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## COVID-19, Fund Board Meetings, Business Continuity Plans, and Other Considerations for Fund Boards

The novel coronavirus disease 2019 (COVID-19) has disrupted communities, businesses, and many sectors of our economy, including the fund industry. Fund complexes are implementing business continuity plans (BCPs) and preparing for possibly larger disruptions in the weeks and months ahead. Fund boards oversee the management and operations of funds by the adviser and other service providers. As these business continuity and contingency plans and preparations are underway, we asked Lori Schneider, a partner in the Asset Management and Investment Funds group at K&L Gates LLP, for her insights on the topics and questions fund boards might consider in connection with their oversight role.



This article is for informational purposes and does not contain or convey legal advice. Each investment company board should seek the advice of its own counsel for issues relating to its individual circumstances.

**Board Update:** Let's start with board meetings. The Securities and Exchange Commission (SEC) recently issued an **order** providing exemptive relief from the in-person meeting requirement. This followed the SEC's Division of Investment Management staff **statement** extending the **no-action position** provided to IDC last year regarding the in-person meeting requirement for certain board approvals. Can you explain what relief the exemptive order provides and what factors a board might consider when determining whether to conduct a meeting via telephone or videoconference, instead of in person?

**Lori Schneider:** The SEC order provides exemptive relief from the in-person meeting requirements for board approvals of advisory and underwriting agreements, Rule 12b-1 plans, and the funds' independent auditors. The relief covers all required in-person approvals, including those involving new funds or material changes to the agreements, plans, or arrangements. The relief is effective until August 15, 2020, and requires that three conditions be met:

1. reliance on the order is necessary or appropriate due to circumstances related to current or potential effects of COVID-19;
2. the votes required to be cast at an in-person meeting are instead cast at a meeting in which directors may participate by any means of communication that allows all directors participating to hear each other simultaneously during the meeting; and
3. the board of directors, including a majority of the independent directors, ratifies the action taken pursuant to the order by vote cast at the next in-person meeting.

The Commission's order carries greater legal authority than a staff statement or position, and thus, is a welcome form of relief.

All fund boards we work with that have board meetings scheduled in the near future have determined to hold meetings telephonically or by videoconference because of the travel and health concerns associated with COVID-19. As a practical matter, we have seen some boards and advisers carefully reviewing agendas to determine which agenda items or presentations need to be addressed at the meeting and which may be deferred to the next in-person meeting (such as those that may not translate well at a telephonic or videoconference meeting). Management companies are also coordinating with fund directors to make sure they have the necessary functionality to attend a videoconference meeting. Some have done test runs in advance of the meeting to make sure the technology works properly for each participant.

**BU:** Does the board need to make a specific determination before holding a meeting that is not in person?

**Lori Schneider:** In order to rely on the SEC exemptive order, there should be a finding, consistent with the order's conditions, that "reliance on the order is necessary or appropriate due to circumstances related to current or potential effects of COVID-19." This finding may be memorialized in various ways, including in a formal resolution of the board, in a memorandum from the adviser or counsel, or acknowledged at the beginning of a board meeting and incorporated into the meeting minutes. While the order does not expressly require the board to make this finding, it may be prudent for the board to do so—in its reasonable business judgment—in order to be in a position to invoke the protection of the business judgment rule should the approval ever be questioned. This finding can be informed by any COVID-19 guidance provided at the federal or state government level, as well as any travel or meeting restrictions or office closures in place at the adviser. I would note this is similar to the determination required under the IDC no-action letter and Division of Investment Management statement that "unforeseen or emergency circumstances" make meeting in person impracticable or impossible.

To rely on the SEC order, there should also be a confirmation that all directors participating in the meeting can hear each other simultaneously, and there should be a plan that the board approval will be ratified at the next in-person meeting. These should be reflected in the minutes of the board meeting.

**BU:** Recognizing that fund boards oversee the management and operations of funds and the compliance programs of the funds and their service providers, what are some possible topics that boards might raise with the adviser and other service providers to provide that oversight?

**Lori Schneider:** The areas most relevant to the board's oversight under these circumstances include the following:

1. Business continuity and contingency planning at the adviser and the other fund service providers
2. Large outflows or liquidity issues
3. Valuation issues or challenges
4. Fund performance or portfolio management issues
5. Compliance matters resulting from the market turmoil or volatility

I would emphasize that the board's role is one of oversight—it is not the directors' role to be involved in the day-to-day operations of the funds. In trying and hectic times such as this, it is important for boards to stay informed and vigilant and to be available for management, when necessary. But the board also should be mindful that the adviser's personnel are working hard to handle the complexities of the day-to-day business, and responding to multiple questions from board members on a variety of matters may take them away from that work. A board's chair or lead independent director can be an effective conduit to communicate appropriate questions from board members to the extent there are any ongoing concerns.

**BU:** Within those topics you've mentioned, can you elaborate on what specific questions fund directors may want to consider asking the fund adviser?

**Lori Schneider:** Let's take each area and review the relevant questions boards may want to consider.

## Business Continuity and Contingency Planning

When thinking about business continuity and contingency planning, the board may first want to consider getting assurance from the adviser that it has made the health and safety of its employees and clients the top priority and, as necessary, implemented remote work options and travel or in-person meeting restrictions.

Second, the board may want to inquire whether the adviser and each of the funds' key service providers—including the custodian, transfer agent, and any subadvisers—have appropriate business continuity and contingency planning procedures in place and that they are being implemented effectively.

This is important to ensure there will be no business disruptions if and when employees must work remotely for extended periods. Remote work in this instance will be required not only for a period of several days or for a limited geographic region, as we've seen with weather events in more recent years, but likely for a much more extended period of time and on a grander scale, both in terms of numbers and geographically.

**BU:** Regarding a firm's business continuity plan, how much detail should a board receive to evaluate the appropriateness and effectiveness of their plans?

**Lori Schneider:** As a starting point, the board may want to discuss with the adviser at a high level the functional areas that could be affected. For example, not only are BCPs important to continue the funds' portfolio management and trading, but they are also critical to continue other functions, including the funds' pricing and net asset value (NAV) calculations. In this connection, boards may want to ask the adviser what type of testing it has previously done to make sure the adviser has the capacity for its personnel to work remotely on a grand scale and maintain its operations within these functional areas.

Likewise, the board should get appropriate assurances from the adviser that it has reviewed and worked to oversee the business continuity and contingency planning at the funds' third-party service providers, and taken steps to confirm with those service providers that there will be no disruptions in their operations and ability to provide services to the funds. In terms of fund pricing and NAV calculations, lessons learned by some fund groups in recent years with striking the NAV in a timely fashion, and the resulting contingency planning, may prove instructive. Boards may want to ask, for example, for confirmation from the adviser that the funds are prepared to calculate the funds' NAVs if there are significant interruptions in the systems at the funds' administrator or accounting agent.

Boards may also want to confirm with the funds' chief compliance officer (CCO), as well as those responsible for operational risk, that prior SEC staff guidance on BCPs has been followed to the extent appropriate. The SEC's Office of Compliance Inspections and Examinations (OCIE) issued an [alert on BCPs after Hurricane Sandy in 2013](#) that may be instructive. In addition, in 2016, the Division of Investment Management issued an [IM Guidance Update](#) that highlights the need to coordinate interdependent functionalities with the funds' outside service providers within business continuity planning. That Guidance Update was issued following the challenges some fund groups had experienced in timely processing their NAVs due to technology-related issues at the funds' third-party service provider.

More generally, from a cybersecurity or information security perspective, directors may want to ask if remote access under the BCP presents any new challenges.

And, perhaps yet another BCP-related question relates to contingencies for key person risk—making sure that there is sufficient staffing and redundancies in place should key employees become ill with COVID-19.

**BU:** Getting back to the other topics you mentioned, can you elaborate on questions directors may want to consider asking the fund adviser?

**Lori Schneider:** Taking each of these in turn:

## Large Outflows or Liquidity Issues

While we've heard about the flight to quality and safety on the part of some investors during recent days, directors may want to ask whether there have been any large outflows or any unusual redemption activity in any of the funds.

In addition, have there been any liquidity issues in any of the funds, whether stemming from large redemptions or otherwise? And, has the liquidity risk management program (LRMP) operated as intended? For example, have any of the board reporting requirements under the LRMP been triggered?

Another question may be whether there has been a need to rely on a credit or borrowing facility to meet redemptions in a timely manner in accordance with the funds' obligations under the Investment Company Act of 1940.

## Valuation Issues or Challenges

Given the market volatility and potential liquidity challenges, boards may want to ask advisers whether there have been any valuation issues or challenges. Or, whether there has been a significant increase in the number of securities, or the percentage of the overall portfolio, that must be fair valued. A related question is whether pricing vendors have been able to continue to provide reliable prices in a timely manner.

Directors may want to review with counsel the circumstances under the funds' pricing procedures where the relevant committee of the board responsible for overseeing pricing, the committee's chair, or the full board is required to be notified by management. Situations like this might include, for example, if there is a change in a fair value methodology, particularly where there is a material impact on NAV. We have seen some instances of those provisions being triggered recently.

## Fund Performance or Portfolio Management Issues

From the perspective of the adviser's portfolio management of the funds, directors may want to ask the adviser whether the recent market volatility, risk of illiquidity in certain segments of the market, or the Federal Reserve's recent interest rate cuts have created any significant portfolio management or trading issues or challenges for the funds or negatively affected fund performance or yields in a material way. If so, how are these issues being addressed by the adviser?

Similarly, what steps has the adviser taken to manage risk for the funds, particularly those with significant exposure to the regions, sectors, or industries most significantly affected by the coronavirus?

Has the adviser's stress testing been effective in anticipating how fund portfolios may react to the current volatility, and has the stress testing influenced any risk measures that the adviser has implemented?

In terms of fund performance, how does the funds' performance compare with relevant benchmarks or peer groups? Are there any unexpected results versus those benchmarks or peers?

We are beginning to see presentations from funds' chief investment officers or relevant portfolio managers on these issues.

## Compliance Matters

With the extreme market volatility and turmoil, directors may want to consider asking whether the funds have experienced any compliance issues with investment limits, illiquid securities limits, or, in the case of derivatives, asset coverage requirements. Presumably, any material compliance issues would be reported to the board by the fund CCO; depending on the severity, the CCO may promptly report to the board or relevant committee or may report at the next regularly scheduled meeting.

**BU:** Are there any questions specific to closed-end funds that directors should consider?

**Lori Schneider:** In the case of closed-end funds, directors may want to ask if there has been any unusual trading volumes or activist purchases (especially for funds with increasing discounts).

In addition, they may want to ask if there have been any issues with 1) asset coverage limits—both with respect to contractual limits and those under the 1940 Act; 2) events of default for leverage and any related breakage costs or other fees; 3) the funds' ability to pay interest payments on outstanding borrowings, preferred share distributions, and common share distributions; and 4) any changes in relative discounts compared to peer funds.

**BU:** So, how might a board go about asking all of these questions? Might a board schedule a telephonic meeting to get an update from management? Or would these questions be asked in separate communications with management?

**Lori Schneider:** We've seen the board chair (or lead independent director) and the independent directors' counsel in periodic contact with fund management during this challenging period to determine whether any significant issues have developed that require prompt communication with the board, whether in a written communication, informational conference call, or at a telephonic board meeting.

On the directors' behalf, we have communicated to the adviser, often in writing, questions or topics we believe are relevant in this regard. And, advisers have been proactive about keeping boards informed.

In some cases, advisers, often in consultation with the board chair (or lead independent director), have determined to hold a special telephonic board meeting, particularly where the next regularly scheduled meeting is several weeks or months away. Some boards have scheduled informational conference calls that are not formal board meetings (which might otherwise result in board meeting fees depending on the directors' compensation structure). Others, with upcoming meetings more imminent, have chosen to update the board in a written summary communication to give directors assurances that the adviser has adequate business continuity plans in place to address remote working and that there have been no significant portfolio management, liquidity, or valuation issues that require attention or some action by the board. Then the advisers have plans to provide a full update at the upcoming board meeting.

**BU:** Certain issues may need to be escalated to the board on an expedited basis. What are some escalation protocols that boards might follow for these circumstances?

**Lori Schneider:** The adviser will generally bring material issues to the board's attention and may likely have an obligation to do so. In my experience, any such issues would typically be communicated first to the board chair or lead independent director or perhaps the relevant board committee's chair, along with the independent directors' counsel. And, if determined to be advisable or necessary, such issues would be reported to the full board. As previously noted, there may be procedures, such as the funds' pricing procedures or the LRMP, where directors are required to be notified or take some action. In addition, the fund CCO would typically report material compliance matters to the board rather than waiting until the Rule 38a-1 written report is provided.

**BU:** Any other considerations for fund directors?

**Lori Schneider:** A couple of things: first, we've seen funds reviewing their prospectus disclosure to consider whether existing risk disclosure covers coronavirus-type situations—whether that's in market volatility, recent market conditions, or other relevant disclosures. Some fund groups have begun adding pandemic- or coronavirus-specific disclosure, either to their fund prospectuses or statements of additional information. Others have determined that their existing disclosure would cover this type of situation. Boards may want to inquire with the adviser and counsel about whether the fund's existing disclosures cover this type of unusual situation and, if not, whether there is a plan in place to sticker the registration statement.

Second, as a final thought—this is obviously a rapidly evolving situation and one that requires constant monitoring in terms of the latest developments on COVID-19 and its impact on the global markets, or any government stimulus, legislative response, or action by the Federal Reserve to cut interest rates. Flexibility, on the board's part, is crucial to adapt to these ever-changing circumstances. Regular and ongoing communication, as circumstances warrant, between the adviser and board leadership is essential. I'd emphasize again, in closing, that the board's role is one of oversight—board members are not required to be in the trenches with fund management or fund service providers trying to address the multitude of issues stemming from COVID-19, nor should they be. But fund boards serve a vital role: they provide oversight during this critical time on behalf of more than 100 million shareholders who invest in funds to achieve their most important financial goals.

**BU:** Thank you for your time and insights.

**Lori Schneider:** Thank you.