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Investment Management Alert

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Proposed Legislation Would Enhance Closed-End Fund Protections by Closing the Private Funds Loophole Under Section 12(d)(1) of the Investment Company Act

On November 19, 2020, U.S. Representative Anthony Gonzalez (R-OH) introduced the Increasing Investor Opportunities Act (IIOA). The IIOA, among other things, would require private funds to comply with the 10% limitation on investment in registered closed-end funds and business development companies contained in Section 12(d)(1)(C) of the Investment Company Act of 1940 (1940 Act). The effect of this requirement would be to require one or more private funds with the same investment adviser to limit their aggregate holdings of a registered closed-end fund or business development company to no more that 10% of that fund's outstanding voting securities.

Section 12(d)(1) of the 1940 Act limits the ability of private and registered funds to invest in securities issued by registered funds beyond certain thresholds. Section 12(d)(1)(A) of the 1940 Act prohibits both private and registered funds from individually acquiring more than 3% of a registered fund's outstanding voting stock. Section 12(d)(1)(C) prohibits registered funds advised by the same adviser, but not private funds, from acquiring in the aggregate more than 10% of a closed-end fund's outstanding voting securities.

Sections 12(d)(1)(A) and 12(d)(1)(C) were originally added to the 1940 Act in the Investment Company Amendments Act of 1970 to address the danger that an acquiring fund might exert undue influence or control over an acquired fund.[1] Originally, neither Section 12(d)(1)(A) nor Section 12(d)(1)(C) applied to limit private fund investments in registered funds. In 1992, the SEC's Division of Investment Management published the Protecting Investors Report, which studied the investment company industry and made recommendations for updating and improving the regulatory regime.[2] In this report, the division made an important recommendation regarding Section 12(d)(1): "In order to protect the public shareholders of registered investment companies ... the restrictions of section 12(d)(l) should apply to all investments by private issuers in registered investment companies."[3] The division also expressed the same concern that Congress did over 20 years earlier: "Private issuers, excepted from regulation under the [1940] Act, could

[1] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337 (1966), at 315 (PPI Report).

[2] *See* Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation*, at Chairman's Letter (1992) (Protecting Investors Report).

[3] Protecting Investors Report, at 105.

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acquire controlling interests and exert undue influence over registered funds, disrupting their portfolio management through the threat of redemption."[4]

Congress implemented a number of the recommendations from the Protecting Investors Report in the Investment Company Act Amendments of 1996 (1996 Amendments),[5] which included the addition of the "qualified purchaser" private fund exception in Section 3(c)(7) of the 1940 Act as well as language making private funds relying on Sections 3(c)(1) or 3(c)(7) of the 1940 Act subject to the 3% limitation in Section 12(d)(1)(A).[6] Curiously, however, the 10% limitation in Section 12(d)(1)(C) was not made applicable to these private funds. This appears to be a clear oversight given the recommendations in the Protecting Investors Report, Congress' historical concerns governing the potential for undue influence by unregistered and unregulated funds over both open- and closed-end funds, and the division's continuing belief in the seriousness of those concerns as reflected in the Protecting Investors Report. As noted in our November 5, 2020 client alert regarding the recent adoption of Rule 12d1-4 governing fund of funds arrangements, this anomaly has been an area of particular concern for closed-end funds because the restrictions under Section 12(d)(1)(A) of the 1940 Act can be easily circumvented.

Section 12(d)(1)(A) of the 1940 Act has been interpreted as not requiring aggregation across related acquiring funds with a common investment adviser. The 10% acquisition limit in Section 12(d)(1)(C) of the 1940 Act expressly requires such aggregation among acquiring funds having the same investment adviser, but Section 12(d)(1)(C) does not currently apply at all to private acquiring funds. As a result, currently, a group of affiliated private funds managed by the same investment adviser may act in concert to acquire shares of a closed-end fund in any amount without regard to either Section 12(d)(1)(A) or 12(d)(1)(C), other than the limitation that any one private fund in the acquiring group cannot own more than 3% of the acquired fund's voting stock.

The closed-end fund industry has long sought action to address the ability of a group of affiliated private funds, managed by the same investment adviser, to exert undue influence on a closed-end fund by acting in concert to acquire shares of the fund. Although the Securities and Exchange Commission (SEC) acknowledged that ownership in excess of 10% of a closed-end fund raises concerns about the ability to exert undue influence,[7] Rule 12d1-4 did nothing to address the easy circumvention of the 3% limitation in Section 12(d)(1)(A) or the 10% limitation in Section 12(d)(1)(C). Specifically, the SEC stated that it "believe[s] commenters' additional recommendations with respect to investments in closed-end funds that are within the statutory limitations of Section 12(d)(1) are beyond the scope of the [Rule 12d1-4] rulemaking."[8]

The IIOA picks up where the Rule 12d1-4 rulemaking left off by seeking to prevent private funds from exploiting this significant loophole, which the SEC recognized involves the risk of undue influence over closed-end funds. The IIOA, if enacted, would finally correct the apparent oversight in the 1996 Amendments by subjecting private funds not only to the requirements of Section 12(d)(1)(A) of the 1940 Act, but also the requirements of Section 12(d)(1)(C) of the 1940 Act.

While closing the private funds loophole in Section 12(d)(1) of the 1940 Act would come as welcome relief to the closed-end fund industry, this step is also necessary to accomplish the larger goal of the IIOA, which is to give retail investors greater access to private fund investment opportunities by allowing closed-end funds greater flexibility to invest in private funds.[9] Specifically, if a closed-end fund invests a significant portion of its assets in private funds, the closed-end fund may trade at a larger discount to net asset value due to valuation considerations associated with investments in private funds. The purpose of the IIOA would be undermined if these discounts resulted in closed-end funds becoming targets for activist private funds seeking to force a liquidity event for their own short-term gain and to the detriment of the same retail investors that the IIOA seeks to benefit. Accordingly, while closing the private funds loophole in Section 12(d)(1) would be a positive development in its own right, the shift is also a critical element in achieving the overall purpose of the IIOA.

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 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.

[4] *Id.* at 109. Congress has historically viewed the power to vote a significant block of stock of a closed-end company as the equivalent of the threat of redemption for an open-end fund. *See*, *e.g.*, PPI Report, at 324.

[5] Pub. Law 104-290, 110 Stat. 3416.

[6] *See id.* at § 209(a).

[7] Fund of Funds Arrangements, Release Nos. 33-10871; IC-34045 (Oct. 7, 2020) (Adopting Release).

[8] *Id.* at 24.

[9] We discuss this aspect of the IIOA in greater detail in our companion client alert.

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