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Fund Finance Friday

Key Issues for Loans to ’40 Act Funds

January 29, 2021 | Issue No. 111

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While not as robust as we once anticipated, we have seen a steady flow of financings for alternative investment funds that are registered as investment companies under the U.S. Investment Company Act of 1940 (the “Investment Company Act”). In structuring financing transactions with registered investment companies, there are a handful of issues that lenders should be aware of. Below is a brief (and, by design, over-simplified) description of a few of the more common issues that are addressed in loan documentation:

Validity of the Contract: Section 47 of the Investment Company Act provides that any contract made in violation of the Investment Company Act, or whose performance involves such a violation, is unenforceable by either party, unless a court finds that under the circumstances enforcement would produce a more equitable result than non-enforcement. Due to these potentially severe consequences, it is important to be aware of the limitations and restrictions that exist under the Investment Company Act and to make sure that the terms of the loan documents align with such limitations and restrictions. Lenders will typically require specific representations from the borrowers that the transaction does not violate the Investment Company Act. And borrower counsel legal opinions will typically include opinions addressing the status of the borrower as an investment company as well as non-contravention of the Investment Company Act and related regulations.

Leverage Limitations: The Investment Company Act specifies leverage limitations for registered investment companies. Section 18 of the Investment Company Act requires that when a registered closed-end company borrows, it must have asset coverage of at least 300%. Asset coverage is determined by reference to the ratio of the value of its assets to the amount of its outstanding senior securities representing indebtedness (which includes loans that are not “temporary,” meaning they have a term of less than 60 days and are not extended). Open-end funds like mutual funds have a similar 300% asset coverage requirement, but that asset coverage level must be maintained at all times (subject to a three-business-day cure period), not just at the time of a borrowing. Business Development Companies are subject to a similar framework but with certain key differences and exceptions. Another potential source of restrictions on leverage may be found in the governing documents and investment policies of the borrower itself, which may impose specific asset percentages or other limitations on borrowing that are more restrictive than those imposed by Section 18.

Transactions with Affiliated Persons and Underwriters: Section 17 of the Investment Company Act prohibits certain transactions between registered investment companies and their affiliated persons, promoters and principal underwriters (commonly referred to as first-tier affiliates), as well as affiliated persons of such persons, promoters or principal underwriters (commonly referred to as second-tier affiliates). Affiliated persons include persons owning five percent or more of the voting securities of the registered investment company as well as control persons, officers and directors. Prohibited transactions include transactions involving sales of securities to or purchases of securities from such affiliated persons, loans of money to such affiliated persons and (solely if in contravention of other rules published by the SEC) borrowing money from such affiliated persons. In order to avoid entering into transactions in violation of Section 17, many financial institutions maintain lists of funds for which they are first- or second-tier affiliates and prohibit all transactions, including financing transactions, with such funds. So it is important to be aware of other relationships that a financial institution has with a registered investment company in order to confirm that the financial institution is not an affiliated person, promoter or principal underwriter of such investment company. Loan agreements often include representations, covenants and/or events of default to ensure that should such a relationship exist, no further borrowings will be made or the facility will be promptly terminated. Business Development Companies are subject to their own restrictions on transactions with affiliates.

Tax Distributions: Many registered investment companies elect to be treated as “regulated investment companies” under the U.S. Internal Revenue Code. Regulated investment companies generally are permitted to reduce or eliminate corporate-level income tax by distributing out their income and gains each year. To qualify as a regulated investment company, a registered investment company generally must derive at least 90% of its income from capital gains, interest or dividends earned on investments, and must distribute a minimum of 90% of such net investment income to its shareholders each year. Many registered investment companies distribute interest and dividend income quarterly, and capital gains income annually. Investors may elect to receive those distributions, or automatically reinvest them in the registered investment company. Failure to make such distributions may subject the registered investment company to excise taxes or even cause it to lose its pass-through tax status under the tax code. As a result, there can be extensive negotiations around the conditions for distributions to investors. Lenders want assurances that distributions will not be paid to investors when there is a default that has not been resolved under the credit agreement, while borrowers are focused on the need to make the necessary distributions to maintain their status as regulated investment companies.

Restrictions on Fundamental Changes; Investment Advisor: Because lenders often factor into their underwriting the borrower’s investment policies, credit facilities for registered investment companies may restrict the investment company’s ability to alter these policies without consent, at least to the extent that such a change would require shareholder approval under the Investment Company Act. Similarly, because the identity of the borrower’s investment advisor is often critical to the lender’s analysis of the borrower as a credit counterparty, lenders may limit changes of the investment adviser without consent.

Custody of Assets: Section 17(f) of the Investment Company Act requires a registered investment company to maintain its securities and similar investments in the custody of (1) a U.S. bank having aggregate capital, surplus and undivided profits of at least $500,000; (2) a member of a U.S. securities exchange (*i.e.*, an SEC-registered broker-dealer); (3) centralized clearing corporations that meet criteria set by the SEC; and (4) the investment company itself (again, subject to rules set by the SEC). The SEC has adopted various rules, including rules relating to custody by SEC-registered broker-dealers, CFTC-registered futures commission merchants and commodity clearing organizations, U.S. “securities depositories,” “Eligible [foreign] Securities Depositories” (*e.g.*, Euroclear), and “Eligible Foreign Custodians.” Lenders should be aware in specifying conditions for the replacement by borrowers of their custodians that any replacement will have to be a qualifying custodian under the Investment Company Act. As a result, lenders may be more flexible than with private fund borrowers in letting the borrower determine a replacement custodian, provided that it is a qualifying custodian under the Investment Company Act that provides custody services to registered investment companies as part of its core business.