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Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
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TALF 2020: Summary of Revised Term Sheet and 1940 Act Considerations

On May 12, 2020, the Federal Reserve Bank of New York (the Fed) released an updated Term Sheet and Frequently Asked Questions (FAQ) in relation to the 2020 Term Asset-Backed Securities Loan Facility (TALF) program.[1] Multiple new developments and clarifications came out of the FAQ and revised Term Sheet, and this summary will focus on the key high-level takeaways. Notably, the Master Loan and Security Agreement (the MLSA) has yet to be released. However, the FAQ did clarify how an investment fund could fit into the definition of eligible borrower, resolving one of the most pressing concerns raised by the previous Term Sheet.

The revised Term Sheet was not significantly altered from the previous Term Sheet released on April 9, 2020. The notable revisions to the Term Sheet are as follows:

1. The Department of the Treasury will be using funds appropriated to the Exchange Stabilization Fund under section 4027 of the Coronavirus Aid, Relief and Economic Security Act (CARES Act);

2. The embedded definition of "U.S. Company," which required the issuer of eligible collateral to have a majority of its employees based in the United States, was removed from the TALF definition of eligible collateral, thus resolving the main issue with this definition as most asset-backed securities (ABS) traded in the market are issued by a special-purpose entity/vehicle with no employees;

3. "Premium finance loans for property and casualty insurance" will now be considered eligible collateral;[2] and

4. For eligible collateral, SBA Pool Certificates and Development Company Participation Certificates must be issued on or after Jan. 1, 2019, instead of the previously required March 23, 2020.

While the Term Sheet itself was not significantly altered, the corresponding FAQ provided important clarifications, which are summarized below.

2020 TALF Program Details:

While the FAQ has cleared up some operational details, it leaves others outstanding. Of note, the operational date of the TALF program is still unknown and further information will be forthcoming. That said, the Sept. 30, 2020 Termination Date (the date after which no new TALF loans will be made) remains unchanged, although it can be extended by a vote from the Board of Governors of the Federal Reserve System and the Secretary of Treasury.

The FAQ also clarified what information the Fed will be disclosing in respect to TALF eligible borrowers. The Fed will publicly disclose, on a monthly basis, information identifying each eligible borrower and other participants in the facility, information identifying each Material Investor (as defined below) of an eligible borrower, the amount borrowed by each borrower, the interest rate paid by each eligible borrower, the types and amounts of asset-backed securities (ABS) pledged as collateral by each eligible borrower, and overall costs, revenues and other fees for the facility.

While the definition of eligible borrower remains generally unchanged – a United States business that owns eligible collateral may borrow from TALF if it is (a) created or organized in the United States or under the laws of the United States, (b) has significant operations in and a majority of its employees based in the United States, and (c) maintains an account relationship with a TALF Agent – there have been some clarifications surrounding the analysis of the second prong.

Specifically, the FAQ clarified that for an investment fund acting as an eligible borrower, the fund's investment manager must have significant operations in and a majority of its employees based in the United States. By shifting the review from the fund to the manager, the FAQ clarified that investment funds will be able to participate in the TALF program. However, based on the current FAQ and Term Sheet, it remains unclear whether a fund would be able to participate indirectly in TALF via an offshore vehicle, e.g., through a Cayman Islands subsidiary or master fund.[3] For non-investment funds, the Fed will look at consolidated subsidiaries, but not any parent company or sister company in determining if a company has "significant operations in and a majority of its employees based in the United States."

The FAQ provided further clarification about what will constitute "significant operations in the United States." While not an exhaustive list, the FAQ mentioned that an eligible borrower (or investment manager, in the case of an investment fund) would be considered to have significant operations in the United States where greater than 50% of its consolidated assets are in, annual consolidated net income is generated in, annual consolidated net operation revenues are generated in, or annual consolidated operating expenses are generated in, the United States as reflected in the most recently audited financial statements.

There was also some clarification as to which entities are "created or organized in the United States or under the laws of the United States." The FAQ clarified that a United States subsidiary, branch, or agency of a foreign bank would qualify while a United States business with a Material Investor who is a foreign government would be excluded. This extends to investment funds in that the investment manager may not have any Material Investors that are foreign governments. Based on the FAQ, a Material Investor is an investor who owns, directly or indirectly, 10% or more of any outstanding class of securities of an entity.

The Fed clarified what representations a TALF eligible borrower will be required to provide to the TALF Agent[4] to participate in the program. Under the (yet to be released) MLSA, each eligible borrower will have to make the continuous representation that it is an eligible borrower and meets the requirements as such. The eligible borrower will be expected to continually monitor direct and indirect investors (to ensure compliance with the above Material Investor restriction) while the TALF loan remains outstanding. If the eligible borrower trips the Material Investor standard, they must escalate the Material Investor to the TALF Agent for a due diligence review.

Another point that the FAQ clarified is that eligible borrowers seeking to partake in the TALF program will have to certify that they are unable to secure adequate credit accommodations from a banking institution and that the eligible borrower is not insolvent. Unchanged from previous Term Sheets, eligible borrowers will also be required to certify their compliance with section 4019 of the CARES Act.[5] It is unclear what level of undertaking will be required to make these certifications.

Eligible Underlying Asset Details:

The FAQ clarified outstanding questions and filled in many details about the requirements of eligible collateral. While many of the provisions remain the same, such as the haircuts, fees and expenses,[6] the Fed has provided many new details concerning specific assets.

The FAQ clarified that floating rate loans, which reference the London Inter-bank Offered Rate (LIBOR) might be considered "eligible collateral" under the TALF program. However, the Fed will generally expect that any ABS benchmarked to LIBOR will include adequate fallback language, such as that recommended by the Alternative

Reference Rates Committee. Therefore, eligible borrowers should ensure that any floating rate loans which reference LIBOR include adequate fallback language.

The Fed also clarified that an investor might borrow against any eligible ABS, including eligible ABS that the investor already owns. However, if eligible ABS are not issued on the same day the investor borrows from the TALF, the ABS must be acquired in arms-length secondary market transactions within 30 days prior to the relevant loan subscription date.

For ABS used to secure a TALF loan, the eligible borrower must agree not to exercise, or refrain from exercising, any voting, consent or waiver rights, or any rights to direct, initiate, recommend or approve any action, under an ABS that is used as eligible collateral without the consent of the New York Federal Reserve. Presumably, this would be agreed to with the TALF Agent at the time that the customer agreement is executed and the MLSA is entered into. The specifics of this remain unclear as the MLSA has not yet been made available, and no "form-of" customer agreement has been provided. Additionally, in the case of an investment fund eligible borrower, it remains to be seen if the MLSA provision requiring the eligible borrower's agreement not to exercise voting rights will trigger a disclosure obligation in the fund's prospectus or offering document.

While the FAQ makes it clear that there is no minimum maturity limit for ABS that are eligible collateral, it notes that if an ABS's maturity is shorter than the three-year TALF loan, the TALF loan will instead mature upon maturity of the ABS collateral for that loan. Additionally, it should be noted that the average life for a credit card, auto, equipment, floorplan and premium finance ABS cannot be greater than five years, the average life for SBA Pool Certificates and private student loan ABS cannot be greater than seven years, the average life for Development Company Participation Certificates, commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs) cannot be greater than ten years. This is generally consistent with the previous Term Sheets issued by the Fed.[7]

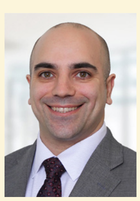
For more information, contact:

David H. Joseph
215.564.8090
djoseph@stradley.com

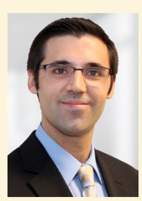
David P. Glatz
312.964.3502
dglatz@stradley.com

Prufesh R. Modhera
202.419.8417
pmodhera@stradley.com

John P. Hamilton
212.404.0652
john.hamilton@stradley.com



Joseph F. Dell'Aquila
215.564.8608
jdellaquila@stradley.com



Stephen LaChine
312.964.3522
slachine@stradley.com

John "JJ" Dikmak Jr.
215.564.8025
jdikmak@stradley.com

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Additionally, all or substantially all of the credit exposures underlying the eligible ABS must (1) for newly issued ABS, except CLOs, be originated by U.S.-organized entities (including U.S. branches or agencies of foreign banks), (2) for CLOs, have a lead or a co-lead arranger that is a U.S.-organized entity (including a U.S. branch or agency of a foreign bank), and (3) for all ABS, (including CLOs and CMBS), be to U.S.-domiciled obligors or with respect to real property located in the United States or one of its territories. The underlying assets must not include exposures that are themselves cash ABS or synthetic ABS.

The FAQ identifies additional requirements for (1) asset type and (2) property type CMBS that are pledged as eligible collateral under TALF.

1. **Asset Types:** Each CMBS must evidence an interest in a trust fund consisting of fully-funded mortgage loans and not other CMBS, other securities or interest rate swap or cap instruments or other hedging instruments. Participation or other ownership interest in such a loan will be considered a mortgage loan and not a CMBS or other security if, following a loan default, the ownership interest is senior to or pari passu with all other interests in the same loan in right of payment of principal and interest.

2. **Property Types:** The security for each mortgage loan must include (or, if payments due under the loan have been defeased, the security for the loan or its predecessor must have previously included) a mortgage or similar instrument on a fee or leasehold interest in one or more income-generating commercial properties.

Finally, eligible ABS being used as collateral in a new TALF loan cannot be on review or watch for downgrade by a nationally recognized statistical rating organization (NRSRO) and the ABS may not be used as collateral for any new TALF loans until it regains its status as eligible collateral. There are three eligible NRSRO's: S&P Global Ratings, Moody's Investors Service Inc. and Fitch Ratings, Inc.[8] However, it should be noted that if an ABS was eligible collateral at the time a TALF loan was entered into, but now is placed on a watch for downgrade or on a review by an NRSRO, nothing will happen to the existing eligible collateral and eligible borrowers will not be required to post any additional margin. For example, if a CMBS that is proposed to collateralize a loan request is downgraded or placed on review or watch for downgrade after the TALF loan subscription date, but before the settlement date, that CMBS will not be deemed ineligible based solely on the downgrade.

Operational Considerations:

While not all operational mechanics are known at this time, the FAQ states that an eligible borrower must be a customer of a TALF Agent and will be required to have executed a customer agreement authorizing the TALF Agent to, among other things, execute the MLSA as an agent for the eligible borrower and to perform all actions required on their behalf. However, the MLSA will provide further details on the requirements that apply to the entities seeking to borrow under the TALF. Also, specific requirements and concerns for investment funds and investment managers, such as whether a fund must or should disclose its participation in this program in its prospectus/offering document or statement of additional information, remain unknown.

We will continue to monitor for updates and additional terms and conditions for the TALF program. While the FAQ and updated Term Sheet did provide some clarifications, many of the details will remain unknown until the MLSA is published. However, the clarification that investment funds will now be considered eligible borrowers is a positive sign and resolves one of the main questions surrounding this program.

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[1] *See* TALF Term Sheet (May 12, 2020), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf; *see also* FAQs: Term Asset-Backed Securities Loan Facility (May 12, 2020), available at: https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-faq.

[2] A change from "Insurance premium finance loans."

[3] The FAQ does not specify whether or not the Fed will look through to the investment manager for determining whether the fund is created or organized in the United States.

[4] A TALF Agent is a financial institution that is a party to the MLSA from time to time, individually and as agent for its eligible borrower. The TALF Agents' role in supporting the TALF is to serve as agents on behalf of their customers, the TALF eligible borrowers. To expedite the implementation of the TALF, TALF Agents will initially consist of the Primary Dealers.

[5] Section 4019 of the CARES Act covers conflicts of interest.

[6] For more information about these, and other, unchanged terms, *see, TALF 2020: Summary of Revised Term Sheet and 1940 Act Considerations*, April 10, 2020, Stradley Ronon, *available at* https://www.stradley.com/insights/publications/2020/04/client-alert-talf-april-10-2020.

[7] The FAQ defines "average life" as follows:

For ABS with bullet maturities, average life is determined by the expected principal payment date. For amortizing ABS, average life is defined as the weighted average life to maturity based on the prepayment assumptions and market conventions listed below. These prepayment assumptions may be updated periodically for future TALF subscriptions and may be adjusted on a deal-specific basis. For auto rental fleets, the average life is the length of any revolving period plus six months.

The average life of a CMBS will be calculated on the basis of (1) the current composition of the mortgage pool, as reflected in recent servicer and trustee reports, (2) the entitlement of the CMBS to make distributions (including, if applicable, its position in a time-tranched sequence of classes), (3) the assumption that "anticipated repayment dates" are maturity dates, and (4) a 0% conditional prepayment rate and the absence of future defaults. For this purpose, loans in default or special servicing will be considered as if they had not defaulted, and previously-modified loans will be considered according to their terms as modified.

[8] The Fed may consider including others in the future.