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Securities Lending Alert

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Internal Revenue Service Issues Clarifying Revenue Procedure For Treatment Of Repos By Regulated Investment Companies

The continuing uncertainties surrounding regulatory treatment of repurchase agreements (repos) was addressed most recently by the Internal Revenue Service in Revenue Procedure 2004-28 with respect to regulated investment companies (RICs). The revenue procedure adopted the approach taken three years ago by the SEC and holds that repurchase agreements of U.S. treasury obligations will qualify as Government securities for the RIC asset diversification requirements. RICs purchase securities in repo transactions to invest idle cash on a secured basis, generally for short periods of time.

Section 5(b)(1) of the Investment Company Act of 1940 (1940 Act) defines a "diversified company" as a management company that has at least 75 percent of its assets invested in cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities that, for the purpose of this calculation, are limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the management company and to not more than 10 percent of the outstanding voting securities of the issuer. The remaining 25 percent of the management company's assets may be invested in any manner.

Effective August 15, 2001, the SEC adopted Rule 5b-3, which was intended to adapt the 1940 Act to the economic realities of repos and to reflect developments in bankruptcy law protecting parties to repos. Subject to certain conditions, Rule 5b-3 permits a fund to "look through" the counterparty to the collateral in determining whether the fund is in compliance with the investment criteria for diversified funds set forth in section 5(b)(1) of the 1940 Act and with certain other securities laws. In its analysis, the SEC focused on whether the repo was fully collateralized.

Under Rule 5b-3:

"Collateralized fully" means that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the investment company reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the resale price provided for in the agreement;

(ii) The investment company has perfected its security interest in the collateral;

(iii) The collateral is maintained in an account of the investment company with its custodian or a third party that qualifies as a custodian under the 1940 Act;

(iv) The collateral consists entirely of:

(A) Cash items;

(B) Government securities;

(C) Securities that at the time the repurchase agreement is entered into are rated in the highest rating category of the requisite nationally recognized statistical rating organizations; or

(D) Unrated Securities that are of comparable quality to securities that are rated in the highest rating category by the requisite

nationally recognized statistical rating organizations, as determined by the investment company's board of directors or its delegate; and

(v) Upon an event of insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller. [This provision is expressly covered by Section 559 of the Bankruptcy Code.]

Section 851(b) of the Internal Revenue Code (the Code) provides that certain requirements must be satisfied for a domestic corporation to be taxed as a RIC under subchapter M, part I (generally income flow-through treatment). Section 851(b)(3) imposes certain asset diversification requirements with respect to a RIC's total assets that must be satisfied as of the close of each quarter of the RIC's taxable year.

Section 851(b)(3)(A) requires that at least 50 percent of the value of a corporation's total assets be represented by cash and cash items (including receivables), Government securities, securities of other RICs, and other securities generally limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the RIC and to not more than 10 percent of the outstanding voting securities of such issuer.

Section 851(b)(3)(B) provides that not more than 25 percent of the RIC's total assets may be invested in the securities (other than Government securities and the securities of other RICs) of any one issuer, or of two or more issuers that the RIC controls and that are determined, under regulations, to be engaged in the same or similar trades or businesses or related trades or businesses.

The RIC diversification rules of subchapter M of the Code are substantially similar in structure and purpose to those of section 5(b)(1) of the 1940 Act. Both sets of rules impose numerical limitations on the percentages and types of assets that may be held by an investment company. Both sets of rules are intended to protect the investor from the risks of loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers. In view of the commonality of structure and purpose of both sets of rules and given the need for RICs simultaneously to comply with both, the IRS recognized in the revenue procedure that RIC diversification provisions of the Code and those of the 1940 Act should be interpreted consistently.

Accordingly, the Service concluded that if a taxpayer has invested in a repo (cash out, Government securities in), the taxpayer may treat its position in that repo as a Government security for purposes of section 851(b)(3) of the Code, rather than a loan secured by the Government security, notwithstanding that the taxpayer is not treated as the owner of the underlying securities for federal tax purposes. The revenue procedure was made retroactive to August 15, 2001 to accord with the adoption of the SEC's Rule 5b-3.

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