Statutory and Regulatory Requirements for a Closed-End Registered Investment Company

Generally, an investment company is a company that is primarily engaged in the business of investing in securities. An investment company invests the money it receives from investors on a collective basis, and each investor shares in the profits and losses in proportion to the investor's interest in the investment company. The performance of the investment company will be based on the performance of the securities and other assets that the investment company owns. An investment fund may be required to register with the Securities and Exchange Commission ("**SEC**") as a registered investment company ("**RIC**") under the Investment Company Act of 1940, as amended (the "**1940 Act**").

Internal v. External Management. An RIC may be internally or externally managed. Generally, an internally managed RIC must develop the infrastructure and hire employees or establish a subsidiary to manage the RIC and must address issues related to having custody of the portfolio assets. In contrast, an externally managed RIC contracts with a third party to provide investment advisory services. An external investment adviser already has the infrastructure, staff and expertise to satisfy the regulatory requirements applicable to RICs, including issues relating to custody of assets. Certain inherent conflicts of interest may exist regarding an adviser's allocation of investment opportunities between the RIC and the adviser's other clients. External investment advisers to RICs must be registered with the SEC.

Diversified v. Non-Diversified. As defined in Section 5(b) of the 1940 Act, a "diversified company" has at least 75% of its total assets in: (i) cash and cash items; (ii) government securities; (iii) securities of other investment companies; and (iv) other securities, which are limited with respect to any single issuer to 5% of the RIC's total assets and 10% of the voting securities of such issuer. A closed-end RIC is typically designated as a "non-diversified" investment company.

Open-End v. Closed-End. As defined in Section 5(a) of the 1940 Act, "open-end companies" (e.g., mutual funds) have securities that are redeemable.[1] In contrast, a closed-end RIC generally has no statutory obligation to redeem any shares (unless it adopts a fundamental policy requiring repurchases at periodic intervals). Closed-end funds generally have the following characteristics:

- Historically, closed-end funds generally did not continuously offer their shares for sale. Rather, they sold a fixed number of shares at one time (in an IPO), after which the shares typically trade on a secondary market, such as the NYSE or NASDAQ. In recent years, a number of closed-end funds have been structured as non-traded interval funds conducting continuous offerings.
- The price of closed-end fund shares that trade on a secondary market is determined by the market and may be greater or less than the shares' net asset value ("**NAV**"). A non-traded closed-end fund's shares may be purchased in the fund's continuous offering at

[1] "Redeemable" essentially means that when investors want to sell their shares, they sell them back to the fund at NAV. Open-end funds generally must pay redemption proceeds to a shareholder within seven days of request. See Section 22(e) of the 1940 Act.

a price per share equal to NAV plus any applicable sales load, and the offering price is subject to increase or decrease based upon changes in NAV.

- Closed-end fund shares generally are not redeemable. That is, a closed-end fund is not required to buy its shares back from investors upon request. Some closed-end funds, commonly referred to as interval funds, offer to repurchase their shares at specified intervals. For example, an interval fund may adopt a “fundamental policy” to make quarterly repurchase offers, at NAV, of no less than 5% of the shares outstanding. This fundamental policy may only be changed by the affirmative vote of a “majority of the outstanding voting securities of the fund” (as defined in the 1940 Act and described below).[2]
- The investment portfolios of closed-end funds generally are externally managed by investment adviser entities that are registered with the SEC.
- Closed-end funds are generally permitted to invest in a greater amount of "illiquid" securities than are mutual funds (an "illiquid" security generally is considered to be a security that cannot be sold within seven days at the approximate price used by the fund in determining NAV). Because of this feature, funds that seek to invest in markets where the securities tend to be more illiquid are typically organized as closed-end funds.[3]

Disclosure Requirements. Closed-end RICs register with the SEC under Section 8 of the 1940 Act by filing a notification of registration on form N-8A and filing a registration statement on form N-2.[4] The registration statement must provide enough "essential information" about the RIC to allow investors to make informed decisions about whether to purchase the securities being offered. Generally, the registration statement must describe, among other things: (i) the terms of the offering, including the number of shares being offered, price, underwriting arrangements and compensation; (ii) the intended use of the proceeds; (iii) the investment objectives, policies and any restrictions; (iv) risk factors; and (v) the management of the investment company, including directors, officers and the investment adviser.

Independent Directors or Trustees. Independent director/trustee requirements are necessitated, in part, by the unique structure of investment companies. Unlike a typical corporation, an investment company usually has no employees of its own. Its officers are typically employed and compensated by its investment adviser, which provides most of the services to the investment company. Due to this unique structure, conflicts of interest can arise because the interests of the investment company do not always parallel the interests of the investment adviser. An investment adviser’s interest in maximizing its own profits for the benefit of its owners may conflict with its paramount duty to act in the best interests of the investment company and its shareholders. Independent directors/trustees play a critical role in policing the potential conflicts of interest between the investment company and its investment adviser and affiliates.[5]

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[2] See Rule 23c-3(b) of the 1940 Act.

[3] http://www.sec.gov/answers/mfclose.htm

[4] 17 C.F.R. § 239.14

[5] Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083, 64 Fed. Reg. 59877 (Nov. 3, 1999)

Under Section 10 of the 1940 Act, an RIC is required to have a board of directors/trustees with at least 40% of its members being independent, i.e., not "interested persons" as defined in Section 2(a)(19) of the 1940 Act. In addition, since July 2002, the SEC has required independent directors to make up a majority or in some instances a super-majority (i.e., 75% or two/thirds if there are only three members)[6] of the boards of RICs that utilize any of the following ten exemptions:

- Rule 10f-3, under which an investment company can acquire securities in a primary offering when the underwriting syndicate includes a broker-dealer affiliated with the investment company;
- Rule 12b-1, under which a registered open-end investment company can use its assets to pay the expenses of distributing the shares it issues;
- Rule 15a-4(b)(2), under which the board of an investment company can, without the approval of its shareholders, approve an interim contract with an investment adviser when a previous contract was terminated by an assignment by an investment adviser or a controlling person of the investment adviser who directly or indirectly receives money or other benefit;
- Rule 17a-7, under which securities transactions are allowed between an investment company and another client of the investment company's investment adviser;
- Rule 17a-8, under which mergers are permitted between certain affiliated investment companies;
- Rule 17d-1(d)(7), under which an investment company and its affiliates can purchase joint liability insurance policies;
- Rule 17e-1, under which an investment company may pay commissions to affiliated brokers in connection with the sale of securities on an exchange;
- Rule 17g-1(j), under which investment companies can maintain joint-insured fidelity bonds;
- Rule 18f-3, under which an investment company can issue multiple classes of voting stock; and
- Rule 23c-3, under with a registered closed-end investment company can offer to repurchase, at periodic intervals, shares it has issued to investors.

Additional statutory safeguards against potential conflicts of interest have been implemented for RICs. Various activities require not only the approval of a majority of the entire board of directors/trustees of an RIC, but also require the approval of a majority of the independent directors/trustees. In addition to approving the ten exemptions mentioned above, a majority of independent directors/trustees must:

- approve contracts with the investment adviser and principal underwriter;[7]
- approve the compliance policies and procedures (for securities laws) of the company and its investment adviser, principal underwriter, administrator and transfer agent;[8]

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[6] 17 C.F.R. §270.0–1(a)(7)

[7] Section 15(c)

[8] Rule 38a-1(a)(2)

- approve the codes of ethics of the company, the investment adviser and the principal underwriter;[9]
- approve the designation, compensation and removal of the chief compliance officer;[10]
- select the public accountant;[11]
- select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract;[12] and
- set the form and amount of the fidelity bond and determine if participation in joint insurance contracts is in the best interest of the company.[13]

Rule 31a-2(a)(4) requires every RIC to preserve for at least six years any record of the initial determination that a director is not an interested person of the RIC and each subsequent determination that the director is not an interested person of the RIC. These records must include any questionnaire and any other document used to make the determination. Similarly, Rule 31a-2(a)(5) requires the preservation for at least six years of any materials used by the disinterested directors to determine that a person who is acting as legal counsel to those directors is an "independent legal counsel" (as defined by 1940 Act rules and regulations).

Pyramiding Control Prohibitions. These prohibitions are intended to prevent abuses relating to pyramiding schemes in which individuals could use a relatively small amount of money to acquire control of a fund and use that fund's assets to acquire control of a second fund, which, in turn, could use that fund's assets to acquire control of a third fund, and so on. Generally, under Section 12(d)(1)(A) of the 1940 Act, an RIC cannot (i) own more than 3% of another investment company's voting stock; (ii) have more than 5% of its total assets in a single investment company's securities; or (iii) have more than 10% of its total assets in any number of investment companies' securities. Section 12(d) imposes additional restrictions on an RIC purchasing securities issued by an insurance company, broker, dealer or investment adviser.

Restrictions on Transactions with Affiliates.[14] Under Section 17(a) of the 1940 Act, affiliates, promoters, principal underwriters and any of their affiliates (i.e., affiliates of affiliates or second tier affiliates) are generally prohibited from selling to, purchasing from, borrowing from, or loaning to the RIC. Under Section 17(d) and (e), there are restrictions on such parties effecting joint transactions with the RIC and limits on commissions that affiliates may receive when acting as a broker in connection with sales to or by the RIC. Accordingly, as an RIC, the fund will generally be limited in its ability to invest in any portfolio company in which its investment adviser or any of its affiliates currently has an investment or to make any co-investments with the investment adviser or its affiliates without permission from the SEC. An investment adviser may

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[9] Rule 17j-1(c)(1)(ii)
[10] Rule 38a-1(a)(4)
[11] Section 32(a)
[12] Section 16(b)
[13] Rule 17g-1(d)-(e)
[14] "**Affiliated person**" is defined in section 2(a)(3) of the 1940 Act and essentially means (A) a 5% shareholder of such other person; (B) an entity 5% owned by such other person; (C) a person controlling, controlled by or under common control with such other person; (D) any director, officer, partner, copartner or employee of such other person; (E) the investment adviser or member of the advisory board of an investment company; and (F) the depositor of an unincorporated investment company not having a board of directors.

apply for an exemptive relief order from the SEC to permit co-investment by various affiliated funds, subject to certain conditions designed to ensure fairness.

Capital Structure and Asset Coverage (Leverage) Ratio. Generally, under Section 18(a) of the 1940 Act, a closed-end RIC may not issue senior securities (e.g., bonds or preferred stock) unless the RIC has an asset coverage ratio[15] of at least 300% (for senior debt securities) or 200% (for preferred stock) immediately after the issuance of the senior security. In other words, a RIC cannot use greater than 33 1/3% leverage (1:2 debt-to-equity ratio) or 50% (in the event leverage is obtained solely through preferred stock) of the RIC's total assets. In addition, holders of senior securities, if any, must be entitled to certain voting rights. Bondholders will be entitled to elect a majority of the board if the asset coverage ratio is below 100% for twelve consecutive months. Preferred stockholders will be entitled to elect at least two directors at all times and will be entitled to elect a majority of the board if dividends have been unpaid for two years (subject to the prior rights of any other senior security holders).

Restrictions on Discount Sales and Repurchases. Under Section 23 of the 1940 Act, a closed-end RIC generally cannot sell its common stock at a price below the current NAV of such stock (exclusive of any distributing commission or discount) except: (i) in an offering to holders of its capital stock; (ii) with the consent of a majority of common stockholders; (iii) upon conversion of a convertible security; (iv) upon the exercise of warrants; or (v) under such other circumstances as the SEC may permit. Under Rule 23c-3(b)(1), a closed-end RIC may make common stock repurchases only at the NAV determined on the repurchase pricing date (but the RIC may deduct a repurchase fee not to exceed 2% of the proceeds), and the RIC may not condition the entire repurchase offer upon the tender of any minimum amount of shares but may place conditions on individual tenders, for example requiring a shareholder tender at no less than a defined percentage of his or her shares.

Operational Considerations. An RIC must adhere to certain substantive regulatory requirements with respect to its operations, which are summarized below.

- Indemnification. An RIC is prohibited from protecting any director/trustee, officer, investment adviser or principal underwriter against any liability to the company or to its security holders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of such person's duties.

- Valuation of Assets. An RIC's board of directors/trustees is required to value portfolio assets on at least a quarterly basis in connection with filing certain periodic reports. Assets must be valued on the basis of market value if available. In the absence of a readily ascertainable market value for an asset, the board must in good faith determine the "fair value."

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[15] "**Asset coverage**" is defined in Section 18(h). For a class of senior debt securities (i.e., bonds, debentures, notes, and similar instruments), "asset coverage" means the ratio of total assets (less liabilities and debt not represented by senior securities) to the aggregate amount of senior debt securities. For preferred stock, "asset coverage" means the ratio of total assets (less liabilities and debt not represented by senior securities) to the aggregate amount of senior debt securities plus the aggregate of any involuntary liquidation preference of such class of preferred stock.

- Fiduciary Duties. Officers and directors/trustees of the RIC and the investment adviser are subject to general fiduciary duties with respect to the conduct of their duties. The RIC and the investment adviser must adopt a code of ethics and institute procedures reasonably necessary to ensure that employees and certain affiliates adhere to the code.

- Fidelity Bond. A RIC must provide and maintain a bond issued by a reputable fidelity insurance company to protect the RIC against larceny and embezzlement. The fidelity bond must cover each officer and employee with access to securities and funds of the RIC, with the required coverage tied to the amount of the RIC's assets.

- Investment Policies. The RIC is subject to certain investment restrictions stated above, and RICs commonly adopt fundamental policies consistent with these restrictions. The RIC may not alter these fundamental policies without the approval of a "majority of the outstanding voting securities," as defined in the 1940 Act (i.e., the lesser of: (i) two-thirds or more of the voting securities present at such meeting if the holders of more than 50% of the RIC's outstanding voting securities are present or represented by proxy; or (ii) 50% of the RIC's voting securities).

Tax Considerations. An investment company may elect to be treated for U.S. federal income tax purposes, and to qualify annually thereafter, as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986, as amended (the "**Code**"). As used hereinafter, "RIC" will refer to regulated investment company under the Code. As an RIC, the company generally will not have to pay corporate-level federal income taxes on net ordinary income or capital gains that are distributed to shareholders. Cash distributions by an RIC generally are taxable to U.S. investors as ordinary income or capital gains. To qualify and maintain qualification as an RIC for federal income tax purposes, the company must, among other things:

- Distribute to shareholders, for each taxable year, at least 90% of its ''investment company taxable income'' ("**ICTI**"), which is generally net ordinary income plus the excess, if any, of realized net short-term capital gain over realized net long-term capital loss (the "**Annual Distribution Requirement**");
- Be registered as a management investment company under the 1940 Act at all times during each taxable year;
- Derive in each taxable year at least 90% of gross income from: dividends, interest and payments with respect to certain securities, loans, gains from the sale of stock, securities or foreign currencies, net income derived from ''qualified publicly traded partnerships'' (as defined in the Code) or other income derived with respect to its business of investing in such stock or securities (the "**90% Income Test**"); and
- Diversify holdings (the "**Asset Diversification Test**") so that at the end of each quarter of the taxable year:
    - At least 50% of the value of its assets consist of cash, cash equivalents, U.S. government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of the value of the company's assets or more than 10% of the outstanding voting securities of any one

issuer (which for these purposes includes the equity securities of a ‘‘qualified publicly traded partnership’’); and

- Other than U.S. government securities or securities of other RICs, no more than 25% of the value of the company’s assets is invested in the securities of either: (i) a single issuer; (ii) two or more issuers controlled by the company and engaged in the same or similar or related trades or businesses; or (iii) one or more qualified publicly traded partnerships.

As an RIC, the company may still be subject to corporate-level federal income tax on undistributed taxable income (if any) and could be subject to federal excise, state, local and foreign taxes. The company will be subject to a 4% nondeductible federal excise tax on certain undistributed income as an RIC unless it distributes in a timely manner an amount at least equal to the sum of: (i) 98% of net ordinary income for the calendar year, (ii) 98.2% of net capital gains for the one-year period ending October 31 of that calendar year, and (iii) any net ordinary income and net capital gains recognized, but not distributed, in preceding years and on which the company paid no federal income tax. RICs typically make distributions sufficient to avoid imposition of the excise tax.

UBTI. Under current law, the RIC serves to "block" (that is, prevent the attribution to shareholders of) unrelated business taxable income ("**UBTI**") from being realized by certain tax-exempt shareholders (including, among others, IRAs, 401(k) accounts, Keogh plans, pension plans and certain charitable entities). Notwithstanding the foregoing, a tax-exempt shareholder could realize UBTI by virtue of its investment in shares of the RIC if the tax-exempt shareholder borrows to acquire its shares. A tax-exempt shareholder may also recognize UBTI if the RIC were to recognize "excess inclusion income" derived from direct or indirect investments in residual interests in real estate mortgage investment conduits or taxable mortgage pools. If a charitable remainder annuity trust or a charitable remainder unitrust (each as defined in Section 664 of the Code) has UBTI for a taxable year, a 100% excise tax on the UBTI is imposed on the trust. Such tax-exempt entities should look to their own tax advisors regarding the tax implications of an investment in an RIC.