SULLIVAN & CROMWELL LLP

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SEC Provides Temporary Flexibility in Lending and Borrowing Arrangements to Registered Open-End Funds and Separate Accounts

Latest Action Follows a Series of Recent Steps Taken by the Agency to Provide Assistance and Relief to Funds and Investment Advisers in Response to Coronavirus

SUMMARY

Late yesterday evening, the Securities and Exchange Commission (the "SEC") announced temporary flexibility for registered funds affected by recent market events to borrow funds from certain affiliates and to enter into certain other lending arrangements. This latest development follows a series of steps taken by the SEC and its staff over the past several weeks to provide assistance and relief to funds and investment advisers, as well as other financial market participants, in response to the COVID-19 (coronavirus) pandemic. It also follows recent announcements by the Board of Governors of the Federal Reserve System of new and expanded lending facilities and other actions that will impact funds, including (i) the Money Market Mutual Fund Liquidity Facility, which will facilitate asset purchases by financial institutions from money market mutual funds in light of significant investor demands for redemptions and (ii) the Secondary Market Corporate Credit Facility, which will provide liquidity for outstanding corporate bonds by providing funding to a special purpose vehicle established by the Federal Reserve Bank of New York to purchase eligible individual corporate bonds as well as shares of U.S.-listed exchange traded funds holding eligible corporate bond portfolios in the secondary market.[1]

This memorandum provides an overview of the SEC's exemptive order, which provides temporary relief (i) permitting registered open-end funds and insurance company separate accounts to borrow money from certain affiliates, (ii) permitting additional flexibility under existing interfund lending arrangements and extending the ability to use interfund lending arrangements to funds that do not currently have exemptive

relief, and (iii) permitting registered open-end funds to enter into lending arrangements or borrowings that deviate from fundamental policies, subject to prior board approval.

BACKGROUND

In recent days, the SEC and other financial regulators have taken a series of steps to provide assistance to financial market participants impacted by the effects of the coronavirus pandemic.[2] Actions by the SEC and its staff to date with most relevance to funds and investment advisers have included:

- staff guidance on conducting an investment advisory business from a temporary location and inadvertent adviser custody of client assets during a temporary office closure;
- a conditional exemptive order to assist funds and advisers by permitting virtual board meetings and providing conditional relief from certain filing procedures and requirements for funds and investment advisers affected by COVID-19;
- staff guidance to facilitate continued shareholder engagement, including at virtual annual meetings, for companies and funds affected by COVID-19;
- a staff statement regarding fund board meetings and unforeseen or emergency circumstances related to COVID-19; and
- a website statement indicating that the SEC will continue to consider comments after the comment deadline for pending rulemakings with a comment period expiring in March and not take final action before April 24 (including, e.g., the SEC's proposed rule regarding use of derivatives by registered investment companies and business development companies).[3]

The SEC has also indicated that its staff is monitoring and engaging in outreach to the asset management industry (including mutual funds, money market funds, exchange traded funds, private equity funds and investment advisers), particularly funds and advisers with material exposures in markets and asset classes that have been most affected by recent events.

RELIEF GRANTED

As described further below, the SEC's exemptive order (the "Order") provides temporary flexibility for (1) registered open-end management investment companies other than money market funds ("open-end funds") and (2) insurance company separate accounts registered as unit investment trusts ("separate accounts") to obtain short-term funding in several possible ways. As discussed below, reliance on the relief in the Order will, in each case, require notice to the SEC, as well as satisfaction of other conditions and requirements.

This temporary relief will extend until the date specified in a public notice from the SEC staff stating that the relief will terminate, which date will be at least two weeks from the date of the notice and no earlier than June 30, 2020. The SEC has indicated that it may provide additional relief as circumstances warrant.

1. Ability of Open-End Fund or Separate Account to Borrow from an Affiliated Person; Ability of an Affiliated Person to Make Collateralized Loans

Section 12(d)(3) of the Investment Company Act of 1940 (the "Investment Company Act") generally prohibits a registered investment company (and any company controlled by a registered investment company) from acquiring securities issued by or other interests in a broker, dealer, underwriter or investment adviser unless certain conditions are met. Section 17(a) of the Investment Company Act generally prohibits certain transactions involving a registered investment company and an affiliated person or underwriter of the company, including certain purchases and sales of securities and borrowing or lending arrangements. Section 18(f)(1) of the Investment Company Act requires registered management companies to comply with certain custody requirements.

Subject to the conditions described below, the Order provides the following temporary exemptions:[4]

- An open-end fund or a separate account is exempt from section 12(d)(3) of the Investment Company Act of 1940 to the extent necessary to permit it to borrow money from any affiliated person, or affiliated person of such affiliated person, that is not itself a registered investment company;
- An affiliated person of an open-end fund or separate account, or an affiliated person of such affiliated person, is exempt from section 17(a) of the Investment Company Act to the extent necessary to permit it to make collateralized loans to such open-end fund or separate account; and
- An open-end fund is exempt from section 18(f)(1) of the Investment Company Act to the extent necessary to permit it to borrow money from any affiliated person, or affiliated person of such affiliated person, that is not a bank and is not itself a registered investment company.

Conditions. To be eligible for the temporary exemptions described above:

- The Board of Directors of the open-end fund, including a majority of the Directors who are not interested persons of the open-end fund, or the insurance company on behalf of the separate account, must reasonably determine that such borrowing:
  - is in the best interests of the registered investment company and its shareholders or unit holders; and
  - will be for the purpose of satisfying shareholder redemptions.
- Prior to relying on the relief for the first time, the open-end fund or separate account must notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order.

2. Interfund Lending Arrangements for Registered Investment Companies with Existing Interfund Lending Orders

Subject to the requirements described below, the Order provides that any registered investment company currently able to rely on an SEC order permitting an interfund lending and borrowing facility ("existing IFL order") may:[5]

- Make loans through the facility in an aggregate amount that does not exceed 25 percent of its current net assets at the time of the loan notwithstanding any lower limitation in the existing IFL order;

- Borrow (if permitted under the existing IFL order to be a borrower) or make loans through the facility for any term notwithstanding any conditions limiting the term of such loans, provided that (i) the term of any interfund loan made in reliance on the Order does not extend beyond the expiration of the temporary relief, (ii) the Board of Directors of the registered investment company, including a majority of the Directors who are not interested persons of the registered investment company, reasonably determines that the maximum term for interfund loans to be made in reliance on the Order is appropriate, and (iii) the loans will remain callable and subject to early repayment on the terms described in the existing IFL order; and

- Avail itself of the relief provided in Section 4 below notwithstanding any condition of the existing IFL order that incorporates limits set forth in its fundamental restrictions, limitations or non-fundamental policies;

Requirements. To be eligible for the temporary exemptions described above:

- Any loan under the facility must otherwise be made in accordance with the terms and conditions of the existing IFL order;
- Prior to relying on the relief described above for the first time, the registered investment company must notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order; and
- Prior to relying on the relief for the first time, the registered investment company must disclose on its public website that it is relying on an SEC exemptive order that modifies the terms of its existing IFL order to permit additional flexibility to provide or obtain short-term funding from its interfund lending and borrowing facility.

3. Interfund Lending Arrangements for Registered Investment Companies Without Existing Interfund Lending Orders

Subject to the requirements described below, the Order provides that any registered management investment company that is not currently able to rely on an SEC order permitting an interfund lending and borrowing facility may establish and participate in such a facility as set forth in another party's exemptive order permitting such a facility that the SEC has issued within the twelve months preceding the date of the Order ("recent IFL precedent").[6]

Requirements. To be eligible for the temporary exemptions described above:

- The registered investment company must satisfy the terms and conditions for relief in the recent IFL precedent (including with respect to whether it may participate as a borrower),[7] except:
  - It may rely on the relief provided in Section 2 above subject to its terms and conditions (other than the public website notice requirement in Section 2);
  - It need not satisfy the condition in the recent IFL precedent requiring prior disclosure in its registration statement or shareholder report; and
  - Money market funds may not participate as borrowers in the interfund facility;

- Prior to relying on the relief for the first time, the registered investment company must notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order and identifying the recent IFL precedent that it is relying on; and
- The registered investment company:
  - Must disclose on its public website, prior to relying on the relief for the first time, that it is relying on the relief to utilize an interfund lending and borrowing facility.
  - To the extent it files a prospectus supplement, or a new or amended registration statement or shareholder report, while it is relying on this relief, must update its disclosure regarding the material facts about its participation or intended participation in the facility.

4. Ability of a Registered Open-End Investment Company to Deviate from Its Fundamental Policy With Respect to Lending or Borrrowing

Sections 13(a)(2) and 13(a)(3) of the Investment Company Act generally require a registered investment company to comply with its policies described in its registration statements regarding, among other things, borrowing, lending and investment concentration, unless otherwise approved by majority vote of its shareholders.

Subject to the requirements described below, the Order temporarily exempts an open-end fund from sections 13(a)(2) and 13(a)(3) of the Investment Company Act to the extent necessary to permit it to enter into otherwise lawful lending or borrowing transactions that deviate from any relevant policy recited in its registration statement without prior shareholder approval.[8]

Requirements. To be eligible for the temporary exemptions described above:

- The Board of Directors of the open-end fund, including a majority of the Directors who are not interested persons of the investment company, must reasonably determine that such lending or borrowing is in the best interests of the registered investment company and its shareholders;
- The open-end fund must promptly notify its shareholders of the deviation by filing a prospectus supplement and including a statement on the fund's public website; and
- Prior to relying on the relief for the first time, the registered investment company must notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order.

CONSIDERATIONS FOR INDEPENDENT DIRECTORS/TRUSTEES OF REGISTERED INVESTMENT COMPANIES

The SEC has conditioned each grant of exemptive relief on there having been a specified "reasonable determination" by the relevant registered investment company's Board of Directors/Trustees ("Directors"), including a majority of the Directors who are not "interested persons" of the registered investment company. No guidance is provided in the Order to disinterested Directors, or to investment advisers of registered investment companies, of the relevant considerations or the information to be provided to Boards and disinterested Directors in connection with the required determinations, leaving such matters to the reasonable business judgment of such persons. While the Order provides welcome relief in an emergency situation, registered investment company Directors and investment advisers, and their advisors considering

whether to rely on the Order will need to carefully consider the relevant facts and circumstances and appropriately document such considerations, as board determinations made in emergency situations may be later judged with the benefit of hindsight.

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ENDNOTES

1 *See, e.g.*, Press Release, "*Federal Reserve announces extensive new measures to support the economy*," dated March 23, 2020, *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm . For further information on measures adopted by the Federal Reserve, see our publication, "*Federal Reserve COVID-19 Response*" dated March 24, 2020, *available at*: https://www.sullcrom.com/files/upload/SC-Publication-Federal-Reserve-New-and-Expanded-Lending-Facilities.pdf.

2 For an overview of SEC actions, *see* SEC Coronavirus (COVID-19) Response, *available at* https://www.sec.gov/sec-coronavirus-covid-19-response.

3 For an overview of this proposed rule, see our publication, "Use of Derivatives by Registered Investment Companies and Business Development Companies" dated December 11, 2019, *available at*: https://www.sullcrom.com/files/upload/SC-Publication-Use-of-Derivatives-by-Registered-Investment-Companies-and-Business-Development-Companies.pdf.

4 These exemptions are ordered pursuant to sections 6(c), 17(b) and 38(a) of the Investment Company Act.

5 These exemptions are ordered pursuant to sections 6(c), 12(d)(1)(J), 17(b),17(d) and 38(a) of the Investment Company Act and rule 17d-1 thereunder.

6 These exemptions are ordered pursuant to sections 6(c), 12(d)(1)(J), 17(b), 17(d) and 38(a) of the Investment Company Act and rule 17d-1.

7 Recent ILF precedents have included conditions requiring approval of certain matters by the fund's Board of Directors, including a majority of its Board members who are not "interested persons" to ensure that both borrowing and lending funds participate on an equitable basis. *See, e.g.*, *In the Matter of Blackstone Alternative Alpha Funds, et al.* and *In the Matter of Diamond Hill Funds and Diamond Hill Capital Management, Inc.*, *available at*: https://www.sec.gov/rules/icreleases.shtml#interfundlending.

8 These exemptions are ordered pursuant to sections 6(c) and 38(a) of the Investment Company Act.

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