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## CLOSED-END FUND IPO CONSIDERATIONS

*Benjamin P. Edwards\**

### INTRODUCTION

While closed-end funds (CEFs) have a long history, relatively recent research in economics and finance has provided new insights about these funds. This essay explains the unique structure of CEFs and argues that absent a compelling reason, investors should generally avoid purchasing CEF shares in an initial public offering (IPO).

Few investment options seem less attractive than buying the shares of a closed-end fund in an IPO, particularly if similar CEFs already exist. Indeed, the continuing existence of CEFs has puzzled economists for decades. Because the IPO shares are sold at a premium and will soon trade at a significant discount, economists cannot discern any good reason why a rational investor would purchase CEF shares in an IPO instead of purchasing the shares of a CEF already on the market.<sup>1</sup> If no rational investor would buy CEF shares during an IPO, then CEFs should eventually cease to exist because new CEFs would not be created.<sup>2</sup> Yet CEF IPOs persist, and stockbrokers continue to sell CEF shares to retail investors, despite a long record of underperformance.<sup>3</sup>

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1. See Charles M. C. Lee, Andrei Shleifer & Richard H. Thaler, *Anomalies: Closed-End Mutual Funds*, 4 J. ECON. PERSP. 153 (1990) [hereinafter *Anomalies*] (“So, puzzle one: Why does anyone buy these funds when they are first issued?”); Charles M. C. Lee, Andrei Shleifer & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 46 J. FIN. 75, 75 (1991) [hereinafter *Investor Sentiment*] (“Few problems in finance are as perplexing as the closed-end fund puzzle”).

2. See Kathleen Weiss Hanley, Charles M. C. Lee & Paul J. Seguin, *The Marketing of Closed-End Fund IPOs: Evidence from Transactions Data*, 5 J. FIN. INTERMEDIATION 127, 127 (1996) (“in a rational expectation equilibrium, these [CEFs] should not get started at all”).

3. One recent study revealed that when compared against CEF shares already on the market (seasoned shares), shares purchased during a CEF IPO underperformed seasoned shares by 8.52% after six months and 11.05% after one year. DIANA SHAO, CLOSED-END FUND IPOs: SOLD NOT BOUGHT (Aug. 27, 2015) (unpublished).

This essay breaks down some of the unique characteristics of CEFs and their IPOs. It then turns to consider whether broker-dealer firms conducting CEF IPOs act in a manner consistent with their customers' best interests. Ultimately, I argue that the sale of CEF IPO shares appears difficult to reconcile with the best interests of retail investors.

### I. CLOSED-END FUND CHARACTERISTICS

A CEF is an investment company that differs from more common open-end mutual funds in important ways.<sup>4</sup> Unlike the ordinary open-end mutual fund, a CEF does not continually offer shares for investors to purchase. Rather, a CEF sells a fixed number of shares at one time.<sup>5</sup> If the CEF's investors seek to liquidate their holdings, they must find another market participant to buy their shares. A CEF share's value is determined by the supply of and demand for the CEF share. The CEF does not sell any assets to redeem shares until some later point when it may liquidate or convert into an open-end fund. This means that the market sets the price for a CEF's shares and that it may differ significantly from the net asset value (NAV) of the assets held by the CEF.<sup>6</sup> In contrast, the price of an ordinary mutual fund's shares is set by the value of its assets, which are sold or purchased as money flows out of or into the fund. This means that investors holding ordinary mutual fund shares may sell their shares in exchange for a payment approximating the mutual fund's NAV. This is not always the case with CEFs, which frequently trade at a discount to NAV because the secondary market value for CEF shares frequently settles at some point significantly below the CEF's NAV.

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manuscript), <http://ssrn.com/abstract=2652432> or <http://dx.doi.org/10.2139/ssrn.2652432>.

4. For a description of the difference, see Daniel S. Alterbaum, *Control Share Acts, Closed-End Funds, and the Battle for Corporate Control*, 17 STAN. J.L. BUS. & FIN. 310, 316 (2012).

5. See SEC, *Closed End Fund Information*, FAST ANSWERS, available: <http://www.sec.gov/answers/mfclose.htm> (last modified Jan 16, 2013).

6. A fund's NAV is calculated by dividing the funds asset value by its number of shares outstanding.

*A. The CEF Initial Public Offering Puzzle*

CEF IPOs puzzle economists because the public pays more for a CEF's shares than the value of the assets held by the CEF. Put differently, investors purchasing CEF shares in an IPO seemingly pay more for the shares than they are worth.<sup>7</sup> Creating a CEF is not costless. The overall underwriting and promotion expenses may reach about eight percent of the offering price.<sup>8</sup> After raising these funds and paying offering expenses, the CEF uses the remaining proceeds to buy its portfolio of securities—assets which already have established market values. This raises an obvious question: why would any rational person pay \$100 for \$92 of assets? What justifies this significant premium?

If a CEF's shares increased in value after the IPO, that price increase could explain why investors would pay a premium for shares. But this is not what happens. CEF IPOs differ significantly from the IPOs of the securities of traditional industrial issuers, *i.e.*, firms that produce goods for sale. When an industrial firm goes public, the securities offered in the IPO usually increase in price by a significant amount, rewarding purchasers and making the decision to purchase IPO shares rational.<sup>9</sup> In contrast, CEF IPOs generally provide their purchasers with zero first day returns because the CEF shares do not ordinarily trade for an amount greater than the CEF's net asset value.

The different first day behavior for industrial firm IPOs and CEF IPOs makes intuitive sense. When an ordinary business sells shares to the public in an IPO, no established market value for the firm exists. As the shares begin to trade, the market sets a price for the shares and values the company. To induce investors to purchase the shares at the IPO, industrial firms ordinarily price their IPO shares at something below anticipated market price. When the shares hit the market, they frequently trade up—which is to say that the shares appreciate in price as other market participants bid to acquire the shares because they view the IPO price to be less than the firm's intrinsic value—or at least the value other market participants will likely assign it. In contrast, a CEF generally purchases financial assets that already have established market values; the CEF's shares do not ordinarily trade up. This indicates that market

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7. *Anomalies*, *supra* note 1, at 162 (“To explain why investors buy funds initially at a premium *one needs to have noise traders, or ‘suckers,’* who are sufficiently optimistic to buy overpriced assets”) (emphasis added).

8. Hanley *et al.*, *supra* note 2.

9. Hanley *et al.*, *supra* note 2 (“While industrial IPOs have an average initial day return of approximately sixteen percent, closed-end fund IPOs show zero first-day returns”).

participants do not view the CEF's creation as transformative enough to justify paying more than \$100 per share for approximately \$92 of net asset value per share.

### *B. The Puzzling Discount*

The decision to purchase shares in a CEF IPO appears even more puzzling because the shares that are first sold at a premium soon sink to trade at a discount to the CEF's NAV as the fund seasons.<sup>10</sup> A "seasoned" CEF is one that has already been on the market for some time and is generally trading at a discount.

Why seasoned CEFs trade at a discount also puzzles economists because a CEF's assets have established market prices. When a seasoned CEF owns \$92 of securities, a rational investor would seemingly want to buy a CEF share if it were priced below \$92 because the investor would be able to acquire \$92 worth of assets for something less than \$92. Despite this, CEFs normally trade at significant discounts after six months, often as much as 10% or more.<sup>11</sup> While a variety of explanations for the usual discount and occasional premium have been proffered by academics, the discount phenomenon is so well established that the Securities and Exchange Commission requires CEF issuers to state that CEFs normally trade at a discount in their prospectuses.<sup>12</sup>

If, for some rational reason, an investor wanted to buy the shares of a CEF, the choice between buying IPO shares and seasoned shares appears clear.<sup>13</sup> If shares of a similar, seasoned CEF may be acquired at a discount, no rational investor should purchase shares in a CEF IPO. Investors purchasing in the IPO essentially forgo the opportunity to acquire a seasoned CEF at a discount and instead purchase an unseasoned CEF at a premium. To illustrate the decision, an investor purchasing shares in a CEF IPO may pay \$100 for \$92 worth of assets with a near certainty that she will only be able to sell her

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10. Of course, CEF shares may also trade at a premium to NAV but do so much less frequently.

11. See Edward S. O'Neal, *Closed-end Fund IPOs*, SEC. LITIG. AND CONSULTING GRP., at 2 (2007), <http://www.slcg.com/pdf/workingpapers/Closed%20End%20Fund%20IPOs.pdf>.

12. Registration Form For Closed-End Management Investment Companies, Securities Act Release No. 6842, 1989 WL 257682 (SEC) (July 28, 1989).

13. See Shao, *supra* note 3 (documenting the remarkable underperformance of CEF IPO shares when compared to similar, seasoned CEF shares).

interest in the CEF at a discount, e.g. for \$82, after a holding the CEF for six months. In contrast, had the investor purchased a similar, seasoned CEF share at a discount in the market, she could have acquired a similar pool of assets with a NAV of \$92 for only \$82. It could be rational for an investor to purchase these discounted shares if she would be able to hold the CEF until it liquidates or converts into an open-ended structure, allowing investors to redeem their shares for NAV.

### C. *The Price Stabilization Problem*

CEF IPOs are also unique because of the time it takes for the discount to emerge. This gap reveals that extensive price stabilization occurs in the weeks following the IPO with the lead underwriter or underwriters seemingly supporting the price for an initial period.<sup>14</sup> While ordinary industrial firm IPOs quickly move to an efficient market price, most of the price decline for CEF shares occurs somewhere between 30 and 100 days after the IPO.<sup>15</sup>

Initial price supports delay the inevitable adjustment to a fair market price. Illustrating the extent of price supports, one recent study found that “the ratio of the volume of seller-initiated to buyer-initiated trades on the first day is approximately 19:1.”<sup>16</sup> This high sell-to-buy ratio indicates that, while many CEF IPO purchasers quickly dump their shares during the initial period, the market provides few willing buyers other than the underwriter providing price supports.<sup>17</sup> This rush of initial sales creates a problem for the underwriters providing financial support. If too many initial investors are “flippers” (persons that immediately sell IPO shares), it may be too costly for an

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14. See Hanley *et al.*, *supra* note 2, at 2 (“We also observe several indicators of *considerable* price stabilization”) (emphasis added).

15. See Kathleen Weiss, *The Post-Offering Price Performance of Closed-End Funds*, 18 FIN. MGMT. 57 (1989).

16. See Hanley *et al.*, *supra* note 2, at 15 (further explaining that “when foreign country funds are removed from the sample [of CEF IPO transaction data] the [sell to buy] ratio exceeds 70:1”).

17. One additional factor causing the delay may be the inability of market participants to short the CEF as soon as it begins to trade. It generally takes at least a month for a CEF’s shares to be formally delivered to broker-dealers and thus available for other investors to borrow and short.

underwriter to sustain price supports.<sup>18</sup>

Yet, why become a flipper with CEF IPO shares? Why would an investor pay a premium over NAV for IPO shares only to sell them back after the IPO for *the same* price-supported purchase price? What profit could come from this rapid turnover? One possible explanation is that brokers employed by members of the underwriting syndicate—particularly those members not providing the price support—may sell to flippers “to quickly collect the selling fees.”<sup>19</sup> The flippers may agree to buy for two reasons: (i) a quick sell during the price stabilization period carries little risk; and (ii) brokers may “promise favors, including large allocations in future *underpriced* IPOs.”<sup>20</sup> Thus, flippers may be seeking to profit not from the CEF IPO but from their relationship with a particular broker. By helping a broker obtain a large commission, the investor may curry favor and gain access to underpriced IPOs.

Buying back IPO shares from these flippers costs the underwriters money. Why do lead underwriters provide this price stabilization? There are at least three reasons for underwriters to stabilize secondary market prices for an initial period. First, a stable price may protect the “lead underwriter’s relationship with investors as well as its reputational capital.”<sup>21</sup> Second, a delayed drop may obscure reality—that the CEF’s shares were overpriced in the IPO. Finally, the actual cost of price support may be mitigated if, anticipating a barrage of flippers, the underwriters sold more shares than actually issued, giving the underwriters a net short position that may be covered by buying back flipper shares post IPO.<sup>22</sup> Correctly anticipating flipper volume allows a lead underwriter to sustain price supports and avoid the reputational stigma associated with an immediate decline in price.<sup>23</sup>

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18. See Hanley *et al.*, *supra* note 2, at 2.

19. *Id.* at 7 (emphasis added).

20. One additional possibility is that some flippers may agree to purchase after the broker promises to split the generous selling commission.

21. See Hanley *et al.*, *supra* note 2, at 6. For a discussion illustrating the vital importance of reputation in a different economic context, see Jamila Jefferson-Jones, *A Good Name: Applying Regulatory Takings Analysis to Reputational Damage Caused by Criminal History*, 116 W. VA. L. REV. 497, 527 (2013).

22. For a description of the techniques underwriters use to manage the costs of flipping, see Hanley *et al.*, *supra* note 2, at 8-10 (describing the use of the over-allotment or “green shoe” option).

23 See Shao, *supra* note 3, at 4 (“To delay and camouflage the price decline,

*D. Institutional Investors Avoid CEF IPOs*

While price stabilization delays the decline and obscures the overpriced nature of CEF IPO shares, it does not induce all investors to buy CEF IPOs.<sup>24</sup> Recent empirical information regarding CEF holders tends to confirm the impression that sophisticated investors do not purchase CEF shares in IPOs.<sup>25</sup> The evidence indicates that “institutional ownership in recent CEF IPOs is extremely low compared to operating company IPOs.”<sup>26</sup> This means that, when institutional money managers evaluate investment opportunities, they generally pass on CEF IPOs.<sup>27</sup>

*E. Other Unique Attributes*

To be sure, the closed-end fund structure does offer certain unique attributes that are not available to open-end funds—attributes which might theoretically justify a decision to pay a premium. For instance, unlike an open-ended fund, a closed-end fund does not have to liquidate investment positions when a shareholder wants to sell.<sup>28</sup> This allows CEFs to take less liquid positions without fear that investor demands for return of capital will force

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underwriters provide price support.”).

24. See Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 725 (2003) (“institutions hold only a very small percentage of closed-end mutual fund shares, leaving individual investors as the central clientele for this type of investment.”).

25. See Shao, *supra* note 3.

26. *Id.* at 3.

27. If an institutional money manager purchased and held CEF IPO shares, they would underperform and likely attract less capital than their competitors. See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 893 (2013) (“For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly.”).

28. See John P. Freeman, Stuart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and A Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 153 (2008) (“closed-end funds feature less liquidity pressure than mutual funds since their shares are not redeemable, and new shares are not constantly being sold.”).



them to liquidate their positions. While CEFs have the ability to take these less liquid, longer-term positions, one recent study found that, in practice, CEFs tend to hold more short maturity assets than open-ended funds.<sup>29</sup>

CEFs may also employ more leverage than open-ended mutual funds.<sup>30</sup> Funds using more leverage may experience higher returns and greater volatility and risk.

## II. CLOSED-END FUND IPOs & INVESTOR INTERESTS

Sales to retail customers are currently governed by the Financial Industry Regulatory Authority's controversial "suitability" standard.<sup>31</sup> Rather than attempting to parse the precise meaning of the suitability standard,<sup>32</sup> this essay simply considers whether recommending CEF IPO shares is generally consistent with most retail investors' best interests in light of the arguments frequently proffered to justify CEF IPOs.

It appears difficult to reconcile most sales of CEF IPO shares with the best interests of investors, raising questions about why the offerings occur. Economists and other experts studying the products have theorized that the

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29. See Edwin J. Elton, Martin J. Gruber, Christopher R. Blake & Or Shachar, *Why Do Closed-End Bond Funds Exist? An Additional Explanation for the Growth in Domestic Closed-End Bond Funds*, 48 J. FIN. AND QUANTITATIVE ANALYSIS 405 (2013), available at <http://ssrn.com/abstract=1591157>.

30. For a discussion about how closed-end funds may use more leverage than open-ended funds, see LOIS YUROW, TIMOTHY W. LEVIN, W. JOHN MCGUIRE & JAMES M. STOREY, *MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK* § 32:4 (2015).

31. For discussions about the distinctions between a best interests Financial Industry Regulatory Authority's current suitability standard, see Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will A Uniform Fiduciary Duty Make A Material Difference?*, 14 J. BUS. & SEC. L. 105, 111 (2014); Christine Lazaro & Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call for Harmonization*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 47, 66-67 (2014) ("the Suitability Rule does not explicitly provide that a Broker's recommendations must be in the customer's best interests").

32. For an analysis and authority that the suitability standard requires recommendations consistent with customers' best interests, see James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and A Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 19 (2012) (collecting authority).

CEF IPO shares are bought by “noise traders, or ‘suckers,’ who are sufficiently optimistic to buy overpriced assets.”<sup>33</sup> Some assert that “[i]nvestors who wish to hold closed-end funds should never buy them at the IPO and the suggestion that they should by financial advisors is suspect.”<sup>34</sup> If only a “sucker” would buy the overpriced asset, there may not be a reasonable basis for concluding that the purchase is consistent with an investor’s best interests.

#### A. *Eventual Positive Share Price Return*

Still, some weak arguments for buying CEF IPO shares have been made. For instance, to educate the public, one financial firm provides articles about CEFs in the “Learning Center” portion of its website.<sup>35</sup> One article contends that it would be “unwise” for investors to pass on CEF IPO because “[a] study we conducted of all CEF IPOs from Jan. 1, 2001, through Oct. 31, 2011, found that 73.7% of the IPOs had positive share price total returns since inception.”<sup>36</sup> Based on this “limited study,” the article’s authors make the interestingly-phrased claim that they do *not* believe “that investing in CEF IPOs, in general, is a fool’s game.”<sup>37</sup>

Given the dynamics discussed above, the meager prospect of eventual positive share price returns does not seem appealing. Consider what eventual positive share price returns means in the context of the hypothetical CEF IPO

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33. *Anomalies*, *supra* note 1, at 162 (noting that “[i]t helps to have a gimmick” such as a famous asset manager). In the economics literature the term “noise trader” is frequently used as a euphemism for idiot. Lawrence Summers famously “began a paper on finance by declaring: ‘THERE ARE IDIOTS. Look around.’” Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES MAG. MM36, Sept. 2, 2009, available [http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?\\_r=0](http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?_r=0) (explaining that “the preferred term in academic literature” for idiots is “noise traders”).

34. See O’Neal, *supra* note 11, at 2.

35. Morningstar, *Closed-end fund IPO Premium* (2012), <https://www.fidelity.com/learning-center/investment-products/closed-end-funds/ipo-premium>.

36. *Id.*

37. *Id.* The article also stresses that “[j]ust because a CEF is suitable for your portfolio doesn’t mean it’s in your best interests. There’s a large difference between the suitability and fiduciary-duty standards.” *Contra* Wrona, *supra* note 32, at 55 (arguing that “the widely held belief that broker-dealers are subject to substantially lower standards of conduct is illusory”).

discussed above. At the IPO, the investor pays \$100 for a share. After subtracting commissions and offering expenses, the CEF purchases \$92 of assets per share. Even though the CEF only holds \$92 of assets per share, the underwriter will likely stabilize the price for the first three months, after which the market will adjust and the CEF's shares will most likely trade at a discount to the CEF's NAV, meaning that if the CEF has \$92 of net assets per share, the market price on offer to buy a share may be only \$82. As months pass into years, the CEF's underlying investments may perform well and the CEF's NAV may rise significantly, perhaps even to \$112 of NAV per share. If the CEF still trades at an approximate 10% discount, the market may then offer more than \$100 per share—yielding the positive share price return.

Plainly, investor interests would be better served by purchasing the shares of CEFs already trading at a discount or by purchasing a lower-cost open-end fund that could be liquidated at something near NAV. At the least, fairly evaluating whether an investor should buy a CEF IPO share requires some comparative assessment to other products on the market. Here, CEF investors could buy seasoned CEF shares instead and experience a near certainty of significantly higher returns than they would obtain by buying unseasoned shares during the IPO. As mentioned earlier, one recent study found that CEF IPO shares underperformed comparable seasoned CEF shares by 11.05% after one year.<sup>38</sup> Given the performance differential, recommending IPO shares over similar, seasoned shares appears most likely to lead to significant underperformance.

### *B. Purported Long-Term Structural Benefits*

Other arguments fail to address the IPO problem. For example, in defense of CEFs, generally, some supporters have contended that the CEF structure allows CEFs to take longer-term positions than could be taken with the redemption demands facing open-ended funds. Unlike open-end funds, CEFs do not need to unwind long-term positions if panicky investors seek to redeem their shares. This argument misses the point because it does not justify the purchase of CEF IPO shares whenever similar funds already trade at a discount.

Additionally, most CEFs may not actually use their purported ability to take longer-term positions. CEFs' actual holdings tend toward shorter-

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38. See Shao, *supra* note 3, at 1.

maturity assets.<sup>39</sup> A CEF IPO featuring short-maturity strategies and holdings should not attempt to justify its existence by pointing out that it has the structural ability to do something it does not intend to do.

### *C. Managerial Skill*

Some CEF IPOs have been justified by claims that the exceptional talent of the manager retained to manage the CEF's assets justifies the premium.<sup>40</sup> While this remains a theoretical possibility, it would require the accurate identification of a truly exceptional manager, one capable of rapidly outperforming the difference between the IPO premium and the seasoned CEF discount. Even if such a manager were identified, it would still appear preferable to wait until the fund seasoned and began to trade at a discount.

### *D. Unusual Market Circumstances*

In limited circumstances, CEF IPOs might appear less ill-advised. For example, in times of high investor sentiment, seasoned CEFs have been known to trade at premiums to their NAV. While this does not occur regularly, it does happen and is associated with increased CEF IPO offerings.<sup>41</sup> When similar, seasoned CEFs trade at a premium, the value differential between IPO shares and seasoned shares diminishes. This, of course, does not mean that it is in an investor's best interests to purchase CEF shares in an IPO. The vast majority of the time, CEFs trade at a discount and CEF shares purchased in an IPO will most likely move to trade at a discount in the future.

## CONCLUSION

Institutional investors generally pass on CEF IPOs for good reasons. The IPO shares tend to significantly underperform existing CEF shares and other mechanisms for gaining exposure to the underlying asset classes, such as

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39. See Elton *et al.*, *supra* note 29.

40. See SIMON LACK, WALL STREET POTHoles 27 (Wiley 2015) (explaining that "[i]t's generally the dumb money that buys a CEF IPO at" issue price).

41. See *Investor Sentiment*, *supra* note 1 (arguing that CEF discounts and premiums may be used to measure investor sentiment).

buying open-ended funds that already exist. Moreover, the problems with CEF IPOs have been known, studied, and discussed for decades in the finance and economics literature. Given this reality, the continued sale of CEF IPOs to retail investors does not appear aligned with their best interests.