

CORONAVIRUS INFORMATION & UPDATES

March 23, 2020

Considerations for Registered Closed-End Funds and Their Advisers

As closed-end funds and their advisers respond to the significant challenges arising from the COVID-19 virus, Ropes & Gray attorneys have responded to a number of common questions and concerns from our clients. This Alert summarizes various ideas and reminders that our attorneys have distilled from these discussions.

Initial Considerations. The recent market dislocations underlie a variety of issues that may require immediate attention or otherwise warrant timely consideration.

- Pay particular attention to activist buying given that many closed-end funds may be trading at a significant discount to NAV.
- For closed-end funds that do not publish a daily NAV, consider whether the last-disclosed NAV and related information may need to be updated.
- A closed-end fund may be unable to offer additional shares because of its current discount to NAV, or may choose to suspend an offering due to the abnormally volatile market conditions. This could be particularly relevant to closed-end funds engaged in shelf offerings.
- Consider the undertaking under Item 34.1 of Form N-2, which requires a closed-end fund to suspend the offering of shares until the prospectus is amended if, subsequent to the effective date of a registration statement, the NAV of the offered shares declines more than 10% from its NAV as of the effective date of the registration statement.
- For closed-end funds with managed distribution orders from the SEC, consider whether recent market movements have affected their ability to offer shares under Condition 6 of the standard relief granted by the SEC, which limits the ability of a fund to engage in public offerings if the fund's performance versus distribution-rate ratio does not satisfy certain requirements.
- Consider whether a closed-end fund is experiencing market effects or implementing a policy that could warrant notification to the applicable exchange or a press release (*e.g.*, complete de-levering or investment policy changes that could materially affect the fund's common share market price).
- For interval funds, consider whether to expect increased repurchase requests that could result in having to repurchase shares on a pro-rata basis and/or increase the repurchase amount as permitted under Rule 23c-3, as well as any operational issues arising from current market conditions.
- Consider whether the market dislocations have led to stock and/or debt that is trading at prices that make this an opportune time for common share buybacks and, if so, whether the requirements for engaging in buybacks (*e.g.*, notice to investors) have been met.
- Given the decline in the market price of many closed-end funds, consider whether this may be an opportune time to conduct a reverse stock split.

CORONAVIRUS INFORMATION & UPDATES

Shareholder Meetings. On March 13, 2020, as described in this Ropes & Gray [Client Alert](#), the staff of the SEC’s Divisions of Corporation Finance and Investment Management published guidance to assist public companies, including investment companies, with their shareholder meetings. The guidance is designed to facilitate the ability of companies to hold “virtual” or “hybrid” meetings through the use of technology, while complying with the federal securities laws. *It is important to note that state law imposes its own requirements that may prevent a fund from taking advantage of the relief. For example, Massachusetts corporate law does not currently permit public companies to conduct solely virtual meetings. Similarly, fund organizational documents may restrict virtual meetings. In light of these issues, we encourage funds and their sponsors to consult with counsel before making any decisions with respect to their shareholder meetings.*

Disclosure. Many closed-end funds are adding disclosure to shareholder reports and/or other documents, either stand-alone or as part of another risk, such as market disruption risk. You may want to consider not just market risks (*e.g.*, the value of investments may go down), but operational risks, too (*e.g.*, investors may be unable to contact you, the increased possibility of trade errors and other mistakes as a result of increased working remotely). The following are additional disclosure-related considerations:

- Consider whether website communications and other shareholder communications should be updated. Consider whether any such communications would be considered a prospectus and/or raise FINRA marketing issues. Be careful to avoid making unfair or overly favorable statements that cannot be supported.
- Consider whether any changes to investment or portfolio management strategies (*e.g.*, reducing leverage) that have been implemented warrant a press release.

Pricing and Liquidity. Consider how pricing services have been performing, especially for asset classes for which it is difficult to obtain prices and/or for which reported prices appear to be unreliable.

If conducting cross trades, consider whether “market quotations are readily available” for the securities being traded and whether the pricing and requirements of Rule 17a-7 can be met. Similarly, even closed-end funds should consider the SEC’s statements in the adopting release for Rule 22e-4 that “it may be prudent for advisers to subject less liquid assets to careful review (and potentially even a heightened review compared to other more liquid assets) before engaging in such transactions.”

Borrowing and Credit Facilities. With respect to leverage arising from borrowings:

- Consider your derivatives trading agreements. Among other things, events of default or termination events may be implicated, and material adverse change (MAC) clauses may have been triggered by COVID-19-related events. See Ropes & Gray’s podcast and transcript [COVID-19 and Derivatives Trading Agreements: Considerations for the Buy-Side](#).
- Consider whether the fund may fail to meet asset coverage and/or segregation/earmarking requirements. This includes not only the 1940 Act’s requirements, but also covenants and other requirements in credit agreements or bond indentures, derivative counterparty requirements and rating agency requirements for preferred shares and/or bonds/notes.
- Consider whether additional disclosure is warranted in view of where a fund is now positioned with respect to required asset coverage tests. For example, consider disclosing what can happen if an asset coverage test is

CORONAVIRUS INFORMATION & UPDATES

breached (*e.g.*, a fund may become unable to declare or pay dividends depending on the type of preferred share or debt).

Debt Investments and Conflicts. Consider whether any borrowers are undergoing financial distress.

- For private debt, consider whether funds/adviser will be required to take additional steps (*e.g.*, hiring lawyers) and consider whether those steps are a fund or adviser expense.
- Be wary of potential conflicts when an issuer is in distress. Under normal circumstances, advising accounts that own stock and others owing debt (or different tranches of debt) does not raise conflicts. However, when issuers are undergoing distress or stress, issues arise under both the Advisers Act and Section 17(d) of the 1940 Act. Consider how to deal with the conflicts arising in these fact patterns:
 - Being asked to vote on a plan of reorganization or similar restructuring, where the interests of various accounts may conflict.
 - Owning large positions in one or more tranches, which gives an adviser significant influence notwithstanding investments for other clients in other tranches. For example, an adviser may find that the interests of one tranche of debt are furthered by taking actions (*e.g.*, foreclosing on collateral) that are adverse to tranches owned by other clients.
 - Issues where new money may need to be injected to keep a company afloat.
 - Dealing with some persons in a fund complex during a workout coming into possession of material non-public information.
 - Whether the fund's and/or adviser's disclosure adequately discuss these conflicts and how they might be addressed.
 - Please see our [Client Alert](#) for more information about potential implications to lenders.

Audits and Financial Statements. A fund's auditor may be unable to complete an audit due to the number of its employees working offsite and, consequently, the fund may be unable to get its financial statements distributed. See this Ropes & Gray [Client Alert](#), describing SEC relief regarding transmittal of annual and semi-annual reports.

Stock Dividends. For funds seeking to conserve cash while continuing to qualify as regulated investment companies for tax purposes ("RICs"), consider the potential utility of IRS guidance permitting satisfaction of the RIC distribution requirements with certain stock dividends. This guidance allows RICs to limit the total amount of cash that shareholders may receive as part of a dividend to 20% of the total amount of the dividend, and to pay the remainder in stock. To qualify, the RIC must either (i) have at least 500 shareholders at all times during its taxable year, (ii) offer its shares under the Securities Act or (iii) be traded on an established securities exchange. Among other technical requirements, all shareholders must have the option to elect cash or share proceeds, subject to the cash limit, and must generally be subject pro rata to any limitation the cash limit imposes on the aggregate cash payout.

CORONAVIRUS INFORMATION & UPDATES



Other Issues to Consider.

- Exemptive orders, no-action letters and interpretive relief for routine matters may not be as forthcoming or may be delayed.
- The implications of negative interest rates, including preferred share dividend rates.
- Any increased pressure on pre-clearance procedures, black-out periods and other restrictions on personal trading by employees.
- Force majeure clauses in service provider contracts, and whom they excuse (*i.e.*, only the vendor or service provider?). Please see these Ropes & Gray Clients Alerts: [New York Contract Law Remedies in the Face of Disruption Caused by COVID-19](#) and [An update on COVID-19 implications for private equity](#).

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney. For additional materials regarding a range of COVID-19-related issues, please visit the Ropes & Gray [Coronavirus Resource Center](#), which includes our publication [COVID in the Workplace: Scenarios and Responses](#).