MEMORANDUM

September 3, 1982

TO: Chairman John S.R. Shad

FROM: Edward F. Greene
General Counsel

RE: Issues Relating to Use of Repurchase Agreements by Mutual Funds

I. Introduction

This memorandum presents a preliminary legal analysis of a number of questions raised by Congressman Rosenthal concerning repurchase agreements. In letters dated June 15, 1982, and July 23, 1982, Congressman Rosenthal inquired about the right of an investor in a repurchase agreement (repo) to liquidate collateral under circumstances of both solvency and insolvency of the other party, and also requested an analysis of the risks to a mutual fund when it enters a repo or reverse repo 1/ with a financial firm which then becomes insolvent. 2/ Our preliminary conclusion is that the situations posited by Congressman Rosenthal may create problems for the mutual fund. As a result, we propose the actions set out in Section II below.

1/ In this memorandum, "repo" refers to a repurchase agreement issued by the financial firm (that is, the fund purchases securities from the firm, which agrees to repurchase them), and "reverse repo" refers to a repurchase agreement issued by the fund (the fund sells securities to the financial firm, and agrees to repurchase them).

2/ The Congressman's inquiries were in response to a report by the Division of Investment Management.

II. Proposed Actions and Timetable

The legal issues related to the rights of parties to repos under the circumstances described by Congressman Rosenthal are complex and in large measure unresolved by definitive judicial interpretations of the applicable statutory provisions. The outcome may depend, moreover, on the terms of the repo agreement and the precise facts of a given case. The situation is, moreover, in flux. We understand that at least some participants in the repo market are taking steps to revise the contractual terms applicable to their repo transactions. There is also litigation pending that may resolve some of the issues at stake. It is, consequently, difficult to say at this time precisely what steps the Commission should take to insure that the interests of investors in mutual funds are adequately protected. Further study is, however, essential. Accordingly, the Office of the General Counsel and the Division of Investment Management plan the following actions:

(1) Preparation by the Office of the General Counsel of a more detailed legal analysis of the issues, particularly in light of pending litigation. 3/

3/ E.g., In re Lombard-Wall, Inc., Reorganization Case No. 82 Bkcy 11556 (EJR) (Bankr. S.D.N.Y., filed Aug. 12, 1982).

(2) Identification of the administrative actions that are available to deal with the problem. These might include, among others, the following:

(a) Revision of the position taken by the Division of Investment Management that it will not recommend enforcement action (that is, that it will take a "no-action" position) under Section 12(d)(3) of the Investment Company Act of 1940 (the "Act") against an investment company that engages in a repo with a broker or dealer so long as the repo is fully collateralized during the entire term of the repurchase agreement. 4/ In light of the possibility that the insolvency of a broker or dealer could partly expose an

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4/ Section 12(d)(3) in part prohibits an investment company from purchasing or otherwise acquiring "any security issued by or any other interest in the business of any person who is a broker, a dealer, [or] is engaged in the business of underwriting." The legislative history of Section 12(d)(3) suggests that its purpose principally was to prevent investment companies from exposing their assets to the entrepreneurial risks of an investment banking business. The no-action position taken in Release No. 10666 was based upon the premise that the investment company, acting under a repo as a lender for purposes of the 1940 Act, "would look to the intrinsic value of the collateral . . . rather than the creditworthiness or other risks associated solely with the business operations of the broker/dealer."

investment company to risks related to the business operations of the broker/dealer, and therefore to the entrepreneurial risks of the investment banking business, the Division will evaluate whether it is necessary or appropriate to add a further condition to its no-action position. For example, an investment company engaging in a repurchase agreement with a broker or dealer could be required to determine that the broker or dealer presents minimal credit risks.

(b) Recommendation that the Commission, when permitting the use of certain methods of valuing the portfolio securities of a money market fund or other investment company, require that the board of directors of a fund consider the creditworthiness of the issuer of the repo. 5/ The board of directors of an investment company that uses certain valuation methods is required to determine

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5/ The methods involved are the amortized cost method and the penny rounding method. For a description of the amortized cost and penny rounding valuation methods and the conditions imposed by orders permitting their use and by proposed Rule 2a-7, which would permit their use, see Investment Company Act Release No. 12206 (Feb. 1, 1982).

that each repo engaged in by the fund is of "comparable quality" to debt securities having a "high quality" rating by a major ratings service. The board, in making this determination, looks to the quality of the securities collateralizing the repo. The Division of Investment Management will consider recommending that the Commission expressly require that the board also evaluate the creditworthiness of the repo issuer.

(c) Recommendation that the Commission issue an interpretative release or a proposed rule that would subject the purchase of repurchase agreements to the diversification requirements of Section 5(b)(1) of the Act 6/ and/or to the disclosure

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6/ Under Section 5(b)(1) of the Act, a management investment company may only be considered "diversified" if at least 75 percent of the value of its total assets consists of cash and cash items, Government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater than five percent of the total assets of the investment company and to not more than ten percent of the outstanding voting securities of the issuer. Acquiring "diversified" status has important tax benefits to investment companies and their shareholders, since the Internal Revenue Service applies a similar, though less stringent, diversification test in determining an investment company's eligibility for pass-through tax treatment under Subsection M of the Internal Revenue Code.

requirements of Section 8(b)(1)(E) of the Act 7/ concerning concentration of investments in a particular industry.

(d) Requirement of additional or different disclosures to ensure that the prospectuses of money market funds are not materially misleading. The Division staff is reviewing the most recent prospectuses of the approximately 250 existing money market funds to evaluate whether their present disclosure of the degree of risk that may be involved in repurchase transactions is adequate.

(3) Consideration of recommending legislative measures to address potential problems.

The Office of the General Counsel and the Division of Investment Management propose that the legal research be completed by September 30, 1982, and that the identification of possible administrative actions and/or possible legislative recommendations

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7/ Section 8(b)(1)(E) of the Act requires an investment company to disclose in its registration statement whether it reserves the freedom to concentrate investments in a particular industry or group of industries. The staff has taken the position that an investment company that invests more than 25 percent of its assets in the securities of issuers in a single industry is concentrating in that industry. See Investment Company Act Release No. 7221 at p. 9 (June 9, 1972).

be completed by October 31, 1982. The time within which specific administrative measures or legislative recommendations could be selected and implemented will depend on the nature of the steps selected and on developments in the courts and in the industry. Should legislation appear in order, we hope to develop specific proposals by the end of October.

III. Right to Liquidate Collateral If It Declines in Value

Our preliminary legal analysis of the problems about which Congressman Rosenthal inquired deals first with a situation not necessarily involving insolvency. In his letter of June 15, 1982, Congressman Rosenthal requested an analysis of "the right of a repo investor to liquidate the collateral at his own discretion, if necessary before expiration of the repo contract, in the event the collateral has suffered a decline in market value and the repo issuer has failed to add more collateral." Although a firm answer to this question is not possible in the absence of more specific facts, ordinary principles of contract law would govern 8/ if an insolvency proceeding relating to the repo issuer is not pending.

8/ Nothing in Uniform Commercial Code article 8, which governs investment securities, specifically governs a breach of contract to purchase securities. For the possible effects of bankruptcy law, see the discussion beginning at p. 10 *infra*.

It is our understanding that the security underlying a repo agreement is often worth somewhat more than the money received in order to provide the repo investor with a margin of safety. If the term of the repo is more than one day, the firm issuing the repo is then usually obligated to maintain the value of the security by mark-to-market payments, and the analysis that follows assumes that such a provision is in the repo agreement. The terms of the agreement to repurchase between the issuer and investor can specifically provide that the investor has the right to liquidate the underlying security in the event of the issuer's failure to maintain its value. The express terms of the agreement would then control, and the investor would be able to protect itself by selling out the security before its price fell below the amount secured.

Assuming no express provision in the agreement, if the issuer failed to maintain the value of the underlying security as promised, he would be in breach of his duty to perform. However, the issuer's breach would not necessarily allow the investor to liquidate the contract at his own discretion. Indeed, if the investor did not have this right, then by liquidating the securities the investor would breach in turn his promise to allow the issuer to repurchase the underlying security (unless, as is common, the repo agreement provides that the investor may substitute similar securities).

The fundamental rule is that "where performances are to be exchanged under an exchange of promises, each party is entitled to the assurance that he will not be called upon to perform his remaining duties of performance with respect to the expected exchange if there has already been an incurred material failure of performance by the other party." Restatement (Second) of Contracts, § 237b. Whether the issuer's failure to maintain the value of the collateral is material depends upon the circumstances, but it is likely that his express failure to do so (as by a failure to add more collateral) would provide the investor reasonable grounds for "insecurity." 9/ In that case, "the obligor's failure to provide within a reasonable time such assurance of due performance as is adequate in the circumstances of the particular case" constitutes a repudiation of the contract. Id., § 251(2).

Assuming a repudiation, whether the event of breach allows the investor to liquidate the underlying security, or whether he must pursue some other remedy, centers on whether the desired

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9/ Indeed, this situation is somewhat similar to a customer's failure to meet a margin call, giving his broker the right and duty to liquidate margin non-exempted securities in the customer's account. See 12 C.F.R. § 220.3(e). Stock exchanges can require customers to maintain margin in exempted securities such as those commonly the subject of repos, see, e.g., Rule 431(b) of the Rules of the New York Stock Exchange.

remedy is consistent with justice. The Restatement provides that courts are empowered to "grant relief on such terms as justice requires." Restatement (Second) of Contracts, § 272(2). According to the reporter's notes, "the court will supply a term that is reasonable in the circumstances." Id. § 272(c). Other things being equal, it appears that a court would view an investor's liquidation of the underlying security in the face of a repudiation, albeit without any express power in the investor to do so, as a permissible course of action.

IV. Treatment of Repurchase Agreements Under the Bankruptcy Code

After a mutual fund enters a repo or a reverse repo with a financial firm, the insolvency of the firm before the time for the repurchase of the securities creates risks for the fund. As detailed below, protections provided to the insolvent firm under the Bankruptcy Code (the "Code") may expose the fund to varying degrees of risk of loss on the repo.

A. Sale with Contract to Repurchase v. Collateralized Loan

The risks under the Code vary depending on whether the bankruptcy court views the repo or reverse repo as (1) a sale coupled with a contractual agreement to repurchase, or (2) a collateralized loan. 10/ The risks to a fund may be greater if the repo or reverse repo is treated as a collateralized loan. 11/ While a number of cases have

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10/ The risks resulting from the insolvency of the financial firm also vary according to the nature of the firm, in part because the Code does not govern all insolvency proceedings. In general, banks, insurance companies, and savings and loan associations may not be debtors in liquidation proceedings under chapter 7 of the Code. Code § 109(b). The legislative history of § 109(b) states: "Banking institutions and insurance companies engaged in business in this country are excluded from liquidation under the bankruptcy laws because they are bodies for which alternate provision is made for their liquidation under various State or Federal regulatory laws." S. Rep. No. 95-989, at 31 (1978), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 5817 (1978); see H. Rep. No. 95-595, at 318 (1977), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 6275 (1978). These entities, as well as commodity brokers and stockbrokers, may not be debtors in reorganization proceedings under chapter 11 of the Code. Code § 109(d). Stockbrokers might be liquidated under chapter 7 or under a Securities Investor Protection Corporation (SIPC) liquidation pursuant to the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa et seq. (The Code also provides for adjustment of the debts of a municipality (chapter 9).) This memorandum discusses the treatment of repos under the Code, as amended in P.L. 97-222, 96 Stat. 235 (July 27, 1982).

11/ If a repo involves a contract for the purchase, sale, or loan of a security, this contract is a "securities contract" within the meaning of Code § 741(7). Consequently, a stockbroker, as defined in Code § 101(40), would enjoy the protection of Code § 362(b)(6) (no automatic stay of certain setoffs with regard to margin payments) and of Code § 555 (protection of certain contractual rights to liquidate securities contracts).

discussed the issue, it has not been definitively resolved for purposes of the Code. 12/

The Commission has generally taken the position that, for purposes of the securities laws, traditional repurchase agreements involve the purchase and sale of the securities to which they relate. 13/ However, for purposes of the Investment Company Act, a repo is also viewed as a collateralized loan, because Section 2(a)(23) of the Act, 15 U.S.C. § 80a-2(a)(23), defines "lend" to include "a purchase coupled

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12/ See, e.g., First National Bank v. Estate of Russell, 657 F.2d 668 (5th Cir. 1981); In re Legel, Braswell Government Securities Corp., 648 F.2d 321 (5th Cir. 1981); In re Financial Corp., 634 F.2d 404 (8th Cir. 1980) (per curiam), aff'g 1 B.R. 522 (W.D. Mo. 1979); Hadsell v. Hoover, 484 F.2d 123 (10th Cir. 1973); Union Planters National Bank v. United States, 426 F.2d 115 (6th Cir.), cert. denied, 400 U.S. 827 (1970); SEC v. Miller, 495 F.Supp. 465 (S.D.N.Y. 1980); Gilmore v State Board of Administration, 382 So.2d 861 (Fla. Dist. Ct. App. 1980).

13/ Generally, the antifraud provisions of the securities laws require that there be an offer, sale, or purchase of a security. See Securities Act of 1933, Section 17(a), 15 U.S.C. § 77q (offer or sale); Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. § 78j(b) (purchase or sale); Rule 10b-5, 17 C.F.R. § 240.10b-5 (promulgated under Section 10(b)) (purchase or sale). Thus, the antifraud provisions of these laws would apply to the offer, sale, and purchase of the securities subject to the repo. Securities Act Release No. 6351, Exchange Act Release No. 18122, Trust Indenture Act Release No. 658, Investment Company Act Release No. 11958 (Sept. 25, 1981).

with an agreement by the vendor to repurchase" and defines "borrow" to include "a sale coupled with a similar agreement." 14/

B. Automatic Stay Provisions

The filing of a petition in bankruptcy court operates as an automatic stay under § 362(a). The actions stayed include any act to obtain possession of property of the estate; any act to create, perfect, or enforce any lien against property of the estate; any act to collect a claim that arose before commencement of the case; and the setoff of any debt owing to the debtor before commencement of the case against any claim against the debtor. With certain exceptions, property of the estate includes all legal and equitable interests of the debtor in property as of the commencement of the bankruptcy case. Code § 541(a). Thus, if the debtor (the financial firm) is viewed as having an interest in the securities that are the subject of the repo or the reverse repo, the automatic stay provision appears to apply to the repo or reverse repo arrangement and thus would prohibit a repo investor from selling out the underlying securities in certain circumstances.

If the repo is treated as a sale and a contract to repurchase, the estate would include the contract to re-

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14/ See Investment Company Act Release No. 10666 (April 18, 1979).

purchase the securities held by the fund. Whether this interest is such that § 362(a) stays any sale of the securities subject to the executory contract by the mutual fund seems unclear, although it may be that the fund could sell the securities if the repo agreement provided it with rights of collateral substitution. If, however, the repo is treated as a collateralized loan, it appears that the fund would be stayed from attempting to enforce a lien against the collateral securities by selling the securities (absent rights of collateral substitution) or from setting off the loan against any debt the fund owed the firm. Still, it may be possible for the fund to obtain expeditious relief by petitioning the court under subsections 362(d) and (f) to lift the stay.

Similarly, if the reverse repo is a sale, the securities seem to be property of the estate, and any efforts by the fund to obtain the securities should be stayed. If the reverse repo is a loan, the security interest in the securities appears to be property of the estate and the stay appears to apply.

C. Trustee's Use or Sale of the Collateral Securities

Section 363 contains provisions for the trustee's use or sale of property of the estate. Code § 542 generally requires the possessor of estate property to deliver the property or its value to the trustee "unless such property is of inconsequential value or benefit to the estate." Section 363(e) provides, however, that upon request of an entity that has an interest in the property, the court shall prohibit the trustee from using or selling such property or condition use or sale upon the trustee's providing the entity with "adequate protection," as defined in § 361. 15/ Thus, if the securities that are the subject of the repo or the reverse repo are property of the estate, the trustee might attempt to use or sell the securities, but he may be required to provide the affected fund with adequate protection.

If the repo is a sale with a contract to repurchase, then the contract might create an interest of the estate in the securities such that the trustee could attempt to force turnover of the securities under § 542, though sale of the securities under § 363 would require the trustee to provide "adequate protection." However, the court may allow the trustee to obtain the securities only if he expressly

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15/ Under § 361, the means of providing adequate protection of an interest of an entity in property include requiring the trustee to make periodic cash payments to the entity to the extent that the automatic stay, use or sale, or certain other actions decrease the value of the entity's interest in the property; providing an additional or replacement lien to the entity; or providing other relief that will be the "indubitable equivalent" of the entity's interest in the property.

assumes the contract to purchase the securities. 16/

Similarly, if the repo is a loan, the trustee also might attempt to force turnover of the securities. The fund might argue that the securities were pledged and, "since the estate has no present possessory interest, turnover will not lie under section 542 and the estate is entitled to restoration of the pledged property or its proceeds only upon payment of the debtor or performance of the engagement." 4 Collier on Bankruptcy ¶ 541.08[9]. On the other hand, the legislative history for § 363 states: "Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale." 17/ Hence, the fund may resist the trustee's attempt to force turnover without repaying the loan, but the trustee might be able to force turnover (and sell the securities) by providing "adequate protection," such as a security interest in the proceeds.

If the reverse repo is a sale, the securities appear to be property of the estate and the trustee apparently may use or sell the securities. 18/

16/ See Section D, p. 17 infra.

17/ S. Rep. No. 95-989, at 56 (1978), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 5842 (1978); H. Rep. No. 95-595, at 345 (1977), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 6302 (1978).

18/ The fund might attempt to construct a reclamation claim under § 546(c), but on its face this section applies to sales of goods.

If the reverse repo is a loan, the security interest in the securities appears to be property of the estate and the trustee may argue for his right to use or sell the securities. The fund might claim that the estate loses its security interest once the fund tenders payment, but the trustee might argue that he need only provide the fund with "adequate protection."

D. Executory Contracts

Under § 365, subject to the court's approval, the trustee may assume or reject an executory contract. The term "executory contract" is not defined in the Code. The legislative history of § 365 states: "Though there is not a precise definition of what contracts are executory, it generally includes contracts on which performance remains to some extent on both sides." 19/ If the trustee rejects the contract, then, with certain exceptions, the rejection constitutes a breach of the contract. Code § 365(g).

If a repo or reverse repo contract is viewed as an executory contract, the trustee might have the choice of assuming or rejecting the contract and might be able to

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19/ S. Rep. No. 95-989, at 58 (1978), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 5844 (1978); H. Rep. No. 95-595, at 347 (1977), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 6303-04 (1978).

delay making his decision for a substantial period of time, thereby subjecting the fund to risk of loss resulting from fluctuations in the value of the underlying securities. Section 365(d)(1) allows the trustee in a chapter 7 case 60 days to decide whether to assume or reject. However, "no good reason exists why the court, upon a showing of cause, could not compel the trustee to act in a chapter 7 case prior to expiration of the 60-day period . . . ." 2 Collier on Bankruptcy ¶ 365.03, at 365-21 n.25 (1982). Section 365(d)(2) provides that, in a case under chapter 11, the trustee may assume or reject the contract at any time before confirmation of a plan, but, again, the court may require a decision in a shorter time. If the debtor is a stockbroker being liquidated under chapter 7, the trustee has a reasonable time, not to exceed 30 days, to assume or reject an executory contract for the purchase or sale of a security in the ordinary course of the debtor's business. Code § 744.

If the repo is a sale with a separate agreement to repurchase, the agreement to repurchase appears to be an executory contract, at least so long as neither party has tendered performance of the second commitment. The trustee then might choose, after a substantial delay, not to repurchase the securities if they have declined in value, leaving the fund with an unsecured claim for damages. However, the fund may be able to obtain a court order requiring a decision within a reasonable time if the securities began to fall in value. 20/

If the reverse repo is a sale, again the trustee apparently may reject the contract to resell the securities to the fund, apparently leaving the fund with an unsecured claim. 21/

E. Preferences

Under § 547(b), "the trustee may avoid any transfer of property of the debtor" if five conditions are met. Among these conditions are that the transfer is "for or on account of an antecedent debt . . .; made while the debtor was insolvent; [and] made . . . on or within 90 days before the

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20/ If the repo is a collateralized loan, the debtor's obligation to repay and the fund's obligation to return the collateral are performances remaining on both sides, so the contract arguably is executory. However, "[a] note is not usually an executory contract if the only performance that remains is repayment." S. Rep. No. 95-989, at 58 (1978), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 5844 (1978); H. Rep. No. 95-595, at 347 (1977), reprinted in 5 U.S. Code Cong. & Ad. News, 95th Cong., 2d Sess. 6303-04 (1978). Because the argument that a loan includes an executory contract apparently would not apply if the debtor were unsecured, so that he had no obligation to return collateral, the court may determine that a secured creditor who possesses the collateral should not be put in a worse position than an unsecured creditor on account of the filing of the bankruptcy case, and the court therefore may determine that the collateralized loan includes no executory contract.

21/ If the reverse repo is a loan, the trustee also might claim an executory contract. See note 20 supra.

date of the filing of the petition." Thus, if transfers such as mark-to-market payments under a repo are preferences, the trustee generally will have the opportunity to void these transfers. However, § 546(d) contains a specific exemption from the trustee's ability to void margin payments under § 547 when the payments are made by or to stockbrokers and certain other parties.

If the repo is a sale with a contract to repurchase, mark-to-market payments arguably are part of the contract to repurchase. These payments, then, would not be made on account of an antecedent debt, and they should not be voidable as preferences.

If the repo is a loan, mark-to-market payments apparently would be on account of an antecedent debt and, if they meet the other conditions, could be voidable preferences. The fund might argue that it may retain the payments under one of the Section 547(c) exceptions, particularly the exception for payments "of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee; . . . made not later than 45 days after such debt was incurred; . . . and . . . made according to ordinary business terms." However, the existence of the exemption in § 546(d) could raise the negative inference that avoidance is not available for margin payments if one of the parties to which § 546(d) applies is not involved in the transaction.