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Emerging Section 18 Issues in Closed-End Fund Finance

Growth of Closed-End Fund Industry

In the current low-yield market environment, investors have been increasingly turning to unlisted, continuously offered closed-end funds, particularly interval funds, seeking higher returns and yields.[1] Without the need for daily liquidity, closed-end funds have greater flexibility to invest in alternative, illiquid assets, and offer investors higher yields in part through a liquidity premium for the risk incurred in holding longer-term assets. These funds have invested in a variety of alternative asset classes, including infrastructure, private equity, reinsurance assets, and marketplace loans. Closed-end funds, along with business development companies, have also played an important part in the growth in the private debt industry. Some closed-end funds directly originate portfolios of loans to small businesses and middle market companies throughout the United States. These funds have seen unique opportunities in loan origination, as community banks and other traditional lenders retreated from the industry due, in part, to overregulation and industry consolidation after the 2008-2009 financial crisis.

Closed-end funds frequently employ leverage to help generate higher returns and yields. A fund, for example, may obtain traditional bank financing priced at LIBOR plus 200-400 basis points and, in turn, leverage a portfolio of directly originated loans at a weighted average yield of 800-900 basis points over LIBOR. The spread the fund realizes between the cost of funds and the realized yield on its loan portfolio contributes to the more attractive returns investors have been seeking when investing in closed-end funds.

Section 18 Background

The Investment Company Act of 1940 subjects closed-end funds to substantial requirements and restrictions when seeking to employ leverage. Section 1(b)(7) of the Act specifically states that the national public interest and the interest of investors "are adversely affected when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities." Addressing this statement of policy, Section 18(a) of the Investment Company Act provides that a closed-end fund is permitted to issue senior securities representing indebtedness only if immediately after such issuance the fund will have an asset coverage of at least 300 percent. A closed-end fund can issue preferred stock if, among other things, the fund maintains asset coverage of at least 200 percent.[2]

A "senior security" is broadly defined under Section 18(g) as any bond, debenture, note, or similar obligation, and any stock of a class having priority over any other class as to the distribution of assets or payment of dividends. In short, a senior security is any type of obligation of the fund that is senior to, or has priority over, the residual claim of equity shareholders of the fund. "Asset coverage" is defined in Section 18(h) of the Investment Company Act. With respect to senior securities representing indebtedness, asset coverage is equal to the ratio of (i) total assets of the fund, minus all liabilities and debt not representing senior securities to (ii) the aggregate amount of senior securities representing indebtedness of the fund. The asset coverage required when a fund issues preferred stock is equal to the ratio of (i) the total assets of the fund, minus all liabilities and indebtedness not representing senior securities to (ii) the aggregate amount of senior securities representing indebtedness of the fund, plus the aggregate value of the involuntary liquidation preference of the preferred stock. The "involuntary liquidation preference" under Section 18(h) is calculated as the amount of value to which preferred stock would be entitled on the involuntary liquidation of the fund in preference to a security junior to the preferred stock.

Closed-End Fund Financing Trends

The growth in the number and size of unlisted, continuously offered closed-end funds has presented unique capital structure issues under Section 18. Some closed-end funds have begun to identify and seek leverage specifically for certain pools of assets within their investment portfolios. These funds then create financing subsidiaries and contribute the assets to those subsidiaries in exchange for the equity ownership interests in the subsidiaries. Each of these subsidiaries is typically "ring-fenced" from the balance sheet of the fund and other financing subsidiaries in the event of an insolvency.

For example, a fund that invests in a variety of private credit instruments may aggregate all or part of its broadly syndicated loan assets and place them in a newly formed financing subsidiary. The fund may separately aggregate its bilateral bank loan portfolio and place it in a separate subsidiary. These portfolios of assets can then be used as collateral for financings with different banks or groups of lenders. This "ring-fencing" of assets can provide the fund with several benefits. First, the fund can offer as collateral only those specific assets a bank is willing to finance. In some cases, a lender may not have obtained the internal approvals necessary to lend against certain types of assets, particularly more illiquid assets such as bank loans or private equity limited partnership interests. By ring-fencing the assets that one lender may finance, the fund then can obtain leverage for the fund's other assets from other lenders that have broader lending authority. Second, the fund can identify lenders that may have more experience and better pricing with respect to specific types of assets. Third, if a financing subsidiary were ever to default on a financing, ring-fencing may allow that default to not adversely affect the arrangements in place with the fund's other financing subsidiaries.

Capital Structure Issues Under Section 18

The growing use of ring-fenced financing subsidiaries, however, raises unique considerations under Section 18. A fund may have two or more financing subsidiaries in place, each of which may have entered into a line of credit with a different bank. One concern under Section 18 is whether these multiple lines of credit may be considered to be separate classes of senior securities. Section 18(c) makes it unlawful for a closed-end fund to issue or sell any senior security representing indebtedness (or stock) if immediately thereafter the fund will have outstanding *more than one class* of senior security representing indebtedness (or stock) (emphasis added).[3] The purpose of limiting senior securities of a closed-end fund to a single class is to prevent a closed-end fund from misleading potential investors with complex capital structures.[4] The Staff (Staff) of the Securities and Exchange

Commission (SEC) has maintained that multiple classes of senior securities with differing rights and priorities makes the valuation of a fund's shares more difficult to determine for an ordinary investor.[5] An investor may also not be fully aware of how the different classes of senior securities may adversely affect the value of the investor's existing position in the fund.[6]

There are two statutory exceptions to the limitations imposed by Section 18(c). First, under Section 18(c)(1), a class of senior securities may be issued in one or more series if no such series has a "preference or priority over any other series upon the distribution of the assets of [the closed-end fund] or in respect of the payment of interest or dividends."[7] Second, indebtedness issued by a fund in consideration of any loan, extension or renewal of a loan that is privately arranged and not intended to be publicly distributed is not deemed to constitute a separate class of senior securities.[8] The legislative history also clarified that different series are permitted to "take care of such things as differences in interest rates."[9] In addition, a trio of no-action letters has provided additional guidance for closed-end funds when considering different but simultaneous financing arrangements.

Israel Development Corporation (1961)

The closed-end fund Israel Development Corporation (IDC) filed an application with the SEC proposing to publicly issue $3 million of unsecured 15-year debentures. The issuance was to occur while the fund also had outstanding $1.625 million principal amount of loans payable to a bank that, unlike the debentures, were secured by a pledge of various portfolio assets.[10] IDC argued that under Section 18(c)(2) the bank loans should not be treated as a class of senior securities separate from the debentures. As noted above, Section 18(c)(2) provides that indebtedness that is privately arranged and not publicly distributed will not be deemed a separate class of senior securities from publicly offered debt.

In its published Findings and Opinion resolving IDC's application, the SEC rejected the fund's argument, holding that if this construction of Section 18(c)(2) were adopted, it would allow a fund to nullify the purposes that Section 18(c) is intended to serve. Instead, the SEC held that the purpose of Section 18(c)(2) was simply to clarify the status of privately arranged debt when a fund also has publicly held debt outstanding, since the public debt would customarily not be considered a separate series and might be regarded as a *separate class* even if the private and public debt were otherwise equivalent in regard to preferences and priority.

Philadelphia Investment Company (1972)

Philadelphia Investment Company (PIC) sought to organize a closed-end fund that would, among other things, simultaneously enter into unsecured, privately negotiated loans and issue unsecured short-term notes that would be guaranteed by banks.[11] PIC represented to the SEC that the private loans and the short-term notes would both be unsecured and would be equivalent in terms of preferences as to the fund's assets. PIC argued that the fund's issuance of unsecured short-term notes was different from the issuance of debentures in the IDC letter since both the PIC private loans and note issuances were unsecured and thus, created no priority or preference of one class in violation of Section 18(c)(2).

The SEC agreed with the company's position and issued no-action assurances, provided that the fund did not enter into any agreements with any bank regarding guarantees of its unsecured short-term notes.

Allstate Municipal Premium Income Trust (1989)

Allstate Municipal Premium Income Trust (Allstate) sought to offer, concurrently, five separate series of auction rate preferred shares (ARPS). The five series of ARPS would have preference over the common shares with respect to dividend and liquidation payments. Allstate argued that offering multiple series would result in lower dividend rates on the ARPS and be more beneficial to the shareholders. Allstate relied on the SEC's conclusion in the IDC letter and maintained that the multiple-series issuance of ARPS was in compliance with Section 18(c) because no one series of ARPS would have a preference or priority over any other series upon distribution of the fund's assets.[12]

The SEC held that the issuance of separate series of preferred shares having different dividend rates would be permitted under Section 18(c) provided that no series of ARPS, in effect, would have any preference or priority over any other series of ARPS upon the distribution of assets of the fund.

Conclusion

These SEC and Staff positions provide helpful guidance for closed-end funds seeking to engage in simultaneous financings with two or more banks. As noted above, these financings are typically collateralized through a contribution of assets to a financing subsidiary. If each of the financings is secured, these arrangements would appear to be consistent with Section 18 as applied by the Staff in the Philadelphia Investment Company no-action letter. In addition, subsidiary financings with different collateral pools will attract different interest rates, and the Allstate no-action letter, along with the earlier guidance from the staff, suggests that different interest rates on senior securities should not result in one financing—or senior security—being treated as a separate class of another financing.

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NOTES

1. *See, e.g.*, "What are Interval Funds," *Wall Street Journal*, July 9, 2017, and "Interval Funds: Pros and Cons of an Alternative Investment You May Have Never Heard of," *Investment News,* April 14, 2017.
2. The required asset coverage must also be maintained after any payments or dividends or other distributions on, or any buy back of, securities that are junior to a fund's senior securities. *See* Investment Company Act Sections 18(a)(1)(B) and (a)(2)(B).
3. 15 USC § 80a-18(c) (1940).
4. *Israel Development Corporation*, Investment Company Act Release No. IC-3214, 40 S.E.C. 582, 1961 WL 61046.
5. *Id.*
6. *Id.*
7. 15 USC § 80a-18(c)(1) (1940).
8. 15 USC § 80a-18(c)(2) (1940).
9. Hearings before the House Subcommittee on Interstate and Foreign Commerce on H.R. 10065, 76th Cong., 3d Sess. (1940).
10. *See* n.2 *supra*.
11. Philadelphia Investment Company, SEC No-Action Letter (pub. avail. Aug. 27, 1972).
12. Allstate Municipal Premium Income Trust, SEC No-Action Letter (pub. avail. July 14, 1989).