SEWARD & KISSEL LLP

Fund Industry Insights

Current Issues Impacting the Registered Fund Industry

April 27, 2020

This is the inaugural edition of Seward & Kissel Fund Industry Insights in which we highlight and provide "color commentary" on significant issues, trends and concerns that we see emerging in the industry in response to regulatory initiatives, and other current developments. It primarily addresses issues affecting registered investment companies under the Investment Company Act of 1940 (1940 Act) and investment advisers registered under the Investment Advisers Act of 1940 (Advisers Act), but also may be of interest to other financial services industry participants.

The Registered Funds Group at Seward & Kissel expects to publish Seward & Kissel Fund Industry Insights on a periodic basis, as warranted, in light of regulatory and market developments. It is intended to supplement our ongoing publication of client alerts and memoranda.

Coronavirus and its Impact on Funds and Their Service Providers

A. Virtual Board and Shareholder Meetings and Challenges

As discussed in prior Seward & Kissel client memoranda,[1] in response to orders issued by state and local authorities throughout the U.S. restricting travel and gatherings over a certain number of people, the SEC and its staff have provided funds with exemptive relief and other guidance to permit board meetings to be held virtually, or to change the date, time or location of a shareholder meeting (including changing the format to a virtual meeting) after proxy materials have been filed or sent to shareholders.[2]

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[1] These memoranda are available at the following links: https://www.sewkis.com/publications/sec-provides-revised-relief-to-assist-registered-funds-affected-by-the-coronavirus/,https://www.sewkis.com/publications/sec-clarifies-requirements-of-virtual-annual-meetings-issues-disclosure-guidance-in-response-to-covid-19-and-extends-filing-deadlines/ and https://www.sewkis.com/publications/impacts-of-covid-19-annual-meeting-changes-sec-relief-granted-to-certain-registrants.

[2] *Order Under Section 6(c) and Section 38(a) of the Investment Company Act of 1940 Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder; Commission Statement Regarding Prospectus Delivery*, SEC Rel. No. IC-33824 (March 25, 2020), available at https://www.sec.gov/rules/other/2020/ic-33824.pdf (providing temporary relief from in-person meeting requirements required under the 1940 Act and rules thereunder subject to certain conditions) and *Staff Guidance for Conducting Shareholder Meetings in Light of COVID-19 Concerns* (April 7, 2020), *available at* https://www.sec.gov/ocr/staff-guidance-conducting-annual-meetings-light-covid-19-concerns (Staff Shareholder Meeting Guidance). The Staff Shareholder Meeting Guidance stated that while the ability to conduct a "virtual" meeting is governed by state law and the fund's governing documents, a fund conducting a virtual shareholder meeting should take care to disclose how such meetings will be conducted to "facilitate informed shareholder voting."

S&K Observations/Insights: Out of necessity, funds have utilized the flexibility provided by the SEC and its staff. A fund changing a board or shareholder meeting from an in-person meeting to a virtual meeting or changing the date, time or location of a shareholder meeting should also consider requirements under applicable state law and its organizational documents. Funds taking advantage of the relief and holding virtual meetings can confront various challenges, including that:

- A fund board considering approvals or renewals of advisory contracts under Section 15(c) under the 1940 Act should be mindful of the unique dynamics of virtual meetings and how deliberations and discussions are presented in board materials and recorded in minutes. A fund may need to rely on these records in response to an SEC examination or in defending litigation brought under Section 36(b) concerning contracts that were approved at a virtual meeting.
- If virtual meetings are conducted using services that have experienced, or are potentially susceptible to, cybersecurity breaches, funds should be mindful of the risks of using such services and their due diligence and third-party vendor oversight responsibilities under their cybersecurity and business continuity plans (BCPs).[3]
- With respect to shareholder meetings, because information regarding how to attend such meetings will be publicly available and it will be easier for shareholders and others to attend these meetings, funds should consider various means to: (i) limit participation to eligible shareholders and other necessary participants; (ii) verify a shareholder's status as an eligible shareholder and entitlement to vote at the meeting; and (iii) permit voting at the meeting by eligible shareholders that attend virtually and reconcile votes with prior proxies.
- Assuming substantial and successful use of virtual shareholder meetings during the current crisis period, such use may increase the prevalence of virtual meetings on a more permanent basis, which could have significant implications for the historical dynamics of such meetings.

B. Fund Share Transaction Processing

Funds and their transfer agents typically require signature guarantees for certain types of transactions (e.g., for redemption requests over certain amounts, changes of share ownership information and requests to send redemption proceeds to an address or account that differs from information included in the transfer agent's records) where there is an increased risk of fraud or unauthorized transactions. Signature guarantees may be provided by guarantors that are financial intermediaries or participants in a signature guarantee program, such as the Securities Transfer Agents Medallion Program. Funds typically disclose in their prospectuses or statements of additional information (SAIs) the circumstances under which signature guarantees are required and which guarantors are acceptable.

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[3] *See* "Zoom Hires Security Heavyweights to Fix Flaws," THE WALL STREET JOURNAL (April 16, 2020).

S&K Observations/Insights: Because guarantors for signature guarantees generally require in-person verification, the current environment, including shelter in place orders, have made obtaining such guarantees difficult or impossible. Funds and their service providers should consider the implications arising from this situation and the risks relating to altering or waiving standard processing procedures, which are designed to protect the fund and its shareholders. Consideration should be given to the following matters:

- *Contractual Protections.* What contractual protections, such as representations and indemnities, would apply if a transaction for which a signature guarantee was not obtained is discovered to be fraudulent or unauthorized? Which entity or entities should bear the risk?
- *Alternative Procedures to Verify the Authenticity of Instructions and Recordkeeping Practices.* Are alternative procedures available to verify the authenticity of instructions, absent a guarantee (*e.g.,* call back procedures or lists of authorized signatories)? If so, which party is best situated to apply those procedures and request additional information?
- *Recordkeeping.* How will proper recordkeeping of alternative procedures and waivers be addressed?
- *Scope of Any Waiver.* To the extent a waiver of the signature guarantee is contemplated, how broad is the waiver and what transactions are covered? What is the duration of the waiver?
- *Disclosure*. How are guarantee requirements disclosed in the fund's prospectus or SAI?

C. BCP Updates and Potential Questions from the SEC Staff on Exams

The SEC's Office of Compliance Inspections and Examinations (OCIE) has announced that it is still conducting exams; however, these are being conducted remotely rather than on-site unless absolutely necessary.[4] OCIE has confirmed that reliance on temporary SEC relief during the pandemic (which in many cases requires an email notification to the SEC) will not be considered "a risk factor utilized in determining whether OCIE commences an examination."

S&K Observations/Insights: It has been reported that advisers in certain regions have received questions regarding pandemic response plans included in their BCPs. In light of these inquiries, funds and advisers should consider carefully documenting procedures in place and other actions being taken to address BCP issues that are being encountered during the pandemic.

D. Lack of In-Person Meetings for Research and Due Diligence on Investments and Risks Relating to Alternatives

Because of state and local travel and gathering restrictions and activation of their own BCPs, advisers may find it difficult or impossible to conduct in-person meetings for performing research and due diligence on potential fund investments.

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[4] *OCIE Statement on Operations and Exams – Health, Safety, Investor Protection and Continued Operations are our Priorities* (March 23, 2020), https://www.sec.gov/ocie/announcement/ocie-statement-operations-health-safety-investor-protection-and-continued

S&K Observations/Insights: Advisers and their personnel may need to pursue alternatives to such in-person meetings, including conducting diligence through virtual meetings and enhancing, as appropriate, due diligence requests in light of the inability to hold in-person diligence meetings. If meetings are conducted using services that have experienced, or are potentially susceptible to, cybersecurity breaches, advisers should consider the risks of using such services and their due diligence and third-party vendor oversight responsibilities under their cybersecurity and BCP programs.[5]

E. Changes to Manual Signature Requirements for EDGAR Filings

Rule 302(b) under Regulation S-T requires each signatory whose signature appears on an EDGAR filing to manually sign the signature page or other document authenticating, acknowledging or otherwise adopting the signature that appears in the filing that is executed before or at the time the filing is made. Filers are required to retain the manually signed document for five years. Considering the continuing impact of coronavirus/COVID-19, the SEC staff will permit a signatory to retain a manually signed signature page or other authenticating document and provide such document to the filer reasonably promptly.[6] This relief is conditioned on the authenticating document indicating the date and time when the signature was executed and the filer establishing and maintaining policies and procedures governing this process.

S&K Observations/Insights: Registrants should consider these requirements in light of current events and ensure that such documentation is being created, maintained and provided in accordance with the above guidance.

F. Potential Fund Participation in the Term Asset-Backed Securities Loan Facility

On March 23, 2020, as part of its response to the COVID-19 pandemic, the Federal Reserve Board (Fed) announced the establishment of a Term Asset-Backed Securities Loan Facility (TALF 2020) to support the asset-backed securities (ABS) market and indirectly provide loans to the U.S. companies whose debt underlies the ABS.[7] The Fed has indicated that TALF 2020 will be primarily modeled after the terms and conditions of the TALF used during the financial crisis of 2007-2009, which was announced in 2008 (TALF 2008).[8] Certain funds participated in TALF 2008.

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[5] See also the discussion above regarding similar issues arising in connection with virtual board and shareholder meetings.

[6] Staff Statement Regarding Rule 302(b) of Regulation S-T in Light of COVID-19 Concerns (March 24, 2020), available at https://www.sec.gov/corpfin/announcement/staff-statement-regarding-rule-302b-regulation-s-t-light-covid-19-concerns.

[7] The press release announcing TALF 2020 is available here: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm. TALF 2020 and information about its terms that have been released so far are discussed in more detail in these Seward & Kissel client memos available here: https://www.sewkis.com/publications/return-of-the-talf/ and here: https://www.sewkis.com/publications/updated-talf-2020-term-sheet/.

[8] TALF 2020 Term Sheet (April 9, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a1.pdf.

S&K Observations/Insights: The definition of "eligible borrower" in the materials for TALF 2020 has created uncertainty as to whether funds can borrow under TALF 2020. Many industry participants expect the Fed to clarify this definition soon.

The SEC staff issued a number of no-action letters in 2008 and 2009 in connection with funds' participation in TALF 2008.[9] Similar relief would be required from the SEC staff for funds intending to participate in TALF 2020, unless the SEC and its staff indicate that a different approach can be taken.

Regulation BI Implementation by Brokers and its Recent Impact on Funds

Regulation BI (Reg. BI) under the Securities Exchange Act of 1934 (1934 Act) was adopted by the SEC on June 5, 2019 and sets forth the standard of conduct applicable to a broker, dealer, or a natural person who is an associated person of a broker or dealer when making recommendations to retail customers of any securities transaction or investment strategy involving securities.[10] Reg. BI sets forth certain obligations of brokers with respect to disclosure, duty of care, conflicts of interest and compliance, including in connection with compensation they receive directly or indirectly from customers. Reg. BI became effective on September 10, 2019 and the compliance date is June 30, 2020.[11]

Brokers that offer and sell shares of funds have requested that funds implement customized sales charge waivers with respect to their customers to facilitate the brokers' compliance with Reg. BI. Unless fund complexes have permitted and disclosed intermediary-specific sales charge waivers, waivers typically vary across fund complexes, but are uniform within a particular fund complex. An initial wave of such requests was made in connection with the U.S. Department of Labor's fiduciary rule, which has since been vacated.[12] The SEC's Division of Investment Management in 2016 issued guidance (2016 IM Guidance) to funds seeking to accommodate these requests.[13]

S&K Observations/Insights: Based on recent filings, several new intermediaries have made intermediary-specific sales charge waivers requests to funds. Section 22(d) of the 1940 Act requires that the public offering price at which fund shares are sold must be described in the fund's prospectus. Funds that have not previously been asked to disclose such waivers should consider the 2016 IM Guidance and communications with their boards on implementation as requests from intermediaries continue to increase

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[9] *See Franklin Templeton Investments, SEC No-Action Letter* (pub. avail. June 19, 2009), *available at* https://www.sec.gov/divisions/investment/noaction/2009/franklintempleton061909.htm and *T. Rowe Price Associates, Inc., SEC No-Action Letter* (pub. avail. October 8, 2009), available at https://www.sec.gov/divisions/investment/noaction/2009/troweprice100809.htm.

[10] *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* SEC Rel. No. 34-86031 (June 5, 2019) (Reg. BI Release), *available at* https://www.sec.gov/rules/final/2019/34-86031.pdf. Reg. BI's requirements were discussed in more detail in this Seward & Kissel client memorandum: https://www.sewkis.com/publications/secs-new-rule-15l-1-regulation-best-interest-standard-of-conduct-requiring-broker-dealers-to-act-in-the-best-interest-of-retail-customers/.

[11] Reg. BI Release at pp. 2 and 371.

[12] *U.S. Chamber of Commerce v. U.S. Department of Labor*, No. 17-10238 (5th Cir. March 15, 2018).

[13] *See Mutual Fund Fee Structures*, IM Guidance Update No. 2016-06 (Dec. 2016), available at https://www.sec.gov/investment/im-guidance-2016-06.pdf (noting that since the adoption of the Fiduciary Rule, funds "have been considering a variety of issues related to the [Fiduciary] Rule's implementation, including contemplating certain changes to [fund] fee structures that would, in certain instances, level the compensation provided to a financial intermediary… and facilitate [i]ntermediaries' compliance with the rule").

Fund Industry Insights

Market Volatility Impacts to Exchange-Traded Products

Certain exchange-traded products (ETPs), including exchange-traded funds (ETFs) registered under the 1940 Act (1940 Act ETFs) and ETPs that are only registered under the 1933 Act and 1934 Act (1933 Act ETFs), have faced unprecedented market volatility because of market conditions arising from COVID-19. One 1933 Act ETF, United States Oil Fund, LP (USO), whose investment objective is to invest in front-month oil futures contracts, recently announced changes to its strategy so that it generally invests most of its portfolio in oil futures contracts expiring in later months. USO also announced the suspension of creations and a reverse share split in order to maintain continued listing requirements. USO was reported to have sizable inflows last quarter and is investing in contangoed futures markets due to the recent significant declines in oil demand.

S&K Observations/Insights: 1940 Act ETFs facing similar challenges as a result of market volatility may need to consider the ability to implement similar strategy or other changes under their regulatory framework, but may have additional flexibility in certain respects compared to 1933 Act ETFs, as discussed below. 1940 Act ETFs are also permitted to suspend creations in certain circumstances, and in a manner that is consistent with their disclosures and the terms of their agreements with authorized participants, and conduct reverse share splits (consistent with applicable exchange rules and the terms of their organizational documents). Although USO is not a 1940 Act ETF and therefore not subject to the following requirements, a 1940 Act ETF that is subject to Rule 35d-1 ordinarily has the flexibility to invest up to 20% of its net assets (including borrowings for investment purposes) in investments that are not suggested by its name. Rule 35d-1 requires a 1940 Act ETF with a name that suggests a type of investment to adopt an 80% policy to invest at least 80% of its net assets (including borrowings for investment purposes) in the investments suggested by its name "under normal market conditions," and can deviate from this policy in unusual conditions, to take temporary defensive positions in response to adverse market, economic, political, or other conditions, or in other circumstances such as during unusually large cash inflows or redemptions. 1940 Act ETFs can also make material changes to their objectives or strategies, but need to consider the timing and process for implementing these changes consistent with applicable requirements, such as 1933 Act disclosure and filing rules, Rule 35d-1 and board oversight.

Form CRS for SEC-Registered Investment Advisers with Retail Investors

Beginning May 1, 2020, and by no later than June 30, 2020, an SEC-registered adviser that has retail investors must file a Form CRS relationship summary (relationship summary) with the SEC. Thereafter, the adviser must deliver its relationship summary to its retail investors.

S&K Observations/Insights: Although the definition of retail investor excludes investors in pooled investment vehicles, such as registered funds and private funds, many SEC-registered advisers to these types of vehicles also provide advisory services to managed accounts of individuals meeting this definition. The SEC has not delayed the compliance date for complying with the filing and delivery requirements of Form CRS, and the SEC's OCIE staff has indicated it will begin examinations to assess compliance with Form CRS after the compliance date and initial examinations of firms with retail investors conducted after the compliance date may include an assessment relating to compliance with Form CRS. [14]

Other Developments

On April 21, 2020, the SEC proposed new Rule 2a-5 under the 1940 Act (Proposed Rule), addressing valuation practices and the role of the board of directors/trustees with respect to determining the fair value of the investments of a fund or business development company.[15] Comments on the proposal are due on or before July 21, 2020. The Proposed Rule would, among other things: (i) provide requirements for determining fair value in good faith with respect to a fund for purposes of Section 2(a)(41) of the 1940 Act; (ii) permit a fund's board to assign the fair value determination to an investment adviser of the fund, subject to board oversight and certain other conditions; and (iii) define when market quotations are readily available for purposes of the 1940 Act. If the Proposed Rule were adopted, the SEC would rescind certain previously issued guidance on the role of a board in determining fair value and the accounting and auditing of fund investments.

S&K Observations/Insights: In moving forward with the Proposed Rule, the SEC has acknowledged the current state of the fund industry in addressing portfolio security valuations by permitting funds to delegate fair value determinations to their advisers. The permitted sharing of valuation responsibilities between boards and advisers contemplated by the Proposed Rule is currently followed, to one degree or another, by many fund complexes. The Proposed Rule would also likely require advisers to modify their valuation procedures to address aspects of the requirements, including the "prompt" reporting to the board and personnel designation aspects of such delegation. However, the delegation of valuation responsibilities that would be permitted under the Proposed Rule is too narrow to accommodate current practices, as some funds (such as funds that are part of a series trust with a single administrator and a unified board, but multiple advisers across funds) delegate valuation responsibilities to the funds' administrator and a fund would not be permitted to delegate fair valuation responsibilities to its administrator under the Proposed Rule.

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[14] SEC Office of Compliance Inspection and Examinations Risk Alert, "Examinations that Focus on Compliance with Form CRS" (April 7, 2020), *available at* https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf. The relationship summary is discussed in more detail in a previous Seward & Kissel memorandum *available here:* https://www.sewkis.com/publications/overview-of-form-crs-relationship-summary-for-investment-advisers/. Paul Miller, Val Vasi and David Tang will host a webinar on Thursday, April 30, 2020 from 9:30 am to 10:30 am ET to review requirements relating to Form CRS for advisers and broker-dealers. To register for the webinar, click here: https://register.gotowebinar.com/register/2735766755702927372.

[15] Good Faith Determinations of Fair Value, SEC Rel. No. IC-33845 (April 21, 2020) (Proposing Release), *available at* https://www.sec.gov/rules/proposed/2020/ic-33845.pdf. This Seward & Kissel memorandum discusses the Proposed Rule in greater detail: https://www.sewkis.com/publications/sec-proposes-rule-to-modernize-fund-valuation-practices/.

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Fund Industry Insights

Seward & Kissel has established a COVID-19 Resource Center on our website to access all relevant alerts that we distribute. We also have a COVID-19 dedicated page on our '40 Act Blog.

If you have any questions regarding the items covered in this edition of Seward & Kissel Fund Industry Insights, please contact any of the partners and counsel listed below or your primary attorney in Seward & Kissel's Registered Funds Group.

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