

## Closed-End Funds and Their Use of Leverage: FAQs

### Frequently Asked Questions About Closed-End Funds and Their Use of Leverage

This document contains FAQs about CEFs, including information related to failed auctions for auction market preferred stock.

#### **General Information About Closed-End Funds**

- What are closed-end funds (CEFs)?
- In what types of securities do traditional CEFs invest?
- How are listed CEFs priced?
- Do some CEFs make distributions to shareholders?
- How is a listed CEF different from an exchange-traded fund (ETF)?
- How many CEFs are there?
- What type of shareholder protections do CEFs offer?

#### **CEF Leverage**

- Do CEFs use leverage?
- What types of leverage do CEFs use?
- What are the regulatory limits on a fund's use of leverage?
- Is leverage commonly used?
- Does the use of leverage present any risks for common shareholders?

#### **CEF Preferred Shares**

- What are CEF preferred shares?
- Do preferred shareholders vote for fund directors?
- Do the directors elected by the preferred shareholders have distinct responsibilities to those shareholders?
- What is the difference between fixed-rate and floating-rate preferred shares?
- What are auction market preferred shares?

- What are puttable preferred shares?
  - What are mandatory redeemable preferred shares?
- 

## General Information About Closed-End Funds

### What are closed-end funds (CEFs)?

There are four types of closed-end funds (CEFs): traditional funds, interval funds, tender offer funds, and business development companies (BDCs). Traditional CEFs (and some interval funds and BDCs) issue a fixed number of shares that are publicly traded on an exchange or in the over-the-counter market, like traditional stocks (these CEFs are also referred to as “listed” CEFs). Other CEFs—like most interval funds, tender offer funds, and BDCs—are not listed on stock exchanges (i.e., they are “unlisted” CEFs) and are permitted to continuously offer their shares at net asset value. The assets of a CEF are professionally managed in accordance with the fund’s investment objectives and policies and may be invested in stocks, bonds, and other securities. Total assets of CEFs were \$544 billion at year-end 2023.

### In what types of securities do traditional CEFs invest?

Traditional CEFs invest in a wide variety of domestic and foreign securities, including common stocks, preferred stocks, high-yield bonds, municipal bonds, and corporate bonds. Because a traditional CEF does not need to maintain cash reserves or sell securities to meet redemptions, the fund has the flexibility to invest in less-liquid portfolio securities. For example, a traditional CEF may invest in securities of very small companies, municipal bonds that are not widely traded, or securities traded in countries that do not have fully developed securities markets.

### How are listed CEFs priced?

Because a listed CEF’s shares often trade in the stock market based on investor demand, the fund may trade at a price higher or lower than its net asset value (NAV). For example, a listed CEF in great demand may trade at a share price higher than its NAV. In this case, the fund’s shares are said to be trading at a “premium” to the NAV. Conversely, a listed CEF trading at a share price lower than its NAV is said to be trading at a “discount.”

### Do some CEFs make distributions to shareholders?

Yes. CEFs may make distributions to shareholders from three possible sources: income from interest and dividends, realized capital gains, and return of capital. Some CEFs follow a managed distribution policy, which allows the fund to provide predictable, but not guaranteed, cash flow to common shareholders.

### How is a listed CEF different from an exchange-traded fund (ETF)?

Even though both securities are traded on a stock exchange, ETFs have a creation and redemption feature that allows for the number of shares outstanding in any particular ETF to expand or contract on a daily basis much like a mutual fund. This creation/redemption mechanism helps ETFs trade at market prices that approximate the underlying market value of the portfolio. By contrast, the number of shares outstanding in a listed CEF is relatively stable. A listed CEF is created by issuing a fixed number of common shares to investors during an initial public offering (IPO), although subsequent issuance of common shares can occur through secondary or follow-on offerings, at-the-market offerings, rights offerings, or dividend reinvestment. As a result, listed CEFs may trade at discounts or premiums to the underlying market value of the portfolio. In addition, a listed CEF, unlike an ETF, may issue debt or preferred shares to raise additional capital to purchase more securities for its portfolio. For more information on ETFs, see ICI's [Exchange-Traded Funds Resource Center](#).

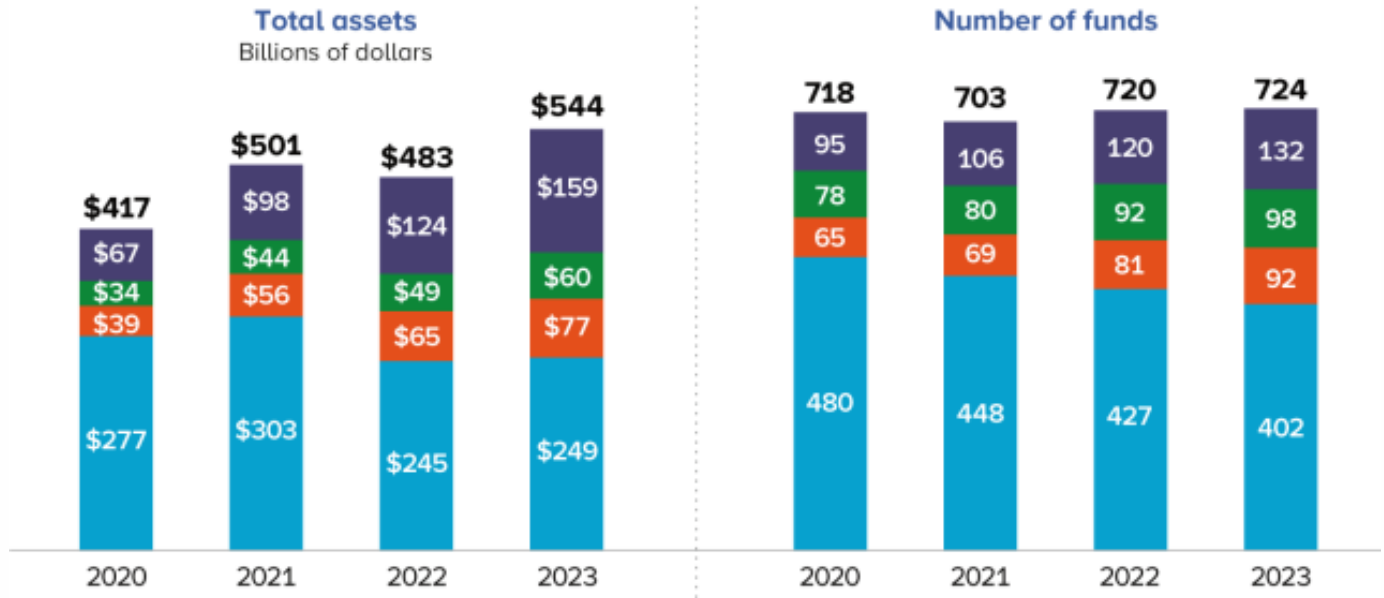
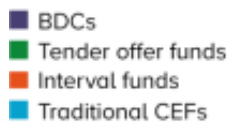
Unlisted CEFs do not issue a fixed number of shares but are permitted to continuously offer their shares at net asset value (NAV) following their IPO. As they are not traded on an exchange, unlisted CEFs engage in scheduled repurchases or tender offers for a certain percentage of the CEF's shares to allow shareholders to exit the fund.

## **How many CEFs are there?**

As of year-end 2023, there were 724 CEFs with \$544 billion in total assets—402 traditional CEFs with \$249 billion in total assets; 92 interval funds with \$77 billion in total assets; 98 tender offer funds with \$60 billion in total assets; and 132 BDCs with \$159 billion in total net assets.

## **Waning Presence of Traditional CEFs Is Offset by Growth of Interval Funds, Tender Offer Funds, and BDCs**

*Year-end*



Note: Data are based on quarterly public filings between November and January. Data for BDCs are total net assets.

Sources: Investment Company Institute and publicly available SECform N-PORT, N-CEN, 10-Q, and 10-K filings.

## What type of shareholder protections do CEFs offer?

Traditional CEFs, interval funds, and tender offer funds are governed by the Investment Company Act of 1940, a law that shapes how all registered investment companies must be structured and operated. 1940 Act CEFs must meet certain operating standards, observe strict antifraud rules, meet diversification requirements, and disclose complete information to investors. The Securities and Exchange Commission (SEC) oversees regulations under the '40 Act.

Like all registered investment companies, 1940 Act CEFs must have a board of directors elected by the fund's shareholders to oversee the management of the fund's business affairs and to protect the fund's interests, taking into account the interests of all shareholders.

BDCs differ from other CEFs in that they are not registered under the 1940 Act but instead elect to be subject to and regulated by certain provisions of the 1940 Act. BDCs also invest in different types of assets than 1940 Act CEFs. In particular, BDCs must invest at least 70 percent of their assets in domestic private companies *or* domestic public companies that have market capitalizations of \$250 million or less. For more information in listed BDCs, see the SEC's [Investor Bulletin: Publicly Traded Business Development Companies \(BDCs\)](#).

## CEF Leverage

### >Do CEFs use leverage?

Yes. CEFs have the ability, subject to strict regulatory limits, to use leverage as part of their investment strategy. The use of leverage allows a CEF to raise additional capital, which it can use to purchase more assets for its portfolio. The use of leverage by a CEF can allow it to achieve higher long-term returns, but also increases the likelihood of share price volatility (for listed CEFs) and market risk.

### What types of leverage do CEFs use?

CEF leverage can be classified as either structural leverage or portfolio leverage. Structural leverage, the most common type of leverage used by closed-end funds, affects the CEF's capital structure by increasing the fund's portfolio assets. Types of CEF structural leverage include borrowing and issuing debt and preferred shares. The issuance of preferred shares accounts for the majority of traditional CEF structural leverage. Portfolio leverage is leverage that results from certain portfolio investments. Types of CEF portfolio leverage include certain types of derivatives, reverse repurchase agreements, and tender option bonds.

### What are the regulatory limits on a fund's use of leverage?

Under the Investment Company Act of 1940, CEFs are subject to asset coverage requirements if they issue debt or preferred shares. For each \$1.00 of debt issued, the fund must have \$3.00 of assets immediately after issuance and at the time of dividend declarations (commonly referred to as 33 percent leverage). Similarly, for each \$1.00 of preferred stock issued, the fund must have \$2.00 of assets at issuance and dividend declaration dates (commonly referred to as 50 percent leverage). BDCs have similar, but slightly more relaxed, limits on their use of leverage. BDCs, subject to certain conditions, have a 2:1 debt-to-equity ratio.

### Is leverage commonly used?

At year-end 2023, at least 249 traditional funds—62 percent of funds—were using structural leverage, portfolio leverage consisting of tender option bonds or reverse repurchase agreements, or both as a part of their investment strategy. Preferred share assets were 11 percent, or \$27 billion, of traditional CEF total assets as of year-end 2023.

### Does the use of leverage present any risks for common shareholders?

Yes. The net asset value of the common shares and the returns earned by common shareholders will be more volatile in leveraged CEFs than in a fund that does not use leverage. If short-term interest rates rise, the cost of leverage will increase and likely will reduce the returns earned by the fund's common shareholders.

## CEF Preferred Shares

## **What are CEF preferred shares?**

As previously noted, preferred shares are a form of structural leverage that allow a CEF to raise additional capital, which it can use to purchase more securities for its portfolio. CEFs are permitted to issue one class of preferred shares under Section 18 of the Investment Company Act of 1940.

Preferred shares differ from common shares in three ways:

- Preferred shareholders typically are paid dividends at a rate that is fixed for some period.
- Preferred shareholders have priority to income and assets of the fund in the event of liquidation.
- Preferred shareholders do not participate in the gains and losses on the fund's investments, as common shareholders do.

## **Do preferred shareholders vote for fund directors?**

Yes. Section 18 of the Investment Company Act provides the preferred shareholders with the exclusive right to elect two fund directors. Preferred shareholders also typically vote, together with the common shareholders, to elect the remaining fund directors. In addition, Section 18 provides preferred shareholders with the right to elect a majority of directors if the fund does not pay dividends to the preferred shareholders for a period of two years. Preferred shareholders continue to be entitled to elect a majority of the directors until all dividends in arrears are paid.

## **Do the directors elected by the preferred shareholders have distinct responsibilities to those shareholders?**

No. Neither the Investment Company Act nor the jurisdictions in which most CEFs are organized (Maryland and Delaware) assign distinct duties to directors elected by preferred shareholders. Those directors, like all fund directors, owe a fiduciary duty to the fund to act in a manner that protects its interests, taking into account the interests of all shareholders, both common and preferred.

## **What is the difference between fixed-rate and floating-rate preferred shares?**

Fixed-rate preferred shares have a fixed dividend rate that is set at the time of issuance based on market conditions. Floating-rate preferred shares pay a variable rate in the form of interest or dividend income. The rate of return is tied to a specific benchmark rate and is adjusted periodically in response to changes in the benchmark rate. As of year-end 2023, 93 percent of preferred share assets in traditional CEFs were held in floating-rate preferred shares and 7 percent in fixed-rate preferred shares.

## **What are auction market preferred shares?**

Auction market preferred shares are a type of preferred share that pay dividends that vary over time. The dividend rates are set through auctions run by an independent auction agent. An auction is governed by a set of procedures established by the CEF and its auction agent. The dollar amount of outstanding CEF preferred shares has declined since auction market preferred shares, once a common type of preferred share, suffered a liquidity crisis in mid-February 2008. Since then, traditional CEFs

have replaced auction market preferred shares with alternative forms of structural and portfolio leverage, such as bank loans, lines of credit, tender option bonds, reverse repurchase agreements, puttable preferred shares, mandatory redeemable preferred shares, or extendible notes.

## **What are puttable preferred shares?**

Puttable preferred shares are similar to auction market preferred shares in that they are expected to pay dividends at variable rates. But the two differ in how the dividend rates are set and in the provision of liquidity to avoid the problems raised by failed auctions. Rather than being set through auctions, rates for variable rate demand preferred shares are set through remarketings run by one or more financial institutions acting as remarketing agents. After providing a preliminary notice of the likely dividend rate, the remarketing agents will solicit existing holders and potential buyers for indications of interest to buy or sell. The agents will then match up buyers and sellers at the lowest possible dividend rate. Bids will be filled to the extent shares are available, and sell orders will be filled to the extent there are bids. All filled bids will receive dividends at the new set dividend rate.

Issuance of puttable preferred shares also involves a third party, commonly referred to as a liquidity provider. If there are more sell orders than bids in a remarketing, the liquidity provider will be contractually obligated to unconditionally purchase all puttable preferred shares. As a result of this feature, puttable preferred shares are an eligible investment for money market funds under SEC rules, expanding the market for these shares and decreasing the possibility of failed auctions.

Puttable preferred shares represented 62 percent of all traditional CEF preferred share assets at year-end 2023.

## **What are mandatory redeemable preferred shares?**

Mandatory redeemable preferred shares pay dividends that may be fixed or variable. The shares have a stated liquidation value that the fund sponsor is required to redeem for cash or other assets at the stated maturity date.

Floating mandatory redeemable preferred shares represented 16 percent and fixed mandatory redeemable preferred shares represented 2 percent of all traditional CEF preferred share assets at year-end 2023.

May 2024