# COVID-19: RAPID SEC ACTION ON OPEN-END FUND BORROWING FOR LIQUIDITY

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**U.S. Investment Management Alert**

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On March 23, 2020, the Securities and Exchange Commission released an order (the "Order") [1] relaxing interfund lending rules for open-end funds impacted by recent market events associated with the pandemic outbreak of COVID-19. The relief is a substantial regulatory step to expand possible sources of liquidity for open-end funds facing redemption pressure. Subject to compliance with detailed conditions, the relief exempts registered open-end management investment companies other than money market funds ("Open-End Funds") from certain provisions of the Investment Company Act of 1940 (the "1940 Act") in order to expand flexibility for Open-End Funds to obtain short-term funding. The relief also applies to insurance company separate accounts registered as unit investment trusts ("Separate Accounts") in the same manner as Open-End Funds.

Specifically, subject to the conditions and limitations discussed further below, the Order permits the following:

- Expansion of Sources of Lending to Open-End Funds. Open-End Funds may borrow money on a collateralized basis from any affiliated person or affiliated person of an affiliated person (i.e., an affiliated adviser);
- Modification of Existing Interfund Lending Orders. Any registered investment company (including a money market fund) that has an existing interfund lending order permitting interfund lending and borrowing faciliies ("Existing IFL Orders") may, notwithstanding any lower limits in such orders: (i) make loans up to 25% of the net assets of the facility; (ii) borrow (if permitted to borrow under the Existing IFL Order) or make loans through the facility for any term not to exceed the expiration of the temporary relief; and (iii) deviate from any relevant policy including a fundamental policy regarding lending or borrowing incorporated into an Existing IFL Order from a fund's registration statement;
- Expansion of Interfund Lending Exemption to Other Registered Investment Companies. Established what in effect is a temporary exemptive rule that will allow any registered investment company that does not have an Existing IFL Order to establish and participate in an interfund lending and borrowing facility in reliance on any exemptive order issued by the SEC within the preceding year permitting such a facility ("Recent IFL Precedent") as if such order had been granted to the fund; and
- Approval to Deviate from Fundamental Policies on Borrowing. Open-End Funds may enter into otherwise lawful lending or borrowing transactions that deviate from the fundamental policies stated in their registration statement without prior shareholder approval.

This temporary relief is effective immediately. The relief will extend at least through June 30, 2020, and will continue in effect beyond that date until terminated in a public notice issued by the SEC staff.

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## BORROWING FROM AN AFFILIATED PERSON TO MEET REDEMPTIONS

The Order provides an exemption from Section 12(d)(3) [2] and Section 18(f)(1) [3] of the 1940 Act to the extent necessary to allow Open-End Funds and Separate Accounts to borrow money from any affiliated person (or an affiliated person of such person) that is not itself an Open-End Fund or a bank.

In order to rely on this relief, the following conditions must be met:

- The Board of Directors or Trustees of the Open-End Fund (the "Board"), including a majority of the independent directors or trustees (the "Independent Directors"), or the insurance company on behalf of the Separate Account, must reasonably determine that the borrowing:
  - is in the best interests of the Open-End Fund or Separate Account and its shareholders; and
  - will be for the purpose of satisfying shareholder redemptions; and
- Prior to relying on the relief, the Open-End Fund or Separate Account must notify the SEC staff via email at IM-EmergencyRelief@sec.gov that it is relying on the Order.

## INTERFUND LENDING ARRANGEMENTS FOR REGISTERED INVESTMENT COMPANIES WITH EXISTING IFL ORDERS

For any registered investment companies (including money market funds) that currently rely on Existing IFL Orders permitting interfund lending and borrowing facilities, the Order temporarily modifies the conditions of such Existing IFL Orders to provide greater flexibility to borrow and lend. Specifically, notwithstanding any lower limits in an Existing IFL Order, a registered investment company may:

- Make loans through the facility up to 25% of the fund's current net assets at the time of the loan;
- Borrow (if permitted to act as a borrower under the Existing IFL Order) or make loans through the facility for any term, provided that
  - the term does not extend beyond the expiration of the temporary relief;
  - the Board, including a majority of the Independent Directors, reasonably determines that the maximum term is appropriate; and
  - the loans remain callable and subject to early repayment on the terms described in the Existing IFL Order; and
- Deviate from any relevant policy, including any fundamental policy incorporated into the Existing IFL Order, consistent with the conditions set forth under "Deviating from Fundamental Policies" below.

In order to rely on this relief, the following conditions must be met:

- Any loan is made in accordance with the other terms and conditions of the Existing IFL Order not modified by the above;
- Prior to relying on the relief, the registered investment company must notify the SEC staff via email at IM-EmergencyRelief@sec.gov that it is relying on the Order; and

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- Prior to relying on the relief, the registered investment company must disclose on its public website that it is relying on the Order.

## INTERFUND LENDING ARRANGEMENTS FOR REGISTERED INVESTMENT COMPANIES WITHOUT EXISTING IFL ORDERS

Any registered investment company (including a money market fund) that does not have an SEC order permitting use of an interfund lending and borrowing facility (and therefore cannot rely on the above), may nevertheless establish and participate in such a facility by relying on Recent IFL Precedent. For an example of the conditions set forth in Recent IFL Precedent, see **Appendix A**.

In order to rely on this relief, the following conditions must be met:

- The registered investment company must satisfy the terms and conditions of the Recent IFL Precedent (including whether the registered investment company could act as a borrower), except that it
  - may rely on the modified conditions provided above for Existing IFL Orders; and
  - is not subject to the condition in Recent IFL Precedent requiring prior disclosure in a registration statement or shareholder report;
- Money market funds may not participate as borrowers in the facility;
- Prior to relying on the relief, the registered investment company must notify the SEC staff via email at IM-EmergencyRelief@sec.gov that it is relying on the Order and must identify the Recent IFL Precedent on which it is relying;
- Prior to relying on the relief, the registered investment company must disclose on its public website that it is relying on the Order; and
- To the extent the registered investment company files a prospectus supplement or a new or amended registration statement or shareholder report while relying on the Order, it must update its disclosure regarding its participation or intended participation in the facility.

## DEVIATING FROM FUNDAMENTAL POLICIES

The Order also exempts Open-End Fund [4] to the extent necessary to allow such funds to engage in lending or borrowing transactions that deviate from a fundamental policy in the fund's registration statement without prior shareholder approval.

In order to rely on this relief, the following conditions must be met:

- The Board, including a majority of the Independent Directors, must reasonably determine that such lending or borrowing is in the best interests of the Open-End Fund and its shareholders;
- The Open-End Fund must promptly notify shareholders of the deviation by filing a prospectus supplement and including a statement on the fund's website; and
- Prior to relying on the relief, the Open-End Fund must notify the SEC staff via email at IM-EmergencyRelief@sec.gov that it is relying on the Order.

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If you have any questions regarding these matters, please contact any of the authors listed above or one of the K&L Gates attorneys with whom you work.

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## NOTES

[1] 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, Investment Company Rel. No. 33821 (Mar. 23, 2020), https://www.sec.gov/rules/other/2020/ic-33821.pdf.

[2] Section 12(d)(3) of the 1940 Act generally prohibits a registered investment company from purchasing or otherwise acquiring any security issued by a securities-related business, such as a broker, dealer, underwriter, or investment adviser.

[3] Section 18(f)(1) prohibits an Open-End Fund from issuing any class of senior security, or selling any class of senior security of which it is the issuer, except that the Open-End Fund may borrow from a bank provided that immediately after any such borrowing there is asset coverage of at least 300% for all of its borrowings.

The Order also permits affiliated persons to engage in such activities, the order also grants an exemption from Section 17(a)[3] of the 1940 Act to allow affiliated persons, such as affiliated investment advisers, to make collateralized loans to Open-End Funds and Separate Accounts.

[4] Exemptions from Sections 13(a)(2) and 13(a)(3) of the 1940 Act. Section 13(a)(2) prohibits a registered investment company from borrowing money, issuing senior securities, underwriting securities issued by other persons, purchasing or selling real estate or commodities or making loans to other persons, except in each case in accordance with the policies contained in its registration statement.

Section 13(a)(3), in relevant part, prohibits a registered investment company from deviating from any investment policy which is changeable only if authorized by shareholder vote.

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## APPENDIX A

### Conditions of Recent IFL Precedent

1. The interest rate charged to the registered open-end management investment companies (the “Funds”) on any Interfund Loan (the “InterFund Loan Rate”) will consist of the average of the (1) highest repo (lending) rate (the “Repo Rate”), and (2) bank credit facility (borrowing) rate (the “Bank Loan Rate”).
2. On each business day when an Interfund Loan is to be made, certain of the investment adviser's fund administrative and fund accounting personnel (other than investment advisory personnel) (the “InterFund Lending Program Administration Group”) will compare the Bank Loan Rate with the Repo Rate and will make cash available for InterFund Loans only if the InterFund Loan Rate is (i) more favorable to the lending Fund than the Repo Rate, and (ii) more favorable to the borrowing Fund than the Bank Loan Rate.

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3. If a Fund has outstanding bank borrowings, any InterFund Loan to the Fund will: (i) be at an interest rate equal to or lower than the interest rate of any outstanding bank borrowing; (ii) be secured at least on an equal priority basis with at least an equivalent percentage of collateral to loan value as any outstanding bank loan that requires collateral; (iii) have a maturity no longer than any outstanding bank loan (and in any event not over seven days); and (iv) provide that, if an event of default occurs under any agreement evidencing an outstanding bank loan to the Fund, that event of default by the Fund, will automatically (without need for action or notice by the lending Fund), constitute an immediate event of default under the interfund lending agreement, which both (aa) entitles the lending Fund to call the InterFund Loan immediately and exercise all rights with respect to any collateral and (bb) causes the call to be made if the lending bank exercises its right to call its loan under its agreement with the borrowing Fund.
4. A Fund may borrow on an unsecured basis through the interfund lending facility (the “InterFund Lending Program”) only if the relevant borrowing Fund's outstanding borrowings from all sources immediately after the interfund borrowing total 10% or less of its total assets, provided that if the borrowing Fund has a secured loan outstanding from any other lender, including but not limited to another Fund, the lending Fund's InterFund Loan will be secured on at least an equal priority basis with at least an equivalent percentage of collateral to loan value as any outstanding loan that requires collateral. If a borrowing Fund's total outstanding borrowings immediately after an InterFund Loan would be greater than 10% of its total assets, the Fund may borrow through the InterFund Lending Program only on a secured basis. A Fund may not borrow through the InterFund Lending Program or from any other source if its total outstanding borrowings immediately after the borrowing would be more than 33 1/3% of its total assets or any lower threshold provided for by a Fund's fundamental restriction or non-fundamental policy.
5. Before any Fund that has outstanding interfund borrowings may, through additional borrowings, cause its outstanding borrowings from all sources to exceed 10% of its total assets, it must first secure each outstanding InterFund Loan to a Fund by the pledge of segregated collateral with a market value at least equal to 102% of the outstanding principal value of the loan. If the total outstanding borrowings of a Fund with outstanding InterFund Loans exceed 10% of its total assets for any other reason (such as a decline in net asset value or because of shareholder redemptions), the Fund will within one business day thereafter either (i) repay all its outstanding InterFund Loans to other Funds, (ii) reduce its outstanding indebtedness to 10% or less of its total assets, or (iii) secure each outstanding InterFund Loan to other Funds by the pledge of segregated collateral with a market value at least equal to 102% of the outstanding principal value of the loan until the Fund's total outstanding borrowings cease to exceed 10% of its total assets, at which time the collateral called for by this condition 5 shall no longer be required. Until each InterFund Loan that is outstanding at any time that a Fund's total outstanding borrowings exceed 10% of its total assets is repaid or the Fund's total outstanding borrowings cease to exceed 10% of its total assets, the Fund will mark the value of the collateral to market each day and will pledge such additional collateral as is necessary to maintain the market value of the collateral that secures each outstanding InterFund Loan to Funds at least equal to 102% of the outstanding principal value of the InterFund Loans.
6. No Fund may lend to another Fund through the InterFund Lending Program if the loan would cause the lending Fund's aggregate outstanding loans through the InterFund Lending Program to exceed 15% of its current net assets at the time of the loan.

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7. A Fund's InterFund Loans to any one Fund shall not exceed 5% of the lending Fund's net assets.
8. The duration of InterFund Loans will be limited to the time required to receive payment for securities sold, but in no event more than seven (7) days. Loans effected within seven (7) days of each other will be treated as separate loan transactions for purposes of this condition 8.
9. A Fund's borrowings through the InterFund Lending Program, as measured on the day when the most recent loan was made, will not exceed the greater of 125% of the Fund's total net cash redemptions for the preceding seven (7) calendar days or 102% of a Fund's sales fails for the preceding seven (7) calendar days.
10. Each InterFund Loan may be called at any time on one business day's notice by a lending Fund and may be repaid on any day by a borrowing Fund.
11. A Fund's participation in the InterFund Lending Program must be consistent with its investment restrictions, policies, limitations, and organizational documents.
12. The InterFund Lending Program Administration Group will calculate total Fund borrowing and lending demand through the InterFund Lending Program, and allocate InterFund Loans on an equitable basis among the Funds, without the intervention of any portfolio manager. The InterFund Lending Program Administration Group will not solicit cash for the InterFund Lending Program from any Fund or prospectively publish or disseminate loan demand data to portfolio managers. After the InterFund Lending Program Administration Group has allocated cash for InterFund Loans, any remaining cash will be invested in accordance with the standing instructions of the relevant portfolio manager(s) or such remaining amounts will be invested directly by the portfolio managers of the Funds.
13. The InterFund Lending Program Administration Group will monitor the InterFund Loan Rate charged and the other terms and conditions of the InterFund Loans and will make a quarterly report to the Board concerning the participation of the Funds in the InterFund Lending Program and the terms and other conditions of any extensions of credit under the InterFund Lending Program.
14. Each Board, including a majority of its Independent Directors/Trustees, will (i) review, no less frequently than quarterly, the participation of each Fund it oversees in the InterFund Lending Program during the preceding quarter for compliance with the conditions of any order permitting such participation; (ii) establish the Bank Loan Rate formula used to determine the interest rate on InterFund Loans; (iii) review, no less frequently than annually, the continuing appropriateness of the Bank Loan Rate formula and; (iv) review, no less frequently than annually, the continuing appropriateness of the participation in the InterFund Lending Program by each Fund it oversees.
15. Each Fund will maintain and preserve for a period of not less than six years from the end of the fiscal year in which any transaction by it under the InterFund Lending Program occurred, the first two years in an easily accessible place, written records of all such transactions setting forth a description of the terms of the transaction, including the amount, the maturity and the InterFund Loan Rate, the rate of interest available at the time each InterFund Loan is made on overnight repurchase agreements and bank borrowings, and such other information presented to the Boards in connection with the review required by conditions 13 and 14.

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16. In the event an InterFund Loan is not paid according to its terms and the default is not cured within two business days from its maturity or from the time the lending Fund makes a demand for payment under the provisions of the interfund lending agreement, the investment adviser to the lending Fund promptly will refer the loan for arbitration to an independent arbitrator selected by the Board of any Fund involved in the loan who will serve as arbitrator of disputes concerning InterFund Loans. If the dispute involves Funds that do not have a common Board, the Board of each affected Fund will select an independent arbitrator that is satisfactory to each Fund. The arbitrator will resolve any problem promptly, and the arbitrator's decision will be binding on both Funds. The arbitrator will submit, at least annually, a written report to the Board of each Fund setting forth a description of the nature of any dispute and the actions taken by the Funds to resolve the dispute.
17. The investment adviser will prepare and submit to the Board for review an initial report describing the operations of the InterFund Lending Program and the procedures to be implemented to ensure that all Funds are treated fairly. After the commencement of the InterFund Lending Program, the investment adviser will report on the operations of the InterFund Lending Program at each Board's quarterly meetings. Each Fund's chief compliance officer, as defined in Rule 38a-1(a)(4) under the 1940 Act, shall prepare an annual report for its Board each year that the Fund participates in the InterFund Lending Program, that evaluates the Fund's compliance with the terms and conditions of the Application and the procedures established to achieve such compliance. Each Fund's chief compliance officer will also annually file a certification pursuant to item 77Q3 of Form N-SAR as such Form may be revised, amended or superseded from time to time, for each year that the Fund participates in the InterFund Lending Program, that certifies that the Fund and the investment adviser have implemented procedures reasonably designed to achieve compliance with the terms and conditions of the order. In particular, such certification will address procedures designed to achieve the following objectives:

    a. that the InterFund Loan Rate will be higher than the Repo Rate, but lower than the Bank Loan Rate;
    b. compliance with the collateral requirements as set forth in the exemptive application;
    c. compliance with the percentage limitations on interfund borrowing and lending;
    d. allocation of interfund borrowing and lending demand in an equitable manner and in accordance with procedures established by the Board; and
    e. that the InterFund Loan Rate does not exceed the interest rate on any third party borrowings of a borrowing Fund at the time of the InterFund Loan.

    Additionally, each Fund's independent registered public accounting firm, in connection with such firm's audit examination of the Fund, will review the operation of the InterFund Lending Program for compliance with the conditions of the Application and such review will form the basis, in part, of the firm's report on internal accounting controls in Form N-SAR.
18. No Fund will participate in the InterFund Lending Program, upon receipt of requisite regulatory approval, unless it has fully disclosed in the relevant registration statement on Form N-1A (or any successor form adopted by the SEC), or, in the case of a closed-end Fund, the relevant registration statement on Form

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N-2 (or any successor form adopted by the SEC) or shareholder reports, all material facts about the Fund's intended participation.

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