

MEMO# 1230

June 22, 1989

ISSUES CONCERNING CLOSED-END FUND TENDER OFFERS

June 22, 1989 TO: CLOSED-END FUND COMMITTEE NO. 19-89 SEC RULES COMMITTEE NO. 30-89 RE: ISSUES CONCERNING CLOSED-END FUND TENDER OFFERS

Several closed-end funds have conducted or have disclosed in their prospectuses their intention to conduct issuer tender offers in an effort to provide liquidity to shareholders or, if a secondary market exists for the fund shares, to seek to prevent the shares from trading at a discount. In March several members of the ICI staff met with representatives of the Divisions of Corporation Finance, Market Regulation and Investment Management to discuss various issues that the staff raised in connection with closed-end fund tender offers. A summary of the issues discussed at the meeting was then distributed. (See Memorandum to Closed-End Fund Members No. 17-89, dated April 7, 1989.) Set forth below are the issues that we believe are of significance and should be further considered:

All Holders Rule. One way to avoid participation by arbitrageurs in a closed-end fund tender offer is to establish a record date for shareholders that may participate in the tender offer. The SEC staff contends that this is prohibited under the "all holders rule" under Rule 13e-4(f)(8)(i) of the Securities Exchange Act of 1934 which requires that a tender offer be open to all shareholders and therefore investors who purchase fund shares after the commencement of the tender offer must be included in the offer.

Odd Lot Tender Offers. With respect to "odd lot tender offers" permitted under Rule 13e-4, i.e., tender offers made only to holders of fewer than 100 shares, the staff raised the issue that such offers may not be permitted under Section 23(c)(2) of the Investment Company Act of 1940. Section 23(c)(2) requires that closed-end fund tender offers be made to all shareholders of the class of securities to be purchased. Generally, the purpose of odd lot tender offers is to enable the issuer to reduce the high costs of servicing small shareholder accounts.

Best Price Rule. The "best price rule" under Rule 13e-4(f)(8)(ii) requires that the highest consideration paid for tendered shares be paid to all shareholders. The staff believes that this rule prohibits funds from waiving sales-related charges for certain affiliated persons of the fund, e.g., officers and employees, that may be imposed as a result of tendering their shares. The staff has also raised the concern that the best price rule may prohibit an issuer from imposing a flat fee on tendering shareholders as opposed to a fee that varies based on the number of shares tendered.

Financing of Tender Offers. Rule 13e-4(f)(5) requires that "prompt" payment be made for shares tendered pursuant to an issuer tender offer. Prompt payment has been interpreted as generally meaning within five business days. The staff is concerned that closed-end funds, especially those tendering for all of their shares, may not have sufficient cash on hand or liquidity of assets to make prompt payment for tendered shares. This issue raises several additional concerns such as the fact that the 1940 Act includes certain restrictions with respect to borrowing, that a fund may be in violation of a fundamental

investment objective if it is holding an excessive amount of cash or cash equivalent assets and that a fund that tenders for only a portion of its shares may, if too many shares are tendered and the fund does not intend to purchase tendered shares on a pro rata basis, have to extend the tender offer period resulting in additional costs and administrative burdens. Tax Issues. In addition to the securities law issues discussed above, there is a possible tax issue with respect to periodic tender offers. Under Internal Revenue Code Section 305(b)(2), a distribution of a corporation's stock is taxable to its recipients if the distribution results in (a) the receipt of property by some shareholders, and (b) an increase in the proportionate interests of other shareholders in the assets or earnings of the corporation. It has been suggested that the regulations under Code Section 305(c) indicate that as a result of periodic tender offers, non-tendering shareholders may receive a "deemed distribution" of fund shares which may be treated as a taxable dividend even though they did not, in fact, receive a distribution. The triggering of the constructive distribution rule also may, under this interpretation, result in the payments to tendering shareholders and the deemed distribution to non-tendering shareholders being treated as preferential dividends. * * * - 3 - We would appreciate receiving your views as to which of the above issues, or any other issues relating to closed-end fund tender offers, the Institute should pursue with the SEC staff or the IRS. In addition, please let me know if you think it would be beneficial to hold a meeting to further discuss these issues. My direct number is (202) 955-3523. Please provide me with your views by July 14, 1989. Amy B. Rosenblum
Assistant General Counsel