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SEC Temporarily Permits Affiliated Purchases of Debt Securities From Mutual Funds

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Section 17(a) of the Investment Company Act of 1940, as amended (the “40 Act”) prohibits certain transactions between an investment company and their affiliated persons.^[1] including transactions where an affiliated person knowingly purchases assets from or sells assets to a registered investment company.^[2] Section 17(a) was designed to prevent self-dealing and overreaching of affiliated persons and protect shareholders from mismanagement by affiliated persons.^[3]

In response to a request from the Investment Community Institute, the Securities and Exchange Commission (the “SEC”) released a no-action letter ^[4] on March 26, 2020 (the “No-Action Letter”), which grants relief to all open-end investment companies, except exchange traded funds and money market funds (“Fund”), to sell debt securities to an affiliated person of the Fund, provided certain conditions are met. This temporary relief is an extension of the exemption granted under Rule 17a-9 of the 40 Act, which permits transactions between money market funds and its affiliated person that would otherwise be prohibited under Section 17(a), provided certain conditions are satisfied.^[5]

The SEC granted this relief in recognition of the fact that there currently is a short-term dislocation in the market for debt securities due to COVID-19.^[6] This dislocation is exacerbated because Funds seeking to enhance liquidity or fund redemption requests are prohibited from selling debt securities to affiliated persons who can provide much needed liquidity to the Fund.^[7]

The No-Action Letter permits affiliated persons of a Fund to purchase debt securities from the Fund if the following conditions are met:

1. The purchase price is paid in cash;
2. The purchase price is the debt securities’ fair market value under Section 2(a)(41) of the 40 Act,

provided that this price is not materially different from the fair market value of the security indicated by a reliable third-party pricing service;

3. Any profits made by the affiliate through a resale of the debt securities will promptly be paid back to the Fund^[8]; and
4. The Fund must publicly post on the Funds website and notify the SEC ^[9] within one day of the sale the name of the fund and purchaser, the securities purchased, the amount purchased, and the total price paid.

It is important to note that the relief granted under the No-Action Letter is temporary and will be revoked upon notice from the SEC. However, while the relief is effective, investment advisers, sub-advisers, and other affiliated persons of a Fund have the opportunity to purchase the Fund's debt securities to help provide liquidity during this time of financial instability.

While the temporary relief offered by the No-Action Letter is designed to provide benefits to Funds in particularly challenging market conditions, Funds and their advisers may want to exercise caution before engaging in transactions pursuant to the relief. The very reason for the relief – the current illiquidity of many issues – makes it challenging to determine some securities' fair market value, even with pricing service marks. In this regard, Funds and their advisers should consider that determinations made now in reliance on the No-Action Letter may be subject to critique or criticism later, particularly with the benefit of hindsight that may reveal circumstances or factors relevant to fair market value that were not obvious at the time. If a Fund nevertheless determines to take advantage of the No-Action Letter, we recommend careful coordination with counsel to ensure that fair market value and No-Action Letter reliance is appropriately considered and documented.

If you have any questions about the No-Action Letter or the regulation of funds, please feel free to contact us.

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Footnotes

[1] Affiliated persons include: (i) any person holding five percent or more of the outstanding voting securities of the fund; (ii) companies that five percent or more of such companies voting securities are held by the fund; (iii) persons controlling, controlled by, or under common control with the fund; (iv) any officer, director, partner, or employee of the fund; and (v) the fund's investment adviser and any subadviser. Investment Company Act, Section 2(a)(3).

[2] Investment Company Act, Section 17(a).

[3] See SEC Release, Investment Company Mergers, Release No. IC-25259 (Nov. 15, 2001), available at https://www.sec.gov/rules/proposed/ic-25259.htm#P48_4091.

[4] Investment Company Institute, SEC No-Action Letter (Mar. 26, 2020), available at: <https://www.sec.gov/investment/investment-company-institute-032620-17a> [hereinafter referred to as "No-Action Letter"].

[5] 17 CFR 270.17a-9.

[6] See No-Action Letter.

[7] See ICI Request for No-Action Relief for Affiliated Purchases of Debt Securities from Registered Open-End Investment Companies, available at: <https://www.sec.gov/divisions/investment/noaction/2020/investment-company-institute-032620-17a-incoming.pdf>.

[8] If the affiliated person is subject to Sections 23A and 23B of the Federal Reserve Act, this condition does not apply to the extent that it would otherwise conflict with (i) applicable banking regulations or (ii) any applicable exemption from such regulations issued by the Board of Governors of the Federal Reserve System.

[9] A Fund will notify the SEC via email to IM-EmergencyRelief@sec.gov.