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Potential Regulatory Developments for Non-Traded Closed-End Funds

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In May of 1993, the US Securities and Exchange Commission (SEC) adopted Rule 23c-3 under the Investment Company Act of 1940, as amended (the 1940 Act), which effectively created a new structure for registered investment companies (RICs).[1] Funds formed under Rule 23c-3 are hybrid funds that are continuously offered and provide for limited liquidity in the form of periodic repurchases of 5 percent to 25 percent of net assets at defined intervals of three-, six- or twelve-months (an Interval Fund). While industry use of the Interval Fund structure historically has been modest, the use of the structure has been increasing rapidly year over year.[2] According to the SEC, as of the end of 2018, there were 57 Interval Funds with just under $30 billion in assets.[3]

In addition to Interval Funds, some closed-end funds with investment strategies that require more flexibility with respect to pricing and liquidity[4] operate as "Tender Offer Funds." Such funds conduct their repurchases pursuant to Section 23(c)(2) of the 1940 Act rather than Rule 23c-3 and also must comply with Rule 13e-4 under the Securities Exchange Act of 1934, as amended (the Exchange Act), as well as the Exchange Act's other tender offer rules.

While Interval Funds and Tender Offer Funds (the Non-Traded CEFs) are technically registered as closed-end funds (CEFs),[5] the Non-Traded CEFs act, in some ways, similarly to open-end funds and are in continuous offering. However, from a legal and regulatory perspective, Non-Traded CEFs currently operate under a rule regime designed around a permanent capital structure, without the benefits of the regulatory structure built for open-end funds (mutual funds). The resulting asymmetry can make operating an Interval or Tender Offer Fund potentially cumbersome. The SEC and the Staff of the Division of Investment Management (Staff) have begun to review these regulatory burdens as the size of the Non-Traded CEF industry has expanded. Additionally, the SEC has recognized that the open-end fund structure may not be conducive to all investment strategies.[6]

Recently, the SEC has begun publicly inviting industry comment on potential regulatory changes that could be beneficial to Interval Funds and Tender Offer Funds, principally through two SEC releases. First, in March of 2019, the SEC proposed Securities Offering Reform for Closed-End Investment Companies (the Proposing Release).[7] Following in June of 2019, the SEC issued the Concept Release (together with the Proposing Release, the Releases).[8] Both Releases are broad in scope. The Proposing Release would modify the registration, communications, and offering processes for business development companies (BDCs) and CEFs to make use of certain rules currently available to operating companies.[9] The Concept Release solicits comments

in connection with a comprehensive review of the framework for exempt securities offerings.[10] Both Releases address some of the current inefficiencies in the structure of Non-Traded CEFs. This article discusses several of the proposals and concepts in the Releases and why the adoption of certain proposals would be important developments for Interval Funds and Tender Offer Funds.

The Proposing Release

On March 20, 2019, in response to direction from Congress, the SEC announced in its Proposing Release new proposed rule amendments that would modify and streamline the securities offering and communication processes for BDCs and other registered CEFs (collectively, the affected funds).[11] The proposed rule amendments would extend certain offering reforms currently available to operating company issuers to certain affected funds. The proposals would also apply the payment methods mutual funds use for securities registration fees to Interval Funds.

The proposed rule amendments would treat certain categories of affected funds differently. For example, some of the proposed rules would apply to just BDCs or just Interval Funds. Additionally, many of the proposed rules would only affect funds that are current and timely in their reporting and have at least $75 million in public float (Seasoned Funds). Some of the proposed rules would only apply to well-known seasoned issuers (WKSIs), which are Seasoned Funds that generally have at least $700 million in public float. Importantly, while not required by the Congressional mandate, the scope of the proposed amendments generally would treat Non-Traded CEFs consistently, so Tender Offer Funds also would be allowed to rely on certain of the proposals.

For the registration of funds, the proposed rule amendments would permit affected funds eligible to file on Form S-3 to file a short-form registration statement on Form N-2 that would function like a Form S-3 registration statement.[12] Additionally, the proposed rule amendments would permit affected funds to rely on SEC Rule 430B to omit information from the base prospectus and to use the process operating companies follow to file prospectus supplements and include additional information in periodic reports to update their registration statements, provided that this information is identified as being included for this purpose.[13]

The Proposing Release would expand the ability to qualify for WKSI status by proposing to (1) amend SEC Rule 405 to no longer exclude BDCs and RICs from the definition of WKSI; (2) add a parallel reference to the registrant requirements of the proposed short-form registration instruction; (3) amend the definition of "ineligible issuer" to state a registered CEF would be ineligible if it has failed to file all reports and materials required to be filed under Section 30 of the 1940 Act during the preceding 12 months; and (4) amend the definition of "ineligible issuer" to give effect to the current anti-fraud prong in that definition in the context of affected funds and propose a parallel anti-fraud prong for affected funds.[14]

In addition, the proposed rule amendments would change the prospectus delivery requirements by allowing affected funds to satisfy their final prospectus delivery obligations by filing their final prospectuses with the SEC, which is consistent with the alternative delivery method used by operating companies.[15] The rule amendments propose to amend SEC Rule 418(a)(3) to add parallel references to registrants that are eligible to file a short-form registration statement on Form N-2.[16] The proposed rule amendments also would exempt affected funds from being prepared to furnish supplemental information to the SEC promptly upon request.[17]

Additionally, among other things, the rule amendments propose a modernized approach that would amend SEC Rules 23c-3 and 24f-2 to permit Interval Funds to pay securities registration fees using the same method as mutual funds and exchange-traded funds.[18] Thus, Interval Funds could pay registration fees based on their net issuance of

shares, no later than 90 days after the fund's fiscal year end rather than in advance.[19]

The Concept Release

On June 18, 2019, the SEC published the Concept Release to solicit comments on the exempt securities offerings rules under the Securities Act of 1933 (the Securities Act). The Concept Release represents an important and timely recognition by the SEC that the "overall framework for exempt offerings has changed significantly" and that a review of the regulatory framework surrounding those offerings is appropriate.[20] While the Concept Release is broad in scope, there are a number of areas discussed in the Concept Release that focus on Non-Traded CEFs. Several of the key requests for comment are discussed below.

Certain requests for comment in the Concept Release suggest that the SEC is looking to generally increase flexibility in the Interval Fund and Tender Offer Fund structures. For instance, among other items, the SEC asks:

- Are there certain measures that can be taken to decrease the compliance costs associated with the Interval Fund structure?[21]
- Should the SEC adopt rules that permit Interval Funds to have multiple share classes?[22]
- Should Interval Funds utilize the series and trust structure used by open-end funds to set up new Interval Funds?[23]

To address these questions, the SEC should consider broadening the scope of Rules 18f-2 and 18f-3 to apply to Non-Traded CEFs.

Rule 18f-2 allows mutual funds to utilize a single legal entity, such as a Delaware statutory trust, to offer shares in segregated series with each fund represented by a separate series.[24] Practically, this results in the filing of a registration statement for an additional fund or funds in the trust to be done through a post-effective amendment, which becomes automatically effective in 75 days pursuant to Rule 485(a).[25] Conversely, a new Interval Fund within a fund family must be formed as a distinct legal entity and must be filed as a new RIC, which can substantially increase the time and costs for the initial registration of the Interval Fund. In concept, however, a fund family launching a new Interval Fund is no different from a fund family launching a new mutual fund. Thus, by amending Rule 18f-2 to apply to Interval Funds and Tender Offer Funds, the SEC would level the playing field for Non-Traded CEFs and mutual funds regarding their abilities to issue separate series.

Rule 18f-3 allows mutual funds to issue multiple classes of shares.[26] Rule 18f-3 does not apply to CEFs, such as Interval Funds and Tender Offer Funds. However, the SEC does issue exemptive relief to Non-Traded CEFs to permit multiple share classes in accordance with Rule 18f-3 (18f-3 Exemptive Relief). As the Non-Traded CEF industry has grown over the past few years, the 18f-3 Exemptive Relief has become routine for the SEC and the applications and orders contain very little variation. Additionally, most new Interval Funds and Tender Offer Funds that are being brought to market operate pursuant to such relief. Therefore, SEC codification of the routine 18f-3 Exemptive Relief to permit Non-Traded CEFs to issue multiple classes of shares would reduce the burden on registrants and on the SEC of processing additional exemptive applications and orders.

In the Concept Release, the SEC also solicits comments about ways in which the 1940 Act limits the ability of Interval Funds and Tender Offer Funds to invest effectively. Among numerous questions, the SEC asks:

- What restrictions should there be, if any, on the ability of CEFs, including BDCs, to invest in private funds, including private equity funds and hedge funds, and to offer their shares to retail investors?[27]
- For example, should there be a maximum percentage of assets that CEFs and BDCs can invest in private funds?[28]
- Should such CEFs be required to diversify their investments across a minimum number

of private funds, if they are not restricting their offerings to accredited investors?[29]

As the universe of Interval Funds and Tender Offer Funds expands, more market participants will need formal guidance or rules regarding limitations for CEFs to invest in private funds. Thus, the SEC's questions in the Concept Release are timely and important.

The Concept Release also states that "[c]urrently, our understanding is that all closed-end funds that invest primarily in private funds are offered only to investors who meet certain wealth requirements (for example, the tests for accredited investor), and require significant minimum initial investments."[30] In practice, these limitations, which are Staff policy and not written law, vary greatly. Some Staff require the limitation to apply to all Section 3(c)(1) and Section 3(c)(7) funds (collectively, Private Funds). Other Staff apply the limitations only to investments in hedge funds. In some cases, the limit is 10 percent, while in others, the limit has been expressed by the Staff to be as high as 35 percent. The SEC should consider codifying any appropriate limitations on the investment by a RIC into Private Funds to level the playing field, as different funds being subjected to different policies creates confusion and frustration in the industry.

In addition, the SEC asks several questions in the Concept Release about the Interval Fund rule itself and whether its provisions should be liberalized. Among other questions, the SEC asks:

- Should the SEC modify the periodic intervals from the current three-, six-, or twelve- months?[31]
- Should a fund have flexibility to determine the length of its periodic interval?[32]
- If so, should there be a maximum permitted periodic interval?[33]
- To what extent would any changes to the Interval Fund rule lessen the need for Tender Offer Funds?[34]

Evaluating this subset of questions together, it appears that the SEC may be considering permitting Tender Offer Funds to fit within the Interval Fund rule but with possible investor qualification limits. This would be a welcome improvement since Tender Offer Funds are substantially similar to Interval Funds, but the current regulations surrounding the two types of funds' operations create disparities and inefficiencies. Under the current regulatory regime, Tender Offer Funds cannot file under Rule 486 of the 1940 Act. As a result, each post-effective amendment for a Tender Offer Fund must be declared effective by the SEC, even if the fund merely updates its financial statements. Additionally, an Interval Fund can file a post-effective amendment to register additional shares immediately,[35] whereas a Tender Offer Fund cannot. Given the overlap and similarity of Interval Funds and Tender Offer Funds, the SEC's consideration of regulating both types of funds within a single set of rules would create more efficiencies and level the playing field among registrants.

Conclusion

Both the Proposing Release and the Concept Release represent important possible developments for the Non-Traded CEF market. As the market has grown, it has, in many ways, developed beyond the current regulations. The SEC has recognized the need to make changes in order to address some of the concerns with the structure of Interval Funds and Tender Offer Funds that have become evident through practice. The final changes and amendments to be proposed and adopted will be an important step in creating more efficiencies to encourage the Non-Traded CEF industry's future growth.

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NOTES

1 1940 Act Release No. 19399 (May 14, 1993).

2 *See* "Get Ready For A Bitcoin Interval Fund: 2019 Q2 Update," *IntervalFundTracker* (July 22, 2019), available

at *https://www.intervalfundtracker.com/2019/07/22/get-ready-for-a-bitcoin-interval-fund-2019q2-update/*.

[3] *Concept Release on Harmonization of Securities Offering Exemptions*, Investment Company Act Release No. 33-10649 (June 18, 2019) (hereinafter the Concept Release), at 176.

[4] While Rule 23c-3 requires an Interval Fund (i) to adopt a fundamental policy that aligns with the requirements of Rule 23c-3, changeable only by a majority vote of the outstanding voting securities of the company, (ii) to choose either three-, six- or twelve-months as the periodic intervals between repurchase offers, and (iii) to offer to repurchase between 5 and 25 percent of the fund's outstanding common stock each periodic interval, Tender Offer Funds do not operate under the same requirements.

[5] A CEF is any management company that is not an open-end company that uses an investment model based on issuing a fixed number of shares which are not redeemable from the fund. *See* Section 5(a)(2) under the 1940 Act.

[6] Rule 22e-4 under the Liquidity Adopting Release requires each fund to assess, manage and periodically review its liquidity risk, considering, among other things, whether the fund's investment strategy is appropriate for an open-end fund. *See Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 (Oct. 13, 2016) (hereinafter the Liquidity Adopting Release), at 43.

[7] *Securities Offering Reform for Closed-End Investment Companies*, Investment Company Act Release No. 33-10619 (Mar. 20, 2019) (hereinafter the Proposing Release).

[8] Concept Release, *supra* n.3, at 1.

[9] Proposing Release, *supra* n.7, at 1.

[10] Concept Release, *supra* n.3, at 1.

[11] Proposing Release, *supra* n.7, at 8.

[12] *Id*. at 19–20.

[13] *Id*.

[14] *Id*. at 37–40.

[15] *Id*. at 47–48.

[16] *Id*. at 60.

[17] *Id*.

[18] *Id*. at 64.

[19] *Id*. at 63.

[20] Concept Release, *supra* n.3, at 1.

[21] *Id*. at 190.

[22] *Id*.

[23] *Id*.

[24] *See* 12 DE Code § 3806 (2017).

[25] *See* Rule 485(a)(2) under the 1940 Act.

[26] Under Rule 18f-3, a fund offering multiple classes of shares must provide that each class of shares has the same rights and obligations, except each class may have different (i) shareholder servicing or distribution arrangements, (ii) expense allocations, (iii) advisory fees, (iv) voting rights, and (v) exchange privileges and conversions.

[27] Concept Release, *supra* n.3, at 188.

[28] *Id*.

[29] *Id*.

[30] *Id*. at 187.

[31] *Id*. at 188.

[32] *Id*.

[33] *Id*.

[34] *Id*. at 191.

[35] *See* Rule 486(b)(1)(i) under the 1940 Act.