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Closed-End Funds at a Crossroads

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Long a valuable financial product, closed-end funds are facing novel challenges. New legislation can help funds overcome them—and empower retail investors to unlock the funds' full potential.

Closed-end funds are at a crossroads. For more than 80 years, these valuable financial products have provided their investors—many of whom are American retirees—with steady, diversified streams of income. These funds have also served as long-term sources of capital for small businesses and operated under a robust regulatory framework governed by the US Securities and Exchange Commission (SEC).

Yet despite their many benefits, closed-end funds have recently come up against two tough challenges, which are preventing retail investors from fully realizing the potential that these funds can offer. This is no small matter. Nearly four million US households own closed-end funds, with 48 percent of closed-end fund investors already retired and using income from these funds to help finance their day-to-day lives.

Facing Novel Challenges

The first challenge involves the securities in which closed-end funds can invest. In recent years, the SEC staff has taken an informal view—generally communicated to closed-end fund registrants during the registration process—that an exchange-listed closed-end fund may not invest in privately offered funds and that no closed-end fund may invest more than 15 percent of its net assets in such funds, unless it sells shares only to larger, professional investors.

The SEC has never issued a formal rule imposing these restrictions—nor published any guidance on the subject—yet closed-end funds must adhere to the staff's informal positions as part of their compliance responsibilities. The SEC staff's positions limit retail investors' opportunities and ability to diversify their portfolios—acting as a major roadblock to achieving the Commission's goal of providing retail investors with greater access to private markets.

The second challenge is no less harmful: sophisticated activists taking over closed-end funds in pursuit of an agenda at odds with the interests of the funds' long-term retail investors. Under current law, these activist investors can acquire large positions—sometimes even a controlling interest—in a closed-end fund, purchasing shares at a discount to the fund's net asset value. They then use their voting power to force the fund into a liquidity event, such as a tender offer, liquidation, or conversion to an open-end mutual fund.

This cynical arbitrage tactic compels the fund to buy back its shares at a price higher than what the activist investors paid—generally at or near the net asset value—providing the activists with short-term windfall profits at the expense of existing long-term retail investors. Making matters worse, the tactic undermines the core features that retail investors value in closed-end funds—such as exposure to a specific investment strategy or the ability to capture ongoing dividend income.

A Promising Solution in the Works

Fortunately, new legislation working its way through Congress—the Increasing Investor Opportunities Act—tackles both of these challenges. Introduced by Representatives Gregory Meeks (D-NY) and Anthony Gonzales (R-OH), this bipartisan bill would prevent the SEC from limiting how much closed-end funds can invest in privately offered funds, solely or primarily because the funds are privately offered. With this provision in place, retail investors will be able to access private investments more easily, under the strong protections that publicly traded, registered funds provide under the federal securities laws.

At the same time, the bill will cap at 10 percent the stake that activist investors and their affiliates can acquire in a closed-end fund, preventing the activists from securing a controlling interest. This provision would help ensure that retail investors using closed-end funds to save for their long-term financial goals can pursue those goals without worry that professional short-term traders will threaten their ability to do so.

Closed-end funds rank among the most important products in a long-term investor's toolkit, sharing many key characteristics with their better-known cousin—open-end mutual funds—but possessing unique qualities all their own. Thanks to the leadership of Representatives Meeks and Gonzalez, the outlook for closed-end funds is turning brighter. Congress should now come together to pass the Increasing Investor Opportunities Act and help closed-end funds overcome the challenges before them, for the benefit of millions of Americans.

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