Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters.
(Also Part I, §§ 851, 852; 1.851-2)

Rev. Proc. 2004–28

SECTION 1. PURPOSE

This revenue procedure describes conditions under which a taxpayer that has invested in a repurchase agreement (repo) may treat its position in the repo as a Government security for purposes of qualifying as a regulated investment company (RIC) under the asset diversification test of section 851(b)(3) of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 A repo is a written agreement that provides for a "sale" and "repurchase" of a security or securities (the "underlying securities," or the "collateral"). The purchaser agrees to purchase the underlying securities at a specific price and the seller, or "counterparty," agrees to repurchase the same securities on a specific date for a specified price, plus an additional amount that reflects the time value of the purchaser's investment from the date of purchase of the underlying securities to the date of their repurchase by the seller.

.02 RICs purchase securities in repo transactions as a convenient means to invest idle cash at competitive rates on a secured basis, generally for short periods of time. See Securities and Exchange Commission (SEC) Release No. IC–25058, 66 FR 36156, 36156–57 (July 11, 2001):

> While a repurchase agreement has legal characteristics of both a sale and a secured transaction, economically it functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan and are placed in the possession or under the control of the fund's custodian during the term of the agreement. . . .
>
> . . . .
>
> A fund investing in a properly structured repurchase agreement looks primarily to the value and liquidity of the collateral rather than the credit of the counterparty for satisfaction of the repurchase agreement.

Id. at 36157 (footnote omitted).

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

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

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

.06 Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. (1940 Act) defines a "diversified company" as a management company that has at least 75 percent of its assets invested in cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities that, for the purpose of this calculation, are limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the management company and to not more than 10 percent of the outstanding voting securities of the issuer. The remaining 25 percent of the management company's assets may be invested in any manner.

.07 Effective August 15, 2001, the SEC adopted Rule 5b–3, which is intended to adapt the 1940 Act to the economic realities of repos and to reflect recent developments in bankruptcy law protecting parties to repos. SEC Release No. IC–25058. Subject to certain conditions, Rule 5b-3 permits a fund to "look through" the counterparty to the collateral in determining whether the fund is in compliance with the investment criteria for diversified funds set forth in section 5(b)(1) of the 1940 Act and with certain other securities laws.

.08 The following definition is set forth in Rule 5b–3:

(1) *Collateralized Fully* in the case of a repurchase agreement means that:

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

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

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

(iv) The collateral consists entirely of :

(A) Cash items;

(B) Government securities;

(C) Securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the requisite nationally recognized statistical rating organizations [as defined in Rule 5b–3(c)(5)]; or

(D) Unrated Securities that are of comparable quality to securities that are rated in the highest rating category by the requisite nationally recognized statistical rating organizations, as determined by the investment company's board of directors or its delegate; and

(v) Upon an Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.

Rule 5b–3(c)(1).

.09 The "Collateralized Fully" definition plays a critical role in the application of the 1940 Act diversification rules to repos:

(a) *Repurchase Agreements.* For purposes of [the 1940 Act investment criteria for diversified investment companies and prohibition on registered investment companies from acquiring an interest in a broker-dealer, underwriter, or investment advisor], the acquisition of a repurchase agreement may be deemed to be an acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the investment company is Collateralized Fully.

Rule 5b–3(a).

The effect of this rule is that, for purposes of the definition of a diversified investment company in section 5 of the1940 Act, if a repo is Collateralized Fully, a fund may (but need not) treat an investment in the repo as an investment in the underlying security or securities.

.10 Section 851(c)(5) provides that, for purposes of section 851(b)(3), all terms not specifically defined in section 851(c) shall have the same meaning as when used in the 1940 Act, as amended. The term "Government security" is not specifically defined in section 851(c).

.11 Section 2(a)(16) of the 1940 Act defines the term "Government security" for purposes of the 1940 Act without specific reference to funds investing in repos for which Government securities serve as collateral.

.12 The RIC diversification rules of subchapter M are substantially similar in structure and purpose to those of section 5(b)(1) of the 1940 Act. Both sets of rules impose numerical limitations on the percentages and types of assets that may be held by an investment company. Both sets of rules are intended to protect the investor from the risks of loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers. See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 820–26. In view of the commonality of structure and purpose of both sets of rules and in view of the need for RICS simultaneously to comply with both, the RIC diversification provisions of the Code and those of the1940 Act should be interpreted consistently.

SECTION 3. SCOPE

This revenue procedure applies to repos that, within the meaning of Rule 5b–3(c)(1), are Collateralized Fully with securities that qualify as Government securities for purposes of section 851(b)(3).

SECTION 4. PROCEDURE

If a taxpayer has invested in a repo to which this revenue procedure applies, the taxpayer may treat its position in that repo as a Government security for purposes of section 851(b)(3) even if the taxpayer is not treated as the owner of the underlying securities for federal tax purposes.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for repos held by a RIC on or after August 15, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Susan Thompson Baker of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact her at (202) 622-3940 (not a toll-free call).