
Chapter 11

Repurchases and Redemptions of Investment Company Shares

I. Introduction and Summary of Recommendations

The earliest United States management investment companies were closed-end, and closed-end companies far outnumbered their open-end counterparts at the time of the enactment of the Investment Company Act;¹ since then, however, open-end companies have been considerably more popular with investors. A major reason for that popularity is that the redemption rights of open-end shares assure shareholders of being able to exchange their shares for net asset value, whereas closed-end securities have no such rights and often trade in the market at a discount to net asset value after the initial public offering is completed.

At the same time, the closed-end form has attracted renewed interest. For example, the increasingly global marketplace has caused sponsors to reconsider closed-end companies as investment vehicles. Open-end companies operate subject to a liquidity standard that restricts their ability to invest in less liquid securities, such as some foreign securities? Because closed-end companies do not issue redeemable securities, they are not subject to a liquidity standard. Thus, sponsors wishing to offer investment companies with portfolios consisting of less liquid securities must choose the closed-end form.

The Investment Company Act contains a rigid classification system from which many important regulatory consequences flow. Investment companies are divided into "face-amount certificate companies," "unit investment trusts," and "management companies." Management companies in turn are divided into "open-end" and "closed-end." These terms are defined comprehensively so that every investment company fits within a particular classification and subclassification? The classification system is crucial to an investment

¹Investment Company Act of 1940, 15 U.S.C. § 80a.

²An open-end company's aggregate holdings of illiquid securities may not exceed 15% of the company's net assets. See *infra* note 34 and accompanying text.

³Section 4 of the Act contains fairly specific definitions for face-amount companies and unit investment trusts, while management companies are defined simply to mean any investment company other than a face amount company or a unit investment trust. 15 U.S.C. § 80a-4. Similarly, section 5 of the Act defines what is meant by open-end company, and then defines (continued...)

company's structure and operation because specific statutory requirements will apply or not apply depending on the classification of the particular company.

Section 5(a) defines an open-end company as a management company that issues or has outstanding any "redeemable security."⁴ All other management companies are closed-end. A redeemable security entitles the holder to receive, upon presentation to the issuer, the holder's approximate proportionate share of the issuer's current net assets, or the cash such share represents?

Open-end and closed-end companies are subject to many of the same key provisions of the Act, including prohibitions on affiliated transactions in section 17, requirements for a written advisory contract approved by shareholders in section 15, requirements attending the composition and operations of the board of directors in sections 10 and 16, and the anti-pyramiding and investment restrictions in section 12(d).⁶ Nevertheless, the fact that open-end shareholders have redemption rights and closed-end shareholders do not leads to many differences in the regulatory treatment of open-end and closed-end companies under the Act.

For example, section 18 restricts the use of leverage by both open-end and closed-end companies but treats the two types of companies quite differently? While closed-end companies may issue "senior securities" such as debt and preferred stock under certain circumstances, open-end companies may not.⁷ This marked difference in how open-end and closed-end companies may organize their capital structures is due, in part, to the nature of redeemable securities. Nothing would prevent the holders of the junior securities (the common stock) in an open-end company from redeeming the equity that normally acts as a "cushion"

³(...continued)

closed-end company as any management company other than an open-end company. 15 U.S.C. § 80a-5. The presence of these "catch-all" categories ensures that the classification system encompasses the entire universe of investment companies.

⁴15 U.S.C. § 80a-5(a).

⁵Investment Company Act § 2(a)(32), 15 U.S.C. § 80a-2(a)(32).

⁶15 U.S.C. §§ 80a-17, -15, -10, -16, -12(d).

⁷15 U.S.C. § 80a-18.

⁸Section 18 does, however, permit open-end companies to borrow from banks under certain conditions.

supporting the payment obligations on senior securities; such senior securities thus would be fundamentally unsound investments.

Section 22 of the Act imposes specific requirements governing the pricing and redemption of open-end shares? Different requirements apply to non-redeemable shares of closed-end companies under section 23,¹⁰ which permits closed-end companies to repurchase their shares from investors on the open market (after notice to shareholders), pursuant to tender offers, or in compliance with Commission rules or orders>*

Because of the special nature of redeemable securities, open-end and closed-end companies distribute their shares quite differently. Open-end companies are subject to constant liquidation pressures from shareholders, who may decide to redeem their shares at any time. To replenish the monies withdrawn, open-end companies generally offer and sell new shares to the public on a continuous basis. Closed-end companies, on the other hand, generally engage in traditional underwritten offerings of a fixed number of shares (either through an initial public offering or a series of discrete offerings) and in most cases do not offer their shares to the public on a continuous basis.

Another major difference between open-end and closed-end companies is that closed-end shares usually are traded in secondary markets, either on exchanges or over the counter, whereas open-end shares are not. This difference stems from section 22(d) of the Act, which in effect fixes the prices at which open-end shares are sold. The result is a system of retail price maintenance that precludes dealers from making a secondary market in open-end shares.¹²

As a result of market fluctuations, closed-end shareholders selling in the secondary market may receive more or less than the net asset value of the shares.¹³ Closed-end securities often trade at a discount to net asset value in the

⁹15 U.S.C. § 80a-22.

¹⁰15 U.S.C. § 80a-23.

¹¹As discussed *infra* notes 19-26 and accompanying text, repurchase procedures are controlled strictly due to the numerous abuses that existed prior to the Act's passage. Repurchases are different from redemptions by open-end companies because the closed-end company may decide whether, when, and how much of its securities to repurchase, and because the repurchases generally do not occur often or regularly.

¹²For a detailed discussion of the effects of this system of retail price maintenance on mutual fund distribution, see Chapter 8.

¹³In contrast, open-end shareholders tendering their shares are assured of receiving net asset value, less any deferred sales load or redemption fee.

secondary market, a situation that has adverse consequences for both investors and sponsors. Some investors lose money when discounts develop; others may profit as discounts diminish. Persistent discounts in the marketplace also make it more difficult for sponsors to launch new closed-end companies. In addition, discounts prevent existing companies from raising capital because the Act generally prohibits closed-end companies from selling new shares at less than net asset value.¹⁴ While some closed-end companies have sought to minimize market discounts by repurchasing their shares, they have been unable to commit to repurchases in advance due to concerns that such an advance commitment may be inconsistent with the fiduciary obligations of closed-end company directors.¹⁵

Despite significant problems **with** the closed-end form, recently some sponsors have used it to offer interests in portfolios consisting of foreign securities and new types of less liquid securities such as participation interests in corporate loans. Use of the closed-end form to offer these types of portfolios raises questions about the restrictiveness of the Act's classification system, which currently forces companies to be either open-end (and highly liquid) or closed-end. Under the existing system of regulation, neither form appears to provide the best vehicle for offering portfolios that have substantial but not complete liquidity.

Given the changes that have occurred in the securities markets since 1940, it is appropriate to re-examine the classification system and its current regulatory requirements. Sponsors organizing an investment company in 1940 did not have available the vast array of semi-liquid portfolio securities that exists today. Today, however, the rigidity of the Act's classification system has become a limitation on sponsors' ability to offer innovative products. The Division has concluded it would be appropriate to provide the opportunity for investment companies to chart new territory between the two extremes of the open-end and closed-end forms, consistent with investor protection.

The Division has examined several alternatives. We considered amending the statutory definition of the closed-end and open-end forms to provide additional flexibility. We also considered recommending either legislation or Commission rulemaking that would permit development of a third, entirely new form of investment company that would combine characteristics from each of the other two. These alternatives did not seem to respond to the problems that

¹⁴Investment Company Act § 23(b). It is also likely that investors would not buy shares priced at net asset value if they could obtain them for less in the secondary market.

¹⁵See *infra* notes 86, 88 and accompanying text.

prompted our examination or to provide for the range of investment choices we believe is necessary for effective reform.

The Division recommends giving the industry the ability to employ new redemption and repurchasing procedures, subject to Commission rulemaking and oversight. First, the Division recommends that the Commission adopt a new rule under section 23 of the Act that would permit closed-end companies to conduct periodic repurchases of their shares at net asset value under specified circumstances. The Division also recommends that the Commission adopt a new rule under section 22 of the Act permitting a new variation within the open-end form (to be called a "limited redemption" investment company) to offer alternative redemption and offering procedures to investors. Finally, the Division recommends that the Act be amended to impose an express portfolio liquidity requirement on all management investment companies that redeem or regularly repurchase their shares. Liquidity requirements would help protect investors' reasonable expectations regarding their ability to exit a particular company at net asset value.

This chapter begins by exploring further the dichotomy between open-end and closed-end investment companies under the Act. It then discusses our recommendation to facilitate periodic repurchases of closed-end securities, followed by our recommendation for developing new limited redemption investment companies. The chapter continues with our proposal for amending the Act to provide the Commission with express authority to impose liquidity requirements on all investment companies that redeem or periodically repurchase their shares. It closes with an analysis of the consistency of our recommendations with prior interpretations of the definition of "redeemable security" in section 2(a)(32) of the Act.¹⁶

II. Background

A. The Treatment of Open-End and Closed-End Investment Companies Under the Act: The Historical Context

The Act's delineation of the closed-end and open-end categories responded to the characteristics of the investment company industry in the decades preceding the Act and sought to correct certain abuses and problems. Closed-end companies became prominent during the 1920's, when new issues quickly sold

¹⁶15 U.S.C. § 80a-2(a)(32).

out at large premiums over net asset value.¹⁷ The stock market crash of 1929 virtually eliminated the market for new public offerings of closed-end securities, however, and closed-end shares began trading in the secondary market at prices below net asset value. Open-end companies, relatively unknown before the crash, quickly became popular because they offered protection from discounts by committing to redeem investors' shares at net asset value.

Although the open-end company was a fairly new form of investment vehicle in 1940, the Commission's Study on Investment Trusts and Investment Companies (the "Investment Trust Study") documented extensive abuses in the operations of both open-end and closed-end investment companies.¹⁸ Not surprisingly, abuses were often related to practices that gave preferential treatment to investment company insiders and affiliates. Three areas in particular provided substantial opportunity for abuse. Closed-end companies had aggressively repurchased their shares in response to discounts, often manipulating the market for shares in ways that benefitted management and insiders to the detriment of selling shareholders. Similarly, open-end companies had engaged in questionable pricing and distribution practices in connection with their ongoing sales and redemptions procedures. Finally, complex capital structures, particularly in closed-end companies, had resulted in dangerous leveraging effects that threatened the viability of many investment companies. These abuses, and the provisions of the Investment Company Act and rules that address them, are discussed more fully below.

1. Repurchases of Closed-End Shares

The condition of the market during the 1920's and 1930's provided powerful incentives for closed-end companies to engage in extensive repurchase operations.¹⁹ While repurchasing of shares is not, in itself, an abusive practice, certain strategies used by closed-end companies during the period of **1927-1935** resulted in market manipulation and harm to public shareholders.

Before the crash, it was not unusual for sponsors of closed-end companies to instigate repurchases for the purpose of influencing the market to aid in the

¹⁷Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L. Q. 303,306 (1941). The tremendous growth of closed-end companies during the 1920's apparently was closely tied to public confidence in the investment houses sponsoring them. *Id.*

¹⁸SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, pt. 3, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939) [hereinafter INVESTMENT TRUST STUDY, pt. 3].

¹⁹*Id.* at 954. From 1927 through 1935, closed-end companies and their affiliated holding companies repurchased a net amount of \$472 million of their securities, or about 12% of the securities issued and sold by closed-end companies during that period. *Id.* at 935-54.

distribution of new shares?’ Repurchases could support or increase the market price, creating an appearance that the value of the shares was steady or rising, and enhancing the value of the sponsors’ own holdings?’

After the crash, repurchases often were made for different reasons. As the price of closed-end shares fell to a discount, repurchases at discount prices became a source of book profits for closed-end companies. Many times, however, the profits were made at the expense of selling shareholders who had no way of knowing the extent of the discount and, therefore, the extent to which they were liquidating their shares at prices that did not reflect their true value.²² This was possible because closed-end companies did not disclose the net asset value of their shares. In addition, because some companies made purchases on the open market without informing investors, investors could not determine the extent to which the market was being driven by the company’s management.²³

Other abuses occurred. Some closed-end companies would repurchase securities from insiders in private purchases, sometimes at a premium or in blocks that could not have been sold at the prevailing market price because of the size of the purchase.²⁴ Some companies would repurchase from certain shareholders to establish control or remove opposition to management.²⁵ Finally, repurchases were used in various ways in connection with mergers, consolidations, and acquisitions. Some companies, for example, made repurchases to manipulate the market values of securities involved in exchanges.²⁶

In response to these abuses, Congress enacted section 23 of the Investment Company Act. Section 23(c) restricts repurchases of closed-end company shares, limiting them to purchases (1) on a national securities exchange or other market designated by the Commission (after adequate notice to all shareholders); (2) pursuant to tenders open to all security holders; or (3) in such other circumstances as the Commission permits by rule or order. Section 23 also regulates additional sales of common stock by closed-end companies after the

²⁰*Id.* at 956-57.

²¹*Id.* at 960-61.

²²*Id.* at 966-67.

²³*Id.*

²⁴*Id.* at 977-78. Repurchases at a premium to market price were particularly troublesome because they diluted the company’s assets for the benefit of the insider seller.

²⁵*Id.* at 997.

²⁶*Id.* at 1009.

initial offering is completed. Section 23(b) generally prohibits such sales at prices below net asset value, except (1) in connection with an offering to holders of one or more classes of capital stock; (2) with the consent of a majority of the holders of common stock; (3) upon conversion of a convertible security in accordance with its terms; (4) upon the exercise of any warrant issued in accordance with the provisions of section 18(d); or (5) under such other circumstances as the Commission may permit by rule or order. These provisions are aimed at protecting existing shareholders from the effects of sales of new shares that would unfairly dilute their holdings.

2. Pricing and Redemption of Open-End Shares

Abusive practices also occurred with early open-end companies that claimed that their securities were redeemable, but then instituted barriers to redemption. Redemptions typically were suspended because a company was redeeming more shares than it was selling and wanted to stop net redemptions from further diminishing assets and decreasing management fees; some companies apparently suspended redemptions to prevent shareholders from switching into other funds.²⁷ Companies often suspended redemptions based on provisions contained in charter documents that shareholders never saw.²⁸ Even if there could be no suspension without a shareholder vote, management could persuade shareholders to vote for suspension by offering a plausible explanation of why suspension was necessary.²⁹

There also were abuses associated with the pricing of redeemable securities. Most significantly, open-end companies engaged in "backward pricing," under which investors were priced into the fund based on the net asset value of the fund on the previous day. In a rising market, insiders and favored customers, who did not pay a sales load, could purchase shares based upon the previous day's lower price, turn around and redeem their shares the next day, and be assured of riskless profits, which resulted in dilution of the remaining shareholders' holdings.

Section 22 of the Investment Company Act regulates the pricing, distribution, and redemption of open-end company securities. Paragraph (c) of section 22 gives the Commission broad power to regulate the pricing of redeemable securities, including the power to prescribe by rule methods for

²⁷See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 291-92 (1940) [hereinafter 1940 Senate Hearings]* (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

²⁸See *id.* at 291.

²⁹See *id.* at 292.

computing the price a shareholder will receive upon redemption?' Rule 22c-1 makes backward pricing illegal for open-end companies and, instead, institutes a requirement of "forward pricing" based on a daily computation of net asset value.³¹ These provisions are intended to prevent dilution and assure that prices bear an appropriate relation to the current net asset value of the shares.³²

Paragraph (d) of section 22 requires that open-end securities be sold only at the current offering price described in the prospectus. This subsection, designed at least in part to prevent insider riskless trading and the resulting dilution, has resulted in a system of retail price maintenance that fixes open-end share prices and prevents dealers from making a secondary market.³³ Paragraph (e) of section 22 provides that registered open-end companies may not suspend the right of redemption, and must pay redemption proceeds within seven days. That subsection recognizes that open-end companies might need to suspend redemptions in certain emergencies, however, or for such periods as the Commission may by order permit.

Because open-end companies must redeem their shares at any time and pay redemption proceeds within seven days, their portfolios must contain enough readily marketable securities to enable them to raise sufficient cash to meet redemptions in a timely manner. To ensure that open-end companies will be able to meet their redemption obligations, the Commission has indicated that they should maintain at least eighty-five percent of their assets in "liquid" securities for which there are readily available market prices.³⁴

³⁰Section 22(c) gives the Commission powers similar to those given to registered securities associations under sections 22(a) and (b) in connection with the promulgation of rules governing member activities with respect to the pricing and distribution of redeemable securities. Section 22(c) specifically provides that Commission rules preempt any conflicting rules adopted by securities associations.

³¹17 C.F.R. § 270.22c-1. Specifically, rule 22c-1 provides that open-end securities may not be sold, redeemed, or repurchased "except at a price based on the current net asset value of such securities which is next computed *after* receipt of a tender of such security for redemption or of an order to purchase or sell such security" (emphasis *added*).

³²See Adoption of Rule 22c-1 under the Investment Company Act of 1940 and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934, Investment Company Act Release No. 5519 (Oct. 16, 1968), 33 FR 16331.

³³See Chapter 8.

³⁴See Guide 4 to Form N-1A, Revision of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (March 12, 1992), 57 FR 9828. See also Interpretative Releases Relating to the Investment Company Act of 1940 and Rules and Regulations Thereunder: Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969), 35 FR 19989 (interpretive release (continued...))

If a certain level of liquidity were not required, an open-end company could maintain a portfolio that would make it difficult to meet the seven day deadline in section 22(e). The company might be forced to sell illiquid assets for less than the best price, diluting the company's net asset value for the non-redeeming shareholders. Alternatively, if the level of liquidity were simply inadequate, the investment manager may have to sell more liquid assets that otherwise would have been kept on the basis of comparative investment merit. These transactions could affect performance, thus harming shareholders who did not redeem.³⁵

3. Use of Leverage

Leverage, applied to investment company assets through excessive borrowing and the issuance of excessive amounts of senior securities, was a primary concern that led to the Act's passage.³⁶ Leverage introduces an element of speculation to both the junior and senior shares. Nevertheless, many public investors did not understand how leverage affected their investment or even how their holdings fit within the investment company's overall capital structure.³⁷

Typically, sponsors and others in the securities business held most of an investment company's equity securities (*i.e.*, common stock) and authorized successive issues of debt and preferred stock to be sold to the public.³⁸

³⁴(...continued)

regarding investment by investment companies in restricted securities); Resale of Restricted Securities; Changes to Methods of Determining Holding Period of Restricted Securities under Rules 144 and 145, Securities Act Release No. 6862 (Apr. 23, 1990), 55 FR 17933 (adopting rule 144A).

³⁵Closed-end companies are not subject to a liquidity requirement because they do not redeem shares on a daily basis. Of course, closed-end companies may need a certain degree of liquidity in order to generate cash to pay expenses and to pay cash dividends and distributions if any. Some amount of liquidity also may be desirable to the extent necessary to pay holders of senior debt securities such as preferred stock or, as recommended later in this chapter, in the event the company repurchases its shares.

³⁶See Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7). Almost 400 pages of the INVESTMENT TRUST STUDY are devoted to problems in connection with capital structure. INVESTMENT TRUST STUDY, pt. 3, *supra* note 18, at 1563-936.

³⁷INVESTMENT TRUST STUDY, pt. 3, *supra* note 18, at 1674-75.

³⁸Complex capital structures were common. About 75% of closed-end companies used some form of leverage. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, pt. 1, H.R. Doc. NO. 707, 75th Cong., 3d Sess. at 29 (1938); INVESTMENT TRUST STUDY, pt. 3, *supra* note 18, at 1582. Use of leverage by open-end companies apparently was rare. *Id.* at 838 (describing one case of a leveraged open-end company).

Purchasers of senior securities, many of whom were individual investors, bought the securities in the belief that they were "safe" investments.³⁹ These investors often had no voting rights! As a result, the equity holders were able to gain control over substantially more capital than they themselves invested.⁴¹ In addition, the equity holders could induce the company to repurchase their shares, thereby reducing the capital available to generate income to pay the senior holders.⁴²

Leverage not only presents dangers to the senior holders, it increases dramatically the speculative nature of the equity securities. Because the equity securities receive the benefits of all capital appreciation, and absorb all capital losses or asset depreciation, the value of the equity shares rises or falls faster than changes in the market value of the underlying assets of the leveraged investment company.⁴³ The effects of leverage are accentuated if equity shares may be repurchased or redeemed, exposing the remaining equity holders to higher risks as well as higher returns.

Section 18 of the Act limits the use of leverage by both closed-end and open-end investment companies, but treats the two types of companies very differently. Closed-end companies may borrow from banks and private sources and may issue one class of senior debt, subject to a 300% asset coverage requirement, and also may issue one class of preferred stock, subject to 200% asset coverage requirement.⁴⁴ Among other restrictions, a leveraged closed-end company may not pay dividends or other distributions, or purchase any of its capital stock, unless the prescribed asset coverage will be in place after the transaction. Provision also must be made to give senior security holders certain

³⁹INVESTMENT TRUST STUDY, pt. 3, supra note 18, at 1594.

⁴⁰*Id.* at 1597.

⁴¹*Id.* at 1594-95.

⁴²See *id.* at 1001.

⁴³*Id.* at 1000-01. In contrast, senior securities represent a fixed charge on the assets of the company and do not share in these gains or losses.

⁴⁴Paragraph (h) of the section defines asset coverage. For example, a closed-end company with \$100 million in assets and no other outstanding indebtedness may issue senior debt of up to \$50 million. The ratio of the total assets after the borrowings (\$150 million) to the amount of debt outstanding (\$50 million) would be 300%. The same company also may issue preferred stock having a liquidation preference of \$50 million. The ratio of the total assets of the company after the issuance (\$200 million) to the aggregate of borrowings and preferred stock (\$100 million) would be 200%.

rights if the asset coverage falls below the prescribed amounts.⁴⁵ Open-end companies, because they issue redeemable securities, are permitted much less freedom to use leverage. They may borrow only from banks and must maintain 300% asset coverage for all amounts borrowed.⁴⁶

B. The Re-Emergence of Closed-End Companies and the Problem of Discounts

In 1940, open-end companies had assets only two-thirds as great as those of closed-end companies.⁴⁷ By 1950, open-end company assets had grown to nearly three times those of closed-end companies! This trend continued until the latter half of the 1980's, when closed-end companies experienced a resurgence. In 1986, there were 69 closed-end companies with \$12 billion in assets.⁴⁹ By the end of 1991, there were 290 closed-end companies with almost \$73 billion in assets.⁵⁰ Although this increase is impressive, the total assets of closed-end companies still are small in comparison to those of open-end companies which, as of the end of 1991, amounted to approximately \$1.3 trillion.⁵¹

Despite their relative lack of popularity, there are a number of reasons why sponsors choose the closed-end form. Because closed-end companies do not sell or redeem their shares continuously, and thus need not take cash inflows and outflows into account in managing their portfolios, closed-end companies arguably have an advantage over open-end companies in efficiency of portfolio management. While open-end companies must maintain a certain amount of cash or highly liquid investments to meet daily redemptions, closed-end companies

⁴⁵Investment Company Act § 18(a).

⁴⁶Investment Company Act § 18(f)(1).

⁴⁷1940 Senate Hearings, *supra* note 27, at 43.

⁴⁸Information compiled by the Division from data prepared by Lipper Analytical Services, Inc., the Investment Company Institute (the "ICI"), Arthur Wiesenberger, and Wiesenberger Financial Services.

⁴⁹*Id.*

⁵⁰Lipper Analytical Services, Inc., Lipper Closed-End Fund Performance Analysis Service 44 (Jan. 31, 1992).

⁵¹Investment Company Institute News Release, ICI-92-03 (Jan.29,1992). This figure does not include monies invested in unit investment trusts and variable insurance products.

may keep their assets fully invested according to their investment objectives.⁵² More importantly, the closed-end form enables sponsors to offer companies with investment portfolios that could not meet the liquidity requirements imposed on open-end companies. Because closed-end companies do not issue redeemable securities, the Act permits them greater use of leverage than open-end companies, providing investors with the opportunity for greater returns (as well as greater risks).⁵³

Internationalization of the securities markets and optimism about emerging markets overseas have created significant opportunities for new offerings of closed-end companies in recent years. So-called "country funds" have provided an important medium for United States investors to invest overseas.⁵⁴ Country fund portfolios often contain a large percentage of securities that are thinly traded or are considered to be illiquid for other reasons. For example, the size of the fund may be relatively large in relation to the overall capitalization of an emerging market and enormous in proportion to the daily trading volume. In addition, securities transactions in foreign countries may be subject to slower settlement procedures than those in the United States, or currency restrictions may limit a fund's ability to convert cash into United States dollars. These portfolios also may be difficult to value, due to limited data on market prices.

Beginning in late 1989, there was a surge of investor interest in single country closed-end companies. During this period, the shares of many country funds were trading at significant premiums to their net asset values. Market prices shortly plummeted, however, with share prices dropping on average 31% during 1990.⁵⁵ While the drop may have resulted from the large number of new

⁵²See, e.g., Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. See also Letter from General American Investors Company, Inc. to Jonathan G. Katz, Secretary, SEC 4 (Oct. 3, 1990), File No. S7-11-90 [hereinafter General American Study Comment]; and Letter from Baker, Fentress & Company to Jonathan G. Katz, Secretary, SEC 2 (Oct. 9, 1990), File No. S7-11-90 [hereinafter Baker, Fentress Study Comment].

⁵³Many, if not most, closed-end companies do not issue significant amounts of senior securities, however. Currently, the issuance of senior securities is most common among closed-end bond funds, particularly municipal bond funds. Edward A. Wyatt, *On Borrowed Time? Leveraged Funds' Promise -- and Perils*, BARRON'S, Nov. 11, 1991, at M16. Some investors may view these senior securities as a higher income alternative to investing in a tax-exempt money market fund. See James E. Leberer, *Mutual Funds' Preferred Shares Offer an Alternative to Investors*, WASH. POST, Aug. 25, 1991, at H10.

⁵⁴Some of these companies invest in a number of countries; others invest only in a particular geographical region or in a single country.

⁵⁵See Jonathan Clements, *Country Fund Fever Leaves Investors Feeling Queasy*, WALL ST. J., Jan. 22, 1991, at C1.

companies launched or fading enthusiasm about markets such as eastern Europe,⁵⁶ many single country funds declined along with the general downward trend in the market.⁵⁷

A key factor that may influence investor interest in new or existing closed-end companies is the recurring tendency of their shares to trade at a discount to net asset value. In general, discounts appear shortly after initial public offerings and affect all types of publicly traded closed-end companies, although to varying degrees. A 1989 study by the Commission's Office of Economic Analysis of the post-offering price performance of closed-end companies found that, on average, closed-end companies lost significant value during the first 120 trading days following their initial public offerings. After twenty-four weeks, the average discount for closed-end United States equity funds was 10.019%. For closed-end foreign stock funds, the discount was 11.424%. The average discount for closed-end bond funds was much lower, only 0.012%.⁵⁸

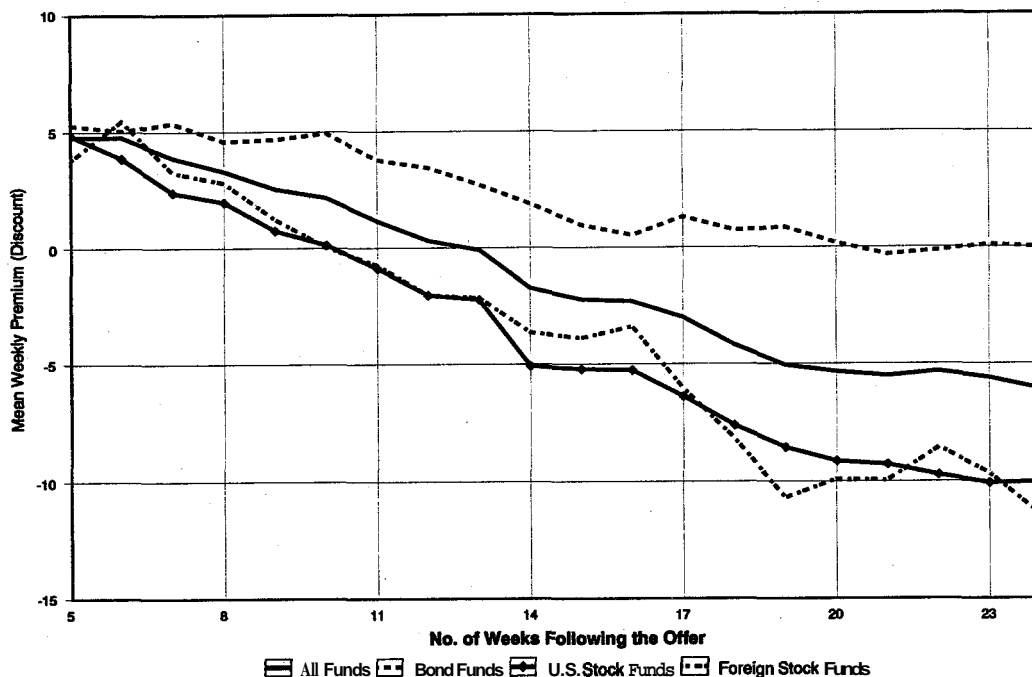
⁵⁶See John Waggoner, *Closed-End Funds Wither in Europe*, USA TODAY, Feb. 13, 1991, at 3B.

⁵⁷See Roger Lowenstein, *Mexico Funds' Deep Discount May Be Bargain*, WALL ST. J., Oct. 18, 1990, at C1 (discussing the general decline in prices of country fund shares). In the market generally, for the year ended January 2, 1991, Standard & Poor's 500 Composite Stock Price Index declined by 9.0%, the Dow Jones Industrial Average by 7.1%, and the Russell 2000 index of small companies by 22.9%. *Investment Figures of the Week*, BUS. WK., Jan. 14, 1991, at 143.

The dramatic slump in share prices forced managers to try various methods to reverse this trend. See Carole Gould, *Hunting the Closed-End Conversion*, N.Y. TIMES, Aug. 26, 1990, at 18F; Deborah Hargreaves, *Euro-Spain Fund May Buy Back Its Shares*, FIN. TIMES, Sep. 27, 1990, at 23; Jonathan Clements, *Public Funds Are Facing Some 'Raiders' They Might Like: Their Own Managers*, WALL ST. J., Dec. 11, 1990, at C1. The methods currently being used by closed-end companies to reduce discounts are discussed in the text below.

⁵⁸See Office of Economic Analysis, SEC, THE POST-OFFERING PRICE PERFORMANCE OF CLOSED-END FUNDS 4 (July 21, 1989) [hereinafter THE POST-OFFERING PRICE PERFORMANCE OF CLOSED-END FUNDS].

FIGURE 11-1
Premiums and Discounts from NAV for IPOs of Closed-End Funds



A popular theory advanced to explain the discount is that market interest in closed-end companies falls significantly after the initial public offering, mainly because brokers are paid low commissions for secondary trades⁵⁹ and because, until recently, few market analysts have followed closed-end companies on a regular basis.⁶⁰ Brokerage houses have begun hiring closed-end company analysts, however, and there is evidence that brokers are recommending purchases of closed-end company shares (at least in the secondary market) to

⁵⁹BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* at 261-62 (Rev. ed., 1975); BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* at 126 (4th rev. ed., 1973).

⁶⁰Another analysis argues that "the closed-end fund discount, the rate at which initial public offerings are made, and the relative valuation of small stocks [are all] driven by changes in the sentiment of the small investors." Under this view, "[t]he closed-end discount thus serves as a thermometer of small-investor sentiment -- of their overoptimism or overpessimism." J. Bradford De Long & Andrei Shleifer, *Closed-End Fund Discounts: A Yardstick of Small-Investor Sentiment*, 18 *J. PORTFOLIO MANAGEMENT*, No. 2, 46 (Winter 1992).

retail investors?' Perhaps as a result of this increased interest, discounts narrowed during 1991.

Whatever the cause of discounts, the initial investors in closed-end companies may be affected more than the initial participants of other securities products. In part, selling fees may be higher with closed-end offerings than with other initial public offerings.⁶² Often investors in closed-end offerings do not realize that part of their investment will go to finance the offering, so that their shares will automatically have a lower net asset value than the amount of their initial investment.⁶³ If those investors have no choice but to sell their shares in the secondary market at a discount, they consequently suffer a loss of capital. For this reason, seasoned investors avoid purchasing during initial offerings and wait for discounts to appear in the secondary market before buying shares.⁶⁴

C. Methods For Reducing Discounts

Market discounts are a frequent source of concern for many closed-end company managers and sponsors. As a result, sponsors have considered and used a variety of techniques for responding to discounts or attempting to forestall them.

Approaches to curing market discounts have met with varying degrees of success. For example, some companies use leverage to borrow cash equal to the underwriting discount paid to brokers, and invest that amount in the company. The theory behind this practice is that discounts result from the company being worth less than the investors' initial investment.⁶⁵ Of course, the benefit of added earnings potential from increasing the assets invested in the company is countered by the increased risk of leverage.

⁶¹See Jonathan Clements, *Slim Pickings Among Closed-End Funds*, WALL ST. J., Mar. 8, 1991, at C1.

⁶²THE POST-OFFERING PRICE PERFORMANCE OF CLOSED-END FUNDS, *supra* note 58, at 23.

⁶³Proposed revisions to Form N-2, the registration form used by closed-end companies, would re-label underwriting discount as "sales load" in the per share table to increase investors' understanding of this charge. Registration Form for Closed-end Management Investment Companies, Investment Company Act Release No. 17091, section III.B. (July 28, 1989), 54 FR 32993 (proposed amendments to Form N-2 and guidelines).

⁶⁴See, e.g. Marsha Meyer, *The Savvy Way to Buy Closed-End Funds*, MONEY, Sept. 1987, at 153, 154; Jonathan Clements, *In Aftermath of Stocks' Sell-Of, Some Advocate Closed-End Funds*, WALL ST. J., Aug. 22, 1990, at C1; Richard Phalon, *Duck Shoot*, FORBES, Sept. 3, 1990, at 165.

⁶⁵See *supra* note 63 and accompanying text.

Some companies offer dividend reinvestment plans, under which the company reinvests shareholder dividends and distributions in additional shares that are issued by the company at the lower of market value or net asset value. Similarly, some companies engage in rights offerings, which are strictly limited by the Act.⁶⁶ While these practices appear to counteract the tendency toward discounts, dilution occurs when shareholders exercise rights or purchase new shares at prices less than net asset value. This eventually may cause a corresponding downward adjustment in the market price.

Finally, some companies offer a variation on the dividend reinvestment plan that includes a "cash purchase" feature through which shareholders may authorize an independent agent to purchase shares in the market whenever the market price is less than net asset value. While these purchases are made by existing shareholders, and not the company, they act in the same way as repurchases by the company on the open market in reducing discounts.

One method of ending discounts is to convert from closed-end to open-end status, but this approach has significant drawbacks. Conversion radically changes how a closed-end company may operate. The company's investment strategy may have to be re-evaluated; there are expenses and potential losses associated with restructuring a portfolio to increase its liquidity to match that of open-end companies; and leverage and capital structure may have to be adjusted. In addition, and perhaps most importantly, the former closed-end company has to develop a relationship with a distributor and comply with the more rigorous pricing, distribution, and redemption requirements that apply to open-end companies. Thus, for many closed-end companies, conversion from closed-end to open-end status has significant drawbacks.

Even the potential for elimination of discounts upon conversion can affect a closed-end company. Discounts attract arbitrageurs who gamble on swings in the discount and "raiders" or others who attempt to take over the company, sometimes forcing proxy contests to cause a company to convert from closed-end to open-end status.⁶⁷ As a result, potential targets have adopted supermajority

⁶⁶Under section 23, closed-end companies may issue warrants or rights exercisable at less than net asset value as provided by section 18(d). Section 18(d) requires warrants and rights to be issued exclusively to existing shareholders and to expire within 120 days of their issuance.

⁶⁷Upon conversion to open-end status, all shareholders may redeem shares at net asset value. Thus, raiders would instantly realize any profit on the difference between the discount prices they paid for the closed-end shares and the net asset value they are entitled to receive for the open-end shares. See, e.g., Gould, *Hunting the Closed-End Conversion*, *supra* note 57, and Phalon, *Duck Shoot*, *supra* note 64.

voting provisions that make it nearly impossible for conversions to succeed.⁶⁸ In addition, to pre-empt the threat of forced takeovers, sponsors have organized closed-end companies that automatically will seek to convert to open-end status under certain circumstances, or after a fixed period of time.⁶⁹ While these provisions are intended primarily as anti-takeover tactics, they may actually minimize discounts, particularly as a shareholder vote approaches.⁷⁰

For many closed-end companies, a more reasonable alternative for reducing discounts may be to repurchase shares under the limited circumstances provided by section 23(c) of the Act and rules 23c-1 and 23c-2 thereunder.⁷¹ Under section 23(c)(1), closed-end companies may purchase shares on a securities exchange and such other open market as the Commission by rule designates, provided that the company has notified stockholders of its intention within the preceding six months (if such securities are stock). Rule 23c-1 permits purchases on other open markets subject to a number of additional provisions designed to protect shareholders.⁷² Rule 23c-2 permits closed-end companies to call or redeem securities according to their terms, under certain conditions.⁷³ Such

⁶⁸Section 13(a)(1) of the Act requires a majority of a company's outstanding voting securities to authorize a change in subclassification from closed-end to open-end. 15 U.S.C. § 80a-13(a)(1). A typical supermajority voting provision requires at least a two-thirds (but usually not over three-fourths) vote in favor of conversion. See Mary Joan Hoene, *Closed End Funds - Discount and Takeover Issues*, 1990 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE at IX-95.

⁶⁹The conversion is contingent, of course, on obtaining the necessary shareholder approval required by section 13(a) of the Act. The shareholder vote usually may take place only several years after the fund's inception, and may hinge on a specific level of discount appearing or continuing for a specified period of time. See, e.g., *id.* at IX-98.

⁷⁰See Gregory A. Brauer, 'Open-Ending' Closed-End Funds, 13 J. FIN. ECON., 491,506-07 (1984) (examining the effect on secondary market prices of closed-end companies' announcements of proposed conversions to open-end status). But see THE POST-OFFERING PRICE PERFORMANCE OF CLOSED-END FUNDS, *supra* note 58, at 18-19, 36 (an examination of a sample of 64 closed-end companies 24 weeks after their initial public offering showed that there was a statistically insignificant difference in the discount or premium between companies with anti-takeover provisions and those without, and that the results did not change when the sample was broken down by type of fund).

⁷¹17 C.F.R. §§ 270.23-1, 23c-2.

⁷²Among other things, the rule generally requires that purchases of junior shares not disturb the asset coverage requirements of section 18, that purchases not be from affiliated persons of the issuer, and that purchases be made at a price not exceeding the lower of the market value, if any, or the net asset value of the security at the time of purchase.

⁷³Rule 23c-2(a) generally permits a registered closed-end company to call or redeem its shares in accordance with the terms of such securities or the company's charter; this rule has been
(continued..)

repurchases can create some market activity that may reduce the discount, but those rules do not facilitate transactions such as periodic direct repurchase offers by closed-end companies.

Under section 23(c)(2), closed-end companies may repurchase shares directly from shareholders by conducting issuer tender offers, after reasonable opportunity to submit tenders is given to all holders of securities of the class to be purchased. In addition, section 23(c)(3) provides the Commission with rulemaking authority to provide other means for closed-end companies to repurchase their shares in a manner that does not unfairly discriminate against any holders of the securities being repurchased.

D. Closed-End Tender Offers

Certain closed-end companies have avoided discounts entirely while still remaining closed-end by making periodic tender offers at net asset value under section 23(c)(2). With one exception, these companies' shares have not been traded in the market,⁷⁴ and the companies have provided shareholder liquidity solely through quarterly tender offers.

The first closed-end companies to use this procedure were loan participation or "prime rate" funds. These companies, first introduced in 1988, invest primarily in illiquid assets consisting of interests in senior, secured

⁷³(...continued)

interpreted as permitting calls and redemptions solely at the issuer's option and without any choice on the part of the shareholder. Dimensional Fund Advisors, Inc. (pub. avail. Nov. 21, 1988).

⁷⁴As a condition to exemptive relief from rule 10b-6 under the Exchange Act (17 C.F.R. § 240.10b-6), closed-end companies that intend to make such repurchases may not list their shares on a securities exchange or have their shares quoted on the National Association of Securities Dealers Automated Quotation system. Moreover, due to the similarities between open-end companies and closed-end companies making continuous offerings and periodic repurchases, United States securities exchanges might not permit the shares of such funds to be listed. Securities exchanges in the United States generally do not list redeemable securities. For example, staff of the New York Stock Exchange have advised us in discussions that the exchange's policy is to begin de-listing proceedings if a listed closed-end company converts to open-end status. Recently, however, the American Stock Exchange ("AMEX") has participated in the development of at least one complex synthetic securities product that includes redeemable securities intended to trade on AMEX. See SuperTrust Trust for Capital Market Fund, Inc. Shares, Investment Company Act Release Nos. 17613 (Jul. 25, 1990), 55 FR 31281 (Notice of Application) and 17809 (Oct. 19, 1990), 47 SEC Docket 1098 (Order).

corporate loans that have floating interest rates.⁷⁵ Although loan participation funds register as closed-end companies, they operate much like open-end companies, offering shares continuously and providing the sole source of liquidity for their shareholders. While only five loan participation funds have registered with the Commission, they have been successful in attracting investors! As of December 31, 1991, the loan participation funds had total assets of almost \$6 billion and accounted for approximately eight percent of the total assets held by closed-end companies.⁷⁷

By the end of 1991, two other closed-end companies had followed the lead of the loan participation funds and indicated that they would periodically consider making tender offers to their shareholders.⁷⁸ In early 1992, by contrast, one loan participation fund appeared to abandon the procedures. Pilgrim Prime Rate Trust announced that it would not make a repurchase tender offer and listed its shares on the New York Stock Exchange on March 9, 1992.⁷⁹ None of the other closed-end companies followed suit, and Pilgrim's shares traded on the exchange at a significant discount. Within two weeks after the beginning of exchange trading, Pilgrim announced a tender offer for nearly nine percent of its shares.⁸⁰

Closed-end company repurchase offers are subject to a number of significant restrictions, however. Issuer tender offers must comply with the

⁷⁵The interest rates float or reset at a margin above a generally recognized base lending rate such as the prime rate quoted by a designated United States bank, the London InterBank Offered Rate, the average secondary market rate for large certificates of deposit, or other base lending rates used by commercial lenders.

⁷⁶The five registrants are Allstate Prime Income Trust, Eaton Vance Prime Rate Reserves, Merrill Lynch Prime Fund, Pilgrim Prime Rate Trust, and Van Kampen Merritt Prime Rate Income Trust.

⁷⁷Lipper Analytical Securities Corp., Lipper Closed-End Performance Analysis Service, Jan. 31, 1992, at 44 (assets of \$5.80 billion out of total closed-end fund assets of \$72.76 billion). *But see* Randall W. Forsyth, *Nut Necessarily Prime Time*, BARRON'S, Oct. 21, 1991, at 47 (indicating that investors tendered their shares at significant levels beginning in mid-1991 as interest rates dropped).

⁷⁸Merrill Lynch High Income Municipal Bond Fund, Inc., and Emerging Markets Growth Fund, Inc. The latter, however, has not made any tender offer since January, 1991.

⁷⁹Jonathan Clements, *Pilgrim Takes Fund Industry by Surprise*, WALL ST. J., Feb. 21, 1992, at C1 (quoting letter to shareholders from Palomba Weingarten, Chairman, Pilgrim Group).

⁸⁰Jonathan Clements, *Pilgrim Prime Rate Plans Tender Offer for 9% of Shares*, WALL ST. J., Mar. 26, 1992, at B6.

requirements of rules 13e-4⁸¹ and 14e-1⁸² under the Securities Exchange Act.⁸³ Moreover, they must obtain exemptive relief from the provisions of rule 10b-6 under the Exchange Act, which generally prohibits participants in a distribution from contemporaneously buying securities of the same class being distributed. They must conduct their offerings in compliance with rule 415⁸⁴ under the Securities Act,⁸⁵ which governs "shelf" registrations. As a result, tender offers generally are a relatively cumbersome and limited way for closed-end companies to provide for shareholder liquidity. They involve costs such as producing offering materials, notifying shareholders, and paying registration and filing fees. Open-end companies are not subject to similar requirements when redeeming their shares.

Tender offers also are subject to a number of qualifications that do not apply to redemptions of open-end shares. For example, tender offers generally are made for limited amounts of shares and, if more shares are tendered than the company is prepared to buy, the company is only required to accept them on a pro rata basis. A company also is not obligated to make a tender offer. Finally, these companies have not been able to provide investors with assurance the tender offers will take place. The Division has stated that committing in advance to make periodic tender offers might result in directors breaching their fiduciary duties to shareholders, since investors could not be certain when or if their shares would actually be repurchased by the company.⁸⁶ Accordingly, these companies' prospectuses represent that each quarter the board of directors will consider whether to make a tender offer for outstanding shares, but caution that tender offers may not take place every quarter.

The closed-end company repurchase offers illustrate clearly the difficulty experienced by sponsors wishing to offer an alternative procedure for shareholders to resell their shares. This chapter has described other examples of funds that do not fit comfortably within the strict open-end/closed-end system.

⁸¹17 C.F.R. § 240.13e-4.

⁸²17 C.F.R. § 240.14e-1.

⁸³Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-7811. These requirements are discussed in Section III.A.1, *infra*.

⁸⁴17 C.F.R. § 230.415.

⁸⁵Securities Act of 1933, 15 U.S.C. §§ 77a-77aa. Closed-end companies may continuously offer new shares in reliance on paragraph (a)(1)(ix) of rule 415, but paragraph (h) of the rule limits them to registering only the number of shares that they reasonably expect will be offered or sold within two years from the effective date of the registration statement.

⁸⁶See Guide 2 to proposed amendments to Form N-2, Inv. Co. Act Rel. 17091, *supra* note 63.

For example, some country funds appear capable of operating much like open-end companies but cannot because of the seven-day requirement for meeting redemptions. Certain closed-end funds appear interested in providing opportunities for shareholders to exchange their shares for net asset value, but have not been able to do so with any certainty and remain within the closed-end classification.

111. Recommendations

The Division believes it is appropriate to modernize the existing regulatory structure to permit the development of new investment companies that, while having characteristics of the current open-end and closed-end forms, would offer a degree of redeemability or "repurchase-ability" between the two traditional extremes. Accordingly, the Division recommends adoption of a rule under section 23(c) of the Act to facilitate periodic repurchases of closed-end shares. In addition, the Division recommends that the Commission propose a new exemptive rule under section 22 of the Act to establish requirements for a new type of open-end investment company (a "limited redemption investment company") that would invest in less liquid securities and provide shareholders with a limited right to redeem shares at net asset value. Finally, given the importance of portfolio liquidity to any investment company that redeems or repurchases its shares, the Division recommends the introduction of legislation enabling the Commission to specify liquidity standards appropriate to each form of investment company.

A. Repurchase Offers by Closed-End Companies

In light of the problems raised by market discounts and the closed-end companies periodic tender offers responding to the discounts, the Division considered whether to recommend to the Commission that it facilitate direct share repurchases by closed-end companies. As discussed above, the only effective mechanism that has emerged for addressing the discounts is the direct repurchase approach that a small number of closed-end companies have made to their shareholders pursuant to section 23(c)(2) of the Investment Company Act and Exchange Act rules governing issuer tender offers.

In view of those companies' experience and the comments received in response to Commission's release soliciting comments on the regulation of investment companies,⁸⁷ the Division believes that it would be appropriate to

⁸⁷Study Release, *supra* note 52. Several commenters favored a mechanism for such repurchases. See, e.g., Letter from American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities, 1940 Act Structured Finance Task Force, to Jonathan G. Katz, (continued..)

provide a more defined, efficient mechanism for direct repurchase offers by closed-end companies. The Division therefore recommends that the Commission adopt rules under section 23(c) to permit closed-end companies to repurchase their shares at fixed intervals in accordance with appropriate safeguards for the protection of investors.⁸⁸

While many companies and shareholders are interested in repurchases at net asset value, repurchase offers would not be appropriate or desirable for all closed-end companies. Some types of companies tend not to have discounts. Other companies invest in securities that are not liquid or easily marketable; the valuation of the assets of these companies may be so imprecise that it is difficult to ensure that repurchase prices would be fair to both tendering and remaining shareholders. In many cases, the portfolio management demands created by repurchases and new sales may be incompatible with a company's (and its shareholders') objective of remaining fully invested in securities.⁸⁹ Accordingly, we do not propose that any repurchase rule be mandatory for all closed-end

⁸⁷(...continued)

Secretary, SEC (Oct. 16, 1990), File No. **S7-11-90** [hereinafter ABA Comment]; Letter from Davis, Polk & Wardwell, to Jonathan G. Katz, Secretary, SEC (Oct. 10, 1990), File No. **S7-11-90** [hereinafter Davis Polk Study Comment]; and Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC (Oct. 18, 1990), File No. **S7-11-90** [hereinafter Merrill Lynch Study Comment].

⁸⁸This recommendation represents a change from the prior position that an advance commitment to repurchase may be inconsistent with the fiduciary duties of the company's board of directors to consider the merits of the proposed repurchase based on the circumstances *at the time* the repurchase is made. Inv. Co. Act Rel. **17091**, *supru* note **63**. While the Division continues to believe that the directors of a closed-end company have a fiduciary duty to consider the appropriateness of share repurchases, this fiduciary duty should not preclude a closed-end company from making an advance commitment to periodic repurchases. This duty would include reviewing a company's portfolio management and borrowing procedures to ensure that the company can meet its repurchase commitments.

The proposed repurchase procedures would address many of the underlying concerns of the Division's prior position, as would the proposed requirement that closed-end companies making repurchases disclose possible limitations on repurchases and possible effects on portfolio management of the need to plan for repurchases. Moreover, the adoption of an express liquidity standard and of limitations on the use of leverage by closed-end companies making repurchases should address concerns about a company's ability to manage its portfolio so as to meet its repurchase commitments.

⁸⁹*See, e.g.*, General American Study Comment, *supru* note 52, at 2-6; Baker, Fentress Study Comment, *supru* note 52, at 2-5 (both of which opposed any procedure for such repurchases).

companies. Rather, any rule should provide a safe harbor within which each company could elect to offer the repurchase feature?'

It is unclear whether there would be a demand for such closed-end repurchase procedures if the Commission also adopts rules permitting limited redemptions by open-end companies; many investment companies that would wish to provide shareholder liquidity might prefer to operate as limited redemption open-end companies rather than as closed-end companies making periodic repurchase offers. Ultimately, if both options are available, sponsors and investors will determine which options works best for a particular fund.

1. Operational Procedures for Repurchases

Periodic repurchases raise a number of operational issues. To address those issues, the discussion below recommends including specific operational requirements in rules authorizing periodic repurchases. The Division has examined the experience of certain companies (mainly the loan participation funds) that currently make periodic tender offers to repurchase their shares. Following that model, the basic steps of the process are the following: (i) a fund makes a repurchase offer to shareholders; (ii) during the tender offer period that follows, shareholders may tender their shares and withdraw their tenders until the termination of that period (the "cut-off date"); (iii) by the cut-off date the fund determines whether to accept or reject tenders; and (iv) the fund makes payment promptly thereafter. The experience of the closed-end companies that have made periodic repurchase offers raises a number of questions, which we explore below, and suggests that it would be appropriate to modify the procedures used by those companies.

a. Relationship to Tender Offer Rules

Currently, closed-end companies that make periodic repurchases do so via tender offers. In many respects, the tender offer rules under sections 13 and 14 of the Exchange Act⁹¹ address important investor protection concerns relating to repurchases by closed-end companies. In other respects, however, the experiences of closed-end companies that have conducted repurchases in accordance with the tender offer rules suggest that some provisions of those rules were intended to apply to different transactions and do not achieve their

⁹⁰Such a rule could be promulgated under section 23(c)(3), which expressly authorizes the Commission to issue rules, regulations and orders defining other circumstances in which repurchases may be made. Alternately (or in addition), the rule could be promulgated under section 23(c)(2) as a safe harbor within which an offer would be deemed to provide "reasonable opportunity to submit tenders given to all holders of securities of the class to be purchased."

⁹¹15 U.S.C. §§ 78m, 78n.

objectives when applied to closed-end companies conducting repurchases at a price based on net asset value. Accordingly, the Division recommends that rule 13e-4 be amended to exempt closed-end company periodic repurchases complying with a new rule under section 23(c) of the Act, and that the new rule under section 23(c) incorporate certain pertinent requirements of rule 13e-4 as adapted to address the unique investor protection concerns that are raised by closed-end company repurchase offers. The Division also recommends taking an analogous approach with respect to rule 14e-1, which prohibits certain tender offer practices. The following discussion examines some of the areas where specific adaptations for repurchasing closed-end companies may be appropriate.

b. Formulation of Repurchase Offers

A key issue to be addressed by the proposed rules would be the procedure to be used by a company in determining the timing and extent of repurchase offers. Because this issue is of critical importance both in shareholders' investment decisions and in a company's ability to manage its portfolio, the Division recommends that the rule require repurchase offers to take place according to a fundamental policy that defines both the timing of repurchases and the minimum and maximum amount of shares to be repurchased under any offer. This approach would contrast with the current practice in closed-end company repurchase offers, where the amount to be repurchased is determined by the company with respect to each repurchase. At the same time, we recognize that, because of market conditions and considerations of portfolio management, it might be appropriate for a company to repurchase a greater or lesser amount in a given offer. For that reason, the Division also recommends that a company have authority to determine, pursuant to guidelines established by the company's board of directors, the amount of each repurchase offer within minimum and maximum limits set by fundamental policy.

(1) Fundamental Policy. The procedures governing closed-end redemption offers should be matters of fundamental policy, because shareholders should have maximum certainty about the timing and extent of purchases.⁹² An irregular or sporadic repurchase program would cause confusion and might also provide opportunities for insider abuse and manipulation.⁹³

⁹²Because the procedures would be fundamental, they could not be changed unless authorized by a majority vote of the shareholders. See Investment Company Act §§ 8(b)(3), 13(a)(3), 15 U.S.C. §§ 80a-8(b)(3), -13(a)(3).

⁹³The rulemaking proceeding also could examine whether alternative requirements would provide sufficient investor protection. One alternative, which we do not favor, but which would continue the current practice of closed-end companies that have made periodic offers, would be to leave the full determination of the timing and amount of the offer to the board of directors, (continued...)

(2) Intervals between Repurchase Offers. The Division believes that any rule should require a schedule for periodic repurchases at regular, fixed intervals. The interval should be regular and easily ascertained; for example, the rule could specify that permissible intervals are three months, six months, or a year. Such intervals reduce the potential for investor confusion and allow investors some ability to plan. From the range of permissible intervals specified in the rule, each company could select the frequency at which it would make repurchase offers as a matter of fundamental policy consistent with the company's investment objectives.

(3) Minimum and Maximum Amounts of Repurchase Offers. The Division believes that a company seeking to periodically repurchase its shares should be *required* to determine at the outset the minimum and maximum amount of shares that will be repurchased, either in absolute terms or as a percentage of shares outstanding. For example, a closed-end company could adopt a policy that provided for quarterly repurchases of between five and ten percent of the shares of common stock outstanding. Establishing a maximum repurchase amount would assist managers in judging the company's liquidity needs, while a minimum would assure shareholders that the company will in fact make repurchase offers at a sufficient level to accommodate shareholder liquidity needs.

(4) Levels of Individual Repurchase Offers. The Division recognizes that a company should have some flexibility to determine at the time of each repurchase offer the maximum amount of that offer. Currently, under rule 13e-4, an issuer may purchase "an additional amount of securities not to exceed two percent of the class of securities that is the subject of the tender offer;" beyond that point, the issuer must extend the tender offer for a specified period.⁹⁴ It would be appropriate for a closed-end company to have similar limited discretion to increase the amount if it determines that repurchasing a larger number of shares is appropriate.⁹⁵ The investment adviser would make these determinations pursuant to guidelines established by the company's board of directors. This discretion would allow the company to respond to portfolio

⁹³(...continued)

subject to a requirement of full disclosure and notice. Cf. rule 11a-3, 17 C.F.R. § 270.11a-3 (60 days' advance notice required before any change in the terms of a mutual fund's exchange offer).

⁹⁴Rule 13e-4(f). Rule 14e-1(b) has a comparable provision.

⁹⁵We recognize that allowing such discretion would necessarily reduce the amount of certainty associated with repurchases. In theory, a company could have a minimum schedule providing for small repurchase amounts, yet regularly accept more shares, possibly lulling investors into believing that the company will always buy back a significant number of shares. We believe, however, that clear disclosure of the minimum and maximum amounts of shares the company commits to repurchase would minimize the possibility for confusion and misleading practices.

management concerns and any expectations of the level of shareholder tenders.⁹⁶ Of course, the amount of the repurchase offer could not be increased beyond the maximum limit set by fundamental policy.

(5) **Exceptions.** Finally, the Division also recognizes that it would be appropriate to allow closed-end companies to suspend scheduled repurchases in limited circumstances when repurchases would have severe consequences for shareholders. For example, in unusual circumstances, repurchases could affect a company's tax status as a regulated investment company under Subchapter M of the Internal Revenue Code.⁹⁷ In those circumstances, a company's board should be allowed to suspend or limit repurchases. **Such** circumstances currently are disclosed in prospectuses where tender offers are contemplated and in issuer tender offer documents.⁹⁸ Closed-end companies seeking to rely on the new rule similarly should be required to disclose these limitations in their prospectuses.

c. Preparation of Disclosure Materials

Rule 13e-4 under the Exchange Act requires an issuer to provide a statement containing extensive disclosure. Among other items, the statement must disclose the source and amount of the consideration to be paid, the purpose of the tender offer, transactions in the issuer's securities by certain related persons, and any arrangements relating to the tender offer. These requirements can impose significant costs and delays on closed-end companies and their shareholders in the preparation, printing, and distribution of the statements.

Much of the current tender offer disclosure requirements would not be relevant to periodic repurchase offers by closed-end companies under the proposed rule. Since the essential purpose would be simply to remind shareholders of the previously disclosed opportunity to have shares repurchased at net asset value, lengthy, detailed disclosure would not be necessary. Investors in such closed-end companies would already know the general terms and

⁹⁶Pursuant to their fiduciary obligations to shareholders, the directors would monitor the repurchase process and serve as a check on proposals by the investment adviser that repurchase offers consistently be made in the minimum amount, since such proposals might serve primarily the adviser's interest by maximizing the level of assets under management on which advisory fees would be paid. On this and other points, the Division expects that the consideration of any proposed rule will examine what role, if any, the independent directors should have.

⁹⁷26 U.S.C. §§ 851-860.

⁹⁸See, e.g., Pilgrim Prime Rate Trust, Offer to Purchase at 5-6 (Aug. 2, 1991), reprinted in **Pilgrim Prime Rate Trust, Schedule 13E-4, Exhibit (a)(1)(ii)** (Aug. 2, 1991); Merrill Lynch Prime Fund, Inc., Offer to Purchase at 5-6 (Aug. 19, 1991), reprinted in **Merrill Lynch Prime Fund, Inc., Schedule 13E-4, Exhibit (a)(1)(ii)** (Aug. 19, 1991).

purposes of such offers from prospectus disclosure -- indeed, this procedure might be a material factor in most investors' decisions to purchase shares of such closed-end companies. Thus, at the time of each repurchase offer, investors would need to receive only basic disclosure concerning the procedures for tendering their shares for repurchase. For example, first, they would need some reminder of the existence and timing of the repurchase offer. Second, they would need to know the amount to be repurchased in a given offering; if the company has discretion to set the amount of the offering, the statement should disclose any material factors pertinent to the determination of the amount. Third, basic information about net asset value also would be appropriate, including the net asset value as of the date of the repurchase offer and information about means for shareholders to learn net asset value at subsequent points (such as references to newspaper publication or any telephone information systems).⁹⁹ Accordingly, the Division recommends that a repurchase offer rule require closed-end companies making periodic repurchases to provide shareholder notification containing the basic information outlined above.

d. Timing of Repurchase Offer Events

The determination of the relative timing of key events in the repurchase process raises several questions. First, how far in advance should the company provide notice to shareholders of each repurchase offer? For issuer tender offers, rule 13e-4(f) requires that a tender offer remain open for "(i) at least twenty business days from its commencement; and (ii) at least ten business days from the date" of notice of certain changes in the offer.¹⁰⁰ Less advance notice may be necessary with periodic repurchase offers than with most issuer tender offers, since under most circumstances shareholders would not need to consider any pertinent extraordinary corporate events or the relation of the offer price to a market price. Instead, the chief concern would be to ensure that shareholders receive enough advance notice to decide whether they want to tender their shares and can return their tender forms to the company by the date of the termination of the repurchase offer. It may be appropriate for the length of the notice period to vary depending on the frequency of repurchase offers: investors may need more advance notice if a company makes repurchase offers annually rather than quarterly.

Second, should there be a mandated minimum or maximum interval between the date by which shareholders must tender shares (the cut-off date) and the date by which the company makes payment, and, if so, how long should the interval be? Certainly some advance notice would be necessary to provide

⁹⁹Cf. Guide 2 to proposed revisions to Form N-2, Inv. Co. Act Rel. 17091, *supra* note 63.

¹⁰⁰See also rule 14e-1(a), (b).

enough time for the portfolio manager to adjust the portfolio without depressing the value of portfolio securities, but the length of time may vary depending on the liquidity of a given company's portfolio. Commenters have suggested a range of intervals, generally between thirty and sixty days;¹⁰¹ that range suggests that it may be appropriate to leave companies some flexibility to set the terms of repurchase offers. Currently, repurchases made as issuer tender offers are subject to a requirement of "prompt" payment; the rules do not expressly mandate a period for payment but the Commission generally has interpreted the term "prompt" as requiring payment within five business days.¹⁰²

Third, when should the repurchase price be calculated? Currently, closed-end companies making tender offers repurchase their shares at the net asset value calculated as of the close of business on the date on which the offer expires, but certain factors raise questions whether that is the most appropriate date for determining net asset value. Pricing shares at or near tender would allow shareholders who tender their shares to "lock in" their prices. Thus, they would not participate either in future losses experienced by other shareholders, or in any potential gains. If, however, exiting shareholders receive repurchase proceeds based on asset valuations calculated before the actual sales take place, remaining

¹⁰¹See, e.g., ABA Comment, *supra* note 87, at 22 (30 to 60 days); Davis Polk Study Comment, *supra* note 87 (30 days); Merrill Lynch Study Comment, *supra* note 87 (not more than 60 days). See also Letter from Ronald L. Gallatin, Managing Director, Shearson Lehman Hutton, to Richard Ketchum, Director, Division of Market Regulation, SEC (Oct. 18, 1989) (suggesting that 21 days would be sufficient, including 14 days between the cut-off date and the valuation date, and seven days between valuation and payment). Mr. Gallatin provided the following diagram illustrating his proposed schedule for repurchases:

Notice Period	Regular Way Sale of Securities by Fund	Valuation Date	Payment Date
Day -14	Day 0	Day 14	Day 21

¹⁰²The Commission has stated that there is not a single standard for what constitutes prompt payment under rules 14e-1 and 13e-4:

The Commission recognizes that the operation of this standard will be affected by the practices of the financial community and the following factors: current settlement, handling and delivery procedures relating to tenders made by guaranteed deliveries by appropriate institutions; procedures to cure technical defects in tenders; and the application of the Hart-Scott-Rodino Antitrust Improvement Act of 1976 and the rules promulgated thereunder.

Tender Offers, Exchange Act Release No. 16384, at text accompanying nn 34-35 (Nov. 29, 1979), 44 FR 70326, 70337 (adoption of amendments to tender offer rules). For the interpretation that "prompt" payment generally requires payment within five business days, see *id.* at n.36.

shareholders' holdings may be diluted if it turns out that the assets sold did not garner the proceeds predicted for them at the time of pricing.

Alternatively, if shares are priced closer to the date of payment, there is a more accurate match between the price paid for repurchased shares and amounts realized upon disposition of portfolio securities sold to pay repurchase proceeds. In addition, shares that are tendered participate proportionally in the company's gains and losses during the payout period. On the other hand, shareholders who tender their shares for repurchase would assume the risk of market changes for extended periods after they have tendered their shares.¹⁰³

Certain of those factors may assume greater weight to the extent that closed-end portfolios include securities that are less liquid or have less reliable valuations. To that extent, there is a greater risk that the amount realized upon disposition to meet redemptions might differ significantly from the amount estimated in calculating net asset value at the time of tender by shareholders. On the other hand, this risk may be reduced by requiring that a company already have sufficient liquid assets to meet its repurchase commitment by the time a repurchase offer is made.

e. Repurchase and Offering Price

The Division recommends that any rule for closed-end repurchase offers should require the repurchase price to be based on net asset value. This requirement would be consistent with the current practice of closed-end company periodic tender offers, which offer to repurchase shares at a price based on net asset value.¹⁰⁴ Moreover, the basic rationale for the Commission's allowance of closed-end company share repurchases is to provide a mechanism for shareholder liquidity at net asset value.

The requirement to base the repurchase price on net asset value need not preclude the imposition of certain charges on redemption. First, the rulemaking should address whether closed-end companies making repurchase offers may

¹⁰³The rule would require forward pricing, that is, pricing *after* shareholders have tendered their shares.

¹⁰⁴*See, e.g.,* Pilgrim Prime Rate Trust, Offer to Purchase, *supra* note 98, at 1. The use of net asset value has departed from traditional practice in other issuer tender offers. First, tender offers generally must state a fixed dollar amount for the price offered because schedule 13E-4 in Item 1(b) requires the issuer to state "the exact amount of such securities being sought and the consideration being offered therefor." For most portfolios, stating a dollar amount would not be possible if the offer is to be made at net asset value. But see, *e.g.,* Baldwin Securities Corporation (pub. avail. Dec. 24, 1986) (exemption granted for tender offer by closed-end company where consideration would be adjusted net asset value).

impose distribution charges comparable to contingent deferred sales loads,¹⁰⁵ currently, some closed-end companies making repurchase tender offers impose comparable early withdrawal charges. The rulemaking also should consider the appropriate treatment of exchanges into or from affiliated investment companies. Similarly, a net asset value requirement need not preclude companies from charging any scheduled fee reasonably necessary to compensate the investment company for the costs incurred in disposing of portfolio securities to generate cash to pay for repurchases.¹⁰⁶

Likewise, the price of shares sold by closed-end companies making periodic repurchases should be based on net asset value. Such a requirement is necessary to comply with section 23(b), which generally prohibits closed-end companies from offering shares at prices below net asset value. Section 23(b) safeguards shareholders against dilution that would occur if subsequent purchasers were to buy shares at prices lower than the asset value of shares held by existing shareholders. This requirement coupled with those relating to the determination of the repurchase price, should preclude manipulation of the price of the company's shares and avoid a number of the abuses noted in the Investment Trust Study.¹⁰⁷

If closed-end companies are to base their repurchase and offering prices on net asset value, they should calculate net asset value on a regular basis, perhaps linked to the periodicity of the repurchase offers. While rule 22c-1 requires open-end funds to determine net asset value every business day, closed-end companies are not required to price their shares more often than quarterly (for reporting purposes). Many closed-end companies, however, do voluntarily calculate and publish net asset values weekly.¹⁰⁸

¹⁰⁵A related issue would be whether to permit closed-end companies to vary scheduled deferred charges for certain classes of shareholders as open-end companies may do with front-end loads under rule 22d-1, 17 C.F.R. § 270.22d-1. For closed-end companies making issuer tender offers, rule 13e-4 originally was interpreted as prohibiting variation in early withdrawal charges (comparable to contingent deferred sales loads). See Michael Berenson, *The Experience of Loan Participation Funds -- Insights for the 1990s*, 1990 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE, at IX-12 to IX-13. The "best price" rule (rule 13e-4(f)(8)) requires that "the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any security holder during such tender offer."

¹⁰⁶Open-end companies may impose similar redemption fees. See *Offers of Exchange Involving Registered Open-End Companies*, Investment Company Act Release No. 17097, at n.37 (Aug. 3, 1989), 54 FR 35177 (adopting rule 11a-3).

¹⁰⁷See *supra* Section ILA.I.

¹⁰⁸Net asset values compiled by Lipper Analytical Services and the ICI appear each week in *Barron's*. Weekly listings also appear in the *Wall Street Journal* every Monday.

2. Repurchase Offer Filing Costs

Under rule 13e-4, in preparing and filing tender offer materials with the Commission, closed-end issuers incur costs that open-end companies do not bear. For loan participation funds that make tender offers every quarter, filing fees can become a significant expense.¹⁰⁹ To minimize the filing fee, closed-end issuers file tender offers for less than the total of their outstanding shares, then stand prepared to extend the tender offer if shareholders tender more shares than the registered amount. The practical effect of the fee requirement is that closed-end companies must pay one fee to register shares and a second to repurchase them. While the same requirement applies to non-investment company issuers, tender offers typically are extraordinary events for those issuers. By contrast, under the proposed repurchase procedures, closed-end companies would be unique because they alone would make periodic repurchase offers as a means of providing shareholder liquidity.

Closed-end company periodic repurchases would not be subject to those filing requirements, if the Commission exempts closed-end companies making periodic repurchases from rule 13e-4, as recommended above.

3. Offerings by Closed-End Companies

Closed-end companies conducting periodic repurchases may need to raise additional equity. Otherwise, as their equity shrinks, their expense ratios will rise, harming their investment return. Moreover, an inflow of new capital can give a company greater flexibility in managing its portfolio by reducing the pressure to sell portfolio securities to meet repurchases. As discussed above, several closed-end companies that make periodic repurchases also conduct continuous offerings of their shares. These companies register their shares under rule 415(a)(1)(ix) under the Securities Act, which permits a continuous offering provided that the offering begins promptly and lasts more than thirty days. Although this rule allows continuous offerings to take place, it is an imperfect mechanism. The rule does not contemplate periodic offerings, although at least one closed-end company has agreed to abstain from offering or selling its shares during certain brief periods as a condition of exemption from rule 10b-6 (discussed below).¹¹⁰ A closed-end company registered under this section also may have to halt continuous offerings temporarily, if, for example, material

¹⁰⁹Filing fees for tender offers under rule 13e-4 are calculated at a rate equal to 1/50th of one percent of the amount to be purchased.

¹¹⁰Merrill Lynch High Income Municipal Bond Fund, Inc. (Oct. 26,1990).

changes occur that require it to file an amendment to the registration statement?''

Closed-end companies cannot qualify for rule 415(a)(1)(x), which allows *continuous or* delayed offerings by registrants that register on Form S-3 or Form F-3 (the so-called "short form registrations") because closed-end companies are not eligible to use those registration forms. But for this problem, rule 415(a)(1)(x) would provide a convenient method for closed-end companies to plan to make intermittent, rather than continuous, offerings. Such an ability would allow closed-end companies to coordinate the timing and amount of repurchases and sales, thus facilitating greater control over portfolio management.

Accordingly, the Division recommends that the Commission amend rule 415 to provide express authorization for closed-end companies making periodic repurchase offers to make delayed or continuous offerings.¹¹² As an alternative, it might be appropriate to impose on closed-end companies registration requirements comparable to those applicable to open-end funds, separate accounts, or unit investment trusts under rules 485, 486, and 487 of the Securities Act.¹¹³ Such a procedure would expedite the filing by closed-end companies of amendments for the purpose of updating financial statements.

4. Rule 10b-6

If a closed-end company offers shares continuously, it currently cannot conduct tender offers without exemptive relief from rule 10b-6 under the Exchange Act. Rule 10b-6 generally prohibits persons involved in a securities offering from purchasing shares until after their participation in the offering is complete.¹¹⁴ The rule's purpose is to prevent persons interested in the

''This is the practice of a limited number of venture capital business development companies structured as closed-end limited partnerships that hold multiple closings, typically when the companies are making a significant investment, such as in connection with "mezzanine financing" of friendly leveraged acquisitions and similar transactions. Each time these issuers make a material investment, they halt sales until they file a post-effective amendment to their registration statement and updated disclosure becomes available.

¹¹²See Merrill Lynch Study Comment, *supra* note 87, at 111-9.

¹¹³17 C.F.R. §§ 230.485, .486, .487.

¹¹⁴The provisions of rule 10b-6 do not apply to redeemable securities issued by an open-end investment company. See rule 10b-6(d).

distribution from "artificially conditioning the market for the securities in order to facilitate the distribution."¹¹⁵

In light of rule lob-6, closed-end companies seeking to periodically repurchase their shares are faced with the choice of either seeking exemptive relief or interrupting their continuous offerings so that the rule does not apply. Neither alternative is entirely satisfactory. Obtaining exemptive relief from rule lob-6 imposes additional costs and delays. Interrupting an offering also is problematic, since rule 415 does not permit closed-end companies to conduct periodic offerings. Each closed-end company that makes periodic repurchases has obtained an exemption from the prohibitions of rule lob-6. These exemptions are subject to requirements designed to prevent manipulation, including a requirement that there be no secondary market for the company's shares.¹¹⁶

The Division recommends that the Commission exempt closed-end companies making repurchase offers from rule lob-6, thus building upon the exemptions previously granted.¹¹⁷ These repurchases would not involve any potential for "artificially conditioning the market for the securities" -- the primary abuse that rule lob-6 was intended to prevent.¹¹⁸ The Commission has stated that rule lob-6 was "designed to protect the integrity of the securities trading market as an independent pricing mechanism. . . ."¹¹⁹ For investment companies, however, net asset value provides an independent pricing mechanism

¹¹⁵Prohibition Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 24003, section I (Jan. 16, 1987), 52 FR 2994 (adopting amendments to rule lob-6).

¹¹⁶Pilgrim Prime Rate Trust (Aug. 23, 1988), Eaton Vance Prime Rate Reserves (July 14, 1989), Van Kampen Merritt Prime Rate Income Trust (Sept. 27, 1989), Merrill Lynch Prime Fund (Oct. 24, 1989), and Allstate Prime Income Trust (Nov. 21, 1989). See also Emerging Markets Growth Fund, Inc. (Aug. 13, 1991), and Merrill Lynch High Income Municipal Bond Fund, Inc., *supra* note 110. The two latter exemptions involved additional requirements. First, neither the company, its principal underwriter, or any other broker-dealer may conduct any offers or sales of the company's shares during the last five business days of any tender offer. Second, the Merrill Lynch exemption provides that the company may not purchase any municipal bonds that are unrated, or are not considered investment grade, during the last five business days of any tender offer, except for bonds that are part of a new issue. We understand that this second requirement responds to concerns of the Division of Market Regulation that purchases of relatively illiquid portfolio securities might present the potential for manipulation of the price of securities held in the fund's portfolio and hence of net asset value.

¹¹⁷The rulemaking proceeding also should address the question of to what extent it would be appropriate to permit secondary market activity in the shares of closed-end companies making periodic repurchase offers.

¹¹⁸Exch. Act Rel. 24003, *supra* note 115.

¹¹⁹*Id.*, 52 FR at 2994.

that distinguishes investment companies from all other issuers. This mechanism is based upon the values of the underlying portfolio assets and is not affected by the terms of a repurchase offer or of a distribution by an investment company. Accordingly, sales and repurchases at net asset value, properly computed, do not necessarily implicate the concerns of rule lob-6, as evidenced by the rule's express exemption for redeemable securities issued by open-end companies. The policies that underlie the exemption of open-end shares also support the exemption of shares of closed-end companies that make periodic repurchases at a price based on net asset value.

5. Leverage

The issuance of senior securities by a closed-end company that periodically repurchases its shares presents two concerns. First, unless new equity is raised, repurchases will shrink the company's asset base, effectively increasing leverage and the riskiness of senior securities. Second, section 18(a) of the Act requires that the terms of senior securities prohibit repurchases of common stock if the repurchases would reduce the asset coverage below the required level. This prohibition creates potential uncertainty regarding scheduled repurchases of common stock. It was intended to respond to closed-end company practices in the 1920's and 1930's, when companies sometimes issued senior securities to the public, then repurchased common shares, leaving the senior securities holders with speculative instruments. If a scheduled repurchase would reduce the company's asset coverage below that required, the repurchase cannot occur unless the company takes other steps, such as retiring senior securities or selling additional common stock. There might be investor confusion if closed-end companies were to schedule repurchases only subject to the proviso that repurchases would not occur if they would reduce asset coverage below that required by section 18.

Accordingly, a repurchase rule for closed-end companies must ensure both that repurchases do not impair necessary asset coverage and that companies' levels of senior securities do not inhibit the companies' ability to meet their repurchase commitments. Accordingly, the Division recommends that closed-end companies making periodic repurchases should be limited to bank borrowing¹²⁰

¹²⁰Some of the closed-end companies that make periodic repurchase offers have bank lines of credit to provide financing for their tender offers. Even if these companies do not use these sources of financing, the commitment fees can add to shareholder expenses. In rulemaking it may be appropriate to consider whether any limitation beyond the provisions of section 18 should be imposed on the use of borrowing to fund the repurchase of shares or on the allocation of borrowing expenses between shares that are tendered for repurchase and those that remain.

under the same standards that apply to open-end funds.¹²¹ This requirement would ensure that a company could make the maximum permitted repurchase offer without running afoul of the requirements of section 18.

B. Limited Redemption Investment Companies

The Division also recommends that the Commission adopt rules providing carefully circumscribed exemptions from the requirement in section 22(e) that open-end companies pay redemption proceeds within seven days. To satisfy this requirement, open-end companies generally must maintain a relatively high degree of portfolio liquidity in order to pay redemption proceeds within seven days.¹²² Thus, investment companies purchasing less liquid securities, notably companies investing in foreign securities, generally register as closed-end companies despite the perceived disadvantages of the closed-end form. Pursuant to the Commission's exemptive authority under section 6(c) of the Act,¹²³ the recommended rule would enable companies issuing *redeemable* securities and investing in securities with limited liquidity to operate within the open-end form with more limited redemption requirements than those traditionally applicable to mutual funds. Hence, we would use the term "limited redemption investment company" to refer to open-end companies that would operate under the rules that we recommend.

We have identified two major forms that a limited redemption investment company could take. The first form, referred to as the "extended payment"

¹²¹Such an approach would follow the provisions of the exemptive order in Wisconsin Investment Company, 10 S.E.C. 555 (1941), in which the Commission permitted a closed-end company, which continuously offered its shares, to make periodic repurchases without complying with the predecessor of rule 23c-1, provided the company complied with provisions of the Act that are applicable only to open-end companies.

¹²²The Commission has stated that open-end investment companies may hold no more than 15% of their assets in illiquid assets. See Guide 4 to Form N-1A, *supra* note 34.

¹²³15 U.S.C. § 80a-6(c). The Commission has previously granted exemptions from section 22(e) to permit issuers investing in less liquid securities to pay redemption proceeds on an intermittent basis or in longer than seven days. See, e.g., American Federation of Labor and Congress of Industrial Organizations Mortgage Investment Trust, Investment Company Act Release Nos. 10650 (Mar. 30, 1979) (Notice of Application), 44 FR 21094, and 10674 (Apr. 26, 1979) (Order) (redemptions only during period preceding quarterly valuation dates of commingled trust fund investing in loans to union built housing); Mutual Investment Fund of Connecticut, Inc., Investment Company Act Release Nos. 2457 (Dec. 12, 1956) (Notice of Application), and 2465 (Dec. 31, 1956) (Order) (investment fund for Connecticut savings banks might limit redemptions on any one day, and by-laws provided for seven business days to pay redemptions); Savings Bank Investment Fund, 24 S.E.C. 531 (1946) (Order) (mutual investment fund for Massachusetts savings banks invested in mortgages and other assets and might take ten days to pay redemption requests).

company, would offer to redeem its shares every day subject to a rolling payout period of, for example, thirty days that would begin to run for each shareholder on the day the shareholder presents shares for payment. Otherwise, the extended payment company would operate like a traditional open-end company. Extended payment companies would accept shares for redemption daily, would be subject to daily pricing requirements, and most likely would offer and sell securities continuously, just like open-end companies.

The second form of limited redemption company, referred to as the "interval" company, would redeem shares periodically at set intervals, such as monthly or quarterly. In order for interval companies to be able to manage their portfolios and have cash available to meet redemptions, the Division recommends that they be permitted to require shareholders to give a reasonable amount of advance notice before redeeming. Interval companies have the potential to be more complex. Because they would redeem only periodically, some interval companies may wish to adopt procedures for selling new shares other than daily.

Beyond those general points, the Division has not set forth in detail all of the requirements of a rule permitting limited redemptions. There are no operating models upon which to base assumptions as to what kinds of portfolios sponsors would wish to offer and what kinds of modified redemption features investors would want or accept. Accordingly, many of the specifics must be worked out through the rulemaking process. The following discussion addresses several of the chief considerations regarding the operation of both types of limited redemption companies to be addressed during the rulemaking process.

1. Pricing of Shares for Redemption

For both extended payment and interval companies, the time between the date of tender and the date of payment would extend beyond the seven day maximum for traditional mutual funds. This extended period raises several concerns in determining the appropriate time to calculate redemption prices for these companies. Even with mutual funds, the value of a fund's assets can fluctuate between the time a shareholder places a redemption order and the time net asset value is determined, as well as over the seven days between the day the order is given and the date by which the fund must make payment. Thus, shareholders may be priced out of the fund based on asset values that decline significantly before redemption proceeds are actually paid or before portfolio securities are actually sold. Excluding periods of market volatility, however, the amount of fluctuation generally is small so that market changes cause minimal change in either the net asset value paid for redeeming shares, or the net asset value of remaining shares. With a longer period of, for example, fourteen or thirty days, the range of possible fluctuation is much greater.

Like closed-end company repurchase offers, limited redemptions raise several concerns in deciding whether pricing should be calculated closer to the date of tender or to the date of payment. The most equitable method of pricing may depend, in part, upon the liquidity and composition of the portfolio. For example, thirty day "rolling" redemptions (of the extended payment type) would be most feasible in cases where the company's portfolio contains securities that are traded in formal marketplaces, such as overseas exchanges. While such a company would need a longer payout period to accommodate overseas settlement and currency exchange procedures, the company would be reasonably assured of obtaining accurate prices daily. Thus, an extended payment company might be able to price redemptions near the time of tender.¹²⁴

Redemptions at periodic intervals, however, may be preferred where the company's portfolio securities are thinly traded and valuations based on actual market transactions are not available. Limiting redemptions to set periods, with advance notice of redemptions from shareholders, may be needed for the manager to plan for redemptions and, at the same time, manage the portfolio with the least disruption. Because portfolio transactions would be more concentrated around specific redemption periods, and because pricing would be less reliable, it may be more equitable for the company to price redemptions close to the payment of proceeds.¹²⁵

Thus, different portfolios may be able to price redemptions fairly and accurately according to different procedures. In the rulemaking process, the proposing release should seek information regarding the portfolio management practices of companies that invest in less liquid securities. The Division also recommends that the Commission request comment regarding the level of liquidity necessary to deal effectively with limited redemption procedures. Finally, the Commission should request comment regarding the most equitable way to price redemptions.

¹²⁴To the extent, however, that a company with substantial foreign investments relied upon receipt of proceeds from selling securities abroad, the precise amount of those proceeds may vary with currency exchange rate fluctuations. In such circumstances, pricing near the time of tender might not provide the most equitable treatment.

¹²⁵*Cf.* Memorandum accompanying Letter from the Investment Company Institute to Jonathan G. Katz, Secretary, SEC 3-4 (Aug. 8, 1991, File No. S7-11-90 [hereinafter ICI Aug. 8, 1991 Study Comment]) (discussing different options for periodic redemption procedures). The ICI argued that the timing of pricing should be left to the business judgment of fund management. At least initially, we question whether this deference would provide adequate investor protection.

2. Interval Company Notice of Redemption

As noted above, an interval company would redeem shares periodically on set dates, such as monthly or quarterly. While the length of the interval would be determined by the company, the Division believes that it should be an easily recognizable period and, at least at the outset, one of a limited choice of intervals (e.g., biweekly, monthly, or quarterly, not every twenty-three days). The Division recommends that interval companies be permitted to require redeeming shareholders to provide notice in advance of the specified redemption date. Advance notice would enable managers to adjust their portfolios to accommodate redemptions.

We expect that the period between shareholder notice and redemption payment might vary depending on the length of the interval. Companies with different portfolio composition may require different notice periods. For example, the less liquid the company's portfolio, the more notice the manager likely would need. We anticipate that at most thirty days' notice would be sufficient for most interval companies. Longer periods in all likelihood would be undesirable from the investor's standpoint. The longer payout period allowed for interval companies would be in lieu of, and not tacked onto, the seven-day period required by section 22(e).

This requirement would depart significantly from the current practice of open-end companies. Because shareholders would have to be aware of the company's redemption dates and notice procedures, the rule should require the company to establish and disclose the notice period and the terms and conditions surrounding notice as matters of fundamental policy.¹²⁶

3. Pricing Procedures for Issuing Shares

The Division anticipates that limited redemption companies generally would offer new shares continuously, much like traditional open-end companies, and recommends that such companies should be required to price their shares daily under rule 22c-1 to the extent feasible.¹²⁷ The task of pricing less liquid portfolio securities, however, may be so time-consuming and expensive that daily pricing may not be feasible for some companies wishing to use the interval form. Industry representatives have advised us that some companies may prefer to

¹²⁶See *supra* note 92 (regarding treatment of closed-end procedures as matters of fundamental policy).

¹²⁷The Act itself does not require daily pricing. The Commission instituted the daily pricing requirement pursuant to its authority in section 22(c) to make rules concerning the pricing of redeemable securities. Closed-end companies are required only to compute prices quarterly for reporting purposes, although many voluntarily price weekly for publication in the trade press.

forego offering new shares continuously to avoid the burden of daily pricing.¹²⁸ Thus, some limited redemption companies, especially interval companies, may prefer to determine the prices of shares, and issue new shares, less frequently than daily. Accordingly, the Commission may need to modify rule 22c-1 or adopt new procedures specifically governing the pricing of sales of shares of limited redemption companies.

Some interval companies might wish to limit their sales to specific days or periods.¹²⁹ For example, some companies might wish to offer continuously, but to issue new shares at set "closings" that are scheduled weekly, monthly, or according to some recognizable interval. This option would be similar to a practice engaged in by certain closed-end companies.¹³⁰ Other companies might prefer to offer and sell new shares only during certain periods. This option would allow interval companies to coordinate redemption and offering periods, and thus to offset shrinking assets with cash from sales of new shares. For example, an interval company might offer new shares only during the period from the deadline for redemption requests until the date redemption proceeds are paid. Still other companies might prefer to arrange their offering periods to coincide with times when the companies expect that attractive investment opportunities might be available.

Such limitations raise significant questions about the extent to which Commission rules governing limited redemption pricing should prescribe clear limitations or grant issuers operational flexibility. The first question is the minimum frequency of pricing. To ensure fairness to shareholders and to provide

¹²⁸See ICI Aug. 8, 1991 Study Comment, *supra* note 125. Rule 22c-1(b) requires issuers of redeemable securities to calculate net asset value daily (excluding weekends and holidays) except on (i) days on which changes in the value of the investment company's portfolio securities will not materially affect the current net asset value of the investment company's redeemable securities; or (ii) days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company. Interval companies may be able to use the second exception.

¹²⁹Nothing in the Investment Company Act would require an interval company, as an issuer of redeemable securities, to engage in continuous offerings. Open-end companies have stopped offering new shares in certain circumstances, such as when their assets are so large that it is difficult to maintain investment returns or find investments that are consistent with investment objectives.

¹³⁰Certain registered closed-end limited partnerships have combined continuous offerings and multiple closings to offer participations in portfolios composed of securities issued in conjunction with the so-called "mezzanine financing" of leveraged acquisitions and similar transactions. These offerings were registered on Form N-2, in compliance with rule 415 under the Securities Act. Because interval companies would be regulated as open-end companies, and since rule 415 does not apply to open-end funds, compliance with rule 415 would not be necessary.

reliable information in connection with any secondary market that may develop,¹³¹ however, the Division recommends that companies be required to calculate the price of their shares according to some minimum schedule -- if not daily, then perhaps at least weekly -- whether or not they are currently selling new shares. The reasonableness of such requirements would be explored during the rulemaking process. In addition, interval companies whose shares are traded in secondary markets may be required to recalculate the price of their shares if there is reason to believe that net asset value has changed materially.

Another question is when new shares would be priced vis-à-vis redemptions. With open-end companies, both redemptions and sales are priced daily and, thus, incoming and outgoing shareholders receive the same price. In a "multiple closing" situation, however, a company may wish, for example, to price sales every Friday and redemptions on the last day of each quarter (a redemption date) whether or not it falls on a Friday. In the case of a company selling new shares only during redemption payout periods, depending on when the company prices redemptions, investors coming into the company may or may not receive the same price as investors exiting the company.³² In the latter case, at least, it may be fair to require that the same price apply to both incoming and outgoing investors, and hence that purchases of shares and redemptions take place only on the designated redemption date. In addition, the Division believes that, to avoid serious investor confusion, selling and redemption periods should be arranged according to easily recognizable schedules.

Finally, another question is whether the Commission should require companies to establish an appropriate mechanism for handling orders for new shares between sale dates. Escrow accounts or temporary investment in affiliated money market funds may provide such a mechanism. The rulemaking process should provide a clearer picture of how these mechanisms might work and of whether such mechanisms would increase administrative costs, and hence shareholder expenses. In addition, escrow accounts or temporary investments may also raise questions about investor's legal relationship with the company and rights in the company's securities.

¹³¹In Chapter 8, we recommend the repeal of the retail price maintenance provision of section 22(d) of the Act, 15 U.S.C. § 80a-22(d); that repeal would permit the development of secondary markets in open-end company shares. Pending legislative action, however, the Division recommends that the rule proposal for limited redemption companies address whether to exempt some or all limited redemption companies from section 22(d).

¹³²The Investment Company Institute suggested that companies that do not price on a daily basis should effect purchases only upon the designated redemption dates in order to give the same price for both purchases and redemptions; the ICI stated its impression that this is the practice of many illiquid private funds and bank collective funds. ICI Aug. 8, 1991 Study Comment, *supra* note 125, at 4.