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A Mutual Fund Wind-down Under Stressed Conditions

By Alison M. Fuller, Michael P. O'Hare, E. Carolan Berkley and Matthew R. DiClemente

On December 10, 2015, Third Avenue Management LLC (Adviser) announced to shareholders that the Third Avenue Focused Credit Fund (Fund) was liquidating. Specifically, the Adviser announced that redemption requests, combined with the general reduction of liquidity in the fixed income markets, made it impracticable for the Fund to raise cash to pay anticipated redemptions without resorting to sales of portfolio securities at prices that would unfairly disadvantage remaining shareholders. The Fund planned to distribute to Fund shareholders available cash and shares of a newly formed liquidating trust, and effective December 10, the Fund would no longer accept any purchase or redemption orders.

On December 16, 2015, the Securities and Exchange Commission (SEC) provided the Fund with temporary relief to suspend the right of redemption of its outstanding redeemable securities (SEC Order). The SEC Order, however, essentially eliminated the use of the liquidating trust to hold Fund assets, and provided that the liquidation would take place subject to the oversight of the Fund's board and the SEC.

Background – the Fund was under redemption pressure. Since 2009, the Fund had sought long-term total return by investing mainly in bonds and other types of credit instruments, focusing significantly on lower-rated investments that the Adviser believed were undervalued, including high-yield bonds (junk bonds) and distressed or defaulted securities.

According to the SEC Order and communications from the Adviser, the Fund experienced significant redemptions, including a total of \$1.1 billion in estimated net outflows for the year to date through December 9, 2015, which reflected outflows of more than 50 percent of the Fund's net asset value. On December 9, 2015, the Fund's board of trustees adopted a plan of liquidation whereby the Fund would suspend purchases and redemptions, the Fund's remaining available cash would be paid to Fund shareholders, and the Fund's remaining noncash assets would be placed in a liquidating trust for the benefit of all Fund shareholders. The Adviser would manage the liquidating trust's assets without charge and would make periodic cash distributions (to the former Fund shareholders) as the trust's assets were sold in the wind-down.

The SEC Order. According to the SEC Order, neither the Fund nor the Adviser sought SEC relief in connection with the implementation of the original liquidation plan. It appears that upon the announcement of the plan of liquidation, the SEC expressed concerns to the Fund and the Adviser. On December 14, 2015, the board canceled the original liquidation plan, but allowed the cash distribution to proceed. The Fund and the Adviser then filed an application to receive the SEC Order, claiming that if the relief were not granted and the Fund were unable to suspend redemptions, retail investors could be harmed by the redemptions of institutional investors that were likely to be better positioned to take advantage of any redemption opportunity. It was asserted that remaining investors would suffer a rapidly declining net asset value and an even further diminished liquidity of the Fund's securities portfolio.

The SEC issued its temporary Order, containing various conditions, including, among other things:

- Limiting the investment of the cash proceeds from the sale of portfolio securities to short-term, cash-like investments.
- Essentially requiring the Fund's board of trustees to determine when, during the liquidation, the Fund should be permitted to reduce the diversification of its assets such that it would lose its tax status under subchapter M of the Internal Revenue Code.
- Record keeping, including with respect to communications with shareholders (including any complaints from shareholders and responses thereto).
- Requiring periodic reporting to the SEC staff regarding the status of the liquidation and distributions.
- Financial reporting by the Fund.
- Compliance with applicable provisions of the federal securities laws.

The SEC Order specifically notes that it does not limit the SEC's rights to investigate or institute legal proceedings against the Fund or the Adviser.

Assessment. On December 10, 2015, the Adviser and the Fund announced that the Fund would no longer sell or redeem its shares. Although a Fund generally has the authority to cease selling its shares, the ability of a fund to suspend redemptions is limited. In particular, section 22(e) of the 1940 Act provides that a registered investment company may not suspend the right of redemption or postpone redemptions for more than seven days after a redemption request except for any period during which the NYSE is closed other than for customary weekend and holiday closings, or during which trading on the NYSE is restricted. Section 22(e)(2) provides that redemptions may be suspended when securities cannot be disposed of or a fund cannot fairly determine the value of its net assets. Section 22(e)(3) of the 1940 Act provides that redemptions may be suspended by a registered investment company for such other periods as the SEC may by order permit for the protection of shareholders. The SEC has

issued very few such exemptive orders; the last one was in 2008 to facilitate the wind-down of the Reserve Primary Fund and the Reserve U.S. Government Fund. The SEC Order appears to signal the SEC's view that the Fund could have sold its assets and determined its net asset value – otherwise no section 22(e) relief would have been needed.

The SEC Order also offers some guidance on Section 7 of the 1940 Act, which provides an exemption from the registration requirements of the 1940 Act for “transactions of an investment company which are merely incidental to its dissolution.” The SEC staff has issued no action letters relating to the use of liquidating trusts to wind down the affairs of an investment company in reliance on that exception. The SEC Order signals that the use of a liquidating trust by the Fund under the circumstances was not acceptable to the SEC, presumably because a liquidating trust would not be subject to the substantive provisions of the 1940 Act.

It is worth noting that on December 16, 2015, the day that the SEC issued the Order, Federal Reserve Chairwoman Janet Yellen mentioned the Fund during her press conference after the Federal Open Market Committee announced its historic decision to raise the federal funds rate. She referred to the Fund as “a rather unusual” open-end fund with “very concentrated positions in especially risky assets and illiquid bonds,” which had been “facing very significant redemption pressure.” She stated her understanding that the SEC was in touch with the Fund and that the SEC had “proposed some reforms to address what is a structural problem of liquidity mismatch with open-end mutual funds,” probably referring to the SEC's proposed liquidity rule for mutual funds. Ms. Yellen exhibited knowledge of the SEC's regulatory agenda, which highlights the pressure on the SEC to adopt initiatives relating to mutual fund asset liquidity and possibly fund wind-downs. See Stradley Ronon *Client Alert*, “[What You Need to Know About the SEC's New Fund Liquidity Risk Management Proposal](http://www.stradley.com/~media/Files/Publications/2015/IMG-Client-Alert-October-2015.pdf)” (<http://www.stradley.com/~media/Files/Publications/2015/IMG-Client-Alert-October-2015.pdf>) for more details.

In conclusion, a fund, its board and its investment adviser may wish to consult with the SEC staff in connection with the suspension of redemptions, even in connection with a liquidation under stressed market conditions. ■



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