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1940 Act Issues to Consider During the Pandemic - Part 3

Stradley's Coronavirus Task Force will be updating this high-level overview of coronavirus disease 2019 (COVID-19) related issues for registered investment companies and fund managers as developments warrant.

NEW ISSUES:

- **State and Local Closures:** *Several states, counties and cities (e.g., California, Pennsylvania, New York and Illinois) have announced business closures in connection with "shelter-in-place" public health efforts to slow the spread of COVID-19. Some of the orders may contain broad exceptions for the financial services industry, while others may not. Beyond the direct impact on firms in those localities, review the location of service providers and the terms of these orders carefully to determine whether necessary support functions will remain available. (New 3/23/2020)*
- **Transfer Agents:** *The SEC provided [a broad exemption](#) for the period from March 16 to May 30 from requirements applicable to transfer agents except for the safeguarding requirement. Transfer agents relying on the relief must provide notice to the SEC by May 30. The SEC encourages transfer agents and the issuers for whom they act to inform affected security holders. (New 3/23/2020)*
- **Tax implications for funds with institutional shareholders:** *For institutional funds with few shareholders, beware that the fund could fall into personal holding company status if at any time during the last half of the taxable year more than 50 percent in value of the fund's shares are owned, directly or indirectly, by or for not more than 5 "individuals." For purposes of this rule, employee pension trusts, private foundations, trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits, and a trust, a portion of which is permanently set aside or to be used exclusively for charitable purposes, are considered individuals. (New 3/23/2020)*

UPDATED ISSUES:

Market closures and market restrictions: A list of securities market closures and market restrictions is available [here](#). (Updated 3/23/2020)

- **Money Market Mutual Funds:**
 - **Form N-CR:** *Several money market funds have filed on Form N-CR to report financial support, and one money market fund has filed on Form N-CR to report a downward deviation of its shadow price by more than ¼ of 1 percent. An amended report is required to be filed within four business days of the provision of financial*

support or downward deviation that describes the reason for the support and terms of the support or the reason for the deviation, as applicable.

- **Purchases by Affiliated Banks:** *The Federal Reserve Board has issued a template exemptive letter allowing banks to purchase assets from affiliated money market funds, subject to certain conditions, including that the assets must be investment grade and purchased at fair market value.¹ In addition, the SEC staff has granted no-action relief to permit certain bank affiliates of money market funds to purchase securities from the funds in accordance with the Federal Reserve Board guidance, but otherwise pursuant to rule 17a-9, subject to certain conditions.² The SEC no-action letter does not affect the ability of other money market fund affiliates to purchase assets from the fund in accordance with rule 17a-9.*
- **Liquidity Facility:** *The Federal Reserve Board has announced a Money Market Mutual Fund Liquidity Facility (MMLF) that is intended to assist money market funds in meeting demands for redemptions.³ Under the MMLF, the Federal Reserve Bank of Boston will lend to depository institutions and bank holding companies, taking as collateral assets purchased by the borrower from prime money market funds (i) concurrently with the borrowing or (ii) on or after March 18, but before the opening of the facility. The facility is similar to the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility that operated from late 2008 to early 2010 but will purchase a broader range of assets. *The Federal Reserve Board expanded the facility to cover certain assets purchased from tax-exempt municipal money market funds.⁴ The Federal Reserve Board has announced that the facility will open today, March 23, and full documentation and additional guidance are now available.⁵**
- **Guaranty:** *In addition, there are proposed congressional actions that would temporarily permit the use of the Exchange Stabilization Fund*

to guarantee money market funds. The Exchange Stabilization Fund was used for this purpose in 2008, but current law prohibits its use for the establishment of any future guaranty programs for the United States money market fund industry, so this would require legislation. See 12 U.S.C. § 5236. (Updated 3/23/2020)

- **Exchange-traded funds:** *For an ETF that invests in foreign markets that close, the ETF may wish to consider whether to invest in alternative instruments, such as ADRs, in order to achieve the desired exposure to the foreign securities. In circumstances where there is no ability to make additional investments in appropriate alternative instruments, an ETF may wish to stop accepting creation unit purchases. The Commission previously has noted that ETFs generally may suspend the issuance of creation units only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF's portfolio holdings are traded are closed for a limited period of time.⁶ ETF issuers should be aware that any decision to suspend creations could have an impact on the arbitrage efficiency of the ETF and could lead to greater deviations between the market price of the ETF shares and the NAV of the shares. Like other open-end funds, ETFs cannot suspend redemptions unless the New York Stock Exchange is closed or there is appropriate guidance from the SEC. *ETFs are permitted to charge transaction fees of up to 2% on redemptions. Such fees are designed to offset the costs of redemptions to the ETF. Some fixed-income ETFs that deliver cash redemptions instead of in-kind redemptions reportedly have increased their transaction fees on redemptions in light of increased transaction costs in the bond market. (Updated 3/23/2020)**
- **CPO NFA Filings:** *The CFTC staff has provided no-action relief to commodity pool operators that extends certain filing deadlines.⁷ With respect to Form CPO-PQR filings under CFTC Regulation 4.27, Small and Mid-Sized CPOs have until May 15, 2020 to submit their annual filings for 2019, while Large CPOs have until July 15, 2020 to submit their filings for Q1 2020. For pool annual reports under CFTC Regulations 4.7(b)(3) or 4.22(c) that are due on or*



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Please do not hesitate to reach out to your Stradley Ronon contact, or to any member of Stradley's Coronavirus Task Force, with any questions and concerns you may have during this period.

before April 30, 2020, the deadline for filing and distributing the report, which must include certified financial statements, has been extended until 45 days after the due date specified in the regulations. For monthly or quarterly reports to pool participants under CFTC Regulation 4.7(b)(2) or 4.22(b) for all reporting periods ending on or before April 30, 2020, the deadline for distribution to participants has been extended to 45 days after the end of the reporting period (instead of 30 days as stated in the regulations). The National Futures Association has issued similar relief for CPO Members and has provided commodity trading advisor Members with similar relief for NFA Form PR filings.⁸ (Updated 3/23/2020)

ISSUES:

- **Liquidity risk management:** Current developments raise a number of issues for the management of funds' liquidity risk:
 - **Assessment, management, and periodic review of liquidity risk:** Funds should review fund liquidity risk in light of current and reasonably expected market events and redemption patterns and may need to consider appropriate mitigating steps for strengthening the fund's ability to meet redemptions, including readying borrowing and other liquidity facilities.
 - **Classification of portfolio investments:** Rule 22e-4 requires funds to review their portfolio investments' liquidity classifications more frequently than monthly if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect classifications. Such reviews should focus especially on holdings that could be considered illiquid investments as a result of these developments or that could fall out of highly liquid investment status. An important consideration will be a review of the reasonably anticipated trading sizes in light of redemption expectations. Funds should be alert to the possibility that vendor classifications may be based on historical rather than current data.
 - **Highly liquid investment minimum:** For funds that currently hold primarily highly liquid assets, and therefore are not required to have an HLIM, the program administrator may need to examine whether the fund can still qualify for that status. For HLIM funds, the HLIM may need to be reviewed under the required factors in light of current market and redemption developments and, if a shortfall is reasonably anticipated, a shortfall response plan should be developed, which must include a plan for reporting shortfalls to the fund's board.
- **Illiquid investments:** During this period of extreme market volatility, the fund should monitor closely whether there is a need to reclassify holdings as illiquid investments. Funds should be prepared to file Form N-LIQUID if the fund's illiquid assets exceed 15% of its net assets. The program administrator should have guidance designed to prevent purchases that would violate the prohibition on acquiring illiquid investments when over the 15% limit. We do not yet know if the SEC will provide guidance relieving funds from filing Form N-LIQUID in the event of foreign or other market closings that are beyond the scope of existing guidance on extended foreign holidays.
- **Redemptions in kind:** Funds may wish to consider whether redemptions in kind would be an appropriate tool for large redemption requests, including whether operational logistics are in place to accommodate any such redemption requests. (Updated 3/19/2020)
- **SEC Filings:** The SEC's 1940 Act Order (cited below) provides relief from the timeliness requirements of Form N-CEN, Form N-PORT, and Form N-23C-2 when a fund is unable to meet a deadline due to circumstances related to current or potential effects of COVID-19. The relief for Forms N-CEN and N-PORT applies to filing obligations for which the original due date is on or after March 13 but on or prior to April 30, 2020, while the relief for Form N-23C-2 extends to June 15, 2020. A separate order under the Investment Advisers Act of 1940 provides timeliness relief for Form ADV and Form PF filings and for Form ADV Part 2 client delivery obligations, when the original due date is on or after March 13 but on or prior to April 30, 2020,⁹ and the SEC has posted staff guidance that Form ADV does not have to be updated to reflect temporary teleworking locations.¹⁰ The SEC previously provided relief from timeliness requirements for certain filings under the Securities Exchange Act of 1934.¹¹ Note that filings not covered by the orders continue to be required on a timely basis, including filings on Form N-LIQUID, Form N-CR, and Form N-MFP, although it is possible that the SEC will consider issues with these forms on an individualized basis. The SEC provided information on contacting the staff with issues, including issues with these filings, in a press release announcing the actions.¹² (Updated 3/19/2020)
- **Form CRS:** We understand that the SEC staff is considering whether brokers and advisers should be given relief from the Form CRS deadline. Unless such relief is given, compliance with the Form CRS requirement will be required as of June 30, 2020. (New 3/19/2020)

- **SEC Comment Periods:** The SEC has issued a statement noting that the Commission and staff have historically considered comments submitted after a comment period closes but before adoption of a final rule or order.¹³ For certain pending rule proposals, including proposals concerning auditor independence, the accredited investor definition, and fund investments in derivatives, the SEC stated that it will not take final action before April 24 in order to allow commenters additional time if needed. (New 3/19/2020)
- **MiFID II Reporting:** Under the MiFID II delegated regulation, investment firms providing the service of portfolio management and subject to MiFID II must inform the client where the overall value of the portfolio, as evaluated at the beginning of each reporting period, depreciates by 10% and thereafter at multiples of 10%, no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day.¹⁴ (New 3/19/2020)
- **Fund Boards:** Fund directors should stay up to speed on current market events so they can properly apply their business judgment as necessary from a governance standpoint. In many cases, fund boards are receiving periodic status reports or attending status updates from fund advisers. Examples of areas for directors to consider include, for funds, fund flows, liquidity levels, valuation, and performance; and for fund advisers, status of operations under business continuity plans, market assessments, and the assessment of critical fund service providers. Board reporting from fund advisers is particularly important during times of market stress. To strike an appropriate balance between staying apprised and being efficient and respectful of fund advisory personnel time, boards may seek to channel questions or communications through independent counsel or the board chair/lead independent director. (New 3/19/2020)
- **In-person board meetings:** On March 13, the SEC issued an order under the Investment Company Act of 1940 (“1940 Act Order”), allowing fund boards to meet telephonically or by video conference to consider and vote on matters that would otherwise require an in-person vote.¹⁵ The relief applies whenever reliance upon it is necessary or appropriate due to circumstances related to current or potential effects of COVID-19 and is available until June 15, 2020. The SEC’s Division of Investment Management previously provided no-action relief for the period from March 4 to June 15.¹⁶
- **Delivery of prospectuses and shareholder reports:** The 1940 Act Order also provides relief from the obligations to timely transmit annual and semiannual reports to shareholders and to file them with the SEC. The relief applies when the original due date is on or after March 13 but on or prior to April 30, 2020, and the fund is unable to prepare or transmit the report due to circumstances related to current or potential effects of COVID-19. In addition, the SEC announced that it would not provide a basis for an SEC enforcement action if a fund does not timely deliver a current prospectus because of circumstances related to COVID-19 when delivery was originally required during this period. The position is not available to an initial purchase by the investor of the fund’s shares.
- **Business continuity plans:** Business continuity at the current time is key. In most cases, those plans already are in effect. Consideration should be given to contingency planning in the event that fund managers, transfer agents, pricing services, or other service providers are unable to provide services because of employee absences. Funds and fund managers should make and communicate revisions to their plans as they adjust to the developing environment.
- **Valuation:** Funds should examine whether they are able to obtain valid prices for their investments, especially in markets that may be closed or have limited availability. Experience from the 2008 financial crisis shows that vendor reassurances as to the quality of their pricing information may provide false comfort, so vendor prices should be checked for reliability. At this time, we do not expect the SEC to provide relief from the daily pricing requirement.
- **Redemptions:** Under Section 22(e) of the 1940 Act, open-end funds generally may not suspend the right of redemption unless the New York Stock Exchange is closed, or the SEC provides guidance that daily redemptions are not required because trading is restricted or an emergency exists. At this point, funds should assume that they must continue to provide daily redemptions. Funds should review any borrowing arrangements that may need to be utilized. We are closely monitoring for any relevant guidance from the SEC or its staff on this topic.
- **Cybersecurity:** Firms are at increased risk of cyberattacks, particularly with the use of remote offices and telework. Anxious employees may be more vulnerable to email phishing attacks. Employees should be reminded of the continued need for vigilance.
- **Prospectus disclosures:** Funds should review their prospectus disclosures, and particularly their risk disclosures. It may be appropriate to add a pandemic risk factor if this risk is not already addressed. However, funds have different risk profiles, and there is no one-size-fits-all solution for the necessary disclosures.
- **Annual meetings:** The SEC staff has provided guidance to both operating companies and funds that are intended to provide regulatory flexibility to companies seeking to

change the date and location of the meetings and use new technologies, such as “virtual” shareholder meetings that avoid the need for in-person shareholder attendance, while at the same time ensuring that shareholders and other market participants are informed of any changes.¹⁷ The guidance notes that the ability to conduct a “virtual” meeting is governed by state law, where permitted, and the issuer’s governing documents.

¹ *Money Market Mutual Funds Template Letter* (Mar. 17, 2020), <https://www.federalreserve.gov/supervisionreg/legalinterpretations/fedreserseactint20200317.pdf>.

² *Investment Company Institute*, SEC No-Action Letter (Mar. 19, 2020), <https://www.sec.gov/investment/investment-company-institute-031920-17a>.

³ Press Release, Federal Reserve Board broadens program of support for the flow of credit to households and businesses by establishing a Money Market Mutual Fund Liquidity Facility (MMLF) (Mar. 18, 2020), <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200318a.htm>.

⁴ Press Release, Federal Reserve Board expands its program of support for flow of credit to the economy by taking steps to enhance liquidity and functioning of crucial state and municipal money markets (Mar. 20, 2020) <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200320b.htm>.

⁵ Policy Tools: Money Market Mutual Fund Liquidity Facility, <https://www.federalreserve.gov/monetarypolicy/mmlf.htm>.

⁶ Exchange-Traded Funds, Release Nos. 33-10695, IC-33646 (Sept. 25, 2019), 84 Fed. Reg. 57162, 57178 (Oct. 24, 2019).

⁷ Press Release No. 8136-20, CFTC Issues Third Wave of Relief to Market Participants in Response to COVID-19 (Mar. 20, 2020), <https://www.cftc.gov/PressRoom/PressReleases/8136-20>.

⁸ Notice to Members I-20-15 (Mar. 23, 2020), <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5218>.

⁹ Release No. IA-5463 (Mar. 13, 2020), <https://www.sec.gov/rules/other/2020/ia-5463.pdf>.

¹⁰ Using IARD, Form ADV: Item 1.F, <https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item1f>.

¹¹ Release No. 34-88318 (Mar. 4, 2020), <https://www.sec.gov/rules/other/2020/34-88318.pdf>.

¹² Press Release 2020-63, SEC Takes Targeted Action to Assist Funds and Advisers, Permits Virtual Board Meetings and Provides Conditional Relief from Certain Filing Procedures (Mar. 13, 2020), <https://www.sec.gov/news/press-release/2020-63>.

¹³ Comment Periods for Certain Pending Actions, <https://www.sec.gov/rules/proposed.shtml>.

¹⁴ European Commission Delegated Regulation art. 62, <https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF>.

¹⁵ Release No. IC-33817 (Mar. 13, 2020), <https://www.sec.gov/rules/other/2020/ic-33817.pdf>. The various forms of relief provided by the SEC are subject to conditions that are set out in the respective orders, such as subsequent ratification of votes, notice to the SEC of filing delays, and website disclosure of issues with the delivery of shareholder reports, prospectuses, and Form ADV client brochures.

¹⁶ SEC Division of Investment Management, Staff Statement on Fund Board Meetings and Unforeseen or Emergency Circumstances Related to Coronavirus Disease 2019 (COVID-19) (Mar. 4, 2020), <https://www.sec.gov/investment/staff-statement-im-covid-19>.

¹⁷ Staff Guidance for Conducting Annual Meetings in Light of COVID-19 Concerns (Mar. 13, 2020), <https://www.sec.gov/ocr/staff-guidance-conducting-annual-meetings-light-covid-19-concerns>.

ABOUT STRADLEY RONON

This pandemic is unprecedented. To continue to assist our clients and friends, we have implemented contingency plans designed to maintain operations and to ensure that we can continue to provide the highest level of service during this rapidly changing environment, while also protecting the health of our personnel. We will continue to review, update, and adapt those plans as the situation progresses, and will certainly keep you apprised of any developments that might impact your business.