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ICI VIEWPOINTS

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Closed-End Funds: Opportunities for a True Renaissance

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Closed-end funds—the dominant collective investment vehicle in the early decades of the 20th century—are in vogue once again. Legislators, regulators, and fund sponsors are turning to the structure as a promising vehicle for retail investment and capital formation. For the first time in nearly 40 years, Congress has passed legislation specifically aimed at benefiting closed-end funds and their investors.

Regulators have followed. In 2017, the Department of the Treasury recommended that the Securities and Exchange Commission (SEC) review rules to encourage the development of certain closed-end funds, and the SEC earlier this year issued a concept release soliciting ways to facilitate closed-end fund investment in private offerings.

Why the renewed interest? Like mutual funds, closed-end funds are comprehensively regulated under the Investment Company Act. Unlike mutual funds, however, closed-end funds do not redeem their shares on demand; instead, closed-end fund investors typically buy and sell shares on exchanges or redeem only at specified intervals throughout the year. Absent liquidity restrictions (like those applicable to mutual funds), closed-end funds can hold less-liquid, often higher-yielding, assets. Given these characteristics, closed-end funds can provide retail investors better access to private offerings traditionally available only to sophisticated investors. At the same time, they offer new sources of capital for small and midsize businesses.

These recent government actions are positive steps that can lead to a deeper pool of closed-end funds, benefiting investors and the economy as a whole. With a few critical tweaks—which we'll describe below—this legislation and related regulatory action could stimulate further growth and better deliver on that promise.

Improving the Offering Process

Thanks to the Economic Growth, Regulatory Relief, and Consumer Protection Act, closed-end funds and their shareholders will soon be able to benefit from modernized rules around registration, offering, reporting, and communications. The act directs the SEC to adopt rules by May 2020 that will allow eligible closed-end funds to use the more streamlined securities offering and proxy rules that are available to other issuers, such as operating companies. In response, the SEC issued a proposal in March allowing closed-end funds to communicate information in ways that previously were restricted; enabling specific closed-end funds to raise capital without the time and expense traditionally associated with such offerings; and permitting closed-end funds to deliver a written notice in lieu of a final prospectus for shares sold during a public offering.

During the act's development, ICI members identified areas of closed-end fund regulation—particularly offering and proxy rules—that would benefit significantly from reform. ICI President and CEO Paul Schott Stevens testified before a subcommittee of the House Financial Services Committee, detailing how that reform would reduce fund costs and enhance financing for the US economy while maintaining stringent protections for investors. Consistent with these goals, Congress intended for the act to provide cost savings for investors, enhance the ability of funds to serve as financing sources, and stem the decline of closed-end fund offerings.

The SEC's proposal, however, went beyond the scope of the act in some areas, by proposing additional amendments to harmonize closed-end fund offerings with those of operating companies. Some of these "discretionary" amendments have caused closed-end

funds great concern.

In particular, the proposed rules go too far in subjecting *all* closed-end funds to unnecessary and costly Form 8-K reporting requirements. In addition, the proposed rules exclude some closed-end funds—namely, interval funds—from reaping key benefits of the proposal.

Form 8-K Reporting. First, the Commission proposed subjecting *all* closed-end funds to reporting requirements that apply to operating companies. The proposed requirements would compel closed-end funds to file a report on Form 8-K, which is intended to promptly alert investors about events affecting an issuer, within four business days anytime one of several specified events occurs (e.g., entering into material definitive agreements, releasing quarterly earnings, changing directors).

On their face, the proposed requirements—to improve current information in a manner consistent with operating companies—make sense. But the Commission did not adequately consider the substantial disclosure that closed-end funds already provide—exceeding, in fact, the information that operating companies release. (We compare corporate and closed-end fund disclosures on pages 19 and 20 of our comment letter.) In particular, closed-end funds already distribute timely material information through other mechanisms—including press releases. Requiring additional reporting, therefore, would not meaningfully enhance information already available about closed-end funds.

But doing so surely will increase closed-end funds' costs, perhaps substantially, forcing those funds to create compliance systems for the specified events, many of which do not even apply to closed-end funds. Given the lack of benefits and potentially large costs, ICI recommended that the Commission eliminate the requirement from any final rule.

Public Float Standard. Second, the SEC proposed to determine whether closed-end funds qualify to use the streamlined offering rules using a "public float standard," similar to its current approach for operating companies. A public float standard would consider whether the aggregate market value of a fund's common shares traded on public trading markets (e.g., exchanges) exceeds certain thresholds. If a fund exceeds $75 million in public float, it could use a simplified registration statement to register the offering. If a fund exceeds $700 million in public float, it could file registration statements that become effective immediately without the time or expense of an SEC review.

This proposal poses two problems.

First, it would exclude interval funds from qualifying to use the streamlined rules. Interval funds are closed-end funds that periodically offer to repurchase a limited percentage of outstanding shares from shareholders. Currently, only one interval fund is exchange traded; the rest would not have public float and thus could not meet the proposed standard.

Second, public float is a far less meaningful metric for funds than for operating companies.

The SEC uses public float as a measure of the market scrutiny an operating company receives. It decided to give more flexibility to entities with higher public floats because of their active participation in the markets and wide analyst coverage. Analysts typically cover operating companies in a particular industry and issue buy or sell recommendations based on forward-looking earnings estimates.

But a public float standard—and related analyst scrutiny—is less meaningful for funds. The way a fund works is much less complex than an operating company. Funds are pass-through vehicles that primarily invest in securities and do not have earnings estimates. They also are subject to Investment Company Act requirements, including rules dictating that they value their investments under board-approved valuation procedures and disclose those valuations and the fund's holdings periodically. Given these fund obligations, analyst coverage plays a much different—and far smaller—role for funds than for other types of public companies.

ICI recommended that the Commission instead use a more tailored metric appropriate for funds. For example, it could use a metric based on the fund's aggregate net assets. At prescribed levels, a metric based on net assets would indicate that the markets have accepted the fund as a viable investment and that it has stature, warranting streamlined regulatory treatment. Further, such a metric would have the benefit of permitting funds that aren't listed on exchanges, including interval funds, to qualify for the rule's benefits.

The SEC's proposal intends to make the securities offering process easier and less costly for closed-end funds—and in some instances it would. Unfortunately, the proposal's strict insistence on parity with operating companies undercuts its effectiveness. We hope the SEC can adopt rules that improve the regulatory treatment of all closed-end funds to enhance the viability of this important investment product.

For more information about closed-end funds, please visit ICI's Closed-End Fund Resource Center.

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