

MEMO# 23582

June 24, 2009

SEC Staff Issues No-Action Letter on TALF Loans for Mutual Funds and Closed-End Funds

[23582]

June 24, 2009

TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 26-09
FIXED-INCOME ADVISORY COMMITTEE No. 15-09
SEC RULES MEMBERS No. 69-09 RE: SEC STAFF ISSUES NO-ACTION LETTER ON TALF
LOANS FOR MUTUAL FUNDS AND CLOSED-END FUNDS

On June 19th, the Staff of the Securities and Exchange Commission responded to a letter requesting no-action assurances relating to mutual fund or closed-end fund participation in the Term Asset-Backed Securities Loan Facility ("TALF"). [\[1\]](#) The TALF, as explained more fully below, involves non-recourse loans that are collateralized by investments in certain eligible securities. The no-action letter addresses senior security issues under Sections 18(a)(1), 18(c), and 18(f)(1) of the Investment Company Act of 1940 (the "Act") and custody issues under Section 17(f) of the Act that arise when a registered open-end or closed-end fund obtains a TALF loan.

Background on TALF

The TALF program is one of a number of stimulus programs implemented since last September in response to the financial crisis. [\[2\]](#) The Federal Reserve created the TALF to help revitalize the securitization markets by supporting the issuance of asset-backed securities ("ABS") collateralized by certain enumerated types of loans, such as automobile loans, student loans, and credit card loans ("Eligible Collateral"). The universe of Eligible Collateral has recently been expanded to include certain types of newly-issued commercial

mortgage backed securities, and may be further expanded in the future.

Under the TALF, the Federal Reserve Bank of New York (the “FRBNY”) will provide non-recourse loans to any eligible borrower, contingent on receipt of Eligible Collateral by the Bank of New York Mellon (as the custodian and administrator for the TALF program). In order to participate in the TALF, borrowers must open a customer account with one or more primary dealers participating in the TALF program, and all transactions, including disbursements, are processed through that account according to the terms of the TALF Standing Loan Facility Procedures (the “Procedures”) and a master loan and security agreement (the “MLSA”). [\[3\]](#)

TALF loans are non-recourse. As such, if the borrower does not repay the loan, the FRBNY may enforce its rights only against the Eligible Collateral and not against other assets of the borrower. TALF loans are prepayable at the option of the borrower without penalty, and the borrower may satisfy its loan obligation in full at any time by surrendering the Eligible Collateral to the FRBNY.

TALF loans are made on a “haircut” basis, meaning that the FRBNY will lend an amount equal to the lesser of the par or market value of the pledged Eligible Collateral minus a haircut that ranges from 5% to 16% depending on the type of Eligible Collateral. For example, with a 5% haircut, a borrower can obtain financing for 95% of the value of its Eligible Collateral for that loan.

Senior Security Issues Under Section 18 of the Act

For registered investment company borrowers, TALF loans implicate certain senior security provisions in Section 18 of the Act. Specifically, Section 18(a)(1) of the Act prohibits any registered closed-end fund from issuing any class of senior security or selling any senior security of which it is the issuer, that represents an indebtedness, unless (among other things) immediately after such issuance or sale the fund will have asset coverage of at least 300 percent. In addition, Section 18(c) of the Act, with certain exceptions, prohibits any registered closed-end fund from issuing any senior security representing indebtedness if immediately thereafter such fund would have outstanding more than one class of senior security representing indebtedness. Section 18(f)(1) of the Act prohibits any registered open-end fund from issuing any class of senior security, or selling any class of senior security of which it is the issuer, except that the fund may borrow from any bank, provided that immediately after any such borrowing there is asset coverage of at least 300 percent for all of the borrowings of the fund.

In SEC Release 10666, the Commission took the position that those provisions of Section 18 would also apply to certain securities trading practices that create leverage, including reverse repurchase agreements, but indicated that the concerns underlying Section 18 could be addressed if an investment company “covers” its future obligations. [\[4\]](#) The letter

requesting no-action assurances argued that TALF loans would affect a fund's capital structure in a manner analogous to the effect of reverse repurchase agreements, and proposed to address the asset coverage requirements of Section 18 for a TALF loan in the manner set forth in Release 10666.

Accordingly, the letter represented that each fund taking a TALF loan would maintain segregated liquid assets, marked-to-market daily, in an amount equal to the fund's outstanding principal and interest on the TALF loan. A fund would not use the Eligible Securities that collateralize its TALF loan to meet the asset segregation requirement. Effectively, this would ensure that the fund's borrowing under the TALF program would have asset coverage of at least 200 percent. Based upon these representations, the Staff agreed not to recommend enforcement action if the fund participates in the TALF without treating the borrowing as a senior security representing indebtedness for purposes of compliance with Sections 18(a)(1), 18(c) and 18(f)(1) of the Act.

Custody Issues Under Section 17(f) of the Act

The TALF program is structured so that prospective borrowers may access it only through a primary dealer that acts as the borrower's agent and sole interface with the FRBNY and its custodian. As a result, the primary dealer may be called upon to hold fund assets in ways that would not comply with Rule 17f-1 under the Act.

The letter requesting no-action assurances argued that the arrangement will not raise the safekeeping concerns underlying Rule 17f-1 or Section 17 of the Act, and requested no-action assurances under Section 17(f) of the Act for a fund using a primary dealer as contemplated in the MLSA. The staff agreed.

Liquidity of the Eligible Collateral

The letter requesting no-action assurances describes the funds' approach to liquidity determinations for Eligible Collateral. It states that during those times, if any, when an ABS subject to a TALF loan is an illiquid security, the fund will count only the amount by which the fair value of the ABS exceeds the amount of the TALF loan as illiquid. The funds did not request any staff no-action assurances with respect to liquidity determinations, and the staff's response letter does not address this topic.

Other Representations

The letter represented that both the investment in Eligible Collateral and borrowing under the TALF program would be consistent with the investment objective, policies, and limitations of each fund that will participate in the TALF program, as stated in each fund's registration statement.

The letter also represented that the Boards of Trustees of the funds have considered and authorized the funds' participation in the TALF program, the MLSA and the agreements with one or more primary dealers.

Robert C. Grohowski
Senior Counsel
Securities Regulation - Investment Companies

endnotes

[1] See Franklin Templeton Investments, SEC No-Action Letter (June 19, 2009), available at <http://www.sec.gov/divisions/investment/noaction/2009/franklintempleton061909.htm>.

[2] For a list of U.S. Government responses to the financial crisis from September 1, 2008 to the present, see http://www.ici.org/fcr/resources/08_market_interventions.

[3] For a complete set of information and documentation relating to the TALF, see <http://www.newyorkfed.org/markets/talf.html>.

[4] *Securities Trading Practices of Registered Investment Companies*, SEC Rel. No. IC-10666 (Apr. 18, 1979).

Source URL: <https://icinew-stage.ici.org/memo-23582>

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.