SEC Provides Relief for Registered Funds to Obtain Short-Term Funding

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On Monday, March 23, 2020, the Securities and Exchange Commission (the "SEC") granted industry-wide exemptive relief permitting additional forms of permissible open-end registered investment company borrowing as a result of the current and potential effects of the COVID-19 outbreak around the world and its impact on the operations of registered funds.[1] Specifically, the SEC provided conditional temporary relief from certain requirements of the Investment Company Act of 1940 (the "1940 Act") providing flexibility for registered open-end management investment companies other than money market funds ("Open-End Funds") and for insurance company separate accounts registered as unit investment trusts ("Separate Accounts") to obtain short-term funding.[2] The exemptive order issued by the SEC (the "Order") provides these registered funds additional options to obtain cash and liquidity in the event that traditional sources of credit (*e.g.*, lines of credit from financial institutions) are unavailable, but is subject to certain conditions, including notifying the SEC staff.[3] The relief, however, for money market funds is limited, as described below.

1 *See* Order Under Sections 6(c), 12(d)(1)(J), 17(b), 17(d) and 38(a) of the Investment Company Act of 1940 and Rule 17d-1 Thereunder Granting Exemptions From Specified Provisions of the Investment Company Act and Certain Rules Thereunder, IC-33821 (Mar. 13, 2020), available here.

2 The SEC and its staff have taken other measures to provide regulatory relief and guidance to investment funds, among others, in response to the COVID-19 outbreak. For more information on these measures, please see our client memorandum entitled "SEC and NFA Provide Special Relief and Guidance as a Result of the COVID-19 Outbreak," dated Mar. 19, 2020, available here.

3 The actions taken by the SEC were similar to the actions taken following the attacks of September 11th. *See* Order under Sections 6(c), 17(b) and 38(a) of the Investment Company Act of 1940 Granting Exemptions from Certain Provisions of the Act and Certain Rules Thereunder, IC-25156 (Sept. 14, 2001). The SEC's Office of Compliance Inspections and Examination ("OCIE") recently announced that reliance on regulatory relief provided in response to the COVID-19 outbreak will not be a risk factor utilized in determining whether to commence an examination. *See* OCIE Statement on Operations and Exams – Health, Safety, Investor Protection and Continued Operations Are Our Priorities (Mar. 23, 2020), available here.

The relief lasts until at least June 30, 2020, and will continue until terminated by the SEC staff on a date to be specified in a public notice.

I. Borrowing from an Affiliated Person; Collateralized Loans

The Order first permits Open-End Funds and Separate Accounts to borrow money from an affiliated person (or an affiliated person of such affiliated person) and permits an affiliated person (or an affiliated person of such affiliated person) to make collateralized loans to Open-End Funds and Separate Accounts. Under this relief, for example, an Open-End Fund or a Separate Account can borrow from the investment adviser, the investment adviser's parent or another affiliated person (including an affiliated private fund), but may not borrow from an affiliated registered investment company. Money market funds cannot rely on this relief.

The Order provides an exemption from three prohibitions in the 1940 Act that would otherwise prevent Open-End Funds and Separate Accounts from engaging in the borrowing, as described below.

Section 12(d)(3) Relief. Section 12(d)(3) of the 1940 Act generally prohibits a registered investment company from purchasing or otherwise acquiring any security issued by or any other interest in a securities-related business, such as a broker-dealer, underwriter or investment adviser, except in certain limited circumstances. The Order exempts an Open-End Fund or Separate Account from Section 12(d)(3) to the extent necessary to permit it to borrow money from an affiliated person (or an affiliated person of such affiliated person) that is not a registered investment company.

Section 17(a) Relief. Section 17(a) of the 1940 Act generally prohibits, among other things, certain transactions involving a registered investment company and an affiliated person (or an affiliated person of such affiliated person), including certain borrowing or lending arrangements. The Order exempts an affiliated person (or an affiliated person of such affiliated person) of an Open-End Fund or Separate Account from Section 17(a) to the extent necessary to permit it to make collateralized loans to such Open-End Fund or Separate Account.

Section 18(f)(1) Relief. Section 18(f)(1) of the 1940 Act prohibits a registered open-end investment company from issuing any class of senior security, except that the registered open-end investment company may borrow from a bank with sufficient asset coverage. The Order exempts an Open-End Fund from Section 18(f)(1) to the extent necessary to permit it to borrow money from an affiliated person (or an affiliated person of such affiliated person) that is not a bank and is not a registered investment company.

To rely on the above relief, the following conditions must be satisfied:

(a) The board of the Open-End Fund, including a majority of the members who are not interested persons of the Open-End Fund, or the insurance company on behalf of the Separate Account, reasonably determines that such borrowing:

(i) is in the best interests of the registered investment company and its shareholders or unit holders; and

(ii) will be for the purpose of satisfying shareholder redemptions.

(b) Prior to relying on the relief for the first time, the Open-End Fund or Separate Account notifies the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order.

As noted above, one of the conditions for this relief is that it is available solely for the purpose of satisfying shareholder redemptions. This relief is therefore available only for this limited purpose and may not be used, for example, for bolstering the general liquidity of an Open-End Fund or Separate Account.

II. Interfund Lending Arrangements

The Order also provides relief for any registered investment company (including a money market fund) that currently can rely on an SEC order permitting an interfund lending and borrowing facility (an "existing IFL order"). An IFL order typically permits registered investment companies in the same complex to participate in an interfund lending and borrowing facility that would otherwise be precluded by certain provisions of the 1940 Act. The Order relaxes certain limitations on the interfund lending activities found in existing IFL orders. Significantly, the Order also permits any registered investment company that does not have an IFL order to establish and participate in an interfund lending and borrowing facility by relying on recent IFL precedent (as defined below). Money market funds may rely on the relief for registered investment companies with an existing IFL order, but cannot, as borrowers in an interfund facility, rely on the relief for registered investment companies without an existing IFL order.

Funds with an Existing IFL Order

Under the Order, a registered investment company (including a money market fund) currently able to rely on an existing IFL order may:

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

(b) 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 the registered investment company, including a majority of the members 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

(c) Avail itself of the relief provided in the Order regarding actions taken by an Open-End Fund without shareholder approval notwithstanding any condition of the existing IFL order that incorporates limits set forth in its fundamental restrictions, limitations or non-fundamental policies.[4]

To rely on the above relief, the following conditions must be satisfied in each case:

(a) Any loan under the facility is otherwise made in accordance with the terms and conditions of the existing IFL order;

(b) Prior to relying on the relief for the first time, the registered investment company notifies the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order; and

(c) Prior to relying on the relief for the first time, the registered investment company discloses on its public website that it is relying on a 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.

Under this relief, the SEC expanded the amounts that could be borrowed pursuant to existing IFL orders. This relief permits a registered investment company to loan an aggregate amount up to 25% of their net assets at the time of the loan, whereas existing IFL orders generally limit the amount to up to 15% of their net assets at the time of the loan. The SEC also relaxed the condition related to the term of an interfund loan — the relief permits an interfund loan to have a term at least through June 30, 2020, whereas existing IFL orders generally limit the term to not over seven days. For example, a loan entered on April 1, 2020, could effectively mature in 90 days. However, any interfund loan made pursuant to this relief would remain callable and subject to early repayment on the terms described in the existing IFL order (*i.e*., loans would be callable on one business day's notice by the lending fund). Finally, as noted above, any loan under the facility must otherwise be made in accordance with the terms and conditions of the existing IFL order. Therefore, all other applicable conditions of an existing IFL order remain applicable, such as the requirement that a lending fund's loans to any one fund may not exceed 5% of the lending fund's net assets.

[4] *See infra* Section III.

Funds Without an Existing IFL Order

Under the Order, a registered investment company that is not currently able to rely on an existing IFL order may establish and participate in an interfund lending and borrowing facility as set out in an exemptive order permitting such a facility that the SEC has issued within the twelve months preceding the date of the Order ("recent IFL precedent").[5] The Order also permits reliance on the relief described above for a registered investment company with an existing IFL order.

To rely on the relief above, the following conditions must be satisfied:

(a) 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), except:

(i) It may rely on the above relief provided to registered investment companies with an existing IFL order, subject to its terms and conditions (other than the notice requirement);

(ii) It need not satisfy the condition in the recent IFL precedent requiring prior disclosure in its registration statement or shareholder report; and

(iii) Money market funds may not participate as borrowers in the interfund facility;[6]

(b) Prior to relying on the relief for the first time, the registered investment company notifies the 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

(c) The registered investment company:

(i) Discloses 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.

(ii) 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, updates its disclosure regarding the material facts about its participation or intended participation in the facility.

[5] *See, e.g.*, Blackstone Alternative Alpha Fund et al., IC-33703 (Nov. 22, 2019) (notice) & IC-33720 (order), available here and here. For additional recent IFL precedent, please see the SEC's listing of IFL orders here.

[6] Unlike the relief provided for funds with an existing IFL order, money market funds may not participate as borrowers in the interfund facility.

III. Deviation from Fundamental Policy Regarding Lending or Borrowing

The final relief in the Order relates to the ability of an Open-End Fund to deviate from its fundamental policies when engaging in lending or borrowing transactions. Sections 13(a)(2) and 13(a)(3) of the 1940 Act generally require a registered investment company to comply with its fundamental policies described in its registration statement regarding, among other things, borrowing, issuing senior securities, lending and investment concentration, unless approved by a majority vote of its shareholders. The Order exempts an Open-End Fund from Sections 13(a)(2) and 13(a)(3) 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[7] without prior shareholder approval. Money market funds cannot rely on this relief.

To rely on the above relief, the following conditions must be satisfied:

(a) The board of the Open-End Fund, including a majority of the members who are not interested persons of the Open-End Fund, reasonably determines that such lending or borrowing is in the best interests of the Open-End Fund and its shareholders;

(b) The Open-End Fund promptly notifies its shareholders of the deviation by filing a prospectus supplement and including a statement on the applicable fund's public website; and

(c) Prior to relying on the relief for the first time, the Open-End Fund notifies the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on the Order.

[7] For example, an Open-End Fund may have the following types of fundamental policies, and the Open-End Fund may deviate from these policies in reliance on the Order and subject to the Order's conditions:

- No fund may borrow money, except that a fund may borrow money from banks as a temporary measure for extraordinary or emergency purposes in an amount not exceeding 5% of a fund's total assets.
- No fund may make loans to other persons.

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