the Buyer, the CUSIP and the purchase price, including applicable fees). This document lists the Buyer or Seller as the principal, but is signed by the adviser (on behalf the client) and the Executing Broker.
- Third, an *assignment and assumption agreement*, generated by the settlement platform (based on information provided by the Administrative Agent), effects the legal transfer of the Loan Interests based on the terms referenced between the Buyer and Seller. The adviser signs the assignment agreement on behalf of the client (the client is listed as the Buyer or Seller), and both the Administrative Agent and the Borrower (if the Buyer is new to the loan and not affiliated with an existing lender of record) execute the assignment agreement to evidence consent of the assignment. Upon execution of the assignment agreement by the Administrative Agent, the client purchasing the Loan Interests is recorded as a lender of record on the books of the Administrative Agent.
- Once the above documentation (*i.e.*, the trade ticket, the trade confirmation and the assignment agreement) is completed, a *funding memorandum* is generated by the settlement platform, calculating the purchase price and providing the wire instructions of the party receiving payment. This funding memorandum is reviewed and signed by the adviser on behalf of the client. On or one day prior to the settlement date, the settlement platform sends the funding memorandum (which includes the Seller’s payment instructions) to the Buyer’s custodian. The custodian will release funds only to the account identified in the funding memorandum. In the event the wire instructions are not sent *via* the settlement platform, the custodian will perform callback verification procedures to authenticate wire instructions. When the callback verification and other internal control and regulatory processes (*e.g.*, OFAC checks) are completed, payment is transmitted in accordance with the wire instructions.

II. Controls that Prevent Loss and Misappropriation

LSTA believes that the bank loan trading and settlement process described above includes strong controls that minimize the risk of loss and misappropriation. The requirements of the Custody Rule, including the quarterly statement and surprise audit requirements, were designed to require “another set of eyes” on client assets in order to protect against their misappropriation.⁶ As explained above, the settlement process for the transfer of

⁶ *Custody of Funds or Securities of Clients by Investment Advisers*, IA Release No. 2968 (Dec. 30, 2009). We note that the Staff previously has granted relief from the Custody Rule requirements such as the surprise audit in circumstances where controls existed to help prevent

Loan Interests includes extensive documentation and the involvement of several outside parties, all of which serve to limit the adviser's role and mitigate the risk of an adviser's misappropriation or self-dealing (as well as inadvertent errors that could harm clients). The risk of deliberate misdirection is minimized by safeguards that exist throughout the process for the transfer of Loan Interests, including the risk-mitigating role of the custodians as described below.

Investment advisory agreements between clients and advisers generally provide the adviser with authority to make and implement all investment decisions relating to the purchase and sale of bank loans, including completion of any necessary documentation, and communication of trading and settlement instructions to brokers and custodians.

Clients separately and independently retain their own unaffiliated custodians to maintain custody of their funds and securities under the adviser's management.

Advisers are only provided limited authority to trade Loan Interests on behalf of clients. At no point during the process described above for purchasing or selling a Loan Interest does the adviser obtain legal ownership or possession of the Loan Interests. The Loan Interests pass directly from the Seller to the Buyer through a book-entry transfer at the Administrative Agent. Thus, the adviser on either side of the transaction never has physical or legal custody of the Loan Interests. Indeed, at no point does the adviser possess any evidence of legal ownership of the Loan Interests. While the adviser completes and retains copies of the Trade Documentation for recordkeeping purposes, the Trade Documentation does not confer any legal rights upon the adviser. Vesting of all legal rights related to the Loan Interests occur only upon settlement of the assignment of the Loan Interests, at which point all rights in such assigned Loan Interests are conferred only upon the Buyer.

III. Role of the Custodians in the Transfer and Settlement of Bank Loan Transactions

The custodians for both the Buyer (the "Buyer Custodian") and the seller (the "Seller Custodian") receive the Trade Documentation for each bank loan transaction and therefore each has access to information regarding the par amount of the transfer, sale price, fees, accrued interest, payment instructions, and other relevant terms in respect of the transaction. Custodians play an important role in preventing loss or misappropriation of Loan Interests.

The Buyer Custodian will not authorize the release of client funds for the purchase of the Loan Interest unless it receives all the Trade Documentation, including an executed funding memorandum in good order, and thereby confirms that funds should be sent per the settlement instructions set forth therein. The Buyer will in fact become the owner of the bank loan as reflected in the Administrative Agent's books and records. Importantly, the Administrative Agent executes the assignment and assumption agreement together with the Buyer and Seller and thus is contractually obligated to adjust its books and records accordingly. Moreover, as noted above, the Administrative Agent performs its own due diligence on the Buyer before the Agent will execute any loan documentation, which provides an additional control over the direction of assets. The Buyer's Custodian will verify the signature on the funding memorandum against a previously established authorized list of signers for that particular Buyer. In certain cases, depending upon the method of delivery of the funding memorandum and the size of the funding, the Buyer's Custodian may make a verification call (*i.e.*, callback) to an authorized person at the adviser other than the person who submitted the bank loan purchase order to confirm that it is appropriate to release funds.

misappropriation or misdirection of client assets, which minimized the need for the audit. Investment Adviser Association, SEC No-Action Letter (pub. avail. Feb. 21, 2017) (relief from the surprise audit requirement granted where the adviser had custody of client assets for the limited purpose of transferring funds to a third-party, either on a scheduled basis or from time to time, at the client's request).

On the sale side of the transaction, the Seller Custodian (as well as the Buyer Custodian) is subject to an obligation to match payables and receivables against transactions in the client's account to ensure that the client receives all payments to which it is entitled, including the proceeds from the sale. Therefore, when the Seller enters into a transaction to sell a Loan Interest, the Seller Custodian monitors for receipt of either the purchase price of the Loan Interest or, in the alternative, continued receipt of interest payments. If neither is received, it would soon become apparent that there was an error and the Seller Custodian would contact the Administrative Agent for the transaction to make a follow-up inquiry and, if necessary, seek to unwind the sale. Likewise, the Buyer Custodian would become aware of an issue if, upon transferring the Buyer's assets to the Seller Custodian, the Buyer Custodian did not subsequently receive interest payments. The Administrative Agent sends notifications to the Buyer Custodian in connection with future interest and principal payments. If expected payments are not made by the Administrative Agent to Buyer's account, the Buyer Custodian's reconciliation process will identify discrepancies and either the adviser or the custodian will contact the Administrative Agent to follow up, inquire where the payment is, and further research any issues.

Because the bank loan transaction process already incorporates robust independent checks and controls against accidental and deliberate misdirection of client assets as described above, surprise examinations are unlikely to result in increased investor protection.

Following settlement, non-DVP positions are disclosed, along with other holdings, to the client by the client's custodian in a format and with frequency as negotiated between the client and the custodian and without influence from the adviser. The adviser typically sends account statements disclosing non-DVP positions to the client as well. LSTA is not aware of any non-DVP Loan Interest position that would not appear on client statements sent from the custodian.

* * * *

We submit that the significant independent checks and controls associated with the purchase and sale of Loan Interests discussed in detail above support the position that authorized trading of bank loans should be deemed to fall outside the definition of "custody" under the Custody Rule, and that the additional regulatory requirements imposed by the Rule would impose additional costs unnecessarily.⁷

We commend the Commission for adding amendments to the Custody Rule to the Commission's regulatory agenda. We intend to engage with the staff actively when the Commission proposes amendments to the Custody Rule. In the meantime, we appreciate the Commission's consideration of our views and would be happy to provide any additional information that may be helpful. Please contact the undersigned if we can be of further assistance.

Sincerely,



Elliot Ganz
General Counsel & Chief of Staff, Co-Head, Public Policy Group
Loan Syndications and Trading Association

⁷ Requiring all advisers that are authorized to purchase or sell Loan Interests on behalf of clients to comply with the Custody Rule, particularly the surprise audit requirement, places a substantial cost burden on advisers with little to no corresponding client protection benefit. Importantly, requiring advisers with authority to trade Loan Interests to undertake a costly annual surprise audit may reduce the number of advisers willing to undertake such trading on behalf of their clients. This in turn may impede the secondary market in Loan Interests and thus loan liquidity, which will not serve the public interest.