4. Regulation As Open-End Companies

Both extended payment and interval companies would be regulated as open-end companies. As such, these companies would be subject to the open-end leverage restrictions of section 18. They would be permitted to impose asset-based distribution fees as provided under rule 12b-1 under the Act.[133] In addition, we anticipate that all limited redemption companies would register their shares on Form N1-A and, in doing so, would be able to use the provisions of sections 24(e) and 24(f) of the Act and the rules thereunder.[134]

To prevent investor confusion between such limited redemption companies and traditional open-end companies, limited redemption companies should be prohibited from calling themselves "mutual funds."[135] To further ensure that investors would not mistake the new companies for traditional mutual funds, the redemption and offering features of each company should be prominently disclosed. Extended payment companies pose the greatest risk that investors would confuse them with traditional open-end companies; the major difference between them would be the time in which the company is required to pay redemption proceeds. It is critical that investors understand this difference before they invest. The Division believes, however, that investors are capable of understanding the consequences of investing in an extended payment company and that, with appropriate disclosure requirements, investors quickly would learn to consider the length of a company's redemption period in deciding whether to invest. Interval company prospectuses should disclose the redemption procedures prominently because they too would be a significant departure from the practices of open-end funds.

5. Market Disruption

Interval companies could affect the markets adversely for certain portfolio securities by clustering portfolio transactions around specific redemption dates. For example, the market prices of portfolio securities could become artificially depressed in anticipation of heavy sales by the interval company, or the sales themselves could depress market prices, so that net asset value would be reduced,

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[133] 17 C.F.R. § 270.12b-1.

[134] 15 U.S.C. § 80a-24(e), (f).

[135] The term "mutual fund" historically has applied only to open-end management investment companies. *See* SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 2337, 89th Cong., 2d. Sess. 43 n.69 (1966). We believe that the investing public generally is unfamiliar with the term "open-end company" but has come to use the term "mutual fund" to refer to open-end companies as those companies have operated traditionally. Our proposal would preserve that usage.

and other investors in the same securities also would experience depressed asset values. Establishing appropriate liquidity standards may assist in preventing these market disruptions. In addition, it is possible to reduce the potential for clustering of portfolio transactions if the rule does not mandate that all companies redeeming at given intervals select the same payment dates; for example, if some companies that redeem monthly may do so on the first, while others may redeem on the fifteenth, transactions are more likely to be dispersed.

C. Portfolio Liquidity

The Division's recommendations raise a number of questions about the appropriate degrees of liquidity for different categories of investment companies. The importance of portfolio liquidity cannot be overstated for any investment company that redeems or periodically repurchases its shares. Recent experiences with open-end real estate unit trusts in Australia reaffirm the tremendous risks inherent with open-end issuers that do not hold sufficient liquid assets; several of those trusts collapsed following massive shareholder redemptions that exhausted any buffer of liquid investments that the trusts had maintained.[136]

1. Current Liquidity Requirements

Currently, the Commission's only liquidity standard is that an open-end company's aggregate holdings of illiquid assets must be limited to fifteen percent of the value of the fund's net assets.[137] The Commission has stated and reiterated that an "illiquid security" generally is any security that cannot be disposed of within seven days in the ordinary course of business at approximately

[136] In the mid-1980'~Australian open-end investment trusts investing in real estate related assets attracted significant investment. Following an economic slowdown in 1989, problems developed in the Australian real estate markets, including bankruptcies of developers, and declines in property values and rental income. The Estate Mortgage group of real estate trusts faced significant redemptions during this period; because the bulk of the trusts' investments were in real estate development and construction lending, the trusts did not have sufficient liquidity to meet the run of redemption demands. In April, 1990, regulators permitted the trusts to suspend redemptions. Subsequently, the Australian National Companies and Securities Commission (now the Australian Securities Commission) promulgated guidelines imposing liquidity standards on open-end trusts. Alan Cameron & Jennifer Puhach, *Unlisted Property Trusts Down Under*, INT'L FUND FORUM (Jan. 1991) (enclosure in letter from Allan S. Mostoff to Matthew A. Chambers, Assistant Director, Division of Investment Management, SEC (Feb. 20, 1991), File NO. S7-11-90).

[137] *See* Guide 4 to Form N-1A, *supra* note 34.

the amount at which the company has valued the instrument (the "seven day standard").[138]

No comparable liquidity standard has developed for closed-end companies. Because they do not issue redeemable shares, they have not needed the same capacity to raise cash promptly. Moreover, many closed-end companies serve as a vehicle for investing in less than fully liquid securities. At the same time, however, managers of other closed-end companies have kept their portfolios highly liquid in order to be able to take advantage of investment opportunities that may arise.

2. Proposed Statutory Liquidity Requirement

The purpose of the liquidity standard for open-end funds has been to ensure that such funds have capacity to meet redemptions pursuant to the requirement in section 22 that repurchase payment be made to shareholders within seven days following tender for redemption.[139] The Division believes that, as a general matter, any investment company that holds itself out as ready to redeem or repurchase its shares on a periodic basis should be required to have sufficient liquidity to meet those demands without causing material deviations from the valuation of its portfolio assets.[140] Accordingly, the Division recommends that express liquidity standards be established for all management investment companies that redeem or periodically repurchase their shares. Specifically, the Division recommends that the Commission seek legislation to amend section 12 of the Investment Company Act to impose an express liquidity requirement on open-end companies and on those closed-end companies that

[138]Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983, section II.A.4 (Mar 12, 1986), 51 FR 9773 (adopting amendments to rule 2a-7); Sec. Act Rel. 6862, *supra* note 34, at II.F, 55 FR at 17940. See also guides 12 and 13 of the guidelines to Form N-1A stating the view that "real estate for which there is no established market" and "debt securities for which there is not established market" should be included in the limit on illiquid assets; and Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 FR 12790 (guidelines for the preparation of Form N-8B-1, a predecessor to Form N-1A), counting restricted securities, interests in real estate, and commodities futures contracts toward the limit on illiquid investments.

[139]Inv. Co. Act Rel. 5847, supra note 34.

[140]Thus, appropriate liquidity standards should address the same concerns as the portfolio liquidity requirements in the rule lob-6 exemption for Merrill Lynch High Income Municipal Bond Fund, Inc., *supra* notes 110 and 116.

periodically repurchase their shares.[141] The appendix to this chapter contains the Division's proposed new paragraph to be added to section 12 of the Act.

As the proposed new paragraph indicates, however, the Division believes that the Act should not set specific requirements for each category of investment company. Specific requirements would run the risk of quickly becoming obsolete because of market changes. Rather, the Division believes that the statute should contain a general, self-effecting requirement that investment company portfolios have sufficient liquidity to meet any redemption or repurchase obligations. In addition, it should give the Commission authority to set specific liquidity requirements for different types of investment companies, including traditional open-end funds, limited redemption companies, and closed-end companies making periodic repurchases. While the final details of those requirements would emerge in the rulemaking process, the Division anticipates that the following issues would need to be addressed.

a. Definition of Liquidity

The current definition of portfolio liquidity applicable to open-end investment companies is a simple standard: a security either is liquid or is not, depending on whether it can be sold within seven days. The proposals outlined above, however, envision other categories of investment companies that would respond to shareholder tenders of shares on a less prompt and continuous basis than do mutual funds. Those other investment companies might need to satisfy different standards depending upon the degree of redeemability or repurchasability. For example, a different degree of liquidity may be necessary for a compan that redeems in seven days than for a company that redeems in thirty days.14Y

Rulemaking also might consider what weight to give to factors that traditionally have been viewed as indicating illiquidity. For example, restricted securities have generally been viewed as illiquid regardless of convertibility or

[141] Such requirements arguably could be promulgated by rule through amendments to rule 22c-1, through any rulemaking defining the circumstances in which closed-end companies may make periodic repurchases, and through any rulemaking permitting limited redemptions. Nevertheless, we recommend that the Commission propose a statutory liquidity requirement in order to make clear the fundamental importance of the appropriate degree of liquidity in investment company portfolios. Pending the adoption of a statutory provision, however, it might be appropriate to include liquidity provisions in the recommended rules for limited redemptions and periodic closed-end repurchases.

[142] This would be analogous to the approach recently taken by the Australian National Companies and Securities Commission, which promulgated special guidelines for unit trusts in August, 1990; under those guidelines, the required level of liquidity decreased as the redemption period increased. See Cameron & Puhach, *supra* note 136.

fungibility with other securities. Such securities in fact may have varying degrees of liquidity, although they are not as liquid as, for example, New York Stock Exchange listed stocks. Conversely, even within the current category of liquid securities, some securities are more liquid than others. For example, securities of issuers with very large market capitalizations and securities that are designated components of an index such as the S&P 500 can be traded in very large blocks with minimal price effect; cash and cash equivalents have the highest liquidity of any assets.

b. Valuation

Another issue to be explored is whether the definitions of liquidity should also incorporate some degree of reliability of valuation. The current seven day standard implicitly requires reliable valuation since it requires that a security be sellable within seven days at approximately the amount at which a company has valued the security. It is not clear whether some liquidity standards should permit an intermediate degree of reliability, as would occur if a security's valuation were susceptible upon disposition to some deviation from the value currently assigned by the company to the security. It might be difficult to construct a definition of such permissible deviation since it could be expected to fluctuate depending on market conditions.[143]

D. Definition of Redeemable Security

The proposed new redemption and repurchase procedures raise interpretive questions concerning the definition of "redeemable security" in section 2(a)(32) of the Act. The definition is key to the distinction between open-end and closed-end companies because, under section 5, any management company that issues redeemable securities is an open-end company; conversely, a closed-end company may not issue redeemable securities. The first question is whether limited redemption rights, and in particular periodic redemptions, would be inconsistent with that definition. The second question is whether closed-end companies would issue redeemable securities if they offer to repurchase shares from investors at net asset value according to a set schedule; if so, then the company could not be a closed-end company. Although the recommended repurchase and redemption procedures depart from practices that traditionally have characterized the two categories of management companies, the Division believes that, under the procedures outlined above, the shares of limited

[143] **Indeed, in some cases, the extent to which investment companies participate in certain markets can have a significant impact on the liquidity and pricing of the markets. This appears to have been the case in the last few years in the market for junk bonds, where recent new issuances and price increases have been attributed by some analysts to extensive purchases by** mutual **funds.** *See also* **George Anders,** *Junk Bond Issuance Soar to Hottest Pace Since '88*, WALL ST. J., **Dec. 2, 1991, at C1.**

redemption companies would be redeemable securities, while the shares of closed-end companies making periodic repurchase offers would not.

1. Limited Redemption Rights

Section 2(a)(32) defines a redeemable security as

> any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

Interpretive questions about what is a redeemable security have arisen primarily in the context of section 3(c)(5) of the Act,[144] which excepts certain companies from the definition of investment company provided, in part, that they do *not* issue redeemable securities. The chief characteristic that distinguishes a redeemable security is whether the security is redeemable at the option of the holder, rather than of the issuer. This is the direct implication of the statutory wording: the holder of a redeemable security is *entitled* to receive redemption proceeds *upon presentation* to the issuer. This distinction is also clear from the legislative history of section 3(c)(5), which was amended in 1970 to include the prohibition on issuing redeemable securities:

> Thus, the proposed amendment would in no way affect companies which issue securities redeemable at the option of the issuer -- the conventional form of redeemable security commonly used in corporate financing. The amendment applies only to those companies which purport to model themselves after open end companies by issuing a security redeemable at the option of the holder.[145]

No-action letters have been issued to companies that voluntarily make a practice of redeeming securities, but do not give the holder an unqualified right to compel the company to redeem, on the basis that the companies had not issued

[144] 15 U.S.C. § 80a-3(c)(5). **Issuers relying on section** 3(c)(5) also **cannot issue face-amount certificates or periodic payment plan certificates and must be primarily engaged in certain specified types of businesses.**

[145] INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 184, 91st Cong., 1st Sess. 37 (1969); INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. NO. 1382, 91st Cong., 2d *Sess.* 17 (1970).

redeemable securities and, thus, were eligible for the section 3(c)(5) exception.[146] No-action relief has been declined for a section 3(c)(5) company that proposed to give investors the right to have their shares redeemed ninety days after presentment on the theory that a security which is redeemable in accordance with its terms is a redeemable security even though it is only redeemable four times per year.[147]

The only question that arguably may remain is whether the definition requires a redeemable security to be redeemable at any time, *i.e.*, essentially upon demand. Such an interpretation would be inconsistent with redemptions at intervals. The language of section 2(a)(32) does not expressly require constant redeemability, but it might be possible to infer such a requirement if the phrase "upon its presentation to the issuer" were interpreted to mean "at any time that a holder tenders securities to the issuer." This reading arguably finds support in the testimony of former Commissioner Healy in describing to Congress in 1940 the differences between open-end and closed-end companies.[148] Section 2(a)(32), however, does not expressly require redemption requests to be honored *at any time*. Instead, any obligation to redeem on demand appears to arise under section 22(e) (concerning payment of redemption proceeds within seven days),[149] not under section 2(a)(32). To the extent that redemption at intervals

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[146]*See, e.g.*, United Bankers, Inc. (pub. avail. Mar. 23, 1988); MBCH, Inc. (pub. avail. Dec. 16, 1981); Salomon Brothers, Inc. (pub. avail. June 17,1985); Arthur D. Little, Inc. (pub. avail. Dec. 16, 1971).

[147]Huntoon, Paige & Co., Inc. (pub. avail. Nov. 28,1974). In addition, no-action letters under section 3(c)(5) have considered a number of other restrictions relating to the redeemability of securities; the specific details of the no-action requests have varied considerably.

[148]Healy remarked

> The peculiarity of open-end companies is that they issue so-called redeemable securities -- that is, [a] security which provides that the holder may tender it to the company *at any time* and receive a sum of money roughly proportionate to the current market value of his share of the company assets.

1940 Senate Hearings, supra note 27, at 43 (emphasis supplied). Commissioner Healy's use of the phrase at *any time* arguably could imply that the holder of a redeemable security is entitled to receive redemption proceeds whenever the holder wishes, and that the company is not able to limit in any way that right. Nevertheless, Commissioner Healy's statements during the Senate hearings describing prior practices clearly do not constitute a definitive gloss on the subsequently enacted definition; for example, his description contemplates redemption only in cash, whereas section 2(a)(32) permits redemption either in cash or in kind, through the distribution of portfolio securities.

[149]Section 22(e) provides that "[n]o registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable (continued...)

might be considered a departure from the redemption rights that shareholders traditionally have had in open-end companies to redeem shares promptly on demand,[150] the Commission could always use its authority to promulgate rules clarifying the status under section 2(a)(32) of limited redemption companies, as well as the status of closed-end companies making periodic repurchase offers.

The Division recognizes that it would be untenable to suggest that a security which is redeemable at the option of the holder in accordance with its terms is a redeemable security no matter what those terms are; such a position would give open-end companies *carte blanche* to impose all kinds of restrictions on redemption rights. For example, at some point, the interval between redemptions could become so long that the company should not be regarded as an issuer of redeemable securities. We have concluded, however, that redemption rights that are limited solely with respect to the times during which presentation will be accepted by the company, or the length of the delay before proceeds are received, do not offend the statutory scheme as long as the parameters of such rights are tightly controlled by rule to prevent possible harm to investors and to assure some degree of *real* redeemability. For this reason, the rule should require that an interval company redeem shares at one of several intervals specified by the rule, but no less frequently than quarterly. Companies wishing to provide liquidity to shareholders at longer intervals should not be able to operate as limited redemption companies but might be organized as closed-end companies using the repurchase rule.

2. Periodic Repurchases of Closed-End Shares

Conversely, the Division believes that repurchases of securities by closed-end companies under the circumstances proposed would not render the securities redeemable within the meaning of section 2(a)(32). There is a critical difference between companies offering limited redemptions and companies committing to repurchase their shares. The former company's securities are redeemable because the redemptions are at the option of the security holder. The latter does not issue redeemable securities because the holder is not entitled upon presentation to the company to receive approximately his or her proportionate share of the company's net assets as required by section 2(a)(32). Rather, significant restrictions on the repurchases would apply, and control over most aspects of the

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[149](...continued)
security in accordance with its terms for more than seven days" except under specified circumstances.

[150]*See* **United States v. National Ass'n of Sec. Dealers, 422 U.S. 694,698 (1975) (under sections 2(a)(32) and 22(e), open-end companies are required to redeem securities on demand); United States v. Cartwright, 411 U.S. 546, 547 (1973) (section 22(e) requires open-end companies to be prepared to redeem their outstanding shares at any time).**

repurchase process would remain with the company.[151] While the repurchases would be conducted at net asset value pursuant to modified tender offer procedures, and the company would be subject to liquidity standards, there also is a real possibility that the company may not purchase all of the shares tendered at any particular time. In particular, the rule would require a company to establish a fundamental policy specifying the maximum amount that the company could repurchase in any repurchase offer; and at the time of each offer, the company could establish a lower maximum for that offer. If more shares were tendered than the company had offered to repurchase, the company would have only limited capacity to increase the offer. Moreover, the rule should restrict the permissible levels of repurchase offers so that a company could not guarantee to repurchase all shares tendered; for example, a company could not set a policy of offering to repurchase all of its outstanding shares. As a result, the primary characteristic of a redeemable security -- the entitlement it provides the holder -- would not be present. This conclusion is consistent with previous interpretations of the Act stating that a closed-end company does not issue a redeemable security if the company decides whether or not to accept the shares tendered.[152] This conclusion is also consistent with the no-action positions holding that companies do not issue redeemable securities if they do not give holders an unqualified right to compel redemption.[153]

IV. Conclusion

The Division recommends that the Commission adopt an exemptive rule under section 23 of the Investment Company Act defining the circumstances under which closed-end companies may make periodic repurchase offers, and a rule under section 22(e) permitting open-end companies to make redemptions on a periodic basis or with an extended period of payment. In conjunction with those proposals, the Division also recommends the amendment of the Act to add an express requirement of portfolio liquidity for all open-end companies and all closed-end companies making periodic repurchases.

[151] *Cf.* **Dimensional Fund Advisors, Inc.,** *supra* **note 73 (rejecting the argument that nominal limitations on redeemability made securities non-redeemable).**

[152] *See* **id. Conversely, securities are redeemable if the issuer or its board has limited ability to defer redemption payments under unusual circumstances, such as the exceptions specified in section 22(e).** See *also* **Savings Bank Investment Fund, 24 S.E.C. at 539-40 (securities were redeemable securities under the Act even though executive committee was authorized to defer payment of redemptions under extraordinary circumstances).**

[153] *See supra* **note 146.**

APPENDIX 11-A

Red-Lined Version of Proposed Amendment to the Investment Company Act of 1940

(new language is shaded)

Section 12 [15 U.S.C. § 80a-12].

* * *

(_). It shall be unlawful for any registered management investment company to purchase or otherwise acquire any illiquid asset if, as a result of such purchase or acquisition, the assets of such company would be sufficiently illiquid as to impair the company's capacity (A) to make payment to shareholders upon tender within the period of time within which the company is required to make payment upon tender for redemption pursuant to section 22 of this title, or upon tender for repurchase pursuant to section 23 of this title, or (B) to determine accurately the value of its assets. For purposes of this paragraph, "illiquid asset" includes (A) any asset that an investment company reasonably cannot expect to sell (i) at approximately the amount at which the company would value the asset, and (ii) in the ordinary course of business within the period of time within which the company is required to make payment upon redemption pursuant to section 22 of this title, or upon repurchase pursuant to section 23 of this title; and (B) such other asset or class or classes of assets as the Commission may, by rule or regulation or order, define as illiquid. The Commission may, for the purposes of this paragraph __, by rules and regulations define and prescribe requirements reasonably designed to ensure that a registered company's assets are liquid to the extent necessary or appropriate in the public interest or for the protection of investors.