

WEBINAR

*COVID-19 Disruption:  
What Registered Investment  
Advisers Need to Know*

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## *Webinar Presenters*



**Phillip Gillespie**  
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## *Agenda*

- Business Continuity Procedures
- Liquidity Risk Management
- Valuation, Pricing Vendor Oversight, and Fair-Value Decision Making
- Side-by-Side Management, Trade Allocation and Cross-Trades
- Counterparty Credit Monitoring
- Breaches of Investment Guidelines Resulting from Market Moves and Downgrades
- Monitoring of Service Providers
- Updating Risk Disclosures
- Communications with Distribution Partners for Registered Funds



## *Business Continuity Procedures (BCP)*

- While the SEC never adopted its 2016 proposed rule\* that would have required registered investment advisers to adopt comprehensive BCPs, there is a clear expectation that firms maintain robust BCPs.
- BCP is already a focus for OCIE examinations and the Staff's focus is likely to increase in light of the Covid-19 events.
- Firms should closely examine the effectiveness of their current BCPs for pandemic-induced disruptions in operations and markets.
- If real-time adjustments or deviations are necessary, document the reasons for those deviations and update the firm's written BCP as promptly as possible.

\* Adviser Business Continuity and Transition Plans, SEC Release No. IA-4439, June 28, 2016.



## *Liquidity Risk Management*

Liquidity management is a priority in disrupted markets, particularly for funds with daily or monthly liquidity.

— Process Points:

- For open-end mutual funds and ETFs – Focus on the specific process requirements of Investment Company Act Rule 22e-4:
  - Review liquidity stress test models and assumptions (i.e., redemption scenarios) against current market realities.
  - Certain less liquid asset classes may need to be re-evaluated against registered funds' liquidity classification buckets.
  - Consider informing the fund's board of the steps you are taking.
- For private funds – Focus on undertakings in offering and organizational documents and side letters.



## *Liquidity Risk Management (continued)*

Liquidity management is a priority in disrupted markets.

— Substantive Points:

- Some asset classes may experience significant liquidity disruptions, which can result in the need to activate lines of credit or, in the case of private funds, the need to implement redemption gates.
- Investment advisers and fund managers should proactively implement liquidity risk management measures reasonably designed to ensure that all clients seeking liquidity are treated fairly, and that available liquidity is not afforded only to the clients that run for the exit first.
- If there are significant fund redemptions, focus specifically on portfolio managers' sale decisions to ensure that there is a plan to preserve as much liquidity in a fund as possible.
- SEC has granted temporary and extraordinary relief to allow affiliate purchases of debt securities from registered funds and to expand funds' ability to borrow from affiliates to meet redemptions (discussed below).
- FRB Money Market Mutual Fund Liquidity was launched to March 18 to allow banks to buy certain debt instruments from prime and tax-exempt money market funds (discussed below).



## *Valuation, Pricing Vendor Oversight, and Fair-Value Decision Making*

Firms need to focus on pricing and valuation for less liquid, thinly-traded or hard-to-value securities.

- Process Points:
  - Pay particular attention to valuation and related policies and procedures.
  - Consider frequent (daily) meetings of your Valuation Committee.
  - Carefully document any fair value determinations and the basis for those determinations.
- Substantive Points:
  - Oversight of **pricing vendors** should be a real priority, especially pricing vendors providing evaluated loan prices.
  - If a fund manager knows that a vendor's evaluated price is not accurate, the manager has an obligation to challenge the vendor's price and, in appropriate circumstances make a fair value determination to override the vendor's price.



## *Valuation, Pricing Vendor Oversight, and Fair-Value Decision Making (continued)*

- Area of SEC Focus:
  - Valuation decisions and pricing vendor oversight are perennial areas of concern for SEC staff.
  - SEC examinations following the crisis are likely to focus on this area.
  - It is important to show a record of a serious and solid process as free as possible from conflicts of interest.



## *Side-by-Side Management, Trade Allocation and Cross-Trades*

Investment advisers need to pay close attention to the conflicts of interest that are inherent in managing proprietary money alongside client accounts and potential conflicts of interests associated with managing client accounts of different size or significance.

### — Process Points:

- Ensure that the firm's trade allocation procedures are followed faithfully and that portfolio managers are reminded that fair allocation of opportunity applies equally in sale decisions as it does in buy decisions.
- Consider heightened monitoring by compliance personnel. Unusual deviations or exceptions from a firm's trade allocation policy and procedures deserve prompt attention from compliance and legal personnel.
- Deviations from the firm's allocation procedures should be documented carefully.

### — Substantive Point:

- Fairly allocating available market liquidity to all selling client accounts is paramount, given the potential for such decisions to be second guessed by clients and regulators in hindsight.



## *Side-by-Side Management, Trade Allocation and Cross Trades (continued)*

- Cross Trades:
  - Also pay particular attention to any unusual cross-trading activity as well as compliance with the firm's cross-trade policy and procedures, including pricing.
  - In times of crisis, it is very tempting for portfolio managers to use other accounts as a source of liquidity, particularly when they “love” the position and don't want to sell it.
  - Unusual cross trades almost always get second guessed by the SEC in hindsight.



## *Counterparty Credit Monitoring*

- It is important for investment firms to proactively monitor their trading counterparties for credit deterioration and downgrades.
- In the context of institutional mandates, investment advisers should pay close attention to counterparty credit restrictions in investment management agreements and proactively manage those restrictions to avoid client disputes and potential liability for counterparty failures.
- Understand the default and unwind triggers in your ISDAs and other trading/netting agreements.
- Be wary of PMs' and traders' reluctance to exercise unwind rights or notices of events of default.



## *Breaches of Investment Guidelines Resulting from Market Moves and Downgrades*

It is important that investment advisers closely monitor downgrades or changes to ensure that their client portfolios remain in compliance with required investment guidelines in this changing market environment.

- Process Points:
  - Consider enhanced compliance monitoring and reporting.
  - Document carefully how guideline breaches are cured.
- Substantive Points:
  - To the extent that proactive steps can be taken to avoid breaches, they should be taken. If a breach is a “passive” one resulting from market movement or downgrades, prompt action should be taken to remedy the breach.
  - In the institutional context, it is important that managers communicate the steps they are taking in this regard with their clients.



## *Monitoring of Service Providers*

- Firms need to closely monitor the ability of operational service providers such as **custodians, administrators, outsourced middle office, back office and risk management providers** to continue to perform.
- As many service providers implement mandatory remote work practices, service levels may come under stress.
- Pay particular attention to service providers performing regulatorily-required functions such as **accounting agents, administrators that strike daily NAVs** for mutual funds and ETFs, and **fulfillment vendors** for delivery of prospectuses for registered funds.



## *Updating Risk Disclosures*

- Fund managers should confirm that their existing investment risk disclosures accurately reflect the investment risks that a fund presents, or update them as appropriate.
- In particular, firms should identify risks previously described in a prospectus or offering documents in hypothetical terms that have manifested, or that have recently become a “principal investment risk” but to date have not been described as such. Recent SEC enforcement actions regarding risk factor disclosures in the corporate context highlight the need to update disclosure when material changes have occurred.
- Some mutual fund families have filed prospectus stickers noting that the current Covid-19 crisis may impair a fund’s ability to meet its investment objective.



## *Communications with Distribution Partners for Registered Funds*

- Many mutual fund distribution agreements contain provisions requiring fund managers to alert the distribution partners to material changes in a fund's investment process or operation.
- In certain cases, a fund's adviser (and principal underwriter/distributor) can have contractual liability for investor losses if a distribution partner is not made aware of material developments.
- Fund managers need to understand and manage their obligations to inform distribution partners of material changes in a fund's operations or investment process.



## *SEC and FRB Temporary Relief Measures*

### **Liquidity Relief Measures**

- **Federal Reserve Board Money Market Mutual Fund Liquidity Facility** (March 18 and 20, 2020) providing collateralized, non-recourse loan to US banks, bank holding company subsidiaries and US branches of foreign banks to facilitate the purchase of high quality assets from prime and tax exempt registered money fund.
- **No-Action Relief under Section 17(a) of the Investment Company Act and Rule 17a-9** (March 19, 2020) allowing affiliated banks subject to Sections 23 and 23A of the Federal Reserve Act (Reg. W) to purchase assets from prime and tax-exempt money funds at market value.
- **SEC Order Sections 6(c), 12(d)(1)(J), 17(b), 17(d) and 38(a) of the Investment Company Act** (March 23, 2020) granting mutual funds and variable annuity separate accounts expanded ability to borrow from affiliates to satisfy redemptions.
- **No-Action Relief under Section 17(a) of the Investment Company Act** (March 26, 2020) allowing affiliates of mutual funds (but not ETFs) to purchase debt instruments from the affiliated mutual fund at market value, subject to an obligation to return any profit on resale to the mutual fund unless the affiliated purchaser is subject to Reg. W.



## *Filing and Governance Relief for Registered Funds and Advisers*

**Investment Company Act Relief Measures** (March 3, 2020 No-Action Letter on In-Person Board Meetings, March 13, 2020 and March 25, 2020 SEC Orders)

- **In Person Board Meeting Requirement** – relief until August 15, 2020
- **Form N-23C-2 Notices for BDCs** – relief until August 15, 2020
- **45-Day Extension for Delivery of Annual and Semi-Annual reports** – for reports due on or before June 30, 2020
- **45-Day Extension for Filing Forms N-CEN and N-PORT** – for filings due on or before June 30, 2020
- **45-Day Extension for Prospectus Delivery for Purchases by Existing Shareholders** – for purchases on or before June 30, 2020

**Advisers Act Relief Measures** (March 13, 2020 and March 25, 2020 SEC Orders)

- **45-Day Extension for Registered Advisers and Exempt Reporting Advisers for Amendments/Updates to Form ADV** – for filings due on or before June 30, 2020
- **45-Day Extension for Filing Form PF** – for filings due on or before June 30, 2020



## *Questions*

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