ALERTS

# Regulated Funds: SEC Provides Temporary Exemption for Borrowing and Lending Arrangements in Response to COVID-19 Outbreak

**March 31, 2020**

On March 23, 2020, in recognition of the current and potential effects of the COVID-19 outbreak, the U.S. Securities and Exchange Commission issued a temporary order ("Order") providing certain registered investment companies the flexibility to engage in short-term funding arrangements that would otherwise be impermissible under the Investment Company Act of 1940 ("1940 Act").[1] The Order allows registered open-end management investment companies other than money market funds ("open-end funds") and insurance company separate accounts registered as unit investment trusts ("separate accounts") to borrow funds from affiliates and to enter into other lending arrangements, subject to certain conditions. The relief, which is effective for the period from the date of the Order until at least June 30, 2020, is intended to allow funds to manage their portfolios, including potential shareholder redemptions, for the benefit of all shareholders in light of the market disruptions resulting from the COVID-19 situation.

## Borrowings from Affiliates

The Order loosens restrictions imposed by the 1940 Act on borrowings by open-end funds and separate accounts if such borrowings are undertaken to satisfy shareholder redemptions. The Order exempts an open-end fund or separate account from the provisions of Section 12(d)(3) of the 1940 Act to the extent necessary to permit such fund to borrow

money from affiliates that are not themselves registered investment companies, as well as provides an exemption under Section 17(a) of the 1940 Act to enable an affiliate of an open-end fund or separate account to make collateralized loans to such an open-end fund or separate account, provided that the conditions below are satisfied.[2] Under the Order, an open-end fund is also exempt from the requirements of Section 18(f)(1) to the extent necessary to permit such fund to borrow money from an affiliate that is not a bank or a registered investment company, also subject to the conditions below.[3] The following conditions must be met in order to rely on the relief provided by the Order:

1. 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, reasonably determines that such borrowing:

    1. Is in the best interests of the registered investment company and its shareholders or unit holders; and

    2. Will be for the purpose of satisfying shareholder redemptions.

2. 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.

## Interfund Lending Arrangements

The Order also loosens restrictions on borrowing and lending arrangements involving registered investment companies that are currently able to rely on an SEC order permitting an interfund lending and borrowing facility ("IFL Order"), while also allowing funds without existing IFL Orders to enter into similar borrowing and lending arrangements.

Among other things, the Order allow funds with IFL Orders to increase the amount of the loans made through such interfund facilities, as well as to extend the term of such loans, subject to certain conditions, including that a majority of the independent directors of the fund determines that the term for any interfund loan made in reliance on the Order is appropriate. Loans made under such a facility must otherwise be made in accordance with the terms and conditions of the existing IFL Order. In addition, prior to relying on the relief for the first time, the registered investment company must notify the SEC staff via email at IM-

EmergencyRelief@sec.gov stating that it is relying on the Order and 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.

Registered investment companies not currently able to rely on an IFL Order may, pursuant to the Order, establish and participate in an interfund facility as set forth 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"); provided that, with certain exceptions, the registered investment company must satisfy the terms and conditions for relief in the recent IFL precedent (as modified by the relief provided by the Order, as applicable). A fund relying on this relief must also notify 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 must also include certain disclosures on its public website and in any prospectus supplements, new or amended registration statements or shareholder reports that it may file while relying on this relief.

## Deviations from Lending or Borrowing Fundamental Policies

The Order also exempts open-end funds from Sections 13(a)(2) and 13(a)(3) of the 1940 Act to the extent necessary to permit such funds to enter into lending or borrowing transactions that deviate from any relevant policy recited in their registration statements without prior shareholder approval, provided that the following conditions are met:

1. The board of directors of the open-end fund, including a majority of the directors who are not interested persons of the investment company, reasonably determines that such lending or borrowing is in the best interests of the registered investment company and its shareholders;

2. The open-end fund promptly notifies its shareholders of the deviation by filing a prospectus supplement and including a statement on the fund's public website; and

3. 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.

## Issues to Consider in Relying on the Order

While the relief contained in the Order may provide funds facing significant shareholder redemptions much-needed short-term funding, the boards of directors of such funds, including the directors who are not interested persons of the fund, must consider whether reliance on the Order is appropriate, given the fund's specific circumstances. Fund boards should work together with a fund's investment adviser and counsel to the fund and the independent directors to determine whether reliance on this relief is warranted and in the best interest of the fund. Funds should also consider how reliance on the Order reflects on the fund's liquidity risk management, in light of the public disclosure requirements of the Order.

*Authored by Karen Spiegel.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Investment Company Act Release No. 33821 (March 23, 2020), available here.

[2] Section 12(d)(3) of the 1940 Act generally prohibits a registered investment company from acquiring any security (including a note or a loan) issued by a securities-related business, including a broker, dealer, underwriter or investment adviser. Section 17(a) of the 1940 Act generally prohibits purchases and sales of securities or other property between a registered investment company and its affiliates, subject to certain exceptions.

[3] Section 18(f)(1) of the 1940 Act generally prohibits an open-end fund from issuing any senior security, except that an open-end fund can borrow from a bank provided that the fund maintains asset coverage of at least 300% for all of its borrowings.

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## Practices

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## Attachments

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