PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

December 2005

Securities Lending by Registered Investment Companies: SEC Broadens No-Action Relief for Use of Joint Cash Collateral Accounts by Funds Which Lend Through an Affiliated Agent

Mutual funds and closed-end funds often enter into securities lending arrangements whereby a lending agent arranges to lend the funds' portfolio securities to broker-dealers or other borrowers. Loans collateralized by cash are typically invested in short-term instruments in accordance with guidelines set by the fund or its investment adviser. The net income from such investments is divided between the fund and the lending agent pursuant to an agreed allocation.

In practice, individual funds within a family of funds (or fund complex) often participate in securities lending arrangements that have been negotiated on behalf of multiple funds within the complex. In such situations, the use of a joint cash collateral account from which investments are made, as opposed to a single cash collateral account for each fund, can generate significant administrative and investment economies and cost savings and thereby enhance securities lending income return to all of the funds.

However, a mutual fund or closed-end fund that is registered with the SEC under the Investment Company Act is subject to the Act's prohibitions against certain transactions involving affiliated persons of the fund (or affiliated persons of such affiliated persons), such as other funds within the same fund complex. In particular, Section 17(d) of the Act provides that the SEC may adopt rules that limit or prevent registered funds from participating in joint transactions with such affiliated persons on a basis different from or less advantageous than that of any other participant. In turn, Rule 17d-1 thereunder provides that no such affiliated person may participate in any joint enterprise or joint arrangement, as defined in the rule, without first obtaining exemptive relief from the SEC. Absent such relief, a registered fund's participation with affiliated funds in a joint cash collateral account could be deemed to violate Rule 17d-1.

Prior to 2001, the SEC issued a number of exemptive orders allowing affiliated registered funds to use joint accounts for the investment of their cash assets, including cash collateral from securities lending activities, subject to specified conditions intended to ensure that no participating fund was disadvantaged as the result of its participation in the joint account. On July 24, 2001, the SEC Staff issued a no-action letter to The Chase Manhattan Bank with respect to the use, subject to such conditions, of a joint cash collateral account by affiliated funds for which Chase acted as custodian and lending agent (the "2001 Chase Letter").

In a footnote to the 2001 Chase Letter, the Staff indicated that affiliated persons of funds that had received exemptive orders permitting joint cash investment accounts, including cash collateral accounts, could elect to rely on the 2001 Chase Letter in lieu of their respective exemptive orders.

Additionally, the Staff indicated, affiliated persons wishing to establish such joint account arrangements in the future could rely on the 2001 Chase Letter rather than obtain their own exemptive orders. However, the footnote specifically precluded reliance on the 2001 Chase Letter with respect to the use of joint cash collateral accounts to invest cash collateral from a securities lending program for which an affiliated person of the participating funds was itself the lending agent, thus leaving intact the requirement to obtain specific exemptive relief with respect to such joint accounts.

In a letter dated December 14, 2005, and addressed to the Investment Company Institute (ICI), the SEC Staff revised its 2001 position and stated that cash collateral from a securities lending program with an affiliated lending agent may now be included in a joint cash collateral account in reliance on the 2001 Chase Letter without specific exemptive relief, provided that the arrangement otherwise fully complies with all conditions set forth in the 2001 Chase Letter. These conditions, however, may be somewhat different from those included in particular exemptive orders previously obtained by market participants. In the future, as a result of the December 2005 letter, securities lending agents wishing to lend on behalf of their affiliated funds should not need to obtain specific exemptive relief with respect to the use of joint cash collateral accounts, but will continue to need more general exemptive relief under the Investment Company Act to lend for such funds. Indeed, in its December 2005 letter, the Staff noted that it was expressing no view with respect to the general application of Rule 17d-1 to securities lending arrangements.

We would be happy to discuss with you the matters addressed in this Client Alert. If we can be of assistance, please contact the lawyers listed below.

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Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.

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