New SEC Staff Guidance Could Leave Mutual Funds In A Bind

Law360 (April 17, 2019, 3:56 PM EDT) –

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In a footnote to an April 2, 2019, U.S. Securities and Exchange Commission staff guidance,[1] the staff requested that mutual funds file a delaying amendment to postpone the effective date of their registration statements if a fund is unable to submit responses to staff comments at least five business days before automatic effectiveness.[2] While the spirit of the guidance seems geared more towards new registrants, its language nevertheless applies to existing funds that are updating current registration statements.

This being the case, it is possible that members of the staff could reiterate this request directly to a mutual fund in the days before automatic effectiveness if the fund fails to submit responses to staff comments before the five-business-day cutoff. Mutual fund sponsors should think carefully before agreeing with an SEC staff request to delay the automatic effectiveness of a fund's annual update. Complying with the staff's request could leave a mutual fund without an effective registration statement.

Mutual funds are required to amend their registration statements at least annually, within four months after their fiscal year end, to update their financial information.[3] The existing registration statement, including the prospectus, can no longer be used once a fund's audited financial statements are more than 16 months old.

Amendments to a registration statement take effect automatically (i.e., without staff action) 60 days after filing when including material changes, and 75 days after filing when registering a new series fund, pursuant to Rule 485(a) under the Securities Act.[4] Most mutual funds filing an annual amendment under 485(a) will file exactly 60 days before that 16-month deadline (i.e., 60 days before May 1 for a fund with a fiscal year end of Dec. 31).[5] By agreeing to delay effectiveness beyond the deadline, even if for only one day, the mutual fund could find itself without an effective registration statement.

Mutual funds face liability under the Securities Act, including potential rescission of share purchases, when a fund is offered without an effective registration statement.[6] To avoid the possibility of investors having a rescission right, a mutual fund would need to temporarily stop offering shares during any period in which its registration statement is not effective. As a practical matter, this may be an impossible task for mutual funds sold through intermediaries, such as brokerage and advisory platforms.

These intermediaries require days, or even weeks, to communicate a halt to the hundreds of financial advisors buying shares through their platforms. An unexpected halt in the offering also exposes the mutual fund's principal underwriter to potential liability. Typically, the underwriter is obligated in its agreement with an intermediary to provide one or two months' notice before discontinuing an offering.[7]

An unexpected stop, without the underwriter providing requisite notice, could trigger contractual liability and/or indemnification obligations for the underwriter. This is separate from, and in addition to, any civil liability incurred by the mutual fund.

The potential liability would be a draconian penalty for mutual funds that unwittingly comply with the staff's requests to voluntarily delay automatic effectiveness. At the same time, the staff has a basis for requesting responses at least five business days before the effective date, assuming the staff gave its comments weeks earlier.[8] The request reflects the staff's frustration that mutual funds often submit their responses to staff comments shortly before (or at) the time of automatic effectiveness, particularly in cases where the fund sponsor does not agree with one or more of the staff's comments.

In these cases, the staff often lacks an opportunity to check whether last-minute responses adequately address investor protection concerns. If the fund declines to file a delaying amendment, the staff's only meaningful recourse would be to ask the SEC to issue a stop order preventing automatic effectiveness, which it rarely does.[9]

With the May 1 deadline fast approaching, everyone's interests are best served by avoiding the need for the staff to request delays in the annual update context.[10] Given the stakes, if one or more of your mutual funds may have difficulty meeting the staff's five-day deadline, we recommend proactively communicating your timeline with the staff examiner. And if you do receive a staff request to delay the effective date, you should consult counsel to discuss the implications before taking any steps to comply with such request.

It would be prudent for the SEC to work with the industry to develop a more permanent solution if, in fact, investor protections are being compromised by a practice of mutual funds submitting last-minute responses to staff comments. The traditional stop order is not a viable solution for a number of reasons. A stop order requires action by the full SEC, may not be the best use of the SEC's time and, in any case, cannot be obtained unless the staff receives responses with sufficient time to identify unresolved concerns and martial SEC action before automatic effectiveness.

The staff's new standing request to file a delaying amendment may work to resolve late responses to timely staff comments in some contexts, such as responses to comments on an amendment registering a new series fund (where there is no existing registration statement that could lapse). In the context of an annual update to an existing fund's registration statement, however, it could require halting the fund's continuous public offering. Requesting that mutual funds file a delaying amendment in that context, without explaining the implications, creates an unintentional trap for the unwary fund that deferentially complies.

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[1] The guidance, titled "ADI 2019-07 — Review of Certain Filings Under Automatic Effectiveness Rules," is issued by the Office of Disclosure Review and Accounting in the Division of Investment Management of the SEC, and available at: https://www.sec.gov/investment/accounting-and-disclosure-information/adi-2019-07-review-certain-filings-under-automatic.

[2] Footnote 2 of the guidance states, "In cases where registrants are unable to submit responses to Staff comments by that time, the Staff requests that registrants file an amendment under rule 485(b)(1)(iii) delaying the effectiveness date of the filing as needed until Staff comments have been resolved."

[3] Section 10(a)(1) of the Securities Act of 1933 provides that, when a prospectus is used more than nine months after the effective date of the registration statement of which it is a part, the information in the prospectus must be as of a date not more than sixteen months prior to the date of use. Further, Rule 8b-16 under the Investment Company Act of 1940 requires that a registrant file an amended registration statement not more than 120 days after the close of their fiscal year.

[4] Rule 485(a)(1) under the 1940 Act provides that a post-effective amendment containing material changes to the registration statement of an existing open-end fund or unit investment trust will automatically become effective 60 days after filing. Rule 485(a)(2) under the 1940 Act provides that a new open-end fund that is organized as a new series of an existing registrant can file a post-effective amendment to an existing registration statement, and automatically become effective 75 days after filing.

[5] For 2019, in order to file a timely annual update to its registration statement under Rule 485(a) and satisfy the staff's request for 5 business days, a mutual fund with a fiscal year end of Dec. 31 would need to file its amendment to the registration statement no later than March 1, 2019, and respond to any staff comments no later than April 24, 2019.

[6] Specifically, Section 5 of the Securities Act prohibits the offer or sale of securities under an ineffective registration statement, while Section 12 of the Securities Act imposes civil liability upon any issuer who does so. Section 12(1) also allows the purchaser of such securities (upon showing a violation of Section 5) to either rescind the purchase of the securities and receive interest on the money invested (less the amount of any income received in relation to the security) or recover damages should they no longer own the security.

[7] For example, common language is "Underwriter will notify Intermediary in writing at least 60 days in advance prior to discontinuing the offering of any Funds or shares offered, and the failure to provide such notification shall obligate the Underwriter and the Funds to accept orders for such discontinued Funds or shares until Intermediary is able operationally to cease offering the Funds or shares."

[8] The staff generally provides initial comments on an amendment to a registration statement within 30 calendar days of filing under Rule 485(a).

[9] Section 8(b) of the Securities Act authorizes the SEC to issue a stop order that will prevent the effectiveness of a registration statement where the SEC determines that the registration statement is on its face incomplete or inaccurate in any material respect.

[10] In line with this thinking, the staff also requests that registrants planning filings under Rule 485(a) that may raise novel material questions or address issues in a manner inconsistent with past guidance contact the staff prior to filing to discuss such issues.