

The image features a dark blue rectangular box in the top left corner containing the text 'K&L GATES' in white, sans-serif font. The background is a complex financial visualization with a grid of orange and blue lines, overlaid with various data series including bar charts, line graphs, and a world map composed of blue dots. A specific data point is labeled '+11,00.00' in orange text.

K&L GATES

2018 BOSTON INVESTMENT MANAGEMENT
CONFERENCE – November 28, 2018

**Closed-End Funds, Interval Funds, Alternative
Strategy Registered Funds, and Business
Development Companies**

Speakers:

Mark P. Goshko, Partner, Boston

Clair E. Pagnano, Partner, Boston

Jon-Luc Dupuy, Of Counsel, Boston

Pablo J. Man, Associate, Boston

OVERVIEW

- Registered funds have expanded the borders of traditional investments and strategies to meet investor demand.
- Investors looking for yield in post-crisis period of low interest rates and high equity volatility
- Fixed income investments have produced attractive interest income
- Many advisers recommend alternative allocations as part of an investor's diversified investment portfolio.
 - May involve alternative assets or alternative strategies and structures - i.e. open or closed end funds depending on liquid or illiquid nature of assets



NON-TRADITIONAL ASSET CLASSES OR STRATEGIES

- Mutual funds using "hedge fund" like strategies
 - Long/short equity funds
 - “Macro” funds using multi-manager, multi-strategy model
 - “Macro” multi-strategy fund of funds
 - Event-driven funds (special situations)
 - Event-linked funds (catastrophe bond)
 - Global macro/managed futures
 - Risk weighted multi-asset funds
 - Emerging market or frontier market investments
- Commodities Exposure (also ETPs that are not investment companies)
- Energy master limited partnership funds (MLPs in open and closed-end funds)
- Closed-end funds and illiquid and less liquid strategies



CLOSED END FUNDS OVERVIEW

- Closed end funds typically involve less liquid assets/strategies
- Increasingly important especially with increased emphasis on liquidity in open end funds due to liquidity rules
- Include various forms
 - Exchange Listed closed end funds
 - Continuously offered closed end funds - Tender Offer Funds/Interval Funds
 - Business Development Companies
 - Listed and traded
 - Continuously offered - Non-listed
 - Private - Non-listed

EXCHANGE LISTED CLOSED-END FUNDS

- Hybrid of a mutual fund and operating company
- Third-party underwritten IPOs
- Stable pool of assets – no redemptions – great for investing in certain instruments (e.g., fixed income)
- Traded on an exchange (most often NYSE)
- NAV of underlying portfolio is not anchored to market trading price
 - Most significant result of this is that the fund may trade at either a premium or a discount to its market value

TAKING ADVANTAGE OF TRADING PREMIUMS: SHELF OFFERINGS

- Permits issuance of additional shares generally into existing trading market
- Generally employed where shares are trading at a significant premium
- Fund Board must approve and conclude that benefits of program through additional assets outweighs possible impact on premium and dilution of existing investors
- Issuer-specific no-action relief permits annual updating under Rule 486(b)
- 1933 Act Rule 415
 - Fund must be reporting for at least one year
 - Permits delayed or continuous offering of Shares
 - “At the market” offering must be on delayed basis
 - Need to file new N-2 registration statement every three years
 - “Take downs” reflected in supplements to shelf registration statement



MANAGING TRADING DISCOUNTS

- When closed-end funds' market prices trade at a discount to net asset value:
 - Shareholder value diminished
 - Attracts activist shareholders seeking to arbitrage discount
 - Presents difficulties in attracting underwriters for future offerings
- Managing the problem:
 - Enhancing competitive distribution rates
 - Section 19(a) disclosures; Section 19(b) exemptive orders (managed distribution plans)
 - Open market share repurchases
 - Section 23(c) of 1940 Act; Exchange Act Rule 10b-18 safe harbor
 - Tender offers for outstanding common shares (13e-4)



ACTIVIST INVESTOR ISSUES

- Activists often engage in proxy fights with closed-end funds.
- Activists often seek seats on closed-end fund boards.
- Goals of activists:
 - Force a Fund Tender Offer
 - Liquidate the fund
 - Open-end the fund
- SEC has often sided with activist investors under rubric of shareholder democracy.



CLOSED END FUND RECENT DEVELOPMENTS

- In May 2018, President Trump signed the “Economic Growth, Regulatory Relief, and Consumer Protection Act”
 - Directed the SEC to adopt rules to allow exchange listed closed-end funds (and interval funds) to use the more streamlined securities offering and proxy rules
 - Required the SEC to propose certain rules by May 24, 2019 and finalize them by May 24, 2020
 - If the SEC does not meet those deadlines, then exchange listed closed-end funds (and interval funds) would be deemed to be “eligible issuers” under the SEC’s rules and be able to use the securities offering and proxy rules on their own
- Enabling closed-end funds to rely on these rules would, among other things:
 - Permit funds to file automatic shelf registration statements;
 - Permit funds to forward incorporate future filings by reference;
 - Permit funds to rely on additional safe harbors to communicate with the public during a public offering; and
 - Permit funds to deliver a written notice in lieu of a final prospectus for shares sold during a public offering



TENDER OFFER FUNDS AND INTERVAL FUNDS OVERVIEW

- Interval and tender offer funds are continuously offered registered closed-end funds that provide periodic liquidity to investors
- Both register on Form N-2 like any other closed-end fund
- If publicly offered, they both also rely on Rule 415 under the 1933 Act
- Differentiated primarily by structure of repurchase offers
 - *Interval funds* – repurchase conducted pursuant to fixed policy adopted under Rule 23c-3 under the 1940 Act
 - *Tender offer funds* – repurchase conducted pursuant to tender offers at the discretion of the fund's board pursuant to Rule 13e-4 under the 1934 Act



TENDER OFFER FUNDS AND INTERVAL FUNDS: KEY DIFFERENCES

- Tender offer funds have more flexibility in timing of repurchase offers than interval funds
 - Contrast: Interval funds must conduct per a fixed policy changeable only by a shareholder vote periodic repurchase offers every three, six, or twelve months; for tender offer funds, board has discretion on timing
- Tender offer funds have more flexibility in amount of repurchase offers
 - Contrast: Interval funds' repurchase offer is restricted to an amount between 5-25%; for tender offer funds, board has discretion on amount
- Tender offer funds are not subject to portfolio liquidity requirements imposed on interval funds



BUT...TENDER OFFER FUNDS OFFER LESS FLEXIBILITY IN OTHER WAYS

- For public offers, both the initial and additional shares registered require the SEC staff declaration of effectiveness
 - Contrast: For interval funds, additional shares are registered in an immediately effective amendment pursuant to Rule 486(b).
- FINRA fees due for shares registered (unlike interval funds)
- Subject to certain FINRA filing requirements and Corporate Financing Rule (However, FINRA will consider individual requests for exemptions from lifetime caps on sales compensation/distribution fee levels)
 - Contrast: Interval funds are not required to pay FINRA filing fees (subject to Rule 2341, which imposes varying caps on sales compensation/distribution fee levels, exactly like open-end funds)



TENDER OFFER FUNDS AND INTERVAL FUNDS RECENT DEVELOPMENTS

- October 2017 Treasury Report encourages SEC to promulgate rules that will allow for greater investment in private companies by registered funds
- Intended to promote creation of registered closed-end funds that invest in offerings of smaller public companies and private companies whose shares have limited or no liquidity
- Treasury Report Recommendations:
 - SEC should review interval fund rules to determine whether more flexible provisions might encourage greater investment in illiquid securities
 - Rather than requiring periodic repurchase offers, SEC should consider allowing redemptions based on a liquidity event of an underlying holding
- Because new liquidity rule may push certain asset classes to be less liquid, managers are considering alternative CEF structures such as TO and Interval Funds



WHAT ARE BUSINESS DEVELOPMENT COMPANIES (“BDCS”)?

- BDCs are special closed-end investment companies created by the Small Business Investment Incentive Act of 1980 enacted to facilitate public investment in small and developing companies. May invest in equity but typically invest in debt or middle market loans.
 - Subject to Sections 54-65 and are subject to other sections of the 1940 Act to the same extent as if they were a registered closed-end investment company.
 - BDCs generally file a form N-54A to elect to be regulated as a BDC, register under the Securities Act of 1933 (N-2), register a class of equity securities under section 12 of the Securities Exchange Act of 1934 and are subject to the disclosure and reporting rules of those laws (8k, 10K 10Q and proxy rules).
 - BDCs are required to have at least 70% of their assets invested in “eligible assets” (generally US private companies that do not have any class of publicly-traded securities with respect to which a broker may extend credit)
 - May have a class of securities listed on a national securities exchange, but must have an aggregate market value of outstanding voting and nonvoting common equity of less than \$250 million
 - BDCs must offer to provide “significant managerial assistance”



TYPES OF BDCS-INTERNALLY V. EXTERNALLY MANAGED

- **Internally Managed BDCs (initially the preferred structure – now more rare)**
 - No advisory agreement
 - Pay the operating costs associated with employing investment management personnel as opposed to an investment advisory fee
 - May issue performance based compensation or profit sharing plan
- **Externally Managed BDCs (predominant structure)**
 - Subject to an advisory agreement
 - No equity-based compensation arrangement or profit-sharing plan
 - Typically pay a management fee and also receive incentive fees
 - The capital gains incentive fee requires BDCs to take into account both capital losses and unrealized depreciation, but excludes unrealized appreciation in a BDC's portfolio.



TYPES OF BDCS

- Traded BDCs
 - Non-Traded BDCs
 - Private BDCs
-
- All BDCs must file periodic reports under the Exchange Act, including 10-Ks, 10-Qs and 8-Ks, and file proxy statements pursuant to Section 14(a) of the Exchange Act
 - Common issues for BDCs include valuation and affiliate transactions (for which exemptive relief is often sought)



BDC RECENT DEVELOPMENTS

- On March 23, 2018, Congress passed the Small Business Credit Availability Act (the “SBCAA”). The SBCAA includes various changes to regulations under the federal securities laws that impact BDCs, including:
 - Allowing BDCs to increase their debt-to-equity ratio from 1:1 to 2:1; and
 - Enabling BDCs to follow the more lenient reporting requirements and communications restrictions applicable to traditional public operating companies (See Appendix).
- This increase in permissible leverage must be approved by a publicly listed BDC’s board of directors (effective 1 year after approval) or shareholders (effective immediately upon approval).
- BDCs not publicly listed must offer to repurchase the outstanding shares of each shareholder as of the board of directors’ approval date or shareholders’ approval date of an increase in leverage. Non-listed BDCs must then repurchase, through tender offer or other means, a maximum of 25% of such outstanding shares to be repurchased in the four calendar quarters following the approval date.
- Credit rating agencies have had a mixed reaction to the new leverage rules, as S&P has announced it will downgrade any BDC that sought approval to increase leverage.



APPENDIX: SUMMARY OF SBCAA CHANGES (EFFECTIVE MARCH 23, 2019)

Securities Act Rule/Form, Schedule, or Regulation	Change
Rule 405: BDCs as WKSIs	Directs the SEC to revise Rule 405 to designate BDCs as WKSIs. BDCs which qualify as WKSIs will now be permitted to file automatic shelf registration statements.
Rules 163, 164: Free Writing Prospectuses	Permits BDCs eligible as WKSIs to utilize the “free writing prospectus” rules under the Securities Act.
Rule 497: Filing Prospectuses	Directs the SEC to revise Rule 497 to allow BDCs to file prospectuses in the same manner as non-BDCs under Rule 424(b) of the Securities Act.
Rules 172 and 173: Delivery of Prospectuses	Exempts BDCs from prospectus delivery requirements of Section 5(b)(1) of the Securities Act if the BDC has already filed or makes a good faith and reasonable effort to file a final prospectus with the SEC; permits BDCs to provide to purchasers, upon completion of a sale, either a copy of the final prospectus or notice that the sale was effected pursuant to a registration statement.
Rule 418: Supplemental Information	Directs the SEC to exclude BDCs from complying with Rule 418, which permits the SEC to request supplemental information regarding the BDC, a registration statement, the distribution of securities, market activities, and underwriters' activities.
Rules 134, 163A: Issuer Communications	Permits BDCs to benefit from safe harbors that allow issuers to make certain communications during the public registration process.
Rules 168 and 169: Factual Business Information	Directs the SEC to revise Rules 168 and 169 to allow for BDCs to benefit from the safe harbor regarding regularly released factual business information and forward looking information.
Rules 138 and 139: Publications, Distributions, and Research Reports	Allows brokers and dealers to publish publications, distributions, and research reports about a BDC and its securities without constituting an offer for sale or offer to sell under Sections 2(a)(10) and 5(c) of the Securities Act.
Form N-2: Incorporation by Reference	Directs the SEC to revise Form N-2 to permit BDCs that would otherwise meet the requirements of Form S-3 to incorporate by reference publicly filed periodic reports into their registration statements.
Schedule 14A: Filing Proxy Statements	Permits BDCs to incorporate the information in Schedule 14A Item 13(a) by reference.
Rule 103 of Regulation FD	Permits BDCs that fail to make public disclosures pursuant to disclosure requirements of Regulation FD to keep their status to utilize Form N-2.

K&L GATES