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**CSP-032**

**By Daniel Wertman under the supervision of Howell Jackson**

**August 2017**

## Financial Regulation Case Study: Closed-End Fund Regulation

### Case Study

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## Memorandum\*

**TO:** Junior Staff Attorney, Division of Investment Management  
**FROM:** Senior Staff Attorney Supervisor, Division of Investment Management  
**RE:** Closed-End Fund Industry Regulatory Analysis  
**DATE:** October 2016

You are a Junior Staff Attorney for the United States Securities and Exchange Commission (SEC) in the Division of Investment Management, the division of the SEC primarily responsible for regulation of investment companies and investment advisers.<sup>1</sup> As you have learned from your time at the SEC, the principal law that governs investment companies is the Investment Company Act of 1940 (1940 Act). The SEC's Division of Investment Management is tasked with interpreting and regulating investment companies in accordance with the 1940 Act.<sup>2</sup> Investment companies are typically registered under the 1940 Act as either open-end or closed-end companies.<sup>3</sup> Open-end companies are management investment companies that “offer or have outstanding redeemable securities of which they are the issuers,” while closed-end companies offer a fixed number of non-redeemable securities and trade on secondary markets like stock exchanges.<sup>4</sup>

In large measure, the investment landscape has changed dramatically since the time that the 1940 Act and its corresponding regulatory framework was enacted. With the advent and increasing popularity of exchange-traded funds (ETFs), investors have questioned the continued relevancy of closed-end funds (CEFs), which carry higher management fees and have limited benefits when compared to ETFs. ETFs provide same-day liquidity while preserving the diversification of a mutual fund product by investing across a basket of

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<sup>1</sup> *Investment Company Registration and Regulation Package*, U.S. Securities and Exchange Commission (December 21, 2004), [www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html](http://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html), [[perma.cc/BH5H-3APE](https://perma.cc/BH5H-3APE)].

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

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\* This case study was prepared by Daniel Wertman, Harvard Law School Class of 2017, under the supervision of Professor Howell E. Jackson. This case study is intended for educational purposes only and is not intended to offer legal advice.

securities, a liquidity concept that was previously limited to CEFs.<sup>5</sup> Still, closed-end funds have illustrated their resiliency despite these recent securities innovations—as of September 30, 2016, nearly \$243 billion are invested in CEFs, up from \$219 billion at the end of 2015 and \$128 billion at the end of 2008.<sup>6</sup>

Your supervisor in the Division of Investment Management has tasked you with determining whether the Commission should revisit its regulatory approach to closed-end investment vehicles, particularly in response to the increased traction of ETFs. The Commission has been increasingly concerned about potential asymmetric informational dynamics between end investors in CEFs and CEF providers during the CEF IPO process, which has historically contributed to investors buying CEFs at a premium to their net asset value (NAV). Your supervisor has provided you with a primer on the CEF market, including a discussion of (1) the regulatory framework for CEFs, (2) the mechanics of a CEF, (3) economic explanations for inefficiency in the CEF market, and (4) potential regulatory and litigation-based solutions to address the Commission’s concerns. **See Overview.**

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<sup>5</sup> Investment Company Institute, *Understanding Exchange-Traded Funds: How ETFs Work*, 20, ICI Research Perspective, 3 (Sept. 2014), [www.ici.org/pdf/per20-05.pdf](http://www.ici.org/pdf/per20-05.pdf), [[perma.cc/M2H2-FW9D](https://perma.cc/M2H2-FW9D)].

<sup>6</sup> Daisy Maxey and Ben Eisen, “Popular Closed-End Funds Look Vulnerable,” *The Wall Street Journal* (October 22, 2016), [www.wsj.com/articles/popular-closed-end-funds-look-vulnerable-1477134002](http://www.wsj.com/articles/popular-closed-end-funds-look-vulnerable-1477134002) (subscription required).

## Overview

Closed-end funds (CEFs) are regulated as investment companies governed under the 1940 Act. Unlike other mutual funds, however, CEFs do not continuously offer their shares for sale to the public. In other words, closed-end funds sell a pre-determined number of shares in an initial public offering (IPO) and are then “closed” to new purchases or redemptions. Instead, in the post-IPO period, CEFs trade on exchanges or other public markets at a “share price” independent of their actual net asset value (NAV). The share price of a CEF over the long run is determined by the supply and demand of the market: investors’ relative confidence or uncertainty in the fund’s prospects may cause the share price to exceed or fall below the NAV. Thus, at any given time, the share price may be lower (“discount”) or higher (“premium”) than the actual NAV of the fund, dependent upon market perceptions of the asset class, the manager, the fund, macro considerations, and other factors.

There are several benefits to the closed-end structure that have contributed to its continued existence. First, by allowing for an effectively irredeemable pool of assets, CEFs can invest in more illiquid securities that may not be permissible when their managers need to anticipate redemptions. Furthermore, CEFs can utilize leverage to enhance performance due to the lack of redemptions and relatively constant borrowing base. With the ability to trade on a securities exchange, CEFs also provide intra-day liquidity, which is far different from open-end mutual funds’ end-of-day liquidity. However, the structure also lends itself to significant drawbacks. With leverage comes increased likelihood of share price volatility and NAV market risk. Furthermore, CEFs have significant potential to trade at discounts to NAV, in which the share price falls lower than the value of the fund due to aforementioned market perception dynamics. While discounts may provide advantageous buying opportunities, due to the fact that on a secondary exchange the fund can be purchased at a lower “price” than the value of the underlying assets (NAV), for investors holding the fund price, depreciation can contribute to a negative total return for the investment.

The financial mechanics of a CEF IPO are particularly interesting when considering the fund structure. Every CEF is essentially sold at a premium to NAV, largely due to the underwriting fee and brokers’ commissions borne by the fund during the IPO process. Typically, these fees will account for 4.5% of the fund’s assets: a 1.5% fee is paid to the underwriters and a 3%

commission is paid to the broker-dealer as a selling concession. Thus, in a scenario where the fund is sold on the IPO for \$20, investors pay roughly \$20 for \$19.10 worth of assets ((20- (.045x20)). In purchasing the product at such a premium on the IPO, investors are signaling an expectation that the product will provide an appreciable return to justify the initial up-front cost.

## Financial Reporting for CEFs

Like other investment companies, CEFs are required to register with the SEC and provide written prospectuses containing a complete disclosure about the fund when its shares are sold to the public. CEF prospectuses typically disclose important information about fund expenses, risks, leverage, net asset value, legal matters, investment objectives, and management.

Prospectuses of CEFs, like other public offerings, are governed by the Securities Act of 1933 section 10(a), which generally outlines information requirements for prospectuses of public securities offerings. The SEC's Form N-2 simplifies compliance with section 10(a) of the 1933 Act by prescribing specific disclosures a CEF prospectus must include.

While in theory a CEF prospectus is meant to elucidate offering procedures and CEF objectives, certain provisions appear more prominently than others. For instance, CEF prospectuses typically disclose the fund's expenses at the beginning of the prospectus, delineating the 4.5% underwriting commission as a "sales load." To explain how the underwriting commission is calculated, prospectuses generally include a separate underwriting section towards the end of the document. Underwriting commissions are described as follows:

The Fund has agreed to pay a commission to the Underwriters in the amount of \$1.125 per Common Share (4.50% of the public offering price per Common Share). The Representatives have advised the Fund that the Underwriters may pay up to \$0.750 per Common Share from such commission to selected dealers who sell the Common Shares and that such dealers may re-allow a concession of up to \$0.100 per Common Share to certain other dealers who sell Common Shares.

This language exemplifies the difficulty for investors in understanding the compensation structure of the IPO. It not only makes it difficult to ascertain that the broker-dealer retains a 3% selling concession, but it also fails to clarify that the investor's individual broker may retain a significant portion of that concession. While individual broker compensation matrices are not generally public, individual brokers typically selling CEFs to a client typically earn some portion of the retained 3% from the offering. It is also nearly impossible to know from this language that brokers are likely to earn a substantially higher commission by purchasing the fund on the IPO than they would purchasing the fund on public markets after the IPO.

Though clearer about the conflict of interest between brokers and end-investors, this language is not required for CEFs where a similar conflict of interest exists. Thus, while the overall expenses of CEFs may be prominently disclosed in the prospectus, the conflict of interest between the individual broker and the investor is much more nebulous in the prospectus disclosure for CEFs.

This conflict of interest is also difficult to recognize within the framework of a CEF issuance due to the exercise of the overallotment provision. Underwriters typically engage in stabilization measures during the 30-60 days immediately following the issuance to counteract the selling pressure and maintain the offering price, which is disclosed in the prospectus.<sup>7</sup> Since the overallotment is designed to stabilize the share price relative to the immediate decrease in the NAV (from the post-issuance underwriting fee payment), investors may not notice the full effect of the de facto commissions on the value of their investment. Moreover, if the price subsequently declines after the stabilization period following the issuance, investors may attribute the decline to a non-commission-based cause, as commissions have been removed from immediate consciousness. Thus, the current regulatory framework governing CEF issuance leads to a troubling result: not only are investors generally unaware of the conflict of interest inherent in the CEF IPO design, but the "commissions" are being actively concealed through legally disclosed provisions to limit potential attribution of negative fund performance to distribution-related causes.

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<sup>7</sup> Kathleen Hanley, Charles Lee, and Paul Seguin, *The Marketing of Closed-end IPOs: Evidence from Transactions Data*, 5, *Journal of Financial Intermediation*, 146 (Apr. 1996) [[perma.cc/6U8Z-2NEC](https://perma.cc/6U8Z-2NEC)]; See PCI, *Prospectus*, PIMCO, 121 (Jan. 28, 2013) [www.sec.gov/Archives/edgar/data/1558629/000119312513028457/d475202d497.htm](https://www.sec.gov/Archives/edgar/data/1558629/000119312513028457/d475202d497.htm) [[perma.cc/GP6A-LTNT](https://perma.cc/GP6A-LTNT)], .

## Current Market Dynamics in Closed-End Funds

While financial services analysts largely view CEFs as a tertiary securities business, the number of funds and assets wrapped in the closed-end structure is quite staggering. As of 2013, total closed-end fund assets were \$279 billion. Furthermore, there were 599 closed-end funds as of 2013.<sup>8</sup> CEF IPOs raised \$14.1 billion in 2013 and \$3.7 billion in 2014.<sup>9</sup> Net issuance of closed-end fund shares was \$10.1 billion for 2013.<sup>10</sup> While these numbers may be substantially smaller than open-end or exchange-traded fund (ETF) counterparts, the closed-end structure continues to account for sizeable assets.<sup>11</sup>

With regard to discounts and premiums, the CEF market has struggled as of late. At year-end 2013, domestic municipal bond CEFs traded at an average discount of 7%.<sup>12</sup> For domestic taxable bond CEFs, the average discount was 6.3%.<sup>13</sup> For domestic equity CEFs, the average discount was 8.3% at 2013 year-end.<sup>14</sup> The discounts have not much improved over the last year and a half. As of the end of February 2015, the average discount for all CEFs was 6.5%, with the median being 8.4%.<sup>15</sup> These discounts were roughly similar across CEF bond funds and CEF equity funds.<sup>16</sup>

## The Discount Puzzle and Asymmetric Informational Dynamics in Closed-End Funds

Over the past three decades, economic and financial scholars have been puzzled by CEF discounts. The puzzle ultimately stems from two key questions: (1) what can explain the

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<sup>8</sup> Investment Company Institute, "The Closed-End Fund Market, 2013," *ICI Research Perspective* 20, no. 1 (July 2013): 2 [hereinafter ICI, "The CEF Market, 2013"], [www.ici.org/pdf/per20-01.pdf](http://www.ici.org/pdf/per20-01.pdf) [[perma.cc/79C2-E42Y](http://perma.cc/79C2-E42Y)].

<sup>9</sup> Closed-End Fund Association, *2014 Initial Public Offerings* (CEFA: Dec. 2014), [www.cefa.com/IPOs/Content/2014.fs](http://www.cefa.com/IPOs/Content/2014.fs) [[perma.cc/QY3R-EX7C](http://perma.cc/QY3R-EX7C)]; Closed-End Fund Association, *2013 Initial Public Offerings* (CEFA: Dec. 2013), [www.cefa.com/IPOs/content/2013.fs](http://www.cefa.com/IPOs/content/2013.fs) [[perma.cc/3NLD-GDJ8](http://perma.cc/3NLD-GDJ8)].

<sup>10</sup> ICI, "The CEF Market, 2013."

<sup>11</sup> For a point of comparison, open-end fund total assets for 2013 were \$10.9 trillion, while ETF assets for 2013 were \$12.6 trillion. Michael Rawson, *Morningstar Direct US Open-End Asset Flows Update* (Morningstar: Jan. 2014), [corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsJan2014.pdf](http://corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsJan2014.pdf) [[perma.cc/JP9S-HLL5](http://perma.cc/JP9S-HLL5)].

<sup>12</sup> *Id.* at 1.

<sup>13</sup> ICI, *The CEF Market, 2013*, ICI Research Perspective.

<sup>14</sup> *Id.* at 4.

<sup>15</sup> Closed End Fund Association, *Current and Historical Premium and Discounts for U.S. Closed-End Funds* CEFA Weekly Reports: Feb. 27, 2015), [www.cefa.com/\\_docs/content/PandD\\_02\\_27\\_2015.pdf](http://www.cefa.com/_docs/content/PandD_02_27_2015.pdf) [[perma.cc/7XET-M87J](http://perma.cc/7XET-M87J)].

<sup>16</sup> *Id.*

persistence of discounts in the CEF market, and (2) why would investors continue to buy CEFs on the IPO?

Most of the scholarly literature related to CEFs has sought to explain the presence and continuation of discounts in the CEF market. Several scholars subscribe to an “investor irrationality” or “investor sentiment” theory, which explains discounts as a natural consequence of additional risk premium associated with “noise traders.”<sup>17</sup> The theory rests upon two assumptions: (1) CEFs are predominantly owned and traded by small retail investors, and (2) these investors are motivated by irrational tendencies towards optimism or pessimism.<sup>18</sup> As an empirical matter, this investor irrationality creates increased share price volatility, which is difficult to diversify. Thus, CEF shares must trade at a discount to account for the increased volatility and risk premium associated with the dynamics of this particular market.<sup>19</sup> However, the “investor sentiment” theory has been disputed by various financial analyses, including the use of proxies for sentiment (i.e. consumer confidence surveys) to illustrate low correlations between investor sentiment and CEF discounts.<sup>20</sup> Furthermore, the theory has failed to fully explain the presence of simultaneous discounts and premiums in the CEF market for substantially similar funds.<sup>21</sup>

Other theories focus on the combination of managerial fees and liquidity facilities as the source of discounts or premiums. These theories focus on the added value of managerial ability relative to fees as a possible explanation for the persistence of discounts or premiums. The discounts in this theory are mitigated by the CEF liquidity benefits in traditionally illiquid asset classes. Thus, the higher liquidity of CEF shares relative to the illiquidity of the underlying asset, the greater the premium, all else equal.<sup>22</sup> Under this analysis, the balance of managerial costs with increased liquidity ratios will determine the presence of discounts and premiums.<sup>23</sup> Furthermore, the interplay between managerial abilities, managerial

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<sup>17</sup> Charles M.C. Lee, Andrei Shleifer, and Richard H. Thaler, “Investor Sentiment and the Closed-End Fund Puzzle,” *Journal of Finance* 46, no. 1 (March 1991): 75–110.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Martin Cherkes, *The 2012 Survey of Closed-End Funds’ Literature*, (May 18, 2012): 5-6, [ssrn.com/abstract=2062336](https://ssrn.com/abstract=2062336) [[perma.cc/F8C4-YM9Y](https://perma.cc/F8C4-YM9Y)].

<sup>21</sup> *Id.* at 6.

<sup>22</sup> Martin Cherkes, Jacob Sagi, and Richard Stanton, “A Liquidity-Based Theory of Closed-End Funds,” *Review of Financial Studies* 22 (2009): 257–97.

<sup>23</sup> *Id.*

compensation, and managerial renegotiation of compensation contracts has been utilized to explain the tendency for IPO premiums to frequently fall to a discount.<sup>24</sup>

Although less widely accepted, several other CEF discount theories offer perspective on factors that could contribute to the discount problem. For instance, the “Tax Overhang” theory attempts to explain discounts through CEFs’ realization of capital gains at times that are not optimal to investors.<sup>25</sup> By limiting the investors’ tax-timing capabilities, the funds carry an implicitly increased expense ratio, which investors are pricing in with the discount.<sup>26</sup> Evidence for this assertion has been found in the correlation between distributed capital gains and discounts, namely, that “each dollar of distributed capital gains shrinks the discount by 7 cents.”<sup>27</sup>

Mechanically speaking, the CEF design leads to discounts due to the lack of arbitrage opportunities. In the ETF structure, discounts are rare due to the creation-redemption process. By contrast, in the CEF structure, discounts are common, because CEFs have no authorized participants with the ability to eliminate discount gaps by realizing arbitrage opportunities.<sup>28</sup> In other words, when an ETF is trading at a discount, authorized purchasers designated by the fund typically buy the ETF shares and sell the underlying securities short.<sup>29</sup> The purchaser then delivers the ETF shares to the fund in return for a basket of the underlying securities or cash, which is used to cover the short position.<sup>30</sup> This process helps eliminate the discounts or premiums through inherent arbitrage opportunities within the ETF structure.<sup>31</sup> CEFs have no such mechanism. While issuers may tender shares at NAV to eliminate discounts, issuers’ incentives are structured to avoid such a process. Tendering shares has the effect of reducing the fund size, thereby decreasing the asset base for managerial fees.

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<sup>24</sup> *Id.*

<sup>25</sup> Theodore Day, George Li, and Yexiao Xu, “Dividend Distributions and Closed-End Fund Discounts,” *Journal of Financial Economics* 100, no. 3 (June 2011): 579–93.

<sup>26</sup> *Id.*

<sup>27</sup> Theodore Day, George Li, and Yexiao Xu, “Dividend Distributions and Closed-End Fund Discounts”; Martin Cherkes, *The 2012 Survey of Closed-End Funds’ Literature*.

<sup>28</sup> Investment Company Institute, “Understanding Exchange-Traded Funds: How ETFs Work,” *ICI Research Perspective* 20, no. 5 (September 2014): 9, [www.ici.org/pdf/per20-05.pdf](http://www.ici.org/pdf/per20-05.pdf) [perma.cc/M2H2-FW9D].

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

While these theories have made significant inroads into determining the causes of persistent discounts, no one theory has proven dominant. Perhaps combinations of all the factors discussed have been contributing, at least to some extent, to the overall puzzle. Still, these questions have proven perplexing, particularly when considering the data. Although CEFs are sold at a premium to NAV (largely due to the aforementioned underwriting fees), CEFs move to an “average discount of over 10% within 120 days from the beginning of trading.”<sup>32</sup> Other studies have cataloged the average time from IPO to discount as between 100 days and 12 months.<sup>33</sup> While this is certainly not the case for all CEFs, it implies that CEF investors should typically wait until after the IPO to purchase shares. Thus, “[i]t seems necessary to introduce some type of irrational investor to be able to explain why anyone buys the fund shares . . . [at IPO].”<sup>34</sup>

The prevalence of discounts, particularly with regard to price declines following initial public offerings, tends to indicate investor susceptibility to marketing tactics of CEF issuers and underwriters. Empirical studies have documented that a CEF IPO is frequently followed by immediate aftermarket selling by large traders, price stabilization by underwriters, and post-issue buying by smaller (less informed) investors.<sup>35</sup> Yet, despite the widely disseminated information regarding “poor aftermarket performance of closed-end fund offerings,” investors continue to purchase shares on the IPO.<sup>36</sup> Some scholars have explained this phenomenon by pointing to two marketing strategies: (1) distancing the new fund from prior funds by highlighting diverging investment strategies and objectives, and (2) broker misrepresentation of commissions.<sup>37</sup> In the first tactic, even though the SEC requires new CEFs to include disclosure as to the frequency of CEF discounts, many brokers mitigate this disclosure by formulaically distinguishing the current IPO from previous issues. Regarding the second tactic, brokers have been found to advertise a “no commission” purchase for pre-issue shares.<sup>38</sup> While this is mechanically correct, given that an explicit brokerage commission

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<sup>32</sup> Charles M.C. Lee, Andrei Shleifer, and Richard H. Thaler, “Investor Sentiment and the Closed-End Fund Puzzle.”

<sup>33</sup> *Id.* at 84; See Martin Cherkas, Jacob Sagi, and Richard Stanton, “A Liquidity-Based Theory of Closed-End Funds;” ; See Weiss, “The Post-Offering Price Performance of Closed-End Funds,” *Financial Management* 18, no. 3 (Autumn 1989): 57–67.

<sup>34</sup> Charles M.C. Lee, Andrei Shleifer, and Richard H. Thaler, “Investor Sentiment and the Closed-End Fund Puzzle,” 84.

<sup>35</sup> Kathleen Hanley, Charles Lee, and Paul Seguin, “The Marketing of Closed-end IPOs: Evidence from Transactions Data,” *Journal of Financial Intermediation* 5, no. 2 (April 1996): 130.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 155

<sup>38</sup> *Id.*

is not charged, the underwriting fee essentially incorporates a robust commission to brokers for the sale. However, investors cannot easily ascertain the misinformation due to the aforementioned aftermarket stabilization period that mitigates the effects of underwriting fees.<sup>39</sup> These findings demonstrate a need to revisit securities regulations governing CEFs, which will be discussed in the following section.

## **Potential Regulatory and Litigation-Based Solutions to the CEF Puzzle**

Having illustrated the pervasive issues with the closed-end structure in the current market, this analysis will now turn to potential regulatory and litigation-based solutions.

### ***Potential Regulatory Solutions***

In the current regulatory regime, disclosure appears to be the primary method of solving investor misinformation for CEFs. The prospectus is ideally meant to mitigate any investor confusion through clearly delineated disclosure sections. Yet, given the data presented above, it is quite clear the prospectus falls short of providing the necessary information to investors.

While SEC regulations generally assume investors read prospectuses that report underwriting fees, the evidence indicates that small investors largely ignore this information and do not understand the implications of their investment.<sup>40</sup> Thus, regulators could begin by establishing more specific disclosure methods to account for investor behavior.

To begin with, the SEC could mandate more prominent disclosures of specific fund and issuer-related information in the prospectus. While the current regime typically involves disclosure of frequent trading at discounts, the new regime could mandate disclosure of trading statistics related to a predetermined number of the issuer's previous issues. For instance, the prospectus could be required to disclose the last 10 CEFs the issuer offered, as well as their current discounts, price depreciation from IPO, total return (including distribution), and average trading volume. This information may give the investor a better understanding of the current CEF market status for that specific issuer. However, entrenched issuers of CEFs are likely to oppose such a requirement. First, these issuers would highlight

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<sup>39</sup> Hanley, Lee, and Seguin, "The Marketing of Closed-end IPOs: Evidence from Transactions Data," 130.

<sup>40</sup> *Id.* at 138–39.

the immense cost associated with the increased data production necessary to fulfill such a requirement, which would only lead to an upward market adjustment of offering expenses borne by the fund. Second, there are publicly available sources for such information that investors, in performing reasonable due diligence at the time of issuance, should consult if they deem the information valuable. Finally, issuers would emphasize the differences in market dynamics, asset classes, portfolio managers, and leverage facilities associated with each fund that makes comparisons across issuer-categorized CEFs confusing and unhelpful.

Still, even with the consideration of these concerns, the information-forcing disclosure regime of past CEFs may present substantial benefits to investors. In accordance with the investor-sentiment theory, the data could mitigate potential informational asymmetries that are theoretically causing persistent discounts by better aligning IPO expectations and post-issuance trading. Furthermore, under a disclosure regime that more directly connects previous issuances with current IPOs, issuers' incentive structure may be altered: instead of solely issuing products that are likely to garner large capital raises, issuers would be more likely to consider secondary market performance as an ex-ante economic factor.

Alternatively, the SEC could mandate separate, predetermined disclosure documents detailing the commission structure in the context of the underwriting fee. While current prospectuses typically disclose the top-level fee prominently at the start of the document, the underlying broker commissions are relegated to a separate section deep within the paperwork. Furthermore, the current sales commission disclosures are extremely difficult to understand. As demonstrated previously, from the typical CEF prospectus disclosure language, it is quite difficult to ascertain that a selling concession is being distributed, let alone that the broker recommending the purchase is receiving a portion of that concession. Simplifying the disclosure with clear and decisive percentages, as well as relocating the disclosure to the front of the prospectus, may help investors make a more informed decision by increasing their understanding of the conflict of interest. For example, the following disclosure may increase clarity of the situation for potential investors on the IPO:

Broker-dealers that sell shares of this fund during the initial public offering are likely to receive a selling concession equal to 3% of the total net asset value of the issuance, of which a portion will likely be distributed to your individual broker. This selling concession is likely greater than the

commissions earned by your broker in subsequent trades of this CEF on the secondary exchange. Please be advised of the potential conflict of interest during recommendations to purchase CEF shares at the initial public offering price.

More drastically, to ensure understanding of broker-dealer selling concessions and the prevalence of discounts in the CEF market, brokers could be forced to orally disclose this information to end investors prior to purchasing shares of CEFs on the IPO. Additionally, individual brokers could be compelled to orally disclose individual compensation matrices as an estimate of brokers' anticipated commissions from the CEF sale. In the extreme, regulators could construct a rule that imposes a "function-specific" fiduciary duty upon all intermediaries of CEFs on the IPO for that transaction, regardless of whether they are formally recognized as brokers or investment advisors. Any one of these regimes would likely achieve heightened awareness of the potential conflict of interest, forcing brokers to defend the purchase of CEFs at the offering price ex-ante. Thus, the rule would serve a direct informational purpose, allowing investors to elicit justifications for purchasing a security with a historically high potential for depreciation. There are, of course, legitimate concerns as to the effectiveness of disclosure regimes in general. These concerns include lack of overall investor understanding, costs associated with disclosure, and investor willingness to read or listen to disclosure information. These factors must be weighed against the costs to investors of poorly disseminated information in a small, asymmetric, and largely irrational market environment like CEFs.

Outside of disclosure, the SEC could enact other mandatory regime solutions to mitigate secondary market discounts and post-IPO performance problems. First, the SEC could institute a mandatory open-ending provision upon the occurrence of a predetermined number of consecutive months at a certain discount. Evidence suggests that open-ending a CEF tends to close discounts after the announcement.<sup>41</sup> Thus, the sheer presence of mandatory open-ending provisions, provided they are clearly delineated in the prospectus and widely acknowledged, should mitigate the discount without the need to necessarily follow through with the open-ending process. Again, issuers are likely to push back on such

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<sup>41</sup> Gregory Brauer, "'Open-ending' Closed-end Funds," *Journal of Financial Economics* 13, no. 4 (December 1984): 491–507.

regulation. Issuers would highlight the benefits of buying opportunities on a secondary exchange created by CEFs trading at persistent discounts and of shareholder ability to petition the independent board of directors for open-ending through the ordinary shareholder oversight process. For a more moderate solution, the SEC could mandate built-in tender offers at NAV for every CEF, which would be triggered in the event of predetermined consecutive discount periods. Since tender offers would theoretically close the discount due to issuer redemption of shares at NAV, such a regime would at a minimum grant temporary reprieve to investors experiencing sustained discount periods. A built-in tender provision would also serve as a powerful signal to investors on the IPO: issuers are willing to effectively shrink the fund size, directly impacting issuer profitability, for the purposes of mitigating investor losses. These provisions may also reallocate incentives. If issuers are directly affected by sustained discounts through mandated tenders that decrease managerial compensation, issuers would be incentivized to produce funds that have a greater likelihood of trading at premiums.

To mitigate poor post-IPO price performance, the SEC could also establish a mandatory maximum underwriting fee below the 4.5% market rate. While this would not guarantee a narrower discount, it would likely mitigate the initial price declines, considering the NAV will bear fewer up-front sales costs. Instead of paying the distribution fees from the proceeds of the fund, the SEC could mandate that issuers bear the burden of the 4.5% underwriting fee, including the selling concession. The approach would likely be the most contentious. Issuers would argue that bearing the distribution fee would alter the economic value of the fund to the issuer, significantly decreasing the likelihood that an issue will be profitable. However, this cost can be accounted for simply in the break-even analysis of initial fund estimates. Assuming a 1% management fee for a CEF issue, the issuer may simply account for a 4-5 year longer break-even period in its budget forecasts. Given the perpetual nature of CEFs, issuers would be incentivized to issue funds that are more sustainable in the CEF structure (i.e. funds that have a lower probability of being open-ended or liquidated due to poor performance), which would allow the issuer to recoup the costs of the issuance.

As with any proposed solution for the CEF market, there will undoubtedly be costs associated with any of these regulatory interventions. Thus, any intervention requires a careful balance between ensuring these products remain in existence—due to

aforementioned liquidity, leverage, and diversification benefits—and protecting investors from almost certain devaluation. Analyzed from this perspective, some of the solutions presented here may coerce investors into purchasing other investment products or serve as a disincentive for issuers, leaving investors without the potential for enhancing returns through the CEF structure. For instance, disclosures of recent trading statistics, discount levels, and the probability for the share price to decrease in the post-IPO period are likely to dissuade investors from an IPO purchase. While these solutions would better inform the public, these measures may not reflect the total return capabilities of CEFs due to leveraged returns, illiquid asset exposure, and uncorrelated diversification benefits. Similarly, mandating issuer payment of underwriting expenses for an offering may decrease the return on investment associated with issuance, resulting in fewer CEF IPOs, decreased compensatory benefits for portfolio managers (and thus a likely drop in quality of management), and reduced variety in product offerings.

However, solutions that focus on mitigating discounts while preserving the IPO process may not produce these drawbacks. Mandatory tenders or open-endings, while having the potential to decrease profitability for issuers in some respects, may not provide the same disincentives relative to solutions that directly target CEF IPO procedures. At the same time, secondary market-focused interventions would protect investors by mitigating the discount problem and incentivizing secondary market support. While comprehensive quantitative and qualitative analyses is necessary to determine the correct course of action, regulators should keep in mind the drawbacks of instituting regulatory interventions that effectively eliminate the CEF structure and strive for a balance between allowing these products to exist and equalizing the playing field.

### ***Potential Litigation-Based Solutions***

In addition to regulatory solutions, investors may be able to litigate the CEF issue under FINRA’s “suitability” rules. FINRA rule 2111, or the “Suitability Rule,” requires that “a firm or associated person have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated

person to ascertain the customer’s investment profile.”<sup>42</sup> This rule can be deconstructed into two relevant provisions: (1) reasonable basis suitability and (2) customer specific suitability.<sup>43</sup> Reasonable basis suitability requires that a broker “to have a reasonable basis to believe based on reasonable diligence, that the recommendation is suitable for at least some investors.”<sup>44</sup> Customer specific suitability requires that “a broker must have a reasonable basis to believe that a recommendation of a security or investment strategy involving a security or securities is suitable for the particular customer based on the customer’s investment profile.”<sup>45</sup>

The litigation theory for CEF purchases would likely rest upon the relative willingness of courts to consider a CEF IPO “reasonably suitable” for at least some investors. As the data previously presented suggests, a significant majority of CEFs will likely trade below their IPO prices soon after issuance. Thus, the legal argument is as follows: how can a CEF purchased on the IPO be suitable for “some investors” when it can likely be purchased more affordably 100 days later?

Of course, several valid counterarguments could emerge. Namely, issuers would argue that the IPO price of a CEF is not guaranteed to depreciate and that buying on the IPO allows certain investors to buy greater volume (whereas secondary trading could be thin for certain issues). Yet, when paired with the consideration of “customer specific suitability,” these counterarguments are less persuasive. For smaller investors, who comprise a significant portion of IPO purchasers in the CEF market, there would be little reason to buy in substantial volume on the IPO. Furthermore, brokers’ assessments of customer-specific suitability would not require an IPO purchase for smaller investors. Thus, when taking the dual suitability standards together, a successful claim under FINRA rules may rest upon the plaintiffs’ ability to demonstrate a high likelihood of post-IPO price depreciation and lack of a reason for purchase of the particular fund at the offering price.

While litigation may be an uphill battle, the climb is not without precedent. In the realm of open-end mutual fund sales charges, some plaintiffs have been successful with claims that

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<sup>42</sup> FINRA, *Additional Guidance on FINRA’s New Suitability Rule*, Regulatory Notice 12-25, (May 2012): 1, [www.finra.org/sites/default/files/NoticeDocument/p126431.pdf](http://www.finra.org/sites/default/files/NoticeDocument/p126431.pdf) [perma.cc/4Z8P-2LBF].

<sup>43</sup> *Id.* at 1-2.

<sup>44</sup> *Id.* at 1.

<sup>45</sup> *Id.* at 2.

brokers violated suitability requirements by recommending Class B shares when Class A shares would have resulted in lower charges to customers.<sup>46</sup> Utilizing the same logic, plaintiffs might successfully argue that recommending CEF IPO shares unnecessarily increases the purchasers' commissions when the shares can be bought on the secondary exchanges soon after at a far lower cost.

Apart from FINRA remedies, plaintiffs may be able to sustain a claim based on SEC Rule 10b-5 under the Securities Exchange Act of 1934. Generally speaking, the rule forbids deceit related to the sale or purchase of a security.<sup>47</sup> Rule 10b-5 claims, however, must be predicated on misrepresentation or non-disclosure.<sup>48</sup> The Second Circuit has held that an investor must establish four premises to sustain a claim based upon 10b-5: (1) the securities were unsuitable to the investor, (2) the broker knew the securities were unsuitable and recommended them, (3) the broker made material misstatements as to the suitability with scienter, and (4) the customer relied on the broker's fraudulent conduct.<sup>49</sup> Analytically, the Second Circuit has held that unsuitability claims are subsets of typical Rule 10b claims, requiring plaintiffs to illustrate "(1) material misstatements or omissions, (2) indicating intent to deceive or defraud, (3) in connection with the purchase or sale of a security."<sup>50</sup> In certain cases, plaintiffs may be successful in arguing that buying CEFs on the IPO where a broker has indicated there are "no commissions" violates Rule 10b-5. Still, the claim is likely a stretch. Rule 10b liability is typically not imposed when an investor could have discovered the truth "through minimal diligence."<sup>51</sup> Since most plaintiffs could have consulted the prospectus in full and conducted diligence on discount trading in previous issues, it is unlikely a court would categorically or individually hold CEF IPOs to the standard of Rule 10b violations. Still, the claim may be recognized under general common law negligence standards.<sup>52</sup> While no federal cause of

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<sup>46</sup> See Belden, Exchange Act Release No. 47859 (May 14, 2003), [www.sec.gov/litigation/opinions/34-47859.htm](http://www.sec.gov/litigation/opinions/34-47859.htm) [perma.cc/PMU8-SZUA] affirming NASD sanctions for sales of Class B shares. See also, e.g., Michael Flanagan, Ronald Kindschi, & Spectrum Admin., Inc., Release No. 160 (ALJ Jan. 31, 2000), [www.sec.gov/litigation/aljdec/id160jtk.htm](http://www.sec.gov/litigation/aljdec/id160jtk.htm) [perma.cc/8JUX-ZSB7] affirming violations of antifraud provisions based on recommendations of class B mutual fund shares.

<sup>47</sup> 17 C.F.R. § 240.10b-5

<sup>48</sup> See e.g., *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977); Cf. *Johnson v. Aegon USA, Inc.*, 355 F. Supp.2d 1337 (N.D. Ga. 2004).

<sup>49</sup> *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2d Cir. 1993).

<sup>50</sup> *Brown*, 991 F.2d at 1031.

<sup>51</sup> *Id.* at 1032.

<sup>52</sup> See, e.g., *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1383-1384 (N.D. Tex. 1976); *Jaffray & Hopwood Inc. v. Ladin*, 399 F. Supp. 292 (S.D. Iowa 1975).

action is created by the FINRA suitability rules, several states have incorporated these administrative guidelines into common law negligence claims, holding that violations of these rules would “be admissible as evidence of negligence.”<sup>53</sup> If a plaintiff can make a compelling case for unsuitability due to a broker’s superior knowledge of likely poor post-IPO performance, and highlight the conflict of interest associated with a sales commission that was poorly disclosed, the plaintiff might sustain a common law negligence claim in certain states. Still, given the current case law, success under a Rule 10b-5 claim in the CEF space is likely out of reach. Thus, regulatory action is the most realistic and preferred method of addressing investor protection.

### **Conclusion: A Starting Point**

As the preceding analysis has demonstrated, an assessment of market dynamics and potential regulatory actions in the closed-end fund market is both complicated and intriguing. Given the relative size of the industry, and the increased focus on mortgage securitization as of late, closed-end funds have been generally under-emphasized in the realm of financial regulatory scholarship. Still, thousands of investors every year continue to buy CEFs on the IPO, and perhaps would not do so if they were better informed of the pitfalls and potential conflicts of interest. Utilizing the analysis presented in this report as a starting point, regulatory officials should begin to review the current practices in the CEF industry and use their regulatory authority to construct rules that will help mitigate the concerns outlined here.

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<sup>53</sup> *Piper, Jaffray & Hopwood Inc. v. Ladin*, 399 F. Supp. 292, 299 (S.D. Iowa 1975).