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Closed-End Fund House Bill Doesn’t Go Far Enough

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George Silfen

George Silfen is a partner in Kramer Levin’s corporate and investment management practices.

A bill that aims to decrease regulation, including for closed-end funds, while increasing retail investors’ access to capital markets is currently navigating its way through Congress, where it has garnered substantial bipartisan support.

That’s the good news.

The bad news is that, without a significant amendment, the legislation may not have a meaningful impact on closed-end funds.

The Expanding Investment Opportunities Act was introduced last November by House Financial Services Committee member Rep. Trey Hollingsworth (R-Ind.). In January, the bill overwhelmingly passed the House of Representatives by a vote of 418 to 2. It now faces consideration in the Senate Committee on Banking, Housing and Urban Affairs.

But the bill does not go far enough for closed-end funds. To really increase access to these vehicles, Congress must first amend a provision in the Investment Advisers Act to relax the restriction on performance fees.

What Does the New Bill Say?

If adopted, the bill would give the Securities and Exchange Commission one year to revise its rules to provide closed-end funds with the flexibility to offer additional shares post-IPO, by relying on rules currently only allowed for non–investment company securities issuers.

The bill is expected to reduce closed-end funds’ filing requirements and reporting costs, and improve fund managers’ efficiencies, which should increase the number of closed-end fund offerings available to investors.

The Problem: Advisers Act Provision Prevents Real Growth in Fund Offerings

However, for the bill to really increase fund offerings and expand investments into closed-end funds, it must first address Section 205 of the Advisers Act. That section, together with its underlying Rule 205-3, prohibits SEC-registered advisors from charging closed-end funds a performance or incentive fee on profits earned, unless all investors in the fund are “Qualified Clients,” with a net worth of $2.1 million, excluding their home.

The rule was adopted to address lawmakers’ and regulators’ concern that performance fees subject clients to the risk that the fee arrangement will incent managers to unduly speculate when trading client assets. As a result, the rule requires client investors to have a degree of sophistication, or the Qualified Client status, to be charged a performance fee.

In practice, this Advisers Act provision prohibits any NYSE or Nasdaq-traded fund from being able to pay a real incentive fee to successful fund managers, since publicly traded funds (listed on a national exchange) must be made available to all investors, regardless of net worth. The problem is that successful hedge fund managers typically demand an incentive fee of up to 20% of profits, and they are generally unwilling to provide the same product to retail investors without getting similar compensation.

As a result, the provision effectively disincents many hedge fund managers from raising fund IPO capital through the U.S. public markets and, therefore, their top products are unavailable to retail investors.

One exception to this preclusion is for Business Development Companies, which are a specialized type of closed-end, public-private equity fund. Managers of such products can charge incentive fees of up to 20%. All closed-end funds should have the same or similar right.

Fixing the Problem: Adjust the Advisers Act

To remedy this, Congress should, as part of the bill, amend Section 205 of the Advisers Act to permit SEC-registered advisors to charge a performance/incentive fee on closed-end funds, as long as the investors participating directly in the fund’s IPO are Qualified Clients. After the IPO, however, the Qualified Client requirement should be eliminated for fund shares purchased via transactions on the exchange.

Granted, under this framework, “non-qualifying” or retail investors that buy closed-end fund shares in the secondary market would be subject to the type of speculation risks inherent in performance fees over which Congress and the SEC expressed concern.

But investors who purchase closed-end fund shares in such exchange transactions always buy shares at their own risk. After all, these investors are not required to receive a prospectus or any

other disclosure document describing any risks associated with closed-end funds. More importantly, though, the fiduciary rules under which fund managers operate prohibit investment them from unduly speculating on client assets anyway.

How Changing a Provision Will Affect the House Bill

The closed-end fund IPO market has been almost nonexistent in recent years and this straightforward amendment would give that market a much-needed boost.

Moreover, increased capital in these closed-end funds could help flow additional capital into the underlying companies in which they invest, further boosting overall capital market activity.

In announcing the recent House bill, Rep. Hollingsworth pointed out that the SEC adopted offering reforms for traditional operating companies in 2005, but has yet to consider a corresponding framework for closed-end funds. This bill would create the conditions necessary to allow these products to "take advantage of the 2005 offering reforms" by "simplifying the closed-end fund offering process and liberalizing existing restrictions on communications," Hollingsworth said.

The result of a simple, additional amendment to Section 205 would more meaningfully improve the ability of closed-end funds to act as a source of financing in the economy.

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