

March 18, 2021

The Honorable Pat Toomey  
Ranking Member  
Committee on Banking, Housing  
and Urban Affairs  
United States Senate  
Washington, DC 20510

Re: Legislative Proposals to Foster Economic Growth and Capital Formation

Dear Ranking Member Toomey:

On behalf of the Investment Company Institute,\* I am pleased to submit the attached recommendations in response to your request for legislative proposals to increase economic growth and job creation by facilitating capital formation. Our recommendations, as described in the attachment, are as follows:

1. Eliminate Restrictions on Closed-End Fund Investments in Private Funds
2. Prohibit Exchanges from Implementing Rules that Restrict the Trading of Closed-End Funds of Private Funds
3. Protect Closed-End Funds from Activist Hedge Funds

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\* The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$28.5 trillion in the United States, serving more than 100 million US shareholders, and US\$9.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in Washington, DC, London, Brussels, and Hong Kong.

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Thank you for considering our submission and for the important work that you do. We look forward to working with you and the Committee as this project moves forward.

Sincerely,

A handwritten signature in black ink that reads "Eric J. Pan". The signature is written in a cursive style with a large, sweeping initial "E".

Eric J. Pan  
President & CEO  
Investment Company Institute

Attachment

cc: Chairman Sherrod Brown

## **Legislative Proposals to Increase Economic Growth and Job Creation**

### **1. Eliminate Restrictions on Closed-End Fund Investments in Private Funds**

Description of the Proposal: Permit any registered closed-end fund (“CEF”), including a CEF that offers its shares to retail investors, to invest in privately offered funds without limit.

Background/Why Proposal is Needed:

- CEFs are important retirement savings and investment vehicles for retail investors. CEFs, like mutual funds and other registered funds, also serve as a long-term source of capital for operating companies.
- CEFs are regulated in a manner similar to mutual funds with, among other things, requirements regarding governance, restrictions on their transactions with affiliates, and custody of their assets. Unlike mutual funds, however, CEFs have more flexibility to invest in less liquid assets. In addition, investment advisers to registered funds, like CEFs, must be registered under, and are subject to, the Investment Advisers Act of 1940. The Investment Advisers Act separately imposes fiduciary obligations and disclosure requirements upon registered investment advisers.
- Congress can increase economic growth and job creation responsibly by eliminating unnecessary barriers CEFs face that prevent them from investing in private funds and being offered to retail investors.
- The Securities and Exchange Commission staff currently restricts any CEF from investing more than 15 percent of its net assets in private funds, unless the CEF sells its shares to accredited investors who make minimum initial investments of at least \$25,000. This position is at odds with the Investment Company Act of 1940, which does not restrict CEFs from investing in less liquid assets. The statutory treatment is appropriate because, unlike mutual funds, most CEFs are not required to offer shareholders redemption rights and, therefore, do not need to hold liquid investments to meet redemptions. Instead, after the CEF’s initial public offering, investors typically buy and sell CEF shares in the secondary market.
- The staff concerns about retail investors’ increased access to private funds seem motivated by valuation of private funds’ portfolio securities and lack of transparency into the funds’ holdings.
- But these concerns are addressed when a registered fund is inserted between retail investors and private funds. Retail investors gaining access to privately offered securities via a registered fund fundamentally differs from them directly investing in private securities. Registered funds are

subject to strict substantive requirements governing their operations and disclosure, which the SEC oversees through examinations and enforcement actions. For example, to comply with the Investment Company Act, a registered fund manager’s due diligence should include an assessment of underlying private fund valuation mechanisms to ensure that the registered fund can meet its own valuation requirements under the Investment Company Act, which the SEC recently enhanced.

- Further, it is consistent with retail investors currently accessing derivatives, other privately offered securities, and repurchase agreements through registered funds – investments that a retail investor could not invest in directly. The ability to gain exposure to such assets through a registered fund, like a CEF, is an important benefit for retail investors.

Impact on Economic Growth and Investor Protection:

- Enabling CEFs to more fully invest in private funds will provide retail investors with greater exposure to investment opportunities that currently are unavailable to them directly.
- The capital from these private fund investments may be deployed to generate new opportunities for growth in areas that may be less well developed. These opportunities could include investments in smaller companies and other areas in need of capital.
- Providing retail investors access to these investments through registered funds, such as CEFs, provides strong investor protections. As noted above, investment advisers to registered funds are subject to the Investment Advisers Act and registered funds are subject to the Investment Company Act. These protections clearly distinguish registered funds and make them eligible for retail investor investment.

Legislative Language:

- We support H.R. 8786, the “Increasing Investor Opportunities Act,” first introduced by Congressman Gonzalez (R-OH) on November 19, 2020, which would amend Sections 5 and 2(a) of the Investment Company Act (15 U.S.C. 80a-5 and U.S.C. 80a-2(a)) and Section 202(a) of the Investment Advisers Act (15 U.S.C. 80b-2(a)):

(a) IN GENERAL.—Section 5 of the Investment Company Act of 1940 (15 U.S.C. 80a-5) is amended by adding at the end the following:

“(d) CLOSED-END COMPANY AUTHORITY TO INVEST IN PRIVATE FUNDS.—

“(1) IN GENERAL. —The Commission may not limit a closed-end company from investing any or all of the company’s assets in private funds solely or primarily because of the private funds’ status as private funds.

“(2) APPLICATION. —Notwithstanding section 6(f), this subsection shall also apply to a closed-end company that elects to be treated as a business development company.”.

(b) DEFINITION OF A PRIVATE FUND.—

(1) INVESTMENT COMPANY ACT OF 1940.—Section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)) is amended by adding at the end the following:

“(55) The term ‘private fund’ means an issuer that would be an investment company but for paragraph (1) or (7) of section 3(c).”.

(2) INVESTMENT ADVISERS ACT OF 1940.—The first paragraph (29) (relating to “private fund”) of section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)) is amended to read as follows:

“(29) The term ‘private fund’ has the meaning given that term under section 2(a) of the Investment Company Act of 1940.”.

Other Background Materials:

- Letter from Susan M. Olson, General Counsel, Investment Company Institute, to Vanessa Countryman, Secretary, Securities and Exchange Commission, dated September 24, 2019, available at <https://www.sec.gov/comments/s7-08-19/s70819-6190597-192465.pdf> (providing comments on the SEC’s concept release on the harmonization of securities offering exemptions).

## 2. Prohibit Exchanges from Implementing Rules that Restrict the Trading of Closed-End Funds of Private Funds

Description of the Proposal: Permit CEFs that invest in private funds to list and trade on public exchanges.

Background/Why Proposal is Needed:

- In addition to Investment Company Act requirements, listed CEFs are subject to national securities exchange requirements. These exchange requirements, among other things, compel CEFs to promptly release any information that might reasonably be expected to materially affect the market for its securities, hold annual shareholder meetings, and comply with governance standards.
- We understand that various exchanges have required CEFs seeking to list to confirm that they will not invest in private funds before permitting them to list and trade. We further understand that the SEC staff has directed the exchanges to take this position.
- Similar to the staff position imposing the 15 percent limit on CEF investments in private funds, the rationale for the listing restriction is not entirely clear. No current CEF initial listing and continuing listing standards otherwise would restrict CEFs that invest in private funds from listing and trading on various exchanges.
- For the same reasons as above, the Commission and exchanges should permit CEFs that invest in private funds to list and trade on public exchanges.

Impact on Economic Growth and Investor Protection:

- In addition to providing retail investors with greater investment opportunities through strictly regulated registered funds and encouraging enhanced capital formation, enabling CEFs that hold private funds to list and trade on a national securities exchange could attract further interest and provide enhanced liquidity to CEF investors.

Legislative Language:

- We support H.R. 8786, the “Increasing Investor Opportunities Act,” first introduced by Congressman Gonzalez (R-OH) on November 19, 2020, which would amend Section 6(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(b)) by adding at the end the following:

“(b) DETERMINATION BY COMMISSION REQUISITE TO REGISTRATION OF APPLICANT AS A NATIONAL SECURITIES EXCHANGE.—

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- “(11) (A) The rules of the exchange do not prohibit the listing or trading of securities of a closed-end company solely or primarily by reason of the amount of the company’s investment of assets in private funds.

“(B) In this paragraph—

“(i) the term ‘closed-end company’ has the meaning given that term under section 5(a) of the Investment Company Act of 1940, and includes a closed-end company that elects to be treated as a business development company under section 6(f) of such Act; and

“(ii) the term ‘private fund’ has the meaning given that term under section 2(a) of the Investment Company Act of 1940.”.

Other Background Materials:

- Letter from Susan M. Olson, General Counsel, Investment Company Institute, to Vanessa Countryman, Secretary, Securities and Exchange Commission, dated September 24, 2019, *available at* <https://www.sec.gov/comments/s7-08-19/s70819-6190597-192465.pdf> (providing comments on the SEC’s concept release on the harmonization of securities offering exemptions).

### 3. Protect Closed-End Funds from Activist Hedge Funds

Description of the Proposal: Treat a private fund that acquires CEF shares the same as a registered fund that acquires CEF shares. That is, restrict any private fund, any investment company having the same investment adviser as the private fund, and any company controlled by the private fund from obtaining more than ten percent of the outstanding shares of a CEF.

Background/Why Proposal is Needed:

- Notwithstanding their many benefits, the number of CEFs has steadily declined over the last decade. One reason for this decline stems from shareholder activists, who have been targeting CEFs more intensively.
- Activists use private funds to acquire a CEF's shares on the secondary market, often targeting CEFs trading at a significant discount to the fund's net asset value. The activists accumulate large positions in the fund and then seek to cause the fund to take actions to provide liquidity (*e.g.*, conduct a tender offer, convert the fund to an open-end fund, or liquidate the fund) at a price at, or close to, net asset value. With this investment strategy, the activists are able to realize the difference between the discounted market purchase price and the higher tender or redemption price.
- To provide liquidity, a CEF often must sell portfolio securities and/or reduce leverage to satisfy the tenders. These actions hurt shareholders that remain in the fund, including long-term shareholders that purchased fund shares for exposure to the fund's investment strategy, as they divert the fund from its investment strategy, cause shareholders to incur negative tax consequences, and, ultimately, reduce the size of the fund.
- Although there are statutory limits on the amounts that funds, including private funds, can invest in registered funds, the limits specifically dealing with CEFs do not restrict private fund investments in CEFs.
- Section 12(d)(1)(A)(i) of the Investment Company Act restricts any investment company and any companies controlled by the investment company from acquiring more than three percent of the outstanding voting stock of a registered fund. For these purposes, the term "investment company" *includes* private funds.
- Section 12(d)(1)(C) of the Investment Company Act similarly restricts investment companies, other investment companies having the same investment adviser, and companies controlled by the investment companies from owning more than ten percent of the total outstanding voting



stock of a CEF. For that section, however, the term “investment company” *does not include* private funds.

- Congress enacted Section 12(d)(1) to address abuses that can arise when one investment company (“acquiring fund”) invests in a registered fund (“acquired fund”), including the pyramiding of control and the exercise of undue influence. Congress feared that the acquiring fund may attempt to use its voting position to exert excessive influence over the acquired fund. Section 12(d)(1) recognized that registered fund investors could be harmed if large outside funds caused the registered fund to be managed to benefit the outside fund (and its investors) rather than in the interest of all of the registered fund’s shareholders.
- Activists now are avoiding the restrictions and intent of Sections 12(d)(1)(A) and (C) to harm CEF long-term shareholders. Many activists use multiple private funds to acquire up to three percent of a CEF in compliance with Section 12(d)(1)(A). They then will use multiple private funds to exceed the ten percent limit under Section 12(d)(1)(C). Upon acquiring a significant position in the CEF, they will force the liquidity events described above, harming long-term CEF shareholders.
- Imposing this restriction would put private funds on a level playing field with registered funds and would close the loophole many activists use to take advantage of CEF shareholders. It also would treat private funds consistently with the way they are treated for other Section 12(d)(1) requirements.

#### Impact on Economic Growth and Investor Protection:

- Protecting CEFs and their shareholders from activist hedge funds seeking profits at the expense of the CEFs and their shareholders would encourage CEF sponsors to launch more registered CEFs that can facilitate capital formation.
- It also would encourage long-term retail investors to invest in CEFs that are operated consistent with the fund’s stated investment objective without fear that the fund’s investment strategy will change or that the fund suddenly will liquidate.

#### Legislative Language:

- We support H.R. 8786, the “Increasing Investor Opportunities Act,” first introduced by Congressman Gonzalez (R-OH) on November 19, 2020, which would amend Section 3(c) of the Investment Company Act (15 U.S.C. 80a-3(c)):
  - (a) in paragraph (1), by striking “subparagraphs (A)(i) and (B)(i)” and inserting “subparagraphs (A)(i), (B)(i), and (C)”;

(b) in paragraph (7)(D), by striking “subparagraphs (A)(i) and (B)(i)” and inserting “subparagraphs (A)(i), (B)(i), and (C)”.

Other Background Materials:

- Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Vanessa Countryman, Secretary, Securities and Exchange Commission, dated April 30, 2019, *available at* <https://www.sec.gov/comments/s7-27-18/s72718-5433908-184637.pdf> (recommending legislative changes to address private fund investments in CEFs).
- ICI, Recommendations on the Availability of Closed-End Fund Takeover Defenses (March 2020), *available at* [https://www.ici.org/pdf/20\\_ltr\\_cef.pdf](https://www.ici.org/pdf/20_ltr_cef.pdf) (describing the prevalence and detrimental effects of activist investors in CEFs).