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Alternative Investments Practice

Client Alert

RICs and BDCs: New SEC Guidance on TALF 2020

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*This client alert updates our recent client alert (the "**May 22 Alert**") regarding investment funds as prospective borrowers under the Term Asset-Backed Securities Loan Facility ("**TALF**" or "**TALF 2020**").[1] For prior Milbank client alerts regarding TALF, see our client alerts of April 9, 2020[2] and May 12, 2020.[3]*

In less than two weeks, the Federal Reserve Bank of New York (the "**NY Fed**") will begin to accept subscriptions from investors seeking to borrow under TALF to acquire and pledge qualifying AAA-rated asset-backed securities ("**ABS**"). Like the TALF facility launched during the last financial crisis ("**TALF 2009**"), TALF 2020 is intended to support the flow of credit to US consumers and businesses by supporting the ABS market, a significant source of funding for lenders, lessors, credit card companies and other providers of credit.

Notwithstanding some investors' reservations regarding potential returns and eligibility conditions for some categories of ABS, a market has formed, and a number of major asset managers have announced private funds of $500 million or more dedicated to purchasing eligible ABS using non-recourse, non-marked-to-market financing under TALF. A private fund with $500 million in committed equity can borrow 5 to 20 times that amount, acquiring up to approximately $2.5 billion to $10 billion in eligible ABS, depending on the ABS sector.[4]

Unlike private funds, registered investment companies ("**RICs**") that seek to borrow under TALF must do so in compliance with the Investment Company Act of 1940 (the "**1940 Act**"), which restricts RICs' leverage as well as most aspects of their operations. RICs were nonetheless able to participate in TALF 2009, facilitated in part by 1940 Act relief issued by the staff of the Securities and Exchange Commission ("**SEC**") in two no-action letters (the "**2009 Letters**"), one issued to Franklin Templeton Investments and

[1] Access to the terms, responses to frequently asked questions, and relevant documentation regarding TALF 2020 is available on the website of the Federal Reserve Bank of New York at https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility.

[2] Our April 9, 2020 client alert is available online at: https://www.milbank.com/en/news/talf-expanded-toinclude-aaa-tranches-of-static-clos.html.

[3] Our May 12, 2020 client alert is available online at: https://www.milbank.com/en/news/talf-clarifications-materially-beneficial-for-clos.html.

[4] The size of a TALF loan will equal the amount of the ABS collateral (generally, its market value at inception) minus a haircut ranging from 5% to 20% of that amount, depending on the ABS sector, sub-sector and average life; see FAQs effective May 26, 2020, available online at: https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-faq, and Term Asset-Backed Securities Loan Facility terms and conditions effective May 12, 2020, available online at: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf.

the other to T. Rowe Price Associates,[5] as discussed in our May 22 Alert. As also noted in the May 22 Alert, it remained to be seen whether the SEC or its staff would clarify whether RICs could rely on the 2009 Letters to participate in TALF 2020.

Updated Guidance

Last week, the SEC staff issued guidance (the "**Updated Guidance**")[6] that not only confirms that RICs may rely on the 2009 Letters to participate in TALF 2020 but also expands the scope of relief and clarifies that the relief extends to business development companies ("**BDCs**"), whose statutory mandate to provide capital to small- and medium-sized US businesses is particularly germane to the objectives underlying TALF.

Below, we discuss the main features of the Updated Guidance and some practical implications for RICs, BDCs and their managers.

Relief under Leverage Restrictions

The Updated Guidance confirms that RICs and BDCs may borrow under TALF 2020 without regard to 1940 Act "senior security" restrictions if they comply with the conditions in the 2009 *Franklin Templeton* letter.

Background – 1940 Act Leverage Restrictions

Borrowings by 1940 Act funds are considered to be issuances of "senior securities" and are prohibited if they exceed the limits mandated under Section 18 of the 1940 Act. As a rule, RICs may not issue senior securities representing indebtedness exceeding one third of the value of their total assets (reflecting a 300% required "asset coverage ratio" under Section 18), and BDCs may not issue senior securities representing indebtedness exceeding one half (or two thirds, for BDCs that have adopted the modified limits permitted under 2018 amendments to the 1940 Act) of the value of their total assets (reflecting a required asset coverage ratio of 200% or 150%).[7]

Section 18 also prohibits closed-end funds from issuing more than one class of senior securities representing indebtedness and prohibits open-end funds (mutual funds) from issuing any senior securities at all other than bank loans.[8]

In *Franklin Templeton*, the staff allowed RICs to borrow under TALF without treating the loan as a senior security subject to the Section 18 restrictions, provided they "cover" their obligations by maintaining a segregated account holding liquid assets (other than the ABS collateral) in the amount of the outstanding principal and interest under the loan. The relief was modeled on the SEC's treatment of reverse repurchase agreements, which similarly are not considered senior securities, even though they create leverage, so long as the fund segregates liquid assets to cover its obligations in compliance with a line of guidance originating in 1979 with SEC Release 10666.[9]

The SEC Division of Investment Management normally permits third parties to rely on prior no-action letters provided their facts and circumstances are substantially similar to those of the applicant.[10] Given the similarity between the 2009 and 2020 TALF programs, it might have seemed a foregone conclusion that RICs could rely on *Franklin Templeton* to borrow under TALF 2020. However, as we noted in the May 22 Alert, the SEC proposed last year to rescind Release 10666, potentially calling into question whether the *Franklin Templeton* conditions would continue to be acceptable to the staff. The Updated

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[5] The 2009 Letters are Franklin Templeton Investments, SEC No-Action Letter (June 19, 2009) and T. Rowe Price Assocs., SEC No-Action Letter (Oct. 8, 2009).

[6] Letter from Jennifer O. Palmer, Senior Counsel, SEC Div. of Inv. Mgmt., to Paul Schott Stevens, President & CEO of the ICI, and Timothy W. Cameron, Head of SIFMA Asset Management Group (May 27, 2020), available online at https://www.sec.gov/investment/ici-sifma-052720.

[7] 1940 Act Sections 18(a) (closed-end fund limits), 18(f) (open-end fund limits), 61(a) (which makes Section 18 applicable to BDCs as if they were closed-end funds, subject to specified modifications).

[8] 1940 Act Sections 18(c) and 18(f).

[9] SEC Release IC-10666 (April 18, 1979).

[10] SEC Release IC-22587 (March 27, 1997).

Guidance dispels any uncertainty on this question, confirming that the *Franklin Templeton* condition referencing Release 10666 remains applicable "at this time."[11]

Practical implications

Practical implications of the above for RICs and BDCs considering participation in TALF 2020 include the following:

- Closed-end funds and BDCs that would otherwise be barred from incurring additional debt because their asset coverage falls below the required ratio can nonetheless borrow under TALF if they maintain segregated accounts in the manner described in *Franklin Templeton*, because the loans will not be viewed as senior securities. (Open-end funds would not generally be in this position, because they must promptly rectify any failure to maintain an asset coverage ratio of at least 300%.[12])
- Similarly, closed-end funds that have outstanding senior securities representing another class of indebtedness, and therefore are prohibited from issuing a second class of senior securities, can nonetheless borrow under TALF in reliance on *Franklin Templeton*.
- Closed-end funds and BDCs that capacity to issue additional senior debt within their asset coverage ratio limits have a choice: they can treat a TALF loan as a senior security and use up a corresponding portion of their asset coverage; or they can avoid the senior security characterization by maintaining segregated accounts under the Franklin Templeton approach. Under the segregated account approach, the combination of the segregated liquid assets and the ABS collateral results in, effectively, slightly over 200% asset coverage of the loan.[13] The segregated account approach thus permits less asset coverage than would otherwise be required for RICs (300%) but more asset coverage than would otherwise be required for BDCs (150% or 200%). The issuer may switch from one approach to the other over the life of the loan.
- Mutual funds that have room to borrow might also choose not to follow *Franklin Templeton* and instead to treat TALF loans as senior securities that count against their asset coverage ratios; however, as noted, the only senior security a mutual fund is permitted to issue is a borrowing from a bank. Loans under TALF 2009 were made directly by the New York Fed – a "bank" as defined in the 1940 Act – whereas loans under TALF 2020 will be made by a special purpose vehicle that is operated and funded by the New York Fed but is not itself a 1940 Act "bank." While the difference would appear immaterial, neither the Updated Guidance nor the 2009 Letters address the issue of the bank definition.

Relief under Custody Requirements

The *Franklin Templeton* letter also provided relief to permit "the unique custody arrangements necessitated by the TALF program." Under both TALF 2020 and TALF 2009, cash and collateral are channeled through the primary dealer that serves as TALF agent for the loan. To the extent these mechanics cause the TALF agent to have intermittent custody of the borrower's assets, they may conflict with 1940 Act custody requirements where the borrower is a RIC or a BDC. The Updated Guidance confirms that RICs and BDCs may rely on the *Franklin Templeton* letter to participate in TALF 2020 notwithstanding these potential inconsistencies with the 1940 Act custody requirements.

Relief for Joint Investment through Pooled TALF Vehicles

In perhaps the most surprising element of the Updated Guidance, the staff confirms and expands on its position in the 2009 *T. Rowe Price* letter, which it had originally declared as off limits for reliance by any third parties other than the applicants.[14] The *T. Rowe Price* letter provided relief from the 1940 Act affiliate transaction restrictions for a structure in which multiple related funds and accounts invested alongside one another in a TALF borrower vehicle.

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[11] Updated Guidance, footnote 4.

[12] 1940 Act Section 18(f)(1).

[13] See footnote 4 above regarding TALF collateral haircuts.

[14] *T. Rowe Price*, footnote 1 to staff's response.

Background – 1940 Act Affiliate Restrictions

To protect RIC investors from self-dealing and other types of overreaching, Section 17 of the 1940 Act prohibits a range of transactions between RICs and their "affiliated persons." Prohibited transactions include, among others, "principal transactions," in which an affiliated person buys securities from or sells securities to a RIC, and "joint transactions" – a broad category that generally includes co-investments among RICs and their affiliated persons – and "affiliated persons" include, among others, a RIC's investment adviser, as well as other funds controlled by the investment adviser or its affiliates;.

The applicant in *T. Rowe Price* sought to form a pooled investment vehicle that would be owned by multiple RICs and accounts managed by T. Rowe Price or its affiliates and would borrow under TALF against eligible ABS collateral purchased by the vehicle or deposited by the RICs and other interest holders. The arrangement potentially involved both principal and joint transactions that would generally be prohibited under Section 17 in the absence of an SEC exemptive order. The staff granted no-action relief permitting the arrangement, subject to a number of detailed conditions, but included a footnote stating that, counter to the Division's general policy, third parties would not be permitted to rely on the no-action position even under similar facts.

In the Updated Guidance, the staff reverses its earlier "no-reliance" limitation, stating that third parties can rely on the relief provided in *T. Rowe Price* and acknowledging that TALF 2020 is sufficiently similar to TALF 2009 to permit reliance, provided other relevant facts are substantially similar.

Practical implications

Practical implications of the above for RICs and BDCs considering participation in TALF 2020 include the following:

- As noted in the May 22 Alert, use of an "aggregator" vehicle may offer advantages over direct participation in TALF or participation through a wholly owned vehicle; these may include, depending on the facts, reduced per-fund transaction costs and flexibility for funds to participate at levels below the minimum TALF loan size or to transfer interests without the need to transfer the underlying loans. The Updated Guidance gives managers of RICs flexibility to structure a RIC's participation through a shared vehicle with other RICs or accounts it managers where it determines that such a structure serves the RICs' best interests and the T. Rowe Price conditions (discussed further below) are satisfied.
- Properly structured, a pooled vehicle owned by multiple RICs and accounts can incur debt without the need for any participating RIC to treat the indirect leverage as a senior security. The *T. Rowe Price* conditions limit any single interest holder to 25% of the outstanding interests in the vehicle. A RIC ordinarily would not be required to consolidate a 25%-owned vehicle for 1940 Act purposes, and as a result would not treat the vehicle's assets and liabilities as assets or liabilities of the RIC. For BDCs, non-consolidation may help limit the impact of ABS investments that do not qualify as "eligible portfolio companies"; as discussed below, BDCs must generally limit such non-qualifying investments to 30% of total assets.
- The *T. Rowe Price* applicants agreed to a number of other conditions, including that RICs relying on the relief would have operating policies restricting purchases of additional securities to the extent the RIC's borrowings exceed 5% of its assets. In a footnote to the Updated Guidance, the staff notes that RICs and BDCs need not observe this condition in order to rely on the *T. Rowe Price* letter.
- Presumably, the other conditions stated in the applicant's request remain applicable, and these require close attention. A number of these are intended to ensure that the manager has no "element of profit motive that is different from the motive provided by its current role as investment adviser" of the participating RICs. These include a condition that the manager and its affiliates will not make any proprietary investment in the pooled vehicle, except as necessary to provide seed capital, and a representation (though not an explicit condition) that the manager and its affiliates will receive no performance or other incentive fees from any of the RICs or other accounts participating in the vehicle.
- As a practical matter, the above conditions may make it difficult for a manager's private funds to participate in the same pooled vehicle as its registered funds. Managers (or their affiliates)

commonly invest significant proprietary capital in, and receive performance-based fees from, the private funds they manage, features that may, depending on the facts, be deemed to give rise to a "profit motive different from the motive provided by" the manager's role as adviser to the participating RICs.

Special Recognition of BDCs

The staff takes pains in the Updated Guidance to make clear that, "[i]n case of doubt," the no-action positions in *Franklin Templeton* and *T. Rowe Price* apply to BDCs as well as RICs, even though BDCs were not explicitly referenced in either of the 2009 Letters. Arguably this went without saying; BDCs generally have greater flexibility than RICs to incur leverage and engage in transactions with affiliates. But the staff's focus on BDCs is understandable given that BDCs' mandate – providing capital to domestic businesses that may not have ready access to capital markets – is close to the heart of the government's recent relief efforts, and that BDCs' own recent challenges in accessing capital prompted targeted relief earlier this year in the form of an SEC temporary order.[15] It is also understandable that regulators' current efforts to support the flow of credit focus more on BDCs than they did in the prior financial crisis, before the explosion in non-bank lending and the growth of aggregate BDC assets to an estimated 600%[16] of what they were in 2009.

In one respect, BDCs are more strictly regulated than RICs; BDCs must focus their investment activities on "eligible portfolio companies" and cannot make non-qualifying investments unless investments in eligible portfolio companies make up at least 70% of total assets.[17] Eligible portfolio companies are defined to include US businesses that either do not have securities listed on a national exchange or do not have aggregate market capitalization over $250 million.[18] Eligible portfolio companies also must not be "investment companies" or companies that rely on certain exclusions from the definition of investment company in the 1940 Act. As a result of this last restriction, most issuers of ABS are not eligible portfolio companies, and eligible TALF collateral would generally need to come out of a BDC's 30% "bad bucket" – a potential deterrent to participation.

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The Updated Guidance goes a long way toward addressing the particular issues affecting regulated 1940 Act funds considering participation in TALF 2020. To the extent there continue to be issues and areas of uncertainty regarding TALF for certain categories of prospective eligible borrowers and ABS issuers, we understand that dialog with the Federal Reserve continues and that further changes or clarifications are possible, although none are promised.

For additional insights into the business and legal implications of the COVID-19 pandemic, please visit our **Knowledge Center**.

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[15] SEC Release IC-33837 (April 9, 2020), discussed in the May 22 Alert in the text accompanying footnote 31.

[16] "Why BDCs Are in Trouble Now," April 13, 2020, Bloomberg News, citing information from Advantage Data.

[17] 1940 Act Section 55.

[18] 1940 Act Section 2(a)(46).

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