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Client Alert

TALF 2020: Key Considerations for Private Funds and Registered Investment Companies

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*This week, the Federal Reserve Bank of New York (the "**NY Fed**") announced that June 17, 2020 would be the start date for loan subscriptions under the Term Asset-Backed Securities Loan Facility ("**TALF**" or "**TALF 2020**").[1] The TALF 2020 program will provide non-recourse financing to qualifying purchasers ("**eligible borrowers**") of qualifying ABS ("**eligible collateral**") backed by credit exposures to US businesses and consumers. For prior Milbank client alerts regarding TALF, see our client alerts of April 9, 2020[2] and May 12, 2020.[3]*

Investment funds – private funds and registered investment companies – were among the major users of the original TALF program ("**TALF 2009**") launched during the 2008-9 financial crisis. When TALF 2020 was first announced, however, it was unclear whether investment funds would be permitted to use it. The initial term sheet[4] omitted investment funds – which had explicitly been included as eligible borrowers under TALF 2009 – from the "eligible borrower" definition, and the revision that followed,[5] which added the requirement that an eligible borrower be a "business that … has significant operations in and a majority of its employees based in the United States," appeared to confirm that only operating companies would be permitted to access TALF. The most recent updates, however, make clear that an investment fund, "including without limitation a hedge fund, a private equity fund, and a mutual fund," as well as a single-investor fund, is eligible to borrow under TALF 2020 provided it meets the requirements of the program.[6]

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[1] The press release is available online at: https://www.newyorkfed.org/newsevents/news/markets/2020/20200520. The NY Fed concurrently published multiple documents pertaining to TALF, including the Master Loan and Security Agreement (the "**MLSA**") that will govern TALF loans; these documents are available online at: https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-documents-and-forms.

[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] See the term sheet released by the Board of Governors of the Federal Reserve System (the "Federal Reserve") on March 23, 2020 (the "**March Term Sheet**"), available online at: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b3.pdf.

[5] See the term sheet released by the Federal Reserve on April 9, 2020 (the "**April Term Sheet**"), available online at: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a1.pdf.

[6] See the answers to frequently asked questions (the "**FAQs**") initially released on May 12, 2020 and updated on May 20, 2020, available online at: https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-faq, and the term sheet released by the Federal Reserve on May 12, 2020 (the "**May Term Sheet**"), available online at: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf.

While clearly good news for US funds and managers seeking to benefit from the program, some challenges and open questions remain. This client alert notes select considerations pertaining to the use of TALF by private funds, registered investment companies and business development companies.

Considerations for Private Funds Seeking Access to TALF

In order for a fund to qualify as an eligible borrower under TALF 2020:[7]

(a) the fund itself must be created or organized in the United States;

(b) the fund's manager must also be organized in the United States; and

(c) the fund's manager must have "significant operations in and a majority of its employees based in the United States." [8]

Funds Must be Organized in the United States or Form a US Borrower Vehicle

Originally, the TALF 2020 terms required that both eligible borrowers and eligible issuers of ABS collateral be organized in the United States.[9] Following industry comment noting that US sponsors commonly use offshore vehicles to issue ABS, the Federal Reserve dropped the "US company" requirement as it applied to issuers of eligible collateral but retained the requirement for borrowers,[10] notwithstanding that many US manager-managed private funds are organized in the Cayman Islands or other non-US jurisdictions.

Such funds can still obtain indirect access to TALF by forming US-organized subsidiaries or alternative investment vehicles ("**AIVs**"). The Federal Reserve specifically authorized this approach in its guidance regarding TALF 2009, which similarly required that borrowers be US-organized.[11] Use of a US vehicle can pose tax, reporting and regulatory issues for certain types of fund investors, however, and may be restricted under fund documentation or side letters. While these issues can often be addressed through further structuring or opt-out mechanisms, some fund managers may be deterred from using the facility by the US vehicle requirement and the associated complexity and consequences.

Fund Managers Must be US-Based

A US subsidiary or AIV of an offshore fund will not be an eligible borrower unless the fund's manager (if organized and based in the United States) or a US affiliate thereof is appointed to act as investment manager of the borrower vehicle. Non-US managers that do not already have a US-organized registered investment adviser ("**RIA**") affiliate may be hard pressed to comply with this requirement before the TALF

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[7] In addition to satisfying the criteria listed in (a)-(c), a fund seeking to qualify as an eligible borrower under the TALF 2020 terms must ensure that it does not have a Material Investor that is a foreign government (see footnote 20 below for the definition of "Material Investor"). Also, a fund seeking to qualify as an eligible borrower must have a relationship with a TALF Agent (see footnote 21 below for a discussion of what constitutes a TALF Agent). See FAQs. A fund that is seeking to qualify as an eligible borrower and does not currently have an account relationship with a TALF Agent should consider taking proactive steps to begin such a relationship, as it may take a significant amount of time to satisfy the extensive on-boarding / KYC requirements of a TALF Agent. See the second paragraph under "Disclosure and Confidentiality Considerations; Monitoring Ownership" below.

[8] Per the FAQs:

> **What does "significant operations in the United States" mean?**
> While not an exhaustive definition, the following are examples of what would constitute significant operations in the United States for a borrower seeking to participate in the TALF:
> A borrower (or an investment manager in the case of investment funds) with greater than 50 percent of its consolidated assets in, annual consolidated net income generated in, annual consolidated net operating revenues generated in, or annual consolidated operating expenses (excluding interest expense and any other expenses associated with debt service) generated in the United States as reflected in its most recent audited financial statements.

[9] See March Term Sheet and April Term Sheet.

[10] See May Term Sheet.

[11] See Term Asset-Backed Securities Loan Facility: Frequently Asked Questions (July 21, 2010), available online at: https://www.newyorkfed.org/markets/talf_faq.html#BE.

window closes, given that "fast-track" registration of an affiliate as a relying adviser is available only where the filing RIA has its principal place of business in the United States.[12]

QIB Status

Eligible collateral under TALF includes both publicly offered and privately placed ABS (if otherwise qualifying), but the ABS must in any event be cleared through DTC.[13] As a practical matter, this means that eligible private ABS must generally be offered under Rule 144A under the Securities Act of 1933, the exemption from registration for certain resales of securities sold exclusively to qualified institutional investors or "QIBs."

In order to qualify as a QIB, a purchaser must generally have at least $100 million in investments in securities. The QIB standard poses a particular challenge to private funds, which, unlike registered investment companies, cannot aggregate their investments with those of other funds having the same investment adviser for purposes of meeting the $100 million threshold.[14] A private fund with less than $100 million in investments can be a QIB if all of its equity owners are QIBs.[15]

Aggregator Structures

It may also be possible to address QIB status issues by structuring the TALF borrower as an aggregator vehicle that holds at least $100 million in investments and is in turn owned by multiple feeders or funds in a family.[16] Borrowings (including under TALF) generally do not need to be deducted in determining total investments for purposes of the $100 million threshold.[17]

Federal Reserve data regarding TALF 2009 show a number of borrowers that appear to be aggregator or similar vehicles held by multiple funds having the same or affiliated advisers.[18] Use of a collective vehicle may be more cost-efficient or offer other advantages (such as flexibility to provide indirect exposures below the minimum TALF loan size) as compared to a fund subsidiary. However, any joint or aggregated investment by multiple funds or accounts of an investment manager involves potential conflicts of interest and should be approached with sensitivity to the fiduciary duty requirements of the Investment Advisers Act of 1940. Moreover, if any fund is a registered investment company ("**RIC**") or business development company ("**BDC**") regulated under the Investment Company Act of 1940 (the "**1940 Act**"), such an arrangement would generally be a "joint transaction" prohibited in the absence of SEC relief.[19]

Disclosure and Confidentiality

The TALF terms include disclosure requirements that may deter some private funds or fund investors from participating. The Federal Reserve will publish, on a monthly basis, the identity of each borrower under TALF as well as each "Material Investor" in each borrower.[20] Because a "Material Investor" includes

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[12] See General Instruction 5(ii) to Form ADV. The related exemption for special purpose vehicles also requires a US-based filing adviser; see American Bar Association, SEC No-Action Letter (Jan. 18, 2012).
[13] Per the FAQs, "[e]ligible ABS must be cleared through the Depository Trust Company."
[14] See 17 CFR § 230.144A(a)(1)(iv); SEC Div. of Corp. Fin. Compliance and Disclosure Interpretations ("C&DI"), Question 138.09 (updated Dec. 8, 2016), available online at: https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#138.09.
[15] See 17 CFR § 230.144A(a)(1)(v).
[16] The Rule 144A(a)(1) QIB definition (unlike other federal securities law definitions prescribing investor qualifications) does not explicitly require "looking through" an entity that is formed for the specific purpose of making the investment in question; however, if the entity is deemed to be purchasing "for the account of" its investors or any other persons, such persons must also be QIBs in order for the entity to qualify.
[17] C&DI, Question 138.05 (updated Dec. 8, 2016), available online at: https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#138.05. Although the value of securities purchased on margin may be included in calculating whether an entity meets the QIB threshold, securities that are borrowed or subject to repurchase may not.
[18] The data is available online at: https://www.federalreserve.gov/regreform/reform-talf.htm.
[19] See the discussion in the text accompanying footnote 32 below.
[20] Per the FAQs:

> **Will the Federal Reserve disclose information regarding the TALF?**
> The Federal Reserve will publicly disclose information on a monthly basis regarding the TALF during the operation of the facility, including information identifying each borrower and other participant in the facility,

each direct *and indirect* owner of 10% or more of any outstanding class of the fund's securities, participation in TALF will result in publication of the names of not only the fund itself and any 10% investors but also, potentially, of persons directly or indirectly controlling such investors. The Material Investor definition is generally the same as under TALF 2009, but the Federal Reserve has been more explicit in TALF 2020 regarding the extent to which disclosures will be made public.

Monitoring Ownership

A borrower must also "have a mechanism for continuously monitoring its direct and indirect investors" and must immediately notify the TALF Agent [21] of any changes in direct or indirect ownership that reach the Material Investor threshold.[22] In order for fund managers to effectively monitor indirect ownership changes, Material Investors will likely need to agree to notice and possibly consent requirements regarding changes in the Material Investors' own ownership and control. Borrowers will also be subject to extensive diligence by the TALF Agent (to the extent not already conducted, where the fund has a pre-existing account with the TALF Agent), both initially and on an ongoing basis, including diligence and KYC review of Material Investors. Fund managers should assume that diligence information may be communicated by TALF Agents to the NY Fed and potentially made public.[23]

Monitoring of ownership may pose a particular challenge for any fund with outstanding securities that trade through DTC, particularly if the fund has multiple classes of securities outstanding (and as a result has a greater likelihood that a holder will acquire 10% of a given class).

Considerations for 1940 Act Funds Seeking Access to TALF

RICs and BDCs are subject to leverage and other restrictions under the 1940 Act that may constrain their ability to use TALF.

Mutual Funds

The 1940 Act generally prohibits open-end investment companies (mutual funds) from incurring any indebtedness, other than bank borrowings, which are permitted provided the fund maintains sufficient asset coverage.[24] During the last financial crisis, however, the SEC staff issued a no-action letter, *Franklin Templeton*,[25] permitting mutual funds to borrow under TALF 2009 provided they complied with asset segregation requirements similar to those permitted under SEC guidance regarding reverse repurchase agreements and similar practices.[26] Mutual funds considering participation in TALF 2020 will need to evaluate whether they can do so in reliance on the *Franklin Templeton* no-action letter. The SEC

> information identifying each Material Investor of a borrower, the amount borrowed by each borrower, the interest rate paid by each borrower, the types and amounts of ABS collateral pledged by each borrower, and overall costs, revenues, and other fees for the facility. A Material Investor is a person who owns, directly or indirectly, 10 percent or more of any outstanding class of securities of an entity.

[21] Per the FAQs: "A TALF Agent is a financial institution that is a party to the MLSA from time to time, individually and as agent for its borrower. The TALF Agents' role in supporting the TALF is to serve as agents on behalf of their customers, the TALF borrowers." TALF Agents will initially consist of the Primary Dealers (a list of the Primary Dealers is available here) that become parties to the MLSA, but the FAQs indicate that "[t]he Federal Reserve will consider increasing the number of institutions that may be TALF Agents, subject to adequate due diligence and compliance work."

[22] See sections 10.1(e)(v) and 11.2(n) of the MLSA.

[23] Per the FAQs:

> Under the TALF program, TALF Agents are required to subject all prospective borrowers to their [anti-money laundering] and customer due diligence programs to demonstrate that they "know their customer" and to review and identify information that should be escalated to the New York Fed for further consideration, including information bearing on whether a prospective borrower satisfies eligibility criteria, as well as information about the prospective borrower of an adverse or negative nature that may bear on the appropriateness of its participation in TALF.

[24] Mutual funds that borrow from banks must generally maintain "asset coverage" (very generally, the ratio of the fund's total asset value (less liabilities other than indebtedness) to its indebtedness) of at least 300%.

[25] Franklin Templeton Investments, SEC No-Action Letter (June 19, 2009).

[26] See SEC Release IC-10666 (April 18, 1979). The *Franklin Templeton* no-action letter also permitted funds to participate in the TALF 2009 collateral custody arrangements notwithstanding certain inconsistencies with 1940 Act custody requirements.

Division of Investment Management generally permits third parties to rely on prior no-action letters provided their facts and circumstances are substantially similar to those of the applicant.[27] Although the relevant features of TALF 2020 are very similar to those of TALF 2009, the SEC's positions on investment companies' use of reverse repurchase agreements and similar practices are in transition.[28] It remains to be seen whether the SEC staff will update its guidance regarding use of TALF by 1940 Act funds.[29]

BDCs and Closed-End Funds

BDCs and closed-end investment companies have greater flexibility to incur debt but are still subject to asset coverage requirements (and, in the case of closed-end funds, are limited to one class of indebtedness).[30] Funds that have suffered asset value markdowns in the current crisis may not have much room for further borrowings without falling below required asset coverage. The approach sanctioned in the *Franklin Templeton* no-action letter, to the extent it is determined to be available, would have the advantage of permitting a fund to borrow under TALF without affecting its asset coverage ratio, provided it segregates liquid assets (other than the ABS collateral) in the amount of its obligations under the loan.

In the case of BDCs, the SEC, recognizing the challenges created by current market conditions, issued temporary relief in April in the form of an exemptive order that permits a BDC to calculate its asset coverage using December 31, 2019 valuations for certain assets then held, subject to significant conditions.[31] Given that one of the conditions is that, for 90 days after electing to rely on the order, a BDC can only invest in portfolio companies it was already invested in as of April 9, 2020 (unless at the time of the investment it satisfies asset coverage requirements calculated without the benefit of the order), the order is unlikely to be of help to BDCs that seek TALF financing to acquire new ABS.

Borrowing through a separate vehicle

A RIC or BDC may be able to avoid 1940 Act leverage concerns by accessing TALF indirectly, through an interest in a separate fund or vehicle that borrows under TALF to acquire eligible ABS, assuming the RIC or BDC is not required to consolidate the vehicle for 1940 Act purposes. As a major caveat, however, such an arrangement would generally constitute a "joint transaction," prohibited under the 1940 Act absent SEC relief, if the other investors in the vehicle include affiliates of the fund or its investment adviser. The SEC staff did grant no-action relief in 2009 permitting a family of investment companies to access TALF through a pooled vehicle in order to address minimum loan size concerns, but the staff's response included a "no-reliance" footnote barring other entities from relying on the staff's position.[32]

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The above is by no means an exhaustive list of the issues that particularly affect funds as potential borrowers under TALF. Fund sponsors and managers evaluating whether to participate will need to mobilize quickly, given the very narrow window (which closes September 30, 2020, unless extended) and the possible premium on acting early, to the extent ABS spreads may come down over time.

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[27] SEC Release IC-22587 (March 27, 1997), n. 20.
[28] Proposed Rule 18f-4 (the "derivatives rule") (SEC Release IC-33704 (Nov. 25, 2019)) would, if and when adopted and following a transition period, withdraw and replace most prior guidance regarding investment companies' use of reverse repurchase agreements, derivatives and certain other practices.
[29] The proposed rule would retain asset segregation requirements for mutual funds engaging in reverse repurchase agreements but, unlike the prior SEC guidance, would require funds to add their exposures under such agreements to any borrowings for purposes of determining asset coverage.
[30] See sections 18(a), 18(c), 18(f) and 61(a) of the 1940 Act.
[31] See SEC Release IC-33837 (April 9, 2020).
[32] T. Rowe Price Assocs., SEC No-Action Letter (Oct. 8, 2009).

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