

SEC Proposes Closed-End Fund Offering Reform

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On March 20, 2019, the U.S. Securities and Exchange Commission (“SEC”) proposed a series of reforms to the registration and offering processes for registered closed-end investment companies (“Registered CEFs”).¹ The proposal responds to the SEC’s congressional mandate to extend offering reforms currently available to operating companies² to Registered CEFs. The proposal includes a number of rule and form amendments that would result in greater consistency between the treatment of Registered CEFs and operating companies with respect to the registration, communication and offering processes under the Securities Act of 1933 (the “Securities Act”).

If adopted, the proposal would:

- Streamline the shelf registration process to allow Registered CEFs to raise additional capital more quickly and efficiently;
- Allow eligible Registered CEFs to qualify as “well known seasoned issuers” (“WKSIs”) and thereby make use of streamlined registration, communication and offering processes comparable to those currently available to operating company WKSIs;
- Adopt a number of changes to Registered CEFs’ ongoing reporting requirements, including a new requirement to file current reports on Form 8-K; and
- Provide Registered CEFs with greater flexibility to communicate with investors in connection with securities offerings both before and after filing a registration statement.

Although the proposed reforms to the registration and offering processes would significantly streamline the secondary offering process for Registered CEFs, the expanded disclosure requirements in shareholder reports and mandatory Form 8-K filings could increase the compliance costs and efforts associated with regular shareholder reporting. The SEC has requested comments on all portions of the proposal. Parties wishing to submit a comment letter may do so until June 10, 2019.

I. Registration and Offering Processes Reform

The SEC’s proposal would streamline the registration and offering processes for Registered CEFs conducting secondary offerings. As a result, Registered CEFs would be able to more quickly offer shares in response to market conditions. The proposed reforms would extend to Registered CEFs many of the processes currently available to operating companies and would codify processes currently available to certain funds through no-action letters or SEC staff guidance. The result would be more streamlined registration and offering processes that would allow Registered CEFs that meet certain conditions to minimize the number of filings (i.e., post-effective amendments and definitive filings under Rule 497) required to maintain a shelf offering and to take down shares off the shelf.

¹ The proposal also includes a number of reforms that would apply to business development companies and unlisted closed-end funds that are not discussed in this article. For the full text of the SEC’s proposal, visit: <https://www.sec.gov/rules/proposed/2019/33-10619.pdf>

² This article uses the term “operating company” to refer to registrants that are not registered as investment companies under the Investment Company Act of 1940.

a. Proposed Short-Form Form N-2

The SEC's proposals would allow Registered CEFs that meet certain eligibility criteria to file a short-form registration statement on Form N-2.³ Under the current regulatory regime, each registration statement or post-effective amendment filed by a Registered CEF, including one filed as part of a shelf take-down, must include all information required by Form N-2 except for pricing information. The SEC must declare any such registration statements or post-effective amendments effective, which subjects registrants to the staff review process and can result in delays in effectiveness. As proposed, the short-form Form N-2 would operate similarly to Form S-3, which is used by operating companies to register securities for shelf offerings. A Registered CEF that meets the eligibility requirements of Form S-3 would be permitted to incorporate by reference into its Form N-2 registration statement information from the fund's previous registration statements and other past *and future* regulatory filings to satisfy most Form N-2 requirements.⁴ The proposed short-form Form N-2 may substantially decrease the disclosure required in a Form N-2 filing, potentially minimizing the time and expense of preparing a registration statement and expediting the staff review process.

b. Eligibility to File Short-Form Form N-2

To be eligible to file a short-form Form N-2, a Registered CEF must meet the "registrant requirements" and "transaction requirements" set forth in Form S-3. The registrant requirements of Form S-3 would require that a Registered CEF: (i) be registered under the Investment Company Act of 1940 (the "Investment Company Act") for at least 12 calendar months immediately preceding the filing of the registration statement and (ii) have timely filed all reports required to be filed under the Investment Company Act and the Securities Exchange Act of 1934 (the "Exchange Act") during that time, including current reports on Form 8-K, as discussed below.⁵ Generally, the transaction requirements of Form S-3 would be satisfied for a primary offering if a Registered CEF has a "public float"⁶ of \$75 million or more.⁷

c. Forward Incorporation by Reference and Online Availability of Information Incorporated by Reference

The SEC proposed amending the instructions to Form N-2 to allow for forward incorporation by reference. Currently, Form N-2 does not permit funds to satisfy prospectus disclosure requirements through incorporation by reference, nor does it allow funds to incorporate by reference information from future shareholder reports or registration statements. Funds are instead required to file post-effective amendments to their registration statements to update financial information or to make other registration statement changes or updates.

If the proposal is adopted, a Registered CEF relying on the short-form Form N-2 would be permitted to incorporate by reference:

- the fund's annual report for the most recent fiscal year;
- any reports filed pursuant to Section 13(a) or 15(d) of the Exchange Act after the fund's most recent fiscal year-end (e.g., semi-annual reports); and
- all documents subsequently filed pursuant to Exchange Act Sections 13(a), 13(c), 14 or 15(d) (e.g., shareholder reports and proxy statements) before the termination of the offering.

The ability to forward incorporate information from shareholder reports filed after the registration statement becomes effective would allow Registered CEFs to efficiently update their prospectuses and access capital markets without the expense and delay of filing post-effective amendments subject to the SEC staff review process. Moreover, the proposal would also eliminate Registered CEFs' obligations to deliver information incorporated by reference to new investors. Instead, Registered CEFs would merely be required to make that information available online and provide it free of charge to any investor who requests copies.

³ The SEC has proposed a revised version of Form N-2 that includes the short-form instructions. The proposed form is available at: <https://www.sec.gov/rules/proposed/2019/33-10619-proposed-form-n-2.pdf>

⁴ Currently, registered investment companies cannot incorporate by reference future regulatory filings.

⁵ A Registered CEF's eligibility to file a short-form registration statement would not be impacted by a failure to timely file a current report on Form 8-K required solely by either of the two new reporting events applicable to Registered CEFs in addition to the other Form 8-K items identified on Form S-3. See discussion in Section II.b-c. for additional information on the proposed Form 8-K reporting requirements.

⁶ "Public float" is the aggregate market value of the voting and nonvoting common equity held by non-affiliates.

⁷ Notably, unlisted closed-end funds and interval funds do not have a public float, meaning they would be unable to use the short-form Form N-2.

d. Automatic Effectiveness of WKSJ Shelf Registration Statements

The proposal would provide for the automatic effectiveness of any short-form Form N-2 registration statement filed by a WKSJ. To qualify as a WKSJ, a Registered CEF must meet the registrant requirements of Form S-3, have at least \$700 million in public float and not otherwise be an “ineligible issuer.”⁸ WKSJs would also benefit from the ability to pay filing fees at any time in advance of each take-down in the amount required for that take-down (i.e., pay-as-you-go).

e. Omitting Information from a Base Prospectus

The SEC proposed amendments to Securities Act Rule 430B to allow Registered CEFs eligible to file short-form Form N-2 registration statements to omit certain information from their registration statements and later provide such information in a prospectus supplement filed under Securities Act Rule 424(b), as discussed below, or a future report that would be incorporated by reference into the registration statement. Currently, under Securities Act Rule 430A, Registered CEFs may omit certain information from a registration statement or post-effective amendment. However, a Registered CEF relying on Rule 430A must file a prospectus supplement pursuant to Securities Act Rule 497 within 15 business days of effectiveness in order to avoid filing another post-effective amendment that must be declared effective by the SEC.

By extending Rule 430B to Registered CEFs, a Registered CEF would be able to omit any information not known or not reasonably available to the fund at the time of filing, including applicable pricing information. In addition, a Registered CEF eligible to file a short-form Form N-2 registration statement, including a WKSJ that files an automatically effective short-form Form N-2 registration statement, would be allowed to omit a plan of distribution. Registered CEFs would then be able to file a prospectus supplement pursuant to Rule 424(b) to provide omitted information, as discussed below.

f. Filing Prospectus Supplements

The SEC proposed the extension of Rule 424(b) to Registered CEFs, which would allow those funds to file a prospectus supplement to update a prospectus, to include information omitted from a previously filed prospectus or to supplement a base prospectus with final offering terms in connection with a shelf take-down. The SEC also proposed to amend Rule 497 to establish Rule 424 as the exclusive means for Registered CEFs to file a prospectus or prospectus supplement. Rule 497, which currently applies to prospectus filings by Registered CEFs, requires Registered CEFs to file every prospectus that varies from a previously filed prospectus. Under the proposal, Registered CEFs would need to file only prospectuses that contain substantive changes, thereby allowing Registered CEFs to use a prospectus updated with minor, non-substantive changes without filing such prospectus with the SEC. In addition, prospectus supplements filed to complete information omitted from a base prospectus, as described above, would, in most cases, need to be filed within two business days of first use, rather than within 15 business days of effectiveness.

g. Final Prospectus Delivery Requirements

The SEC proposed to amend the Securities Act rules⁹ to permit Registered CEFs to satisfy prospectus delivery requirements by filing a final prospectus with the SEC. Registered CEFs would no longer be required to mail or otherwise deliver a final prospectus to each new investor. As is currently the case for operating companies, Registered CEFs merely would need to provide a notice to investors stating that the sale of securities was made pursuant to a registration statement and provide a prospectus free of charge to investors upon request. If adopted, the elimination of physical prospectus delivery would likely reduce Registered CEFs' printing, mailing and electronic distribution costs associated with registration statement updates and prospectus changes.

⁸ Under the proposed rules, an “ineligible issuer” would include: (i) any Registered CEF that has failed to file any materials and reports required by the Investment Company Act during the preceding twelve months, and/or (ii) any Registered CEF whose investment adviser, including any sub-adviser, was the subject of any judicial or administrative decree or order arising out of a governmental action that determines that the investment adviser aided or abetted or caused the Registered CEF to have violated the anti-fraud provisions of the federal securities laws during the past three years.

⁹ Securities Act Rule 172 permits operating companies to satisfy final prospectus delivery obligations under Section 5(b)(2) of the Securities Act if a final prospectus is or will be on file with the SEC within a specified time period. Securities Act Rule 173 requires a notice stating that a sale of securities was made pursuant to a registration statement or in a transaction in which a final prospectus would have been required to be delivered in the absence of Rule 172.

II. Disclosure and Reporting Proposals

a. Additional Information Required in Shareholder Reports

In order to allow Registered CEFs to take advantage of forward incorporation by reference, the SEC has proposed to add a number of disclosure items to shareholder reports. The proposed changes are intended to provide shareholders with the same or equivalent information as is currently provided in Registered CEFs' prospectuses and to create parity between the disclosure requirements applicable to operating companies and Registered CEFs. The SEC staff asserts that some Registered CEFs currently provide the information required under the proposal either voluntarily or in response to prospectus disclosure requirements. Nevertheless, the addition of these requirements may increase the cost and effort associated with the preparation of shareholder reports, offsetting some of the efficiencies of using the proposed short-form Form N-2 registration statement.

i. Information Currently Provided in Registered CEFs' Prospectuses

As proposed, a Registered CEF filing a short-form Form N-2 registration statement would be required to include fee and expense tables, share price data (premium/discount information) and senior securities information in its annual reports to shareholders. The proposed shareholder report requirements are substantially identical to the Form N-2 disclosure requirements currently in place for Registered CEFs' prospectuses.

ii. Management Discussion of Fund Performance ("MDFP")

Under the proposal, all Registered CEFs would be required to provide a narrative discussion of fund performance, including a line graph comparing fund performance to a benchmark index, in their annual reports to shareholders. These requirements would substantively mirror the requirements for open-end funds; however, the SEC also requested comment on whether the MDFP requirements currently applicable to business development companies would be more appropriate.

iii. Information Regarding Unresolved Staff Comments

A Registered CEF filing a short-form Form N-2 registration statement would be required to disclose any material, unresolved written comments received from the SEC staff to the extent those comments relate to shareholder reports, current reports or registration statements filed by the Registered CEF. This disclosure requirement would apply only to comments received within 180 days of the end of the Registered CEF's fiscal year or semi-annual period.

iv. Enhancements to Certain Registered CEFs' Annual Report Disclosure

The SEC proposed to amend Investment Company Act Rule 8b-16 to require additional detail about certain changes to a Registered CEF in its annual report to shareholders, including changes to a Registered CEF's investment objectives and policies. Rule 8b-16 currently allows Registered CEFs to forego filing an annual update to their registration statements, provided that they disclose in their annual reports information regarding certain key changes that have occurred during the prior year. The proposal would require that a Registered CEF's annual report describe any material changes to the fund's investment objectives and policies, principal risk factors, control provisions or portfolio managers with sufficient detail and context to allow shareholders to identify the current strategy or risk factor subject to change. Registered CEFs would also be required to provide a statement indicating that their annual report disclosures provide only a summary of changes that have taken place over the prior year and may not reflect all changes that have occurred since the investor purchased shares of the Registered CEF.

b. Required Form 8-K Reporting

The SEC proposed to amend Form 8-K to require reporting by Registered CEFs. Under the current regulatory regime, Registered CEFs are not required to file current reports on Form 8-K, but some do so voluntarily in compliance with exchange listing rules. Under the proposal, Registered CEFs would be required to provide more timely disclosure (i.e., within four business days) of certain information currently required only on an annual or semi-annual basis (e.g., information about matters submitted to a shareholder vote or change of accountant).

c. Proposed Form 8-K Reporting Items for Registered CEFs

The SEC's proposal would amend Form 8-K to include two new reporting requirements tailored to Registered CEFs:

- a material change to investment objectives or policies; and
- a material write-down in fair value of significant investments (i.e., a portfolio holding exceeding 10% of a fund's assets).

These additional current reporting items are intended to ensure that investors and the marketplace receive timely information about events that uniquely impact Registered CEFs.

III. Communications Reforms

The SEC proposed to amend certain Securities Act rules¹⁰ governing communications associated with a public offering of securities in order to provide increased flexibility for Registered CEFs when communicating with current and potential investors. Current SEC rules do not permit Registered CEFs to make any offers before filing a registration statement. Post-filing, Registered CEFs may make written offers only pursuant to a preliminary or statutory prospectus, although other written communications may be used if preceded or accompanied by a statutory prospectus. The SEC's proposed changes would provide parity with the communication regulations currently applicable to operating companies. The proposed amendments would allow for the types of communications described below.

a. *Tombstone Ads*

The proposal would permit Registered CEFs, and their investment advisers, to publish certain factual information about the fund or the offering.

b. *Safe-Harbor Communications*

The SEC proposed to amend the Securities Act rules to provide a "safe harbor" ending 30 days prior to filing a registration statement. Under the safe harbor, Registered CEFs, and their investment advisers, would be able to communicate without risk of violating the communications rules, as long as the communication does not reference a securities offering that is or will be the subject of a registration statement.

c. *Regularly Released Factual Business Information*

Under the proposal, Registered CEFs' investment advisers would be able to publish regularly released business information and forward looking information at any time, including around the time of a registered offering.

d. *Free Writing Prospectus*

The proposal would allow Registered CEFs to use written communications other than a statutory prospectus (i.e., a free writing prospectus) after a registration statement has been filed.

e. *WKSI Communications*

Under the proposal, Registered CEFs that qualify as WKSI would be permitted to engage in oral or written communications before or after a registration statement is filed. Communications would be subject to the same conditions as operating company WKSI.

IV. Other Proposed Rule Amendments

In addition to the registration, offering and communication rule changes described above, the proposal includes several other noteworthy proposals applicable to Registered CEFs:

a. *Restructured Payment Method for Interval Funds*

As proposed, Registered CEFs structured as interval funds would be allowed to pay registration fees in the same manner as mutual funds on a pay-as-you-go basis.

b. *Incorporate Information by Reference into Proxy Statements*

The SEC proposed to amend Schedule 14A to permit Registered CEFs eligible to file a short-form Form N-2 registration statement to incorporate information by reference from previously filed documents without delivering those documents with the proxy statement.

c. *Structured Data Requirements*

The proposal would also require Registered CEFs to use Inline XBRL format when preparing certain filings.

¹⁰ Communication rules under the Securities Act include Rule 134 (governing information that does not constitute a prospectus under the Securities Act), Rule 163A (providing a safe harbor for communications made more than 30 days prior to filing a registration statement), Rule 168 (providing for the release of factual and forward looking information at any time), Rule 169 (permitting dissemination of certain regular factual business information) and Rules 164 and 433 (regarding the use of free writing prospectuses).

V. Our Take

We believe that the proposed reforms to the registration, offering and communications processes for Registered CEFs will be viewed positively by the industry and will significantly streamline the registration process for Registered CEFs that seek to raise additional capital. The current process, which requires filing post-effective amendments subject to staff review for not only material changes but also routine updates to financial statements, as well as to effect many take-downs from a shelf, is time consuming both for the SEC staff and for registrants. Additionally, the time necessary to complete the process increases completion risk, which is the risk that fluctuations in net asset value during the staff review process may make it difficult to close a transaction at all.¹¹ The current process can also result in registrants having to suspend sales during the period when their financial statements are stale pending completion of the staff review process. Finally, the current process is not evenly applied because some, but not all, registrants are able to rely on no-action relief in connection with updating their financial statements.

We also believe that extending Form 8-K reporting to Registered CEFs will generally be received positively. Today, some Registered CEFs file current reports on Form 8-K voluntarily to report certain current events while others do not. We believe that consistent guidelines for reporting events on Form 8-K would be welcome.

We believe that the proposals to require Registered CEFs to include a narrative discussion of performance will not be objectionable; however, we believe that the specific proposal to mirror the requirements that apply to open-end funds will generate comments. Because closed-end funds normally use leverage, often to a significant degree, many closed-end funds do not consider a comparison of their performance to benchmark indices, which would be unleveraged, to be meaningful to investors. We believe that the requirement to discuss performance should provide Registered CEFs broad latitude to tailor the discussion to their specific context rather than prescribing specific information that must be presented.

We support the proposals and believe the reforms will enhance the offering process for Registered CEFs. However, we urge registrants to carefully review the many details of the proposals and participate in the comment process, particularly with respect to the ongoing reporting reforms, to ensure that the proposals do not have unintended consequences.

VI. Conclusion

If you are interested in knowing more about how the SEC proposal would impact your interests or are interested in providing public comment, please contact **Deborah Bielicke Eades** at deades@vedderprice.com or **Jacob C. Tiedt** at jtiedt@vedderprice.com.

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¹¹ Section 23 of the 1940 Act prohibits the issuance of shares at a price below net asset value. Registered CEFs that seek to issue shares in secondary offerings typically have shares that trade at a sustained premium. The longer the time it takes for the registration statement or post-effective amendment to be declared effective, the greater the risk that market or other factors could cause the premium to disappear, preventing the fund from issuing shares in compliance with Section 23.