The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 27, NO. 12 • DECEMBER 2020

During Significant Market Downturns, Sponsors and Their Affiliates Can Provide Capital Support

By Steven Grigoriou and Patrick Quinn

A "black swan" event, such as the March 2020 downturn related to the COVID-19 pandemic, has the potential to significantly disrupt the operations of regulated investment companies, in part due to challenges maintaining liquidity during market distress. In this article, we discuss how such disruptions can impact closed-end funds and business development companies (BDCs) (together with closed-end funds, referred to as regulated funds),[1] and several ways a sponsor could determine to financially support a regulated fund during such disruptive events in a manner consistent with the requirements of the Investment Company Act of 1940 (1940 Act) and other relevant federal securities laws.

Potential Disruptive Effects of a Severe Market Downturn on Regulated Fund Operations

Potential for Reduced Ability to Borrow or Issue Debt/Preferred Shares

Regulated funds must adhere to asset coverage ratios, measured immediately after issuance, to draw on lines of credit or issue indebtedness or preferred shares (collectively, senior securities) under the 1940 Act. Closed-end funds must maintain an asset coverage ratio of at least 300 percent for indebtedness ($3 in total assets for every $1 of debt) and 200 percent for preferred shares ($2 in total assets for every $1 of preferred shares) under Section 18 of the 1940 Act, each as measured immediately after issuance.[2] BDCs must maintain a 200 percent asset coverage ratio ($2 in total assets for every $1 of senior securities), which may be reduced to 150 percent ($1.5 in total assets for every $1 of senior securities), subject to certain board and shareholder approvals, for any senior security under Section 61 of the 1940 Act.

Accordingly, a decrease in the value of a regulated fund's assets correspondingly reduces its asset coverage, thereby limiting its ability to borrow additional money or issue other senior securities. This hampers a regulated fund's ability to take advantage of potential investment opportunities that may arise due to asset mispricing in a market dislocation or to conduct normal operations. In recognition of the damaging consequences to regulated funds caused by the COVID-19 pandemic and corresponding market downturn, the Staff of the Division of Investment Management of the Commission provided temporary exemptive relief to BDCs, allowing them to calculate adjusted asset coverage ratios

during the term of the relief, provided that certain conditions are met.[3]

In addition to 1940 Act considerations, a regulated fund's credit agreements or other contractual arrangements may include covenants tied to the fund's asset coverage. Reductions in asset valuations may lead to a contractual breach by a fund of asset coverage covenants in existing credit facilities or other lending arrangements, potentially causing an event of default. Due to the decrease in valuations caused by the COVID-19 pandemic, particularly in March 2020, some regulated funds negotiated waivers and/or amendments to their current borrowing facilities, including limiting their ability to take certain corporate actions, such as repurchasing shares or refinancing current debt.

Challenges in Paying Preferred Share Dividends or Declaring Distributions to Common Shareholders

The 1940 Act requires that any issuance of preferred stock or public debt by a regulated fund contain certain provisions limiting the fund's ability to make distributions if such distributions would cause a breach of the applicable asset coverage ratio. Regulated funds with such senior securities outstanding may not declare any distribution (except a dividend payable in stock of the issuer), unless at the time of declaration the regulated fund is in compliance with the 1940 Act asset coverage ratios discussed above. Credit facilities for regulated funds also may include similar contractual restrictions on declaring distributions.

Such restrictions may affect regulated funds intending to qualify as regulated investment companies (RICs) under Subchapter M of the Internal Revenue Code, as amended, (the Code), which must distribute at least 90 percent of their income in a calendar year to shareholders annually or be subject to entity-level taxation under the Code. RICs may rely on a safe harbor that allows "publicly offered RICs"[4] to meet this requirement by distributing a combination of cash and stock assuming certain requirements are met, including that at least 20 percent of the total distribution is in cash.[5] In recognition of the need for enhanced liquidity during the COVID-19 pandemic, the Internal Revenue Service (IRS) temporarily reduced this minimum cash threshold to 10 percent.[6]

Notwithstanding the US regulatory relief described above, portfolio losses caused by a significant market downturn, as well as reduced investment or interest income resulting from market stress, may still restrict a regulated fund's ability to issue dividends to common shareholders or service preferred share dividends. A regulated fund's inability to pay dividends could cause substantial reputational harm to the fund or the sponsor, particularly if the fund is designed to provide investors with current income.

Reduced Ability to Repurchase Shares

A regulated fund with senior securities outstanding (other than privately negotiated debt) may not repurchase any of its outstanding shares unless the regulated fund complies with the asset coverage requirements discussed above at the time of repurchase. Tender offer closed-end funds and BDCs that repurchase shares pursuant to Section 23(c) of the 1940 Act and Rule 13e-4 of the Securities Exchange Act of 1934, as amended, (the 1934 Act) would be forced to suspend share repurchase programs to the extent their asset coverage ratios are not compliant with Section 18 while senior securities are outstanding. Further, "interval" funds, which rely on Rule 23c-3 under the 1940 Act to conduct regular repurchases of shares, may suspend redemptions only in limited circumstances, and may be forced to obtain additional capital or otherwise repay or redeem senior securities to be able to continue to repurchase shares.

Risk of Loss of Well-Known Seasoned Issuer Status and Short Form Registration

An extended downturn could have significant implications on the ability of certain regulated funds

to raise additional capital through public offerings. A regulated fund relying on its status as a well-known seasoned issuer to offer shares, pursuant to an automatic shelf registration statement, could lose that status if it is unable to meet the $700 million public float requirement (measured within 60 days prior to filing a registration statement).[7] Similarly, regulated funds that maintain shelf registration statements to offer shares on a delayed or continuous basis under Rule 415(a)(1)(x) of the Securities Act of 1933 (the 1933 Act) must comply with the eligibility requirements of Form S-3, including the minimum $75 million public float requirement (measured any time within 60 days prior to filing a registration statement).[8]

Challenges Issuing Common Shares

The 1940 Act generally prohibits a regulated fund from issuing common shares at a price below current net asset value (NAV) per share without shareholder approval.[9] Under normal circumstances, shareholders may be willing to approve a share issuance if the discount (that is, the difference between the NAV and market price) is narrow, resulting in limited economic dilution to current shareholders. If the fund's share price trades at a premium (that is, market price is higher than NAV), only board approval is required. During market disruptions, share prices begin to depress, thus limiting a regulated fund's ability to raise common equity without shareholder approval. Both a regulated fund's shareholders and its board may be reluctant to approve issuing shares at a significant discount to NAV because of the higher economic dilution that current shareholders would experience compared to normal circumstances. Further, certain regulated funds may be required to delay any common share issuances due to undertakings made on their registration statements.

Affiliated Capital Infusion Alternatives

As noted above, the occurrence of a significant market downturn can cause typical sources of liquidity (for example, revolving credit facilities with banks, underwritten public debt or common stock equity issuances) for regulated funds to become unavailable or unfavorable, whether due to reduced lending or regulatory constraints. In such circumstances, the sponsor of a regulated fund may provide an alternative source of capital. As the COVID-19 pandemic has caused regulated funds to trade at deeper discounts to NAV per share than usual, and lenders have tightened access to credit, sponsors are in a position to act more quickly to support a regulated fund than third parties due to their familiarity with the regulated fund (for example, due diligence is not required) and often are willing to accept certain risks to act in the best interests of shareholders.

Equity Issuance

A sponsor can purchase common shares from a regulated fund in a private transaction to provide additional capital relatively quickly. Fortunately, unlike the numerous affiliated transaction prohibitions in the 1940 Act, the 1940 Act does not restrict a sponsor's ability to purchase securities issued by a regulated fund.[10]

Considerations:

- The sale of shares below NAV generally is restricted, as discussed above. Accordingly, to the extent regulated fund shares currently are trading on an exchange at a discount to NAV per share, any support provided by a sponsor through a primary issuance by the regulated fund likely would require the sponsor to purchase shares above, and in some cases well above, the current market value.[11]
- A private placement does not require an effective registration statement under the 1933 Act, thereby decreasing timing and execution risk. An investment by a sponsor could be completed with a short and simple purchase agreement.
- Prior to an investment, a sponsor should be wary of any material non-public information concerns under federal anti-fraud securities laws,

Copyright © 2020 by CCH Incorporated. All Rights Reserved.

including Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

- Because a sponsor is likely to be considered a "control" affiliate of a regulated fund for purposes of the 1933 Act, any shares purchased would be subject to the resale restrictions of Rule 144 under the 1933 Act.[12] A sponsor may consider entering into a registration rights agreement with the regulated fund to allow for an efficient disposition of shares at some future time.[13]
- Closed-end funds and exchange-listed BDCs are subject to Section 16 of the 1934 Act and are subject to the short-swing profit restrictions thereunder.

Lending by the Sponsor to a Regulated Fund on an Unsecured Basis or the Issuance by the Regulated Fund of Preferred Shares to the Sponsor

To the extent that a regulated fund is not in danger of breaching its asset coverage requirements as discussed above, a sponsor could act as a rapid form of liquidity to the fund by lending on an unsecured basis or purchasing preferred shares.

Considerations:

- The 1940 Act permits a fund sponsor to make unsecured loans to a regulated fund managed by the sponsor.[14] Any borrowing or the issuance of preferred shares by a regulated fund, however, would require sufficient headroom under the fund's asset coverage ratio prior to the issuance.
- Unlike the issuance of common shares, in which the only term negotiated between the sponsor and a regulated fund is price, a loan or preferred shares entails a number of contractual provisions. Although Sections 17 and 57 of the 1940 Act, as applicable, do not prohibit a sponsor from lending to or purchasing preferred shares from a regulated fund it advises, the 1940 Act has a broad definition of "joint enterprise,"[15] which could apply to any such transaction. Accordingly, regulated fund boards evaluating any such transaction also should view the transaction through the lens of Section 17(d) and Rule 17d-1 thereunder.[16] Section 17(d) and Rule 17d-1 thereunder were adopted to "ensure fair dealing and no overreaching in connection with joint transactions involving an investment company and its affiliated persons."[17]
- In structuring a loan transaction, consideration should be given to prevailing terms in the credit market under current and ordinary conditions. Compensation to the sponsor, whether in the form of interest or dividend payments, should be set at prevailing market rates; although to minimize the appearance of overreaching, some sponsors have gone so far as to provide interest-free loans on a short-term basis. Similarly, loan or preferred share covenants should be reviewed carefully in light of the current market to ensure fair dealing.
- A regulated fund's board should carefully deliberate and not hesitate from obtaining the services of investment banks or legal counsel, as it deems necessary or appropriate.
- In approving the terms of any such transaction, the regulated fund board should consider whether those terms are fair and reasonable and what other adequate safeguards are in place to prevent overreaching by the sponsor. In making such findings, the board should consider the interest rate or dividend yield on other similar products, which terms the fund could obtain in the market from third parties and what the proceeds of such loan or preferred shares will be used for. After careful deliberation, the board should be able to determine that the terms of the loan or preferred shares are reasonable and fair and do not involve overreaching on the part of any person involved.

Rights Offering Backstopped by the Sponsor or an Affiliate

One exception to the 1940 Act's general prohibition against issuing shares below NAV is a rights offering to current shareholders, which may be issued at a subscription price below the current NAV per share to incentivize participation. Some prices may be fixed or they may vary based on a formula accounting for the current trading price of the shares. Since shareholders will experience dilution upon issuance of shares in a rights offering when shares are trading below NAV, the Staff, through no-action relief, requires boards to make certain determinations, including specifically a good faith determination that the offering would result in a net benefit to existing shareholders, including those who choose not to exercise their rights, based on existing Staff guidance.[18] Transferable rights offerings require additional findings.[19]

Rights offerings can provide an alternate source of liquidity for regulated funds that are unable to borrow or issue preferred shares due to asset coverage concerns. To alleviate the risk of a failed rights offering, a regulated fund's sponsor could act as a standby purchaser, or backstop, for the shares. To do so, through agreement and/or by public announcement, a sponsor can agree to participate in the rights offering and oversubscribe to a significant degree. Acting as a standby purchaser of shares in a rights offering eases some of the economic burden on a sponsor by allowing the sponsor to purchase shares closer to the current market price, unlike a common share issuance at NAV, as discussed above.

Considerations:

- Rights offerings can only be conducted pursuant to an effective registration statement under the 1933 Act. If the regulated fund does not maintain a shelf registration statement, it will not be able to execute a rights offering quickly.
- As noted above, a regulated fund board must determine that there is a net benefit to existing shareholders, including those who choose not to exercise their rights, to conduct an issuance of shares below NAV. Therefore, if the subscription prices represent a higher discount to NAV per share, there is greater pressure on the board's analysis. To alleviate some of this burden, a board may choose to conduct a transferable rights offering, which permits non-participating shareholders to sell their rights on an exchange for some compensation.
- The market manipulation rules under Regulation M likely require the sponsor to be a current shareholder in order to act as a backstop and oversubscribe for shares.[20]
- Applicable Staff no-action relief limits transferable rights offerings to three subscriptions right being issued for each issued share.[21] The Staff has required this condition, among others, to seek to limit the negative effect on shareholders that choose not to exercise their rights.[22] Non-transferable rights do not carry the same restriction because they are generally considered less dilutive to current shareholders.

Voluntary Waiver of Fees by the Sponsor

When a regulated fund is in distress or finds expenses too high, sponsors often waive some or all of their management and/or incentive fees (if applicable) for a period of time to reduce the regulated fund's ongoing expenses. Unlike the transactions described above, where a sponsor provides capital to a regulated fund, fee waivers can benefit sponsors by simply limiting a revenue stream as opposed to actively putting capital at risk. During market disruptions, sponsors too may find themselves capital-constrained and waivers may be a more attractive way to help a fund.

Conclusion

Significant market events can come with little warning and stress test the operations of regulated funds. Even though the 1940 Act carries with it a number of significant constraints regarding affiliated

Copyright © 2020 by CCH Incorporated. All Rights Reserved.

transactions, sponsors should be aware that they are not fully handcuffed from providing support to their regulated funds in such circumstances. We hope that this overview provides useful information and is thought-provoking as to possibilities for sponsors to provide emergency capital to funds in distress.

Mr. Grigoriou is a Counsel at Simpson Thacher & Bartlett LLP in Washington, DC and **Mr. Quinn** is an associate at Simpson Thacher & Bartlett LLP in New York, NY. The views of the authors are not necessarily the views of Simpson Thacher & Bartlett LLP. A summary of this article appeared in Simpson Thacher's Registered Funds Quarterly Alert (September 1, 2020), available at *https://www.stblaw.com/about-us/publications/details?id=c7e1f90e-743d-6a02-aaf8-ff0000765f2c*.

NOTES

1 "Closed-end funds" are defined herein as closed-end management investment companies that have registered with the Securities & Exchange Commission (Commission) under the Investment Company Act of 1940, as amended (the 1940 Act). "BDCs" are defined herein as closed-end investment companies that have elected to be regulated as business development companies under the 1940 Act.

2 "Asset coverage" of a class of senior security representing an indebtedness of an issuer means the ratio which the *value of the total assets of such issuer*, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer. "Asset coverage" of a class of senior security of an issuer which is a stock means the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer plus the aggregate of the involuntary liquidation preference of such class of senior security which is a stock. The involuntary liquidation preference of a class of senior security which is a stock is deemed to mean the amount to which such class of senior security would be entitled on involuntary liquidation of the issuer in preference to a security junior to it." Section 18(h) of the 1940 Act (emphasis added).

3 Investment Company Act Release No. 33837 (April 8, 2020), available at *https://www.sec.gov/rules/exorders/2020/ic-33837.pdf*. The temporary exemptive relief expires on December 31, 2020. *See also* New Temporary Exemptive Relief Relating to Coronavirus Gives BDCs the Ability to Use Adjusted Asset Coverage Calculations and Provides Follow-On Flexibility (April 10, 2020), Simpson Thacher & Bartlett LLP, available at *https://www.stblaw.com/docs/default-source/memos/firmmemo_04_10_20.pdf*.

4 "Publicly offered RIC" as defined in Section 67(c)(2)(B) of the Code.

5 Rev. Proc. 2017-45. Investment companies intending to rely on this procedure must also ensure that each shareholder may elect to receive all of the distribution in cash, among other requirements.

6 Rev. Proc. 2020-19. This procedure currently applies to distributions made from April 1, 2020 to December 31, 2020. The IRS provided similar relief for publicly traded RICs during the aftermath of the 2007-2008 global financial crisis. *See* Rev. Proc. 2009-15.

7 17 CFR § 230.405.

8 *See* Nuveen Virginia Premium Income Municipal Fund, SEC No-Action Letter (Oct. 6, 2006); Pilgrim America Prime Rate Trust, SEC No-Action Letter (May 1, 1998). The aggregate market value of the voting and non-voting common stock held by non-affiliates of a company must be at least $75 million within 60 days of filing a registration statement to be eligible for registration on Form S-3, among other requirements. General Instruction 2.c. to Form N-2.

9 Under Section 23(b) of the 1940 Act (as applied to BDCs through Section 63), a closed-end fund or BDC may not sell any common stock at a price below the regulated fund's current NAV per share without

shareholder consent, subject to limited exemptions. BDCs may, and regularly do, receive shareholder consent to issue shares at a price below NAV in accordance with Section 63(2) of the 1940 Act, provided that a required majority of the directors or general partners of the BDC has determined that such sale would be in the best interests of the BDC. In making such a determination, the board of directors of a BDC, in good faith, would consider the share price of the issuance; if the regulated fund is listed on an exchange; the discount of NAV to the market price; alternative sources of liquidity; and market conditions currently in effect, among other factors.

10 Section 17(a)(2), with respect to closed-end funds, and Section 57(a)(2), with respect to BDCs, prohibit affiliated persons, within the meaning of Section 2(a)(3) of the 1940 Act and affiliated persons thereof, of an investment company from knowingly, as principal, purchasing securities or other property from, such investment company, *unless such affiliated person is purchasing securities issued by the affiliated investment company* (emphasis added).

11 A sponsor also can purchase equity securities of a listed fund in the open market, subject to limitations on insider trading or market manipulation. While such purchases may have some effect on the fund's share price, it will not result in an infusion of capital to the fund.

12 "Affiliate" for purposes of the 1933 Act is defined in Rule 405 thereunder as a "person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with," an issuer. The term "control" is defined in Rule 405 under the 1933 Act as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Investment advisers would likely be deemed to directly or indirectly control (within the meaning of the 1933 Act only) a regulated fund.

13 Rule 144 under the 1933 Act, among other things, restricts the resale of securities issued to an affiliate of an issuer that is deemed to control (within the meaning of the 1933 Act) the issuer. "Control" securities may only be resold if (i) they are held for a sufficient holding period depending on the issuer's status (minimum of six months from the date of sale); (ii) there is adequate publicly available current information about the issuer (for regulated funds, compliance with the periodic reporting requirements under the 1934 Act); (iii) the transaction complies with restrictions on the volume sold during a three month period; (iv) requirements for brokerage and solicitation of the shares to be sold are met; and (v) a notice of the proposed sale is filed with the Commission.

14 Although Section 17(a)(4) of the 1940 Act restricts a sponsor from loaning money or other property to an affiliated registered investment company to such rules and regulations as issued by the Commission after consultation with Federal banking agencies, the Commission, to date, has not adopted any prohibition on a sponsor lending funds to a fund it advises. Section 57(a) does not contain a corresponding provision. Such lending should be conducted on an unsecured basis to avoid transferring a security interest in a regulated fund's assets to the sponsor, which would be prohibited under Sections 17(a)(2) and 57(a)(2) of the 1940 Act.

15 Rule 17d-1(c) defines "joint enterprise or other joint arrangement or profit-sharing plan" as "any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby a registered investment company . . . and any affiliated person of . . . such registered investment company, or any affiliated person of such a person . . . have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking . . . ."

16 Section 17(d) and Rule 17d-1 thereunder prevent any affiliated person of a registered investment company, or any affiliated person thereof, from effecting, as principal, any transaction in which a registered investment company, or a company controlled by such registered investment company, is a joint or a joint and several participant with such person, or affiliated person, in contravention of such rules and

Copyright © 2020 by CCH Incorporated. All Rights Reserved.

regulations as the Commission may prescribe for the purpose of limiting or preventing participation on a basis different from or less advantageous than that of such other participant. Section 57(a)(4) of the 1940 Act prohibits any controlling or closely affiliate person (as defined in Section 57(b)) from knowingly effecting any transaction where the BDC is a joint or joint and several participants. Section 57(i) makes Commission rules issued under Section 17(d) applicable to BDC transactions subject to Section 57(a)(4).

17 Chase Manhattan Bank, SEC No-Action Letter (pub. avail. July 24, 2001). *See also* Investment Trusts and Investment Companies: Hearings on S. 3580 Before Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess. 256 (Apr. 9, 1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission, Investment Trust Study).

18 In a 1977 interpretative letter, the Staff stated that in deciding whether to authorize a rights offering, a fund's board of directors must make a good faith determination that the rights offering would result in a net benefit to existing shareholders, considering: (i) the size of any current and proposed discount of price to NAV; (ii) the extent of any dilution, which should normally be minimal, for non-participating shareholders; (iii) that the expected benefits to the fund and to all shareholders should clearly outweigh any potential dilutive effects from the offering; (iv) the basis of the offering (*i.e.*, the number of rights needed to purchase one share); (v) the size of the offering in relation to the number of shares outstanding; (vi) the use to be made of the proceeds from the offering and the return to shareholders therefrom (there must be a specific intended use); (vii) whether a market will exist for any transferable rights; and (viii) the compensation to any underwriter. *Division of Investment Management Interpretative Position Relating to Rights Offerings by Closed-End Investment Companies Below Net Asset Value*, Investment Company Act Release No. 9932 (Sept. 15, 1977). For example, non-participating shareholders may derive a benefit from the offering if the adviser is able to invest additional assets that earn a return that exceeds the dilution or spread fixed expenses over a larger asset base by raising additional capital. *See* Transferable Rights Offering, SEC No-Action Letter (Feb. 11, 1993) (Transferable Rights Letter).

19 Transferable rights offerings with a subscription price below NAV rely on Commission no-action relief from Section 23(b)(1) under the 1940 Act; such relief requires, in addition to the good faith determination by the board that the offering would result in a net benefit to existing shareholders, (i) the board determines that the offering fully protects shareholders' preemptive rights and does not discriminate among shareholders (except for the possible *de minimis* effect of not offering fractional rights); (ii) management uses its best efforts to ensure an adequate trading market in the rights for use by shareholders who do not exercise such rights; and (iii) the ratio of the offering does not exceed one new share for each three rights held. *See* Association of Publicly Traded Investment Funds, SEC No Action Letter (August 2, 1985) (APTIF Letter).

20 The investment adviser is likely an affiliated purchaser for purposes of Regulation M as defined by 17 CFR 242.100(b). Under Rule 102 of the Code, an affiliated purchaser is prohibited from purchasing securities issued by the affiliated issuer during a restricted period, which for a subscription rights offering is the entirety of the offering period.

21 *See* APTIF Letter, *supra* n.19.

22 *See* Transferable Rights Letter, *supra* n.18.

Copyright © 2020 CCH Incorporated. All Rights Reserved.
Reprinted from *The Investment Lawyer*, December 2020, Volume 27, Number 12, pages 1, 4–11, with permission from Wolters Kluwer, New York, NY, 1-800-638-8437, www.WoltersKluwerLR.com