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CLOSED-END FUNDS

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- Traditionally, shareholders of closed-end funds “redeem” their shares differently than open-end (mutual fund) shareholders
- Unlike mutual fund shares, closed-end shares are not redeemable by the issuer at net asset value (NAV)
- Most resales of closed-end fund shares are made through secondary markets, either on exchanges or over the counter
- The market price of closed-end shares often can be at a significant discount from NAV
- Some closed-end funds make repurchase offers directly to shareholders

CLOSED-END FUNDS (*CONT'D*)

- Traditional closed-end funds are not subject to liquidity requirements that apply to mutual funds
- In 1993, the SEC adopted Rule 23c-3 under the Investment Company Act of 1940, which provides exemptive relief allowing certain closed-end funds to make periodic repurchases of their shares
- Closed-end funds that rely on Rule 23c-3 under the 1940 Act to repurchase shares are commonly known as “interval” funds
- Closed-end funds that rely on Rule 13e-4 under the Exchange Act to make periodic tender offers for shares on a discretionary basis are commonly known as “tender offer” funds

WHAT IS AN INTERVAL FUND?

- An interval fund is a hybrid type of closed-end investment company that engages in continuous offerings of shares and periodically offers to repurchase its shares from shareholders
 - Interval funds offer to buy back a stated portion of their shares from shareholders
 - Shareholders are not required to accept these offers or to sell their shares back to the fund
 - Interval funds are permitted to (and many in fact do) continuously offer their shares at a price based on the fund's NAV

WHAT IS A TENDER OFFER FUND?

- A tender offer fund is a type of closed-end investment company registered under the 1940 Act that conducts periodic tender offers (most often conducted quarterly) on a discretionary basis pursuant to the Exchange Act
- Tender offer funds have flexibility to value their assets periodically (daily, weekly, monthly)
- Tender offer funds periodically repurchase a percentage of their outstanding shares at NAV
- Tender offer funds have more flexibility than interval funds because they use Exchange Act Rule 13e-4

WHAT IS RULE 13E-4?

- Rule 13e-4 sets forth the parameters for commencing, terminating, filing, disseminating and generally conducting a tender offer
- At the commencement of a tender offer, the tender offer fund will notify shareholders of the repurchase offer, complete Schedule TO, deliver the Letter of Transmittal to shareholders and file all repurchase offer documents with the SEC
 - Schedule TO is the tender offer statement of the fund and includes, typically by exhibit, the Offer to Purchase

WHAT IS RULE 13E-4? *(CONT'D)*

- Rule 13e-4 is less limiting than Rule 23c-3 in a few key respects:
 - Board has the flexibility to skip a tender offer (although commercial considerations may limit its ability to do so);
 - the amount of the tender offer is not prescribed;
 - the deadline by which shareholders must receive the proceeds from their tendered shares is also not prescribed;
and
 - the rule does not prescribe the amount of liquid assets required to be held by funds in connection with their tender offers.

WHY INTERVAL FUNDS?

- Exchange-traded closed-end funds that trade at a premium from their NAV have several options to raise additional capital
- Closed-end funds that trade at a discount from their initial NAV face limits if they want to raise additional capital following a fund's IPO
 - When trading at a discount to NAV, the only way a closed-end fund can raise additional equity capital is a rights offering to existing shareholders
 - Rights offerings allow shareholders to buy additional shares at a discount
 - Rights offerings may result in dilution to rights of existing shareholders
- Periodic repurchases effectively reduce spread between market value and NAV, thus paving the way for additional fund capital raising

PERIODIC REPURCHASES

- Interval funds make period repurchase offers to shareholders generally every three, six or twelve months
 - Funds must disclose the frequency of repurchases in their prospectus and annual report and periodically notify shareholders of upcoming repurchase dates
 - Funds must specify a date by which shareholders must accept the offer
 - The price shareholders receive on a repurchase will be based on the per-share NAV determined as of a specified (and disclosed) date
 - The repurchase date occurs sometime after the close of business on a date generally not more than 14 days subsequent to the date that shareholders must submit their acceptances of the repurchase offer

DISTRIBUTION AND REDEMPTION FEES

- Interval funds can be distributed either directly by a fund manager or through a broker-dealer network
 - Any investor can invest, because interval funds are registered investment companies
- Interval funds may deduct a redemption fee from redemption proceeds
 - Redemption fees cannot exceed two percent of the proceeds
 - Redemption fees are paid to the fund to compensate the fund for expenses directly related to the repurchase
- Interval funds may charge certain other fees as well

TENDER OFFER PROCESS

- A tender offer fund's Board has discretion to determine the tender offer amount
- All repurchase offers are discretionary as they are determined at the discretion of the tender offer fund's Board
- The tender offer must have a duration of at least 20 business days, and at least 10 business days after certain material changes to the tender offer
- The repurchase price must be determined by "best-price rule" - highest consideration paid to a shareholder must be paid to all other shareholders
- If repurchases exceed the repurchase offer amount, tender offer funds can modify the offer to accommodate the oversubscription or accept tenders on a pro rata basis, subject to other allowances for accepting tenders

PUBLIC REPORTING

Regulatory reporting requirements for interval and tender offer funds:

- Prospectus (or summary prospectus) must be delivered before or at time of sale
- Statement of Additional Information available upon request
- Required SEC reporting includes:
 - Form N-2
 - Form N-CSR
 - Form N-Q
 - Proxy voting record (Form N-PX)
 - Tender offer statements

DISTRIBUTION REGULATION

- Advertising
 - Interval and tender offer funds are subject to the same rules with respect to advertising as apply to mutual funds
- FINRA
 - FINRA exempts interval and tender offer funds from certain filing requirements, filing fees and regulations
 - Instead, interval and tender offer funds are subject to FINRA Rule 2341 which regulates distribution and sales charges of open-end funds

REGULATION OF INTERVAL FUNDS

- Section 23 of the 1940 Act limits the ability of a closed-end fund to repurchase its shares
 - Rule 23c-3 provides an exemption to these limitations
 - The rule establishes general requirements for the terms of closed-end fund repurchases at periodic “intervals” (three, six or twelve months)
 - Repurchase amount must not be less than 5% nor more than 25% of outstanding shares
 - Interval repurchases must be a “fundamental policy”
 - Fundamental policy must state (1) policy of allowing interval repurchases; (2) frequency of periodic intervals between repurchase request deadlines; (3) dates of repurchase request deadlines or the means of determining the repurchase request deadlines; and (4) maximum number of days between each repurchase request deadline and the next repurchase pricing date

REGULATION OF INTERVAL FUNDS *(CONT'D)*

- Interval funds cannot suspend or postpone a repurchase offer except by a vote of a majority of independent directors, and only
 - If the repurchase would cause the fund to lose its status as a “regulated investment company” under the Internal Revenue Code
 - For any period during which the NYSE or any other market in which the securities owned by the company are principally traded is closed, other than customary week-end and holiday closings, or when trading is restricted
 - During “emergencies” when it is not reasonably practicable for the fund to fairly determine its NAV
 - As the SEC determines to protect security holders

REGULATION OF INTERVAL FUNDS *(CONT'D)*

- Not less than 21 days before each repurchase request deadline (but not more than 42 days), the fund must send to each record shareholder (and each beneficial owner) a notice including
 - The repurchase amount and any applicable fees
 - The procedures for security holders to tender their shares and the right to withdraw or modify tenders until the repurchase request deadline
 - The circumstances in which the fund may suspend or postpone an offer
 - The NAV computed no more than seven days before the date of notice
 - The market price, if any, of the shares on the date when NAV is computed

REGULATION OF INTERVAL FUNDS *(CONT'D)*

- If shareholders tender more than the repurchase offer amount, the fund may repurchase an additional amount not to exceed 2% of the outstanding shares
 - If the fund does not elect to increase the repurchase amount, it must redeem tendered shares on a pro rata basis
- Fund governance
 - The board of directors must satisfy the fund governance standards of Rule 0-1(a)(6)
- Senior securities
 - Limitations on senior securities and debt

REGULATION OF INTERVAL FUNDS *(CONT'D)*

- Liquidity
 - Interval funds are better able to anticipate their liquidity needs than open-end funds because interval funds do not permit daily liquidity, limit size and timing of repurchase offers, and shareholders must provide advance notice of redemptions
 - Interval funds are subject to liquidity standards of Rule 23c-3
 - From the date of notice until the repurchase pricing date, the fund must hold at least 100 percent of the repurchase offer amount in “assets that can be sold or disposed of in the ordinary course of business, at approximately the price at which the company has valued the investment. . .”
 - Board of directors must adopt written liquidity procedures
 - Board of directors must review overall composition of the portfolio and make and approve changes to the procedures as necessary
 - But interval funds are not subject to the new liquidity risk management requirements of Rule 22e-4 because Rule 23c-3 requires them to adopt written liquidity procedures

REGULATION OF TENDER OFFER FUNDS

- Regulatory filings for tender offers require significantly more disclosure than filings required for interval funds' repurchase offers
- Tender offers are subject to Regulation 14D and Regulation 14E
 - Regulation 14D governs the tender offer process and ensures that the terms of the offer are disclosed to all shareholders
 - Regulation 14E outlines additional requirements regarding the timing, disclosure, and pricing of tender offers
- Tender offer funds must meet asset coverage limitations of 300%, or 200% for preferred stock; however other leverage requirements, applicable to interval funds, are not applicable for tender offer funds

REGULATED INVESTMENT COMPANIES

- Closed-end funds are typically organized as corporations and obtain pass-through tax treatment by qualifying as regulated investment companies (“RICs”) under Subchapter M of the Internal Revenue Code of 1986, as amended
- To qualify as a RIC, the fund must, among other things, elect to be treated as a RIC, distribute substantially all (e.g., 90%) of its taxable income each year and meet certain income and asset diversification tests

REGULATED INVESTMENT COMPANIES *(CONT'D)*

- Income Test:
 - At least 90% of a RIC's gross income must be derived from passive sources:
 - Dividends
 - Interest (including tax-exempt interest income)
 - Payments with respect to securities loans
 - Gains from the sale or other disposition of stock or securities or foreign currencies
 - Other income (including gains from options, futures, or forward contracts) derived from the RIC's business of investing in such stock, securities, or currencies
 - Net income derived from an interest in a qualified publicly traded partnership

REGULATED INVESTMENT COMPANIES *(CONT'D)*

- Income Test (continued):
 - Income from a partnership or trust qualifies to the extent the RIC's distributive share of such income is from items described above as realized by the partnership or trust

REGULATED INVESTMENT COMPANIES *(CONT'D)*

- Asset Diversification Test:
 - At the close of each quarter during the taxable year, a RIC must be adequately diversified by meeting both the 50% Asset Test and 25% Asset Test
 - 50% Asset Test – At least 50% of the total value of the RIC's assets must be represented by
 - Cash
 - Cash items (including receivables)
 - Government securities
 - Securities of other RICs
 - Diversified Securities

REGULATED INVESTMENT COMPANIES *(CONT'D)*

- Asset Diversification Test (continued):
 - For these purposes, Diversified Securities are securities that, with respect to any one issuer, are not worth more than 5% of the RIC's assets and which are no more than 10% of the issuer's voting securities
 - For example, assume that a RIC owns securities issued by Corporation X
 - Assuming that Corporation X is not a RIC itself, in order to count towards the 50% Asset Test, the value of those securities must be less than 5% of the RIC's total assets and the securities owned by the RIC must be less than 10% of the voting securities of Corporation X
- Assets that are not "securities" (other than cash and cash items) do not count towards satisfying the 50% Asset Test

REGULATED INVESTMENT COMPANIES *(CONT'D)*

- Asset Diversification Test (continued):
 - 25% Asset Test – Not more than 25% of the total value of the RIC's assets can be invested in:
 - The securities of any one issuer, except for Government securities or the securities of other RICs
 - The securities of two or more issuers that the RIC controls (other than other RICs)
 - The securities of one or more qualified publicly traded partnerships
 - Assets that are not "securities" are not subject to the 25 percent Asset Test limit
- Generally, distributions by a closed-end fund are taxable as either ordinary income or capital gains in the same manner as distributions from mutual funds, and a closed-end fund shareholder will recognize taxable gain or loss when it sells its shares

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