

Investment Management Alert

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Proposed Legislation Seeks To Prevent Regulatory Limitations on Closed-End Fund Investments in Private Funds

The **Increasing Investor Opportunities Act (IIOA)**, introduced on November 19, 2020, by U.S. Representative Anthony Gonzalez (R-OH), aims to expand closed-end fund participation in private funds. The IIOA, among other things, would prohibit the Securities and Exchange Commission (SEC) from limiting a closed-end fund's¹ investment in private funds² "solely or primarily because of the private funds' status as private funds" and prohibit a national securities exchange from prohibiting the listing or trading of a closed-end fund's securities "solely or primarily by reason of the amount of the company's investment of assets in private funds." The IIOA, if enacted, is intended to give retail investors greater access to private fund investment opportunities while retaining the protections of the Investment Company Act of 1940 (1940 Act).

Under the current regulatory regime, most retail investors are prohibited from investing directly in private funds. Generally, an individual investor may currently invest in a private fund relying on Section 3(c)(1) of the 1940 Act (*i.e.*, the "100 investor" exemption) only if he or she is an accredited investor,³ and in a private fund relying on Section 3(c)(7) of the 1940 Act (*i.e.*, the "ultra-high-net-worth" exemption) only if he or she is an accredited investor and a qualified purchaser.⁴ Because reliance on Section 3(c)(1) limits the number of investors to 100, the vast majority of private funds require individual investors to be qualified purchasers. Publicly traded closed-end funds, however, are available to all investors and nothing in the 1940 Act explicitly prevents a closed-end fund from investing a significant portion or even all of its assets in private funds. Closed-end funds that invest in private funds therefore have the potential to provide retail investors with indirect exposure to the same private funds in which they cannot invest directly and the potential to diversify exposure among a variety of private funds.

The staff of the SEC Division of Investment Management has taken the view, albeit informally, that a closed-end fund may not invest more than 15% of its assets in private funds unless it limits the sale of its shares to accredited investors. Additionally, securities

¹ "Closed-end fund," as used herein, includes registered closed-end funds and closed-end investment companies that have elected to be regulated as business development companies (BDCs) under Section 54(a) of the 1940 Act.

² "Private fund," as used herein, means any fund relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

³ A natural person can generally qualify as an accredited investor if he or she has an individual net worth, or joint net worth with his or her spouse, of \$1 million (excluding his or her primary residence) or has individual income in excess of \$200,000 in each of the two most recent years or joint income with his or her spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

⁴ To be a qualified purchaser, a natural person must own \$5 million in investments.

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exchanges, at the direction of the staff of the SEC Division of Trading and Markets, have informally taken the view that a closed-end fund that invests any of its assets in private funds may not be listed for public trading. Moreover, various SEC staff positions lead the fund industry to generally take the view that a closed-end fund should not invest more than 40% of its assets in any one underlying private fund to avoid the possible conclusion that the closed-end fund was formed for the purpose of investing in the underlying private fund and therefore endangering that private fund's private offering exception.⁵ Accordingly, retail investors are effectively prevented from gaining any meaningful exposure to private funds indirectly, in addition to being subject to the prohibition on direct investment. The IIOA seeks to change this landscape by allowing retail investors to invest indirectly in private funds via an investment in a closed-end fund, thereby providing such investors with an opportunity to participate in the types of returns associated with private funds that have historically been reserved for select market participants.

Notably, however, the language of the IIOA would not categorically prevent the SEC or a national securities exchange from imposing any limits on closed-end fund investments in private funds. The IIOA states that the SEC or a national securities exchange may not prevent a closed-end fund from investing in private funds "solely" or "primarily" because they are private funds or prohibit the listing or trading of the closed-end fund's securities "solely" or "primarily" because of the amount of the company's investment of assets in private funds. Accordingly, the statutory language appears to give the SEC and national securities exchanges the option (although it would appear to run contrary to the overall spirit and intent of the IIOA) to implement rules that have the effect of limiting closed-end fund investments in private funds generally due to attributes that are not unique to private funds, or in certain types of private funds, for other policy reasons, including, but not limited to: investor protection, pyramiding concerns, excessive or duplicative fees, or valuation concerns.

Additionally, closed-end funds that offer periodic liquidity through tender offers and repurchases may be limited in their ability to invest in private funds due to their liquidity needs. The IIOA may pave the way for closed-end funds structured more

like private equity funds, with automatic self-liquidation by passing through all returns of capital from underlying private fund investments.

Also, important to note is that other market forces or structural features could impose limits on a closed-end fund's ability to invest in private funds. For example, significant investment in private funds could lead to valuation concerns for closed-end funds, similar to those that they currently experience with less liquid, restricted or illiquid investments. As a result, a publicly traded closed-end fund that invests heavily in private funds may trade at a wider discount to net asset value than a closed-end fund that invests primarily in securities for which market quotations are readily available. The resulting discount could put such funds at greater risk of being targeted by activist investors seeking to force a liquidity event for their own short-term gain and to the detriment of long-term retail investors. The IIOA seeks to mitigate some of this risk by requiring private funds to comply with the investment limitations and aggregation requirements of Section 12(d)(1)(C) of the 1940 Act, which would limit a group of related private funds with the same investment adviser to owning no more than 10% of a closed-end fund's outstanding voting securities.⁶

As mentioned in our companion alert, closed-end funds relying on the IIOA to make investments in private funds would still, however, be subject to the risk of undue influence by activist investors seeking liquidity events that would disrupt closed-end fund investments in private funds. Further action is needed to address these continuing risks if the IIOA is to achieve its goals. As noted in our [November 5, 2020, client alert](#) regarding the recent adoption of Rule 12d1-4 governing fund of funds arrangements, we believe that this problem may also be addressed through rulemaking under Section 17(d) of the 1940 Act.

Given that the legislative process is still in early stages, the ultimate nature and scope of closed-end funds' ability to invest in private funds if the IIOA is enacted is still unclear. Nevertheless, the IIOA, if enacted, would represent another important step in providing retail investors with greater access to private capital markets and enhancing the utility and importance of closed-end funds to retail investors.

⁵ See, e.g., Cornish & Carey Commercial, Inc., SEC Staff No-Action Letter (June 2, 1996); Securities Act Rule 140.

⁶ We discuss this aspect of the IIOA in greater detail in our [companion client alert](#).

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