

SEC Issues Exemptive Relief to Provide Funds Additional Short-Term Borrowing Flexibility

March 30, 2020

The U.S. Securities and Exchange Commission ("SEC") recently issued an order providing temporary flexibility for certain registered investment companies ("funds") and certain of their affiliates to enter into short-term borrowing and lending arrangements (the "Order").^[1] The Order is another in a series of steps the SEC has taken to assist financial market participants in addressing the broader market impacts of the coronavirus. Specifically, subject to certain conditions, the Order provides temporary exemptive relief from the Investment Company Act of 1940, as amended (the "1940 Act"), through at least June 30, 2020, that:

- permits registered open-end management investment companies other than money market funds ("open-end funds") and insurance company separate accounts registered as unit investment trusts ("UITs") to borrow money from certain affiliates;
- provides additional flexibility for funds under existing interfund lending arrangements;
- extends the ability to use interfund lending arrangements to funds that do not currently have exemptive relief; and
- permits open-end funds to enter into lending or borrowing arrangements that deviate from fundamental policies, subject to prior board approval.

The Order gives funds that are facing redemption pressure in the midst of extremely volatile markets access to certain additional sources of liquidity that the 1940 Act otherwise may prohibit them from accessing. The Order also raise questions for fund advisers and boards considering taking advantage of the relief.

Ability of Open-End Fund or UIT to Borrow from an Affiliated Person; Ability of an Affiliated Person to Make Collateralized Loans

Relief. Subject to the conditions listed below, the Order temporarily permit open-end funds and UITs to borrow from certain affiliates, and those affiliates to make collateralized loans to such funds and UITs.[\[2\]](#)

Conditions. To use this relief, the following conditions must be met:

- [a.](#) The board of the open-end fund, including a majority of the board members who are not "interested persons" (as defined in the 1940 Act ("Independent Board Members")) of the fund, or the insurance company on behalf of the UIT, must reasonably determine that such borrowing (i) is in the best interests of the fund 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 UIT must notify the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order.

Considerations: Temporary borrowings under the conditions of the Order to meet redemptions may allow funds to avoid current sales of impaired assets to meet redemptions. This action may permit a fund to postpone realizing losses. However, these borrowings will leverage the fund and may exacerbate future losses. Fund advisers and boards considering recommending and approving the use of borrowings in turbulent markets to meet redemptions will need to balance carefully the interests of redeeming shareholders (who may benefit) with those of the remaining shareholders (who may experience later losses). Moreover, collateralized borrowing by a fund from an affiliate of its investment adviser involves various conflicts, such as the selection of collateral, that the fund's board—in cooperation with the fund's adviser—will need to satisfy itself are being sufficiently identified and appropriately managed in the interest of the fund. Finally, boards considering short-term borrowings will need to consider whether a non-affiliate lender may be able to provide similar or better terms, thus avoiding some of these conflicts, recognizing that it may be difficult to enter into an arrangement with a non-affiliate on an expedited basis.

Additional Flexibility Under Existing Interfund Lending Arrangements

Relief. Subject to the conditions listed below, the Order temporarily permits a fund currently able to rely on an SEC order permitting an interfund lending and borrowing facility (an "Existing Interfund Lending Order") to:

1. Make loans through the facility in an aggregate amount not exceeding 25% of its current net assets at the time of the loan, notwithstanding any lower limitations in the Existing Interfund Lending Order.[\[3\]](#)
2. Borrow (if permitted under the Existing Interfund Lending Order) or make loans through the facility for any term, notwithstanding any conditions of the Existing Interfund Lending Order, provided that (i) the term does not extend beyond the expiration of the Order (currently, June 30, 2020); (ii) the fund's board, including a majority of the Independent Board Members, 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 Interfund Lending Order.
3. Avail itself of the ability to deviate from its fundamental policy with respect to lending or borrowing (as discussed below) notwithstanding any condition of the Existing Interfund Lending Order.

Conditions. To use this relief, the following conditions must be met:

1. Any loan under the facility must otherwise be made in accordance with the terms and conditions of the Existing Interfund Lending Order;
2. Prior to relying on the relief for the first time, the fund must notify the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order; and
3. Prior to relying on the relief for the first time, the fund must disclose on its public website that it is relying on the Order, which modifies the terms of its Existing Interfund Lending Order to permit additional flexibility to provide or obtain short-term funding from its interfund lending and borrowing facility.

Considerations. Fund advisers and, when a single board oversees more than one fund, boards owe separate fiduciary duties to both the lending and borrowing funds, which obligates them to act in the best interests of each fund. It is important, therefore, that the lending fund's cash resources are not being used inappropriately to benefit the borrowing fund whose portfolio liquidity may be impaired. As a practical matter, that may mean both the fund's adviser and the fund's board must consider whether the interests of lending fund would be better served retaining its cash, particularly if the lending fund may, under reasonably foreseeable conditions, itself need the cash to fund redemptions, or using its cash to take advantage of new investment opportunities that become available under current market conditions.

Extension of Ability to Use Interfund Lending Arrangements

Relief. Subject to the conditions listed below, the Order temporarily permits any fund that is not currently able to rely on an Existing Interfund Lending Order to establish and participate in a facility as permitted by an exemptive order issued by the SEC within the last twelve months preceding the date of the Order (a "Recent Interfund Lending Order"), as modified by the exemptive relief described above.

Conditions. To operate under this relief, the following conditions must be met:

1. The fund must satisfy the terms and conditions for relief in the Recent Interfund Lending Order (including with respect to whether it may participate as a borrower), except: (i) it may rely on the relief described above with respect to additional flexibility for Existing Interfund Lending Orders, above subject to its terms and conditions (other than the notice public website notice requirement); (ii) it need not satisfy the condition in the Recent Interfund Lending Order requiring prior disclosure in its registration statement or shareholder report; and (iii) money market funds may not participate as borrowers in the interfund facility;
2. Prior to relying on the relief for the first time, the fund must notify the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order and identifying the Recent Interfund Lending Order that it is relying on; and
3. The fund must (i) disclose on its public website, prior to relying on the relief for the first time, that it is relying on the Order to utilize an interfund lending and borrowing facility; and (ii) to the extent the it files a prospectus supplement, or a new or amended registration statement or shareholder report, while it is relying on the Order, the fund must update its disclosure regarding the material facts about its participation or intended participation in such a facility.

Considerations. In advance of relying on the relief, fund counsel might consider reviewing Recent Interfund Lending Orders to identify any favorable differences among them. Fund advisers and boards also will need to consider and, perhaps, resolve the issues relating to the risks and conflicts associated with such arrangements summarized above. In addition, a fund complex considering implementing a facility for the first time should assure that it has both the operational and compliance infrastructure in place to implement the program and to assure that the fiduciary duties owed to all funds involved in the facility are satisfied.

Ability to Deviate from Fundamental Policies

Relief. Subject to the conditions listed below, the Order temporarily exempts open-end funds from their fundamental investment policies, as disclosed in their registration statements, to the extent necessary to permit them to enter into otherwise lawful lending or borrowing transactions without prior shareholder approval.[\[4\]](#)

Conditions. To use this relief, the following conditions must be met:

1. The fund's board, including a majority of the Independent Board Members, reasonably determines that such lending or borrowing is in the best interests of the fund and its shareholders;
2. The fund promptly notifies its shareholders of the deviation by filing a prospectus supplement and including a statement on its website; and
3. Prior to relying on the relief for the first time, the fund notifies the SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order.

Considerations. Fundamental policies are a bedrock upon which fund disclosures are built and fund assets are managed. Where action in reliance to the Order results in fund losses, litigious investors in both borrowing and lending funds may be able to assert their reliance on those policies to support their claims. At a minimum, the extent and duration of disclosures prior to using the relief will require careful consideration. Reliance on the relief under the 1940 Act provided by the Order may not fully insulate against claims under other federal securities laws by investors who may allege that they suffered investment losses as a result of a change in a fund's investment policies that is approved by the fund's board, and not by its shareholders, under the terms of the Order. Fund advisers and boards should consider these risks in determining whether to take advantage of the relief provided by the Order, along with the timing, content and delivery of disclosures to current and potential investors.

Term of Temporary Relief

This temporary relief will extend until the date specified in a public notice from the staff of the SEC 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 and its staff continue to assess impacts relating to the coronavirus on investors and market participants, and will consider additional relief from other regulatory requirements where necessary or appropriate. The SEC may provide additional relief as circumstances warrant and, as evidenced already, may extend and/or modify currently available relief.

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[1] The Order is available at <https://www.sec.gov/rules/other/2020/ic-33821.pdf>.

[2] The Order grants relief from Section 12(d)(3), Section 17(a) and Section 18(f)(1) of the 1940 Act to the extent necessary to permit these borrowing and lending arrangements. Not all transactions may require relief from each of those sections (e.g., uncollateralized loans may not give rise to Section 12(d)(3) or Section 17(a) concerns, and UITs are not subject to Section 18(f)(1)).

[3] Recent Existing Interfund Lending Orders generally limit aggregate lending amounts to 15% of a fund's current net assets. The Order does not appear to change the related condition in Existing Interfund Lending Orders that limits lending to any one fund under a facility to 5% of the lending fund's current net assets.

[4] The Order provides relief from Sections 13(a)(2) and 13(a)(3) of the 1940 Act, which prohibit a fund from (i) borrowing money except in accordance with a policy contained in its registration statement and (ii) deviating from its policy regarding borrowing without shareholder approval, respectively.