The Other Bailout: How the Fed is Financing the Financiers, and Related SEC Disclosure

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Introduction

The legislative response to the ongoing economic crisis took the form of the Emergency Economic Stabilization Act of 2008 (EESA). The EESA greatly enhanced the powers of both the Federal Reserve Board and the U.S. Treasury Department to implement specific plans to stabilize the domestic economy. Funding made available to the U.S. Treasury under the EESA’s Troubled Asset Relief Program (TARP) may be used broadly to acquire illiquid assets from financial firms and to inject capital into banks. The EESA, however, is just one piece of the overall economic recovery plan. A further examination of the Fed’s powers and response to the financial crisis beginning over one year ago provides a more complete picture of the federal government’s total response to the current economic crisis.

This paper will begin with an overview of the Fed’s traditional tools for implementing monetary policy as well as the various emergency powers that may be invoked to respond to economic crises. The analysis will then examine each of the lending facilities established by the Fed to enhance liquidity in the capital markets. The paper will close with a discussion of financial reporting obligations under the securities laws relevant to financial institutions’ use of the Fed lending facilities.

Powers of the Federal Reserve

The Fed has substantial powers to affect national and global monetary policy. The Fed’s tools of monetary policy seek to achieve specific economic goals through the setting of reserve requirements and policy interest rates. The Fed also has significant powers to address economic crises. In addition, the Fed may engage in coordinated regulatory actions with other domestic and global financial regulators.

Traditional Powers Related to Monetary Policy

The Fed may use its traditional tools of monetary policy as well as its powers to engage in certain emergency actions to intervene in economic crises. In the last year, the Fed and the District Federal Reserve Banks have frequently invoked these powers to implement a monetary policy response and to establish lending facilities targeted to address specific elements of the financial industry.

—Tools of monetary policy. In general, under Section 2A of the Federal Reserve Act, the Board of Governors and the Federal Open Market Committee (FOMC) are charged with maintaining “long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” (12
USC §225a) The Fed’s overall economic mission, however, is often referred to as the “dual mandate” because the three goals are thought of as seeking long-term interest rates consistent with maximum employment and stable prices. (Roger W. Ferguson, Jr., The Evolution of Central Banking in the United States (April 27, 2005), http://www.federalreserve.gov/boarddocs/speeches/2005/20050427/default.htm)

The Board of Governors and the FOMC implement national monetary policy through the exercise the Fed’s traditional tools of monetary policy. The Board’s tools include the power to set reserve requirements. (12 USC §461) The Board also must review and determine the discount rate set by the Federal Reserve banks. (12 USC §357) The Board, as part of the FOMC, also provides guidance to the Federal Reserve Bank of New York to conduct open market operations to achieve the desired target federal funds rate, which is the rate banks charge to each other to borrow funds. (12 USC §263(b))

—Payment of interest on reserves. The Board recently announced that it will pay interest on required reserves and excess reserves in the expectation that doing so will eliminate the “tax” on required reserves and establish a floor to the federal funds rate. EESA Section 128 accelerated the effective date of the Fed’s authority to pay interest on reserves to October 1, 2008. (Interest on Required Reserve Balances and Excess Balances, http://www.federalreserve.gov/monetarypolicy/reqresbalances.htm; Interest on Required Reserve Balances and Excess Balances FAQs, http://reportingandreserves.org/IOR_FAQ.pdf; See 12 USC §461 and 12 CFR §204.1, et seq.). The Fed has announced several adjustments to the method for calculating the interest rate on reserves. (Federal Reserve Board Press Release (October 22, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081022a.htm; Federal Reserve Board Press Release (November 5, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081105a.htm)

Emergency Powers

The Fed and the Federal Reserve Banks have substantial emergency powers under several sections of the Federal Reserve Act. The Fed has invoked several of these provisions in establishing various lending facilities to provide liquidity to capital markets during the current financial crisis. Following is a summary of the Fed’s emergency powers related to the new lending facilities.

—Discounting. Section 13(3) of the Federal Reserve Act authorizes the Board of Governors and the Federal Reserve Banks to engage in secured discounting with any individual or business entity. The Board, upon finding that “unusual and exigent circumstances” exist, and upon the affirmative vote of at least five members of the Board, may authorize any Federal Reserve Bank to discount notes, drafts, and bills of exchange for any individual, partnership, or corporation at rates consistent with the Federal Reserve Act. Under Section 13(3), the Federal Reserve Bank must find the following:
the notes, drafts, and bills of exchange are “indorsed or otherwise secured to the satisfaction of the Federal Reserve bank”

evidence that the individual, partnership, or corporation is “unable to secure adequate credit accommodations from other banking institutions.”

The Board of Governors may impose additional limits, restrictions, or regulations regarding discounting activities. (12 USC §343, §357)

—Advances. Federal Reserve Act Section 10B authorizes the Federal Reserve Banks to make advances to individual member banks on a member bank’s time notes or demand notes with maturities of up to four months. A member bank must pledge collateral that is secured to the satisfaction of the Federal Reserve Bank. A Federal Reserve Bank also may make advances to a member bank on time notes secured by mortgage loans covering one-to-four family residences. Advances secured by mortgage loans must satisfy any regulations, including maximum maturities, set forth by the Board of Governors. Advances made pursuant to Section 10B must have an interest rate fixed at the lowest discount rate available at the Federal Reserve Bank. (12 USC §347b(a))

Under Section 10A of the Federal Reserve Act, Federal Reserve Banks can make emergency advances to groups consisting of at least five member banks. The member banks must be located within the Federal Reserve Bank’s district and a majority of the banks must be independently owned and controlled. Emergency advances may be made on member banks’ time or demand promissory notes, provided that the member banks are unable to provide “adequate amounts of acceptable assets” that would allow them to obtain credit from the Federal Reserve Bank in the form of rediscounts or advances, other than from advances under Section 10B. The Board of Governors must approve those arrangements by the consent of at least five of its members. (12 USC §347a)

Coordinated Domestic and Global Response

The Fed has from time to time engaged in coordinated monetary policy actions with domestic implications and global reach. In terms of national monetary policy, the Fed has entered into memorandums of understanding with other federal regulators, including the U.S. Treasury, the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC). The MOUs generally require these agencies to share economic information and to coordinate regulatory actions. (See Federal Reserve Board Press Release (October 14, 2008),
The Fed also has engaged in coordinated policy actions with its global counterparts. For one, the Fed recently reduced the target federal funds rate 50 basis points in coordination with policy interest rate reductions by the Bank of Canada, the Bank of England, the European Central Bank, the Sveriges Riksbank (Central Bank of Sweden), and the Swiss National Bank. The Bank of Japan announced its support for the coordinated action. (See Federal Reserve Board Press Release (October 8, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081008a.htm) Similarly, the Fed has coordinated with other central banks to support reciprocal currency arrangements (swap lines) by providing any amount of U.S. dollar funding demanded under the arrangements. (See Federal Reserve Board Press Release (October 13, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081013a.htm)

In addition, EESA Section 112 directs the Secretary of the Treasury to coordinate economic response efforts with foreign financial authorities and central banks. The U.S. Treasury also may purchase troubled assets from foreign financial authorities or banks. Numerous other provisions in the EESA also require the Secretary of the Treasury and other financial regulators to consult with the Fed.

**Emergency Lending Facilities**

The Fed has frequently invoked Sections 13(3) and 10B of the Federal Reserve Act in implementing the various emergency lending facilities. Below is a description of the Fed’s lending facilities, including the following: (i) Term Auction Facility, (ii) Primary Dealer Credit Facility, (iii) Term Securities Lending Facility, (iv) Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, (v) Commercial Paper Funding Facility, and (vi) Money Market Investor Funding Facility.

Due to the evolving nature of the Fed’s response, it is recommended that the reader periodically check the Fed’s website for new lending facilities and for revisions to the terms and conditions of existing lending facilities.

**Term Auction Facility**

The Fed established the Term Auction Facility (TAF) on December 12, 2007 for the purpose of providing liquidity to depository institutions through auctions for advances. In creating the TAF, the Fed exercised its powers under Federal Reserve Act Section 10B to make advances to individual member banks and to amend Regulation A to provide for the TAF. (12 USC §347b(a); 12 C.F.R. § 201.4(e) and §201.51(e)) The Fed has from time to time increased the amounts of term funds available in an auction from $20 billion to up to $150 billion per auction, such that total TAF funding outstanding at year end 2008 could approach $900 billion. (Federal Reserve Board Press Release (October 6, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081006a.htm) The TAF may be continued on a temporary basis for so long as the Fed determines it is necessary to provide liquidity to capital markets. The Fed has indicated that it would seek public

**Definition**

Amended Regulation A defines the term “Term Auction Facility” to mean “an advance to a depository institution pursuant to an auction conducted under this paragraph and at a rate specified in Section 201.51(e) if, in the judgment of the Reserve Bank, the depository institution is in generally sound financial condition and is expected to remain in that condition during the term of the advance.” The Fed may impose additional requirements, including conditions regarding the participants, size and duration of the facility, minimum bid amount, maximum bid amount, term of advance, minimum bid rate, use of proceeds, and schedule of auction dates. The Fed may appoint any number of Reserve Banks or others to conduct TAF auctions. The TAF will expire on a date to be determined by the Board. (12 CFR 201.4(e))

**Applicable Law—Liability of Local Reserve Bank and Auction Agent**

The terms of the TAF are to be construed under the laws of the state in which the local Reserve Bank is located and without regard for the state’s conflict of laws provisions. The local Reserve Bank and the auction agent generally are not liable for technical and other failures and cannot be held liable for lost profit, consequential, incidental, exemplary, special, or punitive damages. The auction agent and local Reserve Bank, however, may be liable for delays, errors, and omissions that amount to gross negligence. Similarly, the auction agent works for the local Reserve Bank and is liable to the local Reserve Bank only for direct damages from delays, errors, or omissions that amount to gross negligence.

The terms and conditions of the TAF govern in the event of a conflict between Operating Circular 10 (OC-10) and the TAF terms.

**Notice of Auction**

Under the TAF terms, the Fed will provide notice of an auction on or before the auction announcement date. The notice issued by the Fed must state the following: (i) the offering amount, (ii) minimum bid amount, (iii) maximum bid amount, (iv) minimum bid rate, (v) bid increment, (vi) opening time, (vii) closing time, (viii) bid submission date, (ix) notification date, (x) settlement date, (xi) stated maturity date, (xii) the rounding convention (if applicable), and (xiii) any additional terms. An authorized submitter may submit a bid in response to the notice.
**Authorized Submitters—Bid Submission**

An “authorized submitter” is one or more individuals at a participant who are authorized to make a borrowing request under OC-10 with the participant’s local Reserve Bank. A “participant” is a depository institution or a U.S. branch or U.S. agency of a foreign bank that has executed a letter of agreement under OC-10 with its local Reserve Bank, is eligible for primary credit, and has pledged assets to its local Reserve Bank to secure the indebtedness. A participant who makes a winning bid and is awarded an advance under the TAF is a “borrower” for purposes of OC-10.

An authorized submitter must submit bids via the telephone hotline for requesting advances from the local Reserve Bank’s discount window. A participant must provide the following information in its bid: (i) the participant’s name and ABA number, (ii) the authorized submitter’s name and contact number, (iii) the requested amount of each bid, and (iv) the interest rate stated as an annual rate to three decimal points for each bid. A participant must separately identify multiple bids and more than one bid can be submitted during the same telephone call. A participant also may place a maximum of two bids, but the aggregate amount of the bids must not exceed the maximum bid amount, and no participant may submit a bid that would cause it to violate the collateralization rules.

In the case of foreign banks with U.S. branches or agencies, each branch or agency may submit two bids, subject to the collateralization rules. A foreign bank may not submit more than two interest rates. The aggregate amount of all bids submitted by a foreign bank’s branches and agencies must be equal to or less than the maximum bid amount.

A bid is deemed to be submitted when it has satisfied both the TAF announcement terms and the TAF Terms and Conditions. A bid that has been submitted cannot be cancelled.

**Eligible Collateral—Loan Terms**

In general, a depository institution that is eligible to bid for TAF advances may pledge any collateral that may be pledged to secure loans from the Fed’s discount window. Additional rules apply regarding collateralization, stated maturity, interest rate, and repayment.

—**Collateralization rule.** The TAF’s collateralization rule provides that the aggregate sum of all advances outstanding with a term to maturity of more than 28 days must not exceed 75 percent of the collateral value of the collateral available to secure the advances. A participant may have to pledge additional collateral if the collateralization requirement has not been met. A participant cannot request an advance for more than 28 days if the advance would result in the participant violating the collateralization rule. However, the collateralization rule does not apply to advances made prior to July 30, 2008, seasonal credit, advances with remaining term to maturity of 28 days or less, or to

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advances with a remaining term to maturity of 29 days where the 28th day is not a business day.

Loans with a remaining term to maturity of 28 or fewer days must be collateralized to the satisfaction of the local Reserve Bank. Pursuant to OC-10, a local Reserve Bank also may seek additional collateral from a participant to secure any outstanding advances.

—**Maturity.** Advances made under the TAF are for advances with stated maturities of either 28 days or 84 days. Stated maturities can be adjusted to account for holidays.

—**Interest rate.** Regulation A provides that the interest rate on TAF advances must be set at the rate at which all bids at an auction may be fulfilled, subject to the maximum amount offered, the minimum bid rate, and any other limits imposed by the Fed. (12 CFR 201.51(e)) Pursuant to the Terms and Conditions of the TAF, the interest rate (stop-out-rate) for TAF advances in a particular auction must be set at the lowest accepted interest rate. Winning bidders must pay the stop-out rate, even if they bid a different interest rate.

—**Prepayment—Acceleration of repayment.** Borrowers under the TAF cannot repay advances before the stated maturity date. The local Reserve Bank has discretion to accelerate a participant’s repayment of an advance if the participant becomes ineligible for primary credit while an advance is outstanding under the TAF.

**Review by Auction Agent—Awards**

The auction agent or the Fed’s staff must review all bids and accept bids subject to the requirement that the aggregate amount of all accepted bids must not exceed the lesser of the offering amount and the aggregate amount of all bids accepted at or above the minimum bid rate. TAF auctions are single price auctions and all accepted bids will be awarded advances at the same interest rate.

—**Determination of awards.** Advances are awarded to bids beginning with the highest rate bid and continuing down to the lowest rate bid until the first of the following occurs: (i) the offering amount has been allocated or (ii) the minimum bid rate has been reached. The lowest accepted interest rate is the stop-out rate and is the rate at which all advances will be made. The amounts of advances awarded are rounded as specified in the announcement of a particular TAF auction.

Bids at the stop-out rate may be prorated. The amount of prorated advances to be awarded is determined as follows:

1. Offering Amount – Amount of Bids Above Stop-out Rate = Remaining Offering Amount
2. Remaining Offering Amt / Aggregate Amt of Bids at Stop-out Rate =
   Proration Percentage

3. Each Bid at Stop-out Rate x Proration Percentage = Amount Awarded

The prorated amount awarded will be rounded up or down according to the rounding
convention specified in the auction announcement. Proration can result in a total amount
awarded at an auction that is different from the offering amount stated in the auction
announcement.

—Settlement. Advances are credited to a participant’s account at the local Reserve Bank
on the settlement date. A local Reserve Bank may decline to post an award to a winning
bidder’s account if the bidder has not provided sufficient collateral. A winning bidder,
however, may not reject an award since the act of bidding is deemed to be a commitment
to accept any funds awarded under the TAF.

—Results. Results of TAF auctions are transmitted by the auction agent to the local
Reserve Bank. The local Reserve Bank then notifies the winning bidders. The auction
agent and the local Reserve Bank generally are not required to review or correct any
errors unless a participant notifies the local Reserve Bank of an error within the time
specified in the award announcement. The Fed will publish a summary of the results of
each TAF auction on its website.

Call Reports

Depository institutions report advances under the TAF on their call reports with other
liabilities they have outstanding from Federal Reserve Banks. The TAF FAQ document
states, as an example, that TAF advances would be reported on FFIEC 031 (September
2007) in Schedule RC, item 16 as “Other borrowed money” and in Schedule RC-M, item
5.b as “Other borrowings.”

Primary Dealer Credit Facility

The Fed, in conjunction with the Federal Reserve Bank of New York, established the
Primary Dealer Credit Facility (PDCF) under Section 13(3) of the Federal Reserve Act.
The PDCF is an overnight lending facility that provides funding to primary dealers in
exchange for eligible collateral. The PDCF facility is set to continue until January 30,
2009. (Primary Dealer Credit Facility: Program Terms and Conditions (effective
September 15, 2008), http://www.newyorkfed.org/markets/pDCF_terms.html; Primary
Dealer Credit Facility: Frequently Asked Questions (effective September 15, 2008),
http://www.newyorkfed.org/markets/pDCF_faq.html)
**Mechanics of PDCF**

Primary dealers may initiate loans by making a request to their clearing bank. All loans are for one day only and a primary dealer may borrow an amount up to the margin-adjusted collateral delivered by the primary dealer to the Federal Reserve’s account at the clearing bank. PDCF loans may be secured by any collateral eligible to be pledged in tri-party funding arrangements through major clearing banks as of September 12, 2008. The clearing banks are responsible for the valuation of eligible collateral. PDCF loans are made subject to a rate equal to the primary credit rate offered to depository institutions through the discount window at the Federal Reserve Bank of New York. Borrowers may be assessed a fee based on how frequently they access the PDCF within a specified period. PDCF loans are made subject to recourse beyond the eligible collateral and against the primary dealer.

**Primary Dealers**

Primary dealers are banks and securities broker-dealers who have been designated by the Federal Reserve Bank of New York as such for purposes of trading in U.S. government securities with the Federal Reserve Bank of New York Open Market Desk. The Open Market Desk is responsible for effecting U.S. monetary policy through its trading authority as directed by the Fed. Although the Fed does not have authority to regulate primary dealers, the Federal Reserve Bank of New York, the Board of Governors, the Securities and Exchange Commission, the U.S. Treasury Department, and the Commodities Futures Trading Commission coordinate to monitor market conditions with respect to primary dealers. (Federal Reserve Bank of New York, Primary Dealers, [http://newyorkfed.org/aboutthefed/fedpoint/fed02.html](http://newyorkfed.org/aboutthefed/fedpoint/fed02.html))

The Federal Reserve Bank of New York maintains and periodically updates a list of current primary dealers. (Federal Reserve Bank of New York, Primary Dealers List, [http://newyorkfed.org/markets/pridealers_current.html](http://newyorkfed.org/markets/pridealers_current.html)) The most recent update on the Federal Reserve Bank of New York’s website was dated October 1, 2008 and listed the following firms as primary dealers:

- BNP Paribas Securities Corp.
- Banc of America Securities LLC
- Barclays Capital Inc.
- Cantor Fitzgerald & Co.
- Citigroup Global Markets Inc.
- Credit Suisse Securities (USA) LLC
- Daiwa Securities America Inc.
- Deutsche Bank Securities Inc.
- Dresdner Kleinwort Securities LLC
- Goldman, Sachs & Co.
- Greenwich Capital Markets, Inc.
Term Securities Lending Facility

The Term Securities Lending Facility (TSLF) is a lending facility through which primary dealers may borrow treasury securities from the System Open Market Account (SOMA) at the Federal Reserve Bank of New York. (Term Securities Lending Facility: Program Terms and Conditions (effective September 15, 2008), http://www.newyorkfed.org/markets/tslf_terms.html; Term Securities Lending Facility: Frequently Asked Questions (effective September 15, 2008), http://www.newyorkfed.org/markets/tslf_faq.html)

Notice of Auction

The Federal Reserve Bank of New York will hold single price auctions for general treasury collateral, including Treasury bills, notes, bonds, and inflation-indexed securities. Auctions will be held after one day’s advance notice, which must state (i) the offering amount (par value of treasuries offered), (ii) schedule of eligible collateral, (iii) the minimum bid rate, (iv) auction start and close times, (v) settlement date, and (vi) loan maturity date. Auctions generally will be held at 2 P.M. Eastern time on each Wednesday (Schedule 2 collateral) and on every other Thursday (Schedule 1 collateral). Auction dates and times are subject to change.

Submission of Bids

A primary dealer may submit no more than two propositions per auction and each bid must be for 20 percent or less of the offering amount. The minimum bid amount is $10 million dollars and bids may be incremented in $10 million dollars up to the maximum bid amount allowed per primary dealer. Bids also must state a bid rate in 1/100th basis points, subject to a minimum bid rate of 10 basis points (Schedule 1 collateral) and a maximum bid rate of 25 basis points (Schedule 2 collateral). TSLF auctions are single price auctions and all winning bids will be awarded at the lowest accepted fee rate (stop-out rate). The Federal Reserve Bank of New York must determine the total lending fee to be charged to a primary dealer’s clearing bank accounts on the loan maturity date. In general, the lending fee is calculated as follows:

Lending Fee = Total Quoted Price (“clean price”) x Stop-Out Fee Rate x Loan Term (days)/360
The Federal Reserve Bank of New York must determine any margin requirements and has the right to reject any bids that do not meet the specifications for an auction.

**Eligible Collateral**

Eligible collateral for TSLF securities is divided into two schedules. Schedule 1 collateral includes all collateral eligible for tri-party repurchase agreements arranged by the Federal Reserve Bank of New York Open Market Trading Desk. Schedule 2 collateral includes (i) all Schedule 1 collateral and (ii) investment grade securities comprised of corporate securities, municipal securities, mortgage-backed securities, and asset-backed securities. Both the Federal Reserve Bank of New York and primary dealers may substitute collateral. However, the Federal Reserve Bank of New York must require substitution of collateral in a case where collateral offered by a primary dealer has become ineligible.

**Auction Results**

The Federal Reserve Bank of New York must review all bids and announce the results of the auction. Bids accepted by the Federal Reserve Bank of New York will be awarded at the stop-out rate. The aggregate amount of accepted bids in an auction must not exceed the lesser of the offering amount and the aggregate amount of all bids submitted at or above the minimum bid rate. Auction awards are rounded to the nearest $1 Million dollars and bids made at the stop-out rate may be prorated. The results of an auction must be communicated in a timely manner to the primary dealers who submitted bids. Auction results and other auction data are available on the Federal Reserve Bank of New York’s website.

**Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility**

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) was established under Section 13(3) of the Federal Reserve Act to provide liquidity to the asset-backed commercial paper (ABCP) market and to encourage ABCP market participants to purchase ABCP from money market mutual funds to ease strains on these funds due to redemptions. The Federal Reserve Bank of Boston will administer the AMLF. The AMLF is scheduled to expire on January 30, 2009, but may be extended by the Federal Reserve Board. (Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility Terms and Conditions, [http://www.frbdiscountwindow.org/mmmftc.cfm?hdrID=14&dtlID; Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility (AMLF or “the Facility”) (October 23, 2008), [http://www.frbdiscountwindow.org/mmmf.cfm?hdrID=14] )
Eligible Borrowers

Eligible borrowers obtain advances from the AMLF by filing the ABCP Liquidity Facility Document Package with their local Reserve Bank. A prospective borrower who does not have a current OC-10 resolution on file with their local Reserve Bank must file a resolution and letter of agreement before seeking advances. A borrower also must submit a completed Excel spreadsheet titled “ABCP MMMF Liquidity Facility Request Form.” Eligible borrowers include all U.S. depository institutions, bank holding companies (including parent companies and U.S. broker-dealer affiliates), and U.S. branches and agencies of foreign banks. A money market mutual fund is eligible for participation in the facility if it satisfies the definition of money market fund contained in SEC Rule 2a-7. (17 CFR §270.2a-7) The Federal Reserve Bank of Boston has discretion to accept or reject borrowers.

Eligible Collateral

In order to be pledged for advances under the AMLF, the collateral must have been: (i) purchased by the borrower from a money market mutual fund no earlier than September 19, 2008, (ii) purchased by the borrower at the money market mutual fund’s cost, subject to amortization of premium or accretion of discount on the ABCP up to the purchase date, (iii) satisfy the minimum credit rating specified in the terms and conditions at the time the collateral is pledged to the Federal Reserve Bank of Boston, (iv) issued by an entity organized under U.S. law or by a political subdivision that existed no later than September 18, 2008, and (v) issued with a maturity that does not exceed 120 days (borrower is a bank) or 270 days (non-bank borrower). Eligible collateral will be valued at its amortized cost under the terms of the borrower’s letter of agreement and the amount will not be margin adjusted. Eligible collateral must be deposited at the Federal Reserve Bank of Boston’s restricted account at the Depository Trust Company before an advance will be approved.

Loan Terms

The principal amount of an advance under the AMLF must equal the amortized cost of the ABCP pledged as security. Similarly, the maturity of an advance will be the maturity date of the ABCP pledged as collateral. Advances are made without recourse, subject to the terms of the borrower’s letter of agreement on file at the local Reserve Bank. The rate charged on advances is the primary credit rate in effect at the Federal Reserve Bank of Boston at the time of the advance. No special fees are imposed on advances made under the AMLF. A borrower also may not prepay a loan under the AMLF, but prepayment may be allowed for a borrower who enters into receivership or files for bankruptcy.
Bank Reports

The guidance included in the FAQ document states that a bank holding company should report any ACBP acquired under the AMLF on its balance sheet as an investment security and report the transaction on its Y-9 reports. State member banks are directed to follow the FAQ guidance for treating acquired ABCP for purposes of calculating leverage capital. U.S. branches and agencies of foreign banks must report use of the AMLF on FFIEC 002.

SEC No-Action Letter

The Investment Company Institute (ICI), on behalf of its money market fund members, sought no-action relief from the SEC staff regarding transactions in asset-backed commercial paper between money market funds and banks participating in the AMLF. Absent no-action relief, these transactions may violate the provisions applicable to affiliated persons as defined in the Investment Company Act. Based on the facts and other representations made by the ICI, the staff indicated that it would not recommend enforcement under Section 17(a)(2) of the Investment Company Act against a bank that purchases ABCP from a fund that is an affiliated person of the bank in transactions made under the AMLF. (Investment Company Institute (September 25, 2008)) The ICI no-action letter is discussed in more detail below in the section discussing SEC financial reporting obligations.

Commercial Paper Funding Facility

The Commercial Paper Funding Facility (CPFF) is a credit facility established under Section 13(3) of the Federal Reserve Act to purchase unsecured and asset-backed commercial paper (ABCP) from eligible issuers of commercial paper for purposes of providing a liquidity backstop to the commercial paper market. The CPFF will begin operations on October 27, 2008 and the facility will expire on April 30, 2009, subject to being extended by the Fed. However, the Federal Reserve Bank of New York will fund the CPFF after the expiration date until the CPFF’s underlying assets have matured. (Commercial Paper Funding Facility: Program Terms and Conditions (effective October 14, 2008), http://www.newyorkfed.org/markets/cpff_terms_conditions.html; Commercial Paper Funding Facility: Frequently Asked Questions (effective November 5, 2008), http://www.newyorkfed.org/markets/cpff_faq.html)

Special Purpose Vehicle

The CPFF consists of a special purpose vehicle (SPV) that will operate as a credit facility and be financed by recourse loans at the target federal funds rate made by the Federal Reserve Bank of New York to the SPV. Loans by the Federal Reserve Bank of New York to the SPV are made with recourse to the SPV and will be secured by the assets held by
the SPV. The U.S. Treasury Department also will make a special deposit at the Federal Reserve Bank of New York in support of the CPFF. The SPV will then use its funds to acquire U.S. dollar-denominated commercial paper with three-month maturities from eligible issuers through the Federal Reserve Bank of New York’s designated primary dealers. The SPV will use the proceeds from matured commercial paper to repay loans from the Federal Reserve Bank of New York.

**Eligible Issuers**

Eligible issuers include U.S. issuers of commercial paper and U.S. issuers of commercial paper who have a foreign parent company. A parent company and subsidiary that separately issue commercial paper are considered to be separate issuers under the CPFF. An eligible issuer must submit the Registration Form and Qualification Certification documents to Pacific Investment Management Company LLC (PIMCO), the private sector manager of the CPFF. The registration forms and the applicable fee are to be submitted to PIMCO on the same business day, but not later than 5 P.M. (ET) on the second business day prior to the eligible issuer using the CPFF. ([http://www.newyorkfed.org/markets/CPFF_Reg_and_Certification.pdf](http://www.newyorkfed.org/markets/CPFF_Reg_and_Certification.pdf))

**Eligible Commercial Paper**

To be eligible for sale to the CPFF, an issuer’s commercial paper must be U.S. dollar denominated, have a stated maturity of three months, and satisfy the minimum credit rating standards set forth in the terms and conditions of the CPFF. The CPFF may acquire from a single issuer an amount no greater than the greatest amount of commercial paper the issuer had outstanding on any day between January 1, 2008 and August 31, 2008. The CPFF is prohibited from acquiring more commercial paper from an issuer whose commercial paper exceeds the SPV’s single issuer limit.

**Loan Terms**

Upon registering to use the CPFF, an eligible issuer must pay a facility fee of 10 basis points of the maximum amount of its commercial paper that may be owned by the CPFF. Pricing generally is based on the 3-month overnight index swap (OIS) rate and a fixed spread. The lending rate for unsecured commercial paper is the 3-month OIS plus 100 basis points, subject to an unsecured credit surcharge of 100 basis points per annum. The unsecured credit surcharge may be avoided if the issuer enters into a collateral arrangement or obtains an indorsement or guarantee that is acceptable to the Federal Reserve Bank of New York. Participation by an eligible issuer in the Federal Deposit Insurance Corporation (FDIC) Temporary Liquidity Guarantee Program is sufficient guarantee of its commercial paper to avoid the unsecured credit surcharge. An issuer who participates in the CPFF during its first 30 days of operation and who also participates in the FDIC’s guarantee program must still pay the unsecured credit surcharge, but the issuer will be reimbursed the amount of the surcharge if they have not opted out of the
FDIC program after the CPFF’s first 30 days of operation. The lending rate for ABCP is the 3-month OIS plus 300 basis points. There is no surcharge for ABCP.

**Money Market Investor Funding Facility**

The Fed has established the Money Market Investor Funding Facility (MMIFF) pursuant to its authority under Section 13(3) of the Federal Reserve Act to aid money market mutual funds in the face of redemptions and scarcity of buyers of money market instruments. The MMIFF is intended to complement the Fed’s previous efforts to support money market mutual funds and the commercial paper market through several lending facilities. The MMIFF is set to begin operations on November 24, 2008 and will expire April 30, 2009, but the Fed has discretion to extend the facility. (Money Market Investor Funding Facility: Program Terms and Conditions (effective November 10, 2008), http://www.newyorkfed.org/markets/mmiff_terms.html; Money Market Investor Funding Facility: Questions and Answers (effective November 10, 2008), http://www.newyorkfed.org/markets/mmiff_faq.html)

**MMIFF Structure—Private Sector Special Purpose Vehicles**

The terms of the MMIFF require each private sector special purpose vehicle (PSPV) to finance the purchase of eligible assets by borrowing funds under the MMIFF and by selling ABCP equal to 10 percent of an eligible asset’s price to the seller of an eligible asset. The ABCP has the same maturity as the eligible asset and must satisfy the minimum credit rating standards of the MMIFF. The Federal Reserve Bank of New York provides financing to a PSPV by lending an amount equal to 90 percent of the purchase price of an eligible asset to the PSPV on an overnight basis, subject to the primary credit rate, until the asset’s maturity date. Loans from the Federal Reserve Bank of New York are senior to any issued ABCP, have recourse to individual PSPVs, and are secured by all the assets of a PSPV. The PSPVs will use the proceeds from matured assets to repay loans from the Federal Reserve Bank of New York and the ABCP.

**Private Sector Manager—SEC No-Action Letter**

J.P. Morgan Securities, Inc. (JPMS) has been selected by the Fed to be the private sector manager of the PSPVs under the MMIFF. Eligible investors may contact JPMS to obtain the required documentation, including lists of eligible assets, operating procedures, Fund Representation Letter, and Asset Allocation Spreadsheet. Eligible investors also must submit IRS Form W-9.

The SEC staff granted no-action relief to JPMS to facilitate the company’s role in the management of the PSPVs under the MMIFF. (J.P. Morgan Securities, Inc. (October 22, 2008)) The no-action relief granted by the SEC staff includes the following:
commercial paper notes issued by PSPVs may be considered asset-backed securities under Rule 2a-7. (17 CFR §270.2a-7(a)(3))

an alternative method may be employed to comply with the portfolio diversification requirements of Rule 2a-7. (17 CFR §270.2a-7(c)(4)(i)(A))

certain transactions involving securities-related issuers are allowed with respect to the MMIFF. (15 USC §80a-12(d)(3))

enforcement was not recommended regarding the participation of certain affiliated money market funds in the MMIFF. (15 USC §80a-10(f))

transactions involving second-tier affiliates may be conducted under the MMIFF. (15 USC §80a-17(a)(2), (d), and (e); 17 CFR §270.17d-1)

A detailed discussion of the Investment Company Act provisions for money market funds and the JPMS no-action letter is contained in the section below regarding financial reporting obligations under the federal securities laws.

**Eligible Investors and Assets**

Eligible investors are U.S. money market mutual funds, but the Fed may define additional eligible investors. Eligible assets for purchase by a PSPV include U.S. dollar-denominated certificates of deposit, bank notes, and commercial paper with remaining maturities of at least seven days and no more than 90 days. There will initially be five PSPVs, which will acquire only debt instruments from ten designated financial institutions, subject to the stated minimum short-term debt rating standard. As a result, 50 financial institutions will participate in the MMIFF. A financial institution’s debt instruments must not exceed the concentration limit of 15 percent of a PSPV’s assets. During the initial ramp-up period, the concentration limit will be temporarily raised to 20 percent. An eligible investor also must satisfy the requirements for money market funds set forth in Investment Company Act Rule 2a-7. (17 CFR §270.2a-7)

In the event that a financial institution’s eligible assets held by a PSPV are downgraded, the PSPV may not buy additional eligible assets until all of the assets issued by the particular financial institution have matured. If any asset held by a PSPV defaults, the PSPV must stop asset purchases and repayments on outstanding ABCP. The proceeds from matured assets held by the PSPV will then be used to repay the Federal Reserve Bank of New York. Any remaining assets will be used to repay the principal and interest on the ABCP. Excess spread must be treated according to the winding down procedures.

**Winding Down of MMIFF**

The MMIFF is scheduled to wind-down on April 30, 2009, but the Fed may extend the duration of the facility. Upon winding down, the proceeds from matured assets held by a
PSPV on any given day must first be used to repay loans from the Federal Reserve Bank of New York and then to repay any ABCP that matures on that day. Excess spread is first allocated proportionately to the ABCP investors and then the remaining excess spread must be paid to the Federal Reserve Bank of New York.

SEC Regulations: Financial Reporting Obligations

The use by financial institutions of the Fed’s lending facilities gives rise to a number of considerations that impact these firms’ financial disclosures under the securities laws. Under the federal securities laws and regulations, reporting obligations may involve periodic reports, management discussion and analysis (MD&A), risk factors, accounting rules, asset-backed securities, and Investment Company Act rules regarding money market funds.

Form 8-K

Public companies that issue securities under either the Securities Act or the Exchange Act must file periodic reports of significant changes in their business operations and financial condition with the SEC on Form 8-K (17 CFR §240.13a-11 and §240.15d-11; 17 CFR §249.308) An issuer must file or furnish Form 8-K within four business days after a reportable event has occurred. Events that may be reportable on Form 8-K by companies taking advantage of the Fed’s lending facilities include, but are not limited to, the following:

- Items 1.01 and 1.02—Entry into or termination of a material definitive agreement.
- Item 1.03—Bankruptcy or receivership.
- Item 2.06—Material impairments.
- Items 6.01 through 6.05—Asset-backed securities.
- Item 7.01—Disclosure pursuant to Regulation FD.
- Item 8.01—Reportable events not specifically required by Form 8-K.

Instruction G to Form 8-K provides that an issuer of asset-backed securities need not report material impairments related to those securities on its Form 8-K, but an issuer should consider if it must report other material impairments on Form 8-K. Special rules applicable to these issuers are discussed below in the context of asset-backed securities and the requirements of Regulation AB.

In addition, Regulation FD sets forth the disclosure obligations of companies that engage in selective disclosure of material nonpublic information. (17 CFR §243.100 et seq.) A financial institution that is subject to Regulation FD may need to report these activities in
Item 7.01 of Form 8-K. At least one financial institution reported its eligibility to use the Term Auction Facility in this manner.

**Management Discussion & Analysis (MD&A)**

Item 303(a) of Regulation S-K requires that a registrant discuss its financial condition, changes in financial condition, and the results of operations. In addition to the specified items to be discussed, Regulation S-K instructs registrants to discuss other information believed to be necessary to an understanding of its financial condition. (17 C.F.R §229.303(a))

—**Liquidity and capital resources.** Pursuant to Item 303(a) of Regulation S-K, the discussion of liquidity and capital resources may be combined if the topics are interrelated. In the case of liquidity, a registrant must discuss any known trends, demands, commitments, events, or uncertainties that will or are reasonably likely to cause the registrant’s liquidity to materially increase or decrease. If the registrant will suffer a material deficiency in its liquidity, it must discuss any actions taken or proposed actions to be taken to correct the deficiency. The registrant also must provide a separate discussion of any internal and external sources of liquidity, including any material unused sources of liquid assets. (17 C.F.R §229.303(a)(1)) For purposes of the MD&A, the term “liquidity” means “the ability of an enterprise to generate adequate amounts of cash to meet the enterprise’s needs for cash.” Liquidity should be discussed on a long-term and short-term basis. The discussion should focus on the issuer’s specific liquidity concerns. The example set forth in Regulation S-K suggests that a discussion of working capital may be appropriate for certain types of businesses, but may be inappropriate for a bank. (Instruction 5 to paragraph 303(a))

A registrant also must discuss its capital resources, including any material commitments for capital expenditures as of the latest fiscal period. The description should indicate the general purpose of the commitments and the source of funds to meet them. The discussion of capital resources should further indicate any known material trends in the registrant’s capital resources and describe the expected material changes, the relative cost of the capital resources, and discuss any changes between debt, equity, and off-balance sheet financing arrangements. (17 C.F.R §229.303(a)(2))

—**Off-balance sheet arrangements.** Financial institutions may be required to report certain off-balance sheet items under Item 303(a)(4) of Regulation S-K. (17 CFR §229.303(a)(4)) However, there is no obligation to report off-balance sheet items pursuant to Regulation S-K until there exists a definitive agreement that is unconditionally binding or subject only to customary conditions or, in the absence of an agreement, when the transaction has settled. (Instructions to Paragraph 303(a)(4))

—**Material changes in financial condition.** The registrant must discuss any material changes in its financial condition as of the end of the preceding fiscal year to the date of its most recent interim balance sheet. (17 C.F.R §229.303(b)(1))
Financial institutions. Regulation S-K advises financial companies to consult the applicable industry guides. Bank holding companies are referred to the SEC Industry Guide on Banks titled “Statistical Disclosure by Bank Holding Companies.” Similarly, insurance companies are referred to the industry guide titled “Disclosures concerning unpaid claims and claim adjustment expenses of property casualty underwriters.” (17 C.F.R §229.801(c) and (f) and §229.802(c) and (d))

Risk Factors

Several items within Regulation S-K require a registrant to address quantitative and qualitative risk factors. Items 503(a) and (c), for example, require that a summary prospectus contain a section discussing the most significant factors that may cause an offering to be speculative or risky. Risk factors should be specific to the issuer or to the securities being offered and include, but are not limited, to (i) lack of operating history, (ii) lack of profitable operations in recent periods, (iii) financial position, (iv) business or proposed business, and (v) lack of a market for the securities. Issuers of asset-backed securities also should consult Item 1103 of Regulation AB. (17 CFR §229.503(a) and (c); 17 CFR §229.1103)

Regulation S-K, Item 305, also provides that a registrant must include quantitative and qualitative information regarding market risk in its current reports. A registrant has several options for presenting quantitative risk information, but generally a registrant must divide its market risk sensitive instruments into (i) instruments for trading purposes and (ii) instruments for other than trading purposes. Within each category, a registrant must address the topics of interest rate risk, foreign currency exchange rate risk, commodity price risk, equity price risk, and other relevant market risks. Similarly, Item 305(b) requires that a registrant present qualitative information about market risk by category with emphasis on primary risk exposures, how risks are managed, and any changes in the registrant’s primary market risk exposures or how such risks are managed. (17 CFR §229.305(a) and (b))

Regulation S-X

In addition to the general rules under Regulation S-X, insurance companies and bank holding companies must comply with special rules governing assets, balance sheets, and income statements. (17 CFR §§210.7-01-210.7-05 and §§210.9-01-210.9-07)

Asset-Backed Securities—Regulation AB

Regulation AB governs the issuance of and reporting obligations for asset-backed securities. Entities using the Fed’s lending facilities should consult Regulation AB regarding the underlying assets that may be pledged as collateral for advances and borrowed securities since these pledged or borrowed assets may consist of asset-backed securities.
Item 1101(b) of Regulation AB provides that an “asset-backed issuer” is an issuer that has reporting obligations arising from the registration or offering of asset-backed securities under the Securities Act or from the registration of a class of asset-backed securities under Exchange Act Section 12. (17 CFR §229.1101(b)) The term “asset-backed security” is defined to mean “a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designated to assure the servicing or timely distributions of proceeds to the security holders.” (17 C.F.R. §229.1101(c)(1)) Regulation AB imposes several additional considerations on the definition of “asset-backed security”, including the requirement that neither the depositor nor the issuing entity be an investment company. (17 C.F.R. §229.1101(c)(2)) However, even though the definition requires that asset pools be “discrete” pools, the definition of asset-backed security does include (i) master trusts, (ii) prefunding periods, and (iii) revolving periods. (17 C.F.R. §229.1101(c)(3))

Issuers of asset-backed securities also should consult Item 503 of Regulation S-K regarding the presentation of risk factors in a summary prospectus. (17 CFR §229.503)

—Form 10-D. Asset-backed issuers under Exchange Act Rules 13a-17 or 15d-17 must file Form 10-D with the SEC no later than 15 days after each required distribution date on the asset-backed securities. (17 CFR §240.13a-17 and §240.15d-17; 17 CFR §249.312) Distribution information that must be provided on Form D includes the following:

- Item 1—Distribution and pool performance information
- Item 2—Legal proceedings
- Item 3—Sales of securities and use of proceeds
- Item 4—Defaults on senior securities
- Item 5—Submission of matters to a vote of security holders
- Item 6—Significant obligors of pool assets
- Item 7—Significant enhancement provider information
- Item 8—Other information
- Item 9—Exhibits

Item 1118 of Regulation AB sets forth additional reporting obligations for issuers of asset-backed securities. (17 CFR §229.1118)

—Form 8-K. General Instruction G to Form 8-K contains provisions applicable to asset-backed issuers. For purposes of Instruction G, the definitions of terms contained in
Regulation AB are controlling. Under Instruction G, an asset-backed issuer need not report the specified events, including material impairments, on its Form 8-K. However, an asset-backed issuer must provide additional disclosure on the cover page of its Form 8-K. The Form 8-K also must be signed by the depositor, an authorized representative of the servicer, or in the case of multiple servicers, an authorized representative of the master servicer. (Form 8-K, General Instruction G, 17 CFR §249.308)

**Investment Company Act—Money Market Funds**

The rules applicable to investment companies provide, in general, that a money market fund may not adopt a name or otherwise hold itself out as a money market fund unless the fund has complied with Rule 2a-7(c). (17 CFR §270.2a-7(b)) To qualify as a money market fund, a fund must satisfy the rules pertaining to portfolio maturity, quality and diversification. (17 CFR §2a-7(c)(2), (3), and (4))

In the case of portfolio maturity, a money market fund must maintain a dollar-weighted average portfolio maturity that is consistent with maintaining a stable net asset value or share price. However, a money market fund may not (i) acquire any instrument with a remaining maturity in excess of 397 calendar days, (ii) if the money market fund is not using the amortized cost method, acquire a government security with a maturity in excess of 762 calendar days, or (iii) maintain a dollar-weighted average portfolio maturity of more than 90 days. (17 CFR §270.2a-7(c)(2)) Subject to special rules covering taxable and tax exempt money market funds, a money market fund must satisfy the portfolio quality requirements by investing only in U.S. dollar-denominated securities, which the fund’s board of directors has determined pose “minimal credit risks.” (17 CFR §270.2a-7(c)(3)) A money market fund also must satisfy the portfolio diversification requirements, which provide that taxable and national funds generally may not invest more than 5 percent of total assets in securities issued by a single issuer. An exception allows investments of up to 25 percent of a fund’s total assets in first tier securities of a single issuer for periods not exceeding 3 business days. (17 CFR §270.2a-7(c)(4))

Notwithstanding certain other provisions of the Investment Company Act and the applicable rules, a money market fund may elect to calculate its share price using either the amortized cost method or the penny-rounding method. The board of directors of a money market fund must determine in good faith that the fund’s best interests are served by adopting one of these methods in order to achieve a stable net asset value per share or a stable share price, for so long as the board believes that the chosen pricing method fairly reflects the market-based net asset value per share of the fund. (17 CFR §270.2a-7(c)(1)) The “amortized cost method” is defined to mean a method of calculating a fund’s net asset value by valuing portfolio securities based on the fund’s acquisition cost (adjusted for amortization of premium or accretion of discount) instead of by reference to market factors. (17 CFR §270.2a-7(a)(2)) Under the penny-rounding method for calculating share price, the net asset value per share is rounded to the nearest one percent. (17 CFR §270.2a-7(a)(18))
A money market mutual fund cannot participate in the Fed’s Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) unless it meets the requirements set forth in Investment Company Act Rule 2a-7. Similarly, eligible investors under the Money Market Investor Funding Facility (MMIFF) must comply with Rule 2a-7. (17 CFR §270.2a-7) Below is a summary of the no-action relief obtained by the Investment Company Institute and J.P. Morgan Securities, Inc. regarding the AMLF and the MMIFF, respectively.

—SEC no-action letter regarding AMLF. Eligible investors under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) must comply with Investment Company Act Rule 2a-7. (17 CFR §270.2a-7) The Investment Company Institute (ICI), on behalf of its money market fund members, sought no-action relief from the SEC staff regarding transactions in asset-backed commercial paper between money market funds and banks participating in the AMLF. (Investment Company Institute (September 25, 2008)) The ICI sought no-action relief because the structure of the AMLF may result in transactions that could violate the rules regarding affiliated persons. The ICI also argued that relief is necessary so that its members can participate in the AMLF for purposes of mitigating the lack of liquidity in the ABCP market, to address the high volume of money market fund redemptions, and to reduce the risk that money market funds may need to re-price their shares at a price below $1 (i.e. “break the buck”).

Section 17(a) of the Investment Company Act provides, with certain exceptions, that no affiliated person or promoter of or principal underwriter for a registered investment company may knowingly purchase any security or other property (other than securities issued by the seller) from the registered investment company or any company controlled by the registered investment company. (17 USC §80a-17(a)(2)) The ICI stated that (i) transactions subject to no-action relief will comply with Rule 17a-9, (ii) the no-action relief will apply only to ABCP transactions for which the amortized cost value is equal to or greater than market value at the time of the transaction, (iii) the ABCP to be purchased from a money market fund will be determined by the fund’s advisor, consistent with the adviser’s fiduciary duties to the fund and in the best interests of fund shareholders, (iv) the fund will maintain records required by Rules 31a-1 and 31a-2, and (v) the transactions subject to no-action relief satisfy the standards for the issuance of an exemptive order under Section 17(b). Based on the facts and other representations made by the ICI, the staff indicated that it would not recommend enforcement under Section 17(a)(2) against a bank that purchases ABCP from a fund that is an affiliated person of the bank in transactions made under the AMLF.

—SEC no-action letter regarding MMIFF. J.P. Morgan Securities, Inc. (JPMS) is the private sector manager of the Money Market Investor Funding Facility (MMIFF) and as such sought no-action relief from various provisions of the Investment Company Act and the accompanying rules. (J.P. Morgan Securities, Inc., (October 22, 2008)) The SEC staff, upon considering JPMS’s arguments, granted no-action relief pertaining to the following:
— —Commercial paper notes issued by PSPVs are asset-backed securities. The SEC staff concluded that commercial paper notes to be issued by the private special purpose vehicles (PSPVs) under the MMIFF satisfy the definition of asset-backed security as the term is defined in Rule 2a-7 and thus would not recommend enforcement under Investment Company Act sections 2(a)(41), 34(b), and 35(d) and Rules 2a-4 and 22c-1. JPMS requested no-action relief because of the concern that the issuance of commercial paper notes by the PSPVs may not be viewed as operation of a SPV solely for the purpose of issuing asset-backed securities. The term “asset-backed security” means “a fixed income security (other than a Government security) issued by a Special Purpose Entity (as defined in this paragraph), substantially all of the assets of which consist of Qualifying Assets.” The term “qualifying asset” includes “financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.” A special purpose entity (SPV) is “a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets.” However, the definition of a SPV excludes a registered investment company. (17 CFR §270.2a-7(a)(3))

— —Alternative method to comply with diversification requirement. The SEC staff indicated that enforcement would not be recommended under Investment Company Act Sections 2(a)(41), 34(b), and 35(d) and Rules 2a-4 and 22c-1 if JPMS employed an alternative method for determining portfolio diversity for purposes of the money market funds investing in commercial paper notes issued by the PSPVs. Under Rule 2a-7, a SPV is an issuer of asset-backed securities and must comply with portfolio diversification rules that limit taxable money market funds to investing no more than 5 percent of total assets in securities issued by an issuer. (17 CFR §270.2a-7(c)(4)(i)(A)) An exception to the rule states that a money market fund must “look-through” a SPV and treat any person whose obligations amount to 10 percent or more (a “Ten Percent Obligor”) of the principal amount of qualifying assets of the SPV as if that person issued a proportionate share of the SPV. (17 CFR §270.2a-7(c)(4)(ii)(D)(1)) The staff would allow JPMS to not apply the “look-through” provision under the following conditions:

1. A Money Market Fund may not acquire Commercial Paper Notes issued by the SPVs if it would result in such securities collectively (i.e., commercial paper notes issued by all the SPVs to the Money Market Fund added together) exceeding 2.5% of the Money Market Fund’s total assets (as defined in rule 2a-7(a)(25));

2. All Commercial Paper Notes must be “First-Tier Securities” as defined in Rule 2a-7(a)(12) when acquired by a Money Market Fund; and

3. For purposes of the Money Market Fund making additional purchases of securities of an issuer (where that issuer is one of the 10 issuers the securities of which may be held by an SPV), the Money Market Fund must add the entire value
of the Commercial Paper Notes it holds to the value of other holdings of securities of the issuer held by the money market fund for diversification purposes.

4. If a Money Market Fund purchases Commercial Paper Notes in the secondary market (i.e., not in connection with a sale of eligible assets to an SPV pursuant to the [MMIFF]), it must treat such Commercial Paper Notes as set forth in condition 3 above for purposes of the diversification requirements of rule 2a-7 (i.e., prior to such purchase, it must consider the entire value of each commercial paper note as additional exposure to each of the issuers whose securities may be held by the SPV that issued the Commercial Paper Note for diversification purposes).

The SEC staff included in footnote 5 of the no-action letter response an example, originally provided by JPMS, that suggests how the alternative method of portfolio diversification works:

For example, if 4.5% of a Money Market Fund’s net assets are accounted for by securities of XYZ, and it acquires Commercial Paper Notes issued by an SPV (where one of the securities that may be held by the SPV is XYZ) equal to 1% of the Money Market Fund’s net assets, the Money Market Fund would have a 5.5% exposure to XYZ and be precluded from making additional purchases of XYZ securities unless and until its percentage exposure (including the exposure from the Commercial Paper Notes) to XYZ is reduced below 5%. Likewise, if a Money Market Fund owns no securities of ABC and acquires Commercial Paper Notes issued by an SPV (where one of the securities that may be held by the SPV is ABC) having a value equal to 2% of the Money Market Fund’s net assets, the Money Market Fund would have a 2% exposure to ABC for purposes of computing the amount of ABC securities it may purchase and be within the 5% diversification limit.

— —Securities-related issuers. Investment Company Act Section 12(d)(3), subject to certain exceptions, provides that “[i]t shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under title II of this Act.” (15 USC §80a-12(d)(3)) JPMS noted that eligible assets of a PSPV may be issued by a securities-related issuer. JPMS also observed that, through the operations of the PSPVs under the MMIFF, unrelated money market funds will sell eligible assets to the PSPVs, but a money market fund may purchase commercial paper notes from a PSPV that holds eligible assets sold to the PSPV by another money market fund, and which notes were issued by a securities-related issuer that is an affiliated person of the principal underwriter or investment adviser of the first money market fund. The staff concluded that it would not recommend enforcement under
Investment Company Act Section 12(d)(3) in order to support the important, temporary liquidity goals of the MMIFF.

— Participation of affiliated money market funds in MMIFF. Under Section 10(f) of the Investment Company Act, “[n]o registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security (except a security of which such company is the issuer) a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of such registered company, or is a person (other than a company of the character described in section 12(d)(3)(A) and (B)) of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person, unless in acquiring such security such registered company is itself acting as a principal underwriter for the issuer.” (15 USC §80a-10(f)) The staff response observed that one of the purposes of Section 10(f) is to prevent a person who may influence a registered investment company from engaging in the “dumping” of unmarketable securities. JPMS observed that several affiliated companies (collectively affiliated money market funds) may participate in the MMIFF, subject to the following stipulations made by JPMS:

- JPMS will enter into a commercial paper placement agreement with each PSPV and act as principal for sales of eligible assets to a PSPV by money market funds;
- JPMS and at least one broker-dealer unaffiliated with JPMS will be the dealers for the commercial paper notes;
- transactions will be made at the amortized cost of the eligible assets and JPMS, as placement agent, will not earn a spread on sales of eligible assets to PSPVs or on the issuance of commercial paper notes and will not receive compensation from PSPVs for its services as placement agent;
- JPMS, as structuring, referral, and placement agent for PSPVs, will receive a fee consisting of the spread between the interest payable on commercial paper notes and loans made by the lender and the interest earned on eligible assets;
- JPMS and any other dealers will have separate dealer agreements and will not be required to purchase or sell a particular amount of commercial paper notes for the PSPVs; and
- dealers for commercial paper notes are not members of an underwriting or selling syndicate and the purchase of commercial paper notes by the affiliated money market funds from JPMS is not prohibited under Section 10(f).

The SEC staff concluded that it would not recommend enforcement under Investment Company Act Section 10(f) if certain affiliated money market funds participated in the MMIFF.
--- Second-tier affiliates. JPMS sought no-action relief form various provisions within Section 17 of the Investment Company Act. Section 17(a)(2) prohibits an affiliated person or a second-tier affiliate (i.e. an affiliated person of an affiliated person) acting as principal from knowingly purchasing any security or other property from the registered investment company or a company controlled by the registered investment company. (15 USC §80a-17(a)(2)) JPMS argued that (i) the proposed relief is urgent and temporary and otherwise satisfies the requirements for an order under Section 17(b), (ii) the proposed transactions will comply with Rule 17a-9, (iii) transactions are to be effected only if the amortized cost of the eligible assets being sold by an affiliated money market fund to a PSPV is equal to or greater than the market value of the eligible assets at the time of the transaction, and (iv) that conducting such transactions is consistent with the fiduciary duties owed to the affiliated money market funds and is in the best interests of the affiliated money market funds and the funds’ shareholders. On this basis, the staff concluded that it would not recommend enforcement under Section 17(a)(2).

JPMS next sought no-action relief under Section 17(d) and Rule 17d-1. Section 17(d), subject to certain exceptions, prohibits an affiliated person or a second-tier affiliate acting as principal from engaging in a transaction in which a registered investment company or a company controlled by the registered investment company is a joint or a joint and several participant with the person, principal underwriter, or affiliated person in violation of any rules prescribed by the SEC. (15 USC §80a-17(d)) Rule 17d-1 defines the term “joint enterprise or other joint arrangement or profit-sharing plan” to include numerous types of agreements, but provides an exception for investment advisory contracts. (17 CFR §270.17d-1(c)) JPMS noted that the purpose of the MMIFF is to address “unprecedented” lack of liquidity in money markets and that it would be improper to bar the affiliated money market funds (among the largest in the industry) from availing themselves of the MMIFF because certain companies affiliated with JPMS participate in the management of the MMIFF. JPMS also noted that participating money market funds would not be treated “on a different basis” or “less advantageously” than would other participants in the MMIFF. The SEC staff determined that it would not recommend enforcement under Section 17(d) or Rule 17d-1.

JPMS also requested no-action relief under Investment Company Act Section 17(e). Under Section 17(e)(1), no affiliated person of a registered investment company or second-tier affiliate acting as agent may accept from any source any compensation for the purchase or sale of property to or for the registered investment company other than in the course of the person’s business as underwriter or broker. (15 USC §80a-17(e)(1)) In support of its argument, JPMS stipulated that (i) JPMS and the bank will not receive compensation in violation of Section 17(e)(1) with respect to participating affiliated money market funds, (ii) JPMS will receive fees from the PSPVs for acting as structuring and referral agent, (iii) the bank will receive fees for acting as collateral agent, depository, and issuing and paying agent for PSPVs, (iv) the lender selected JPMS and its affiliates to manage elements of the MMIFF and established the compensation plan for such services without considering whether the affiliated money market funds would participate in the MMIFF (JPMS conceded that participation by money market funds and the affiliated money market funds would determine the amount of compensation JPMS
and its affiliates receive), and (v) JPMS represented that most of the money market funds expected to participate in the MMIFF would not be affiliated with JPMS. The staff determined that it would not recommend enforcement under Section 17(e)(1). □
About the Author