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SEC worried about closed-end funds

By Dan Jamieson

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Directors and managers of closed-end funds, beware: The Securities and Exchange Commission is worried about "significant compliance and risk management issues" associated with such funds.

Andrew "Buddy" Donohue, director of the SEC's division of investment management, is worried that the fat yields and high-payout policies offered by some closed-end funds can't be maintained.

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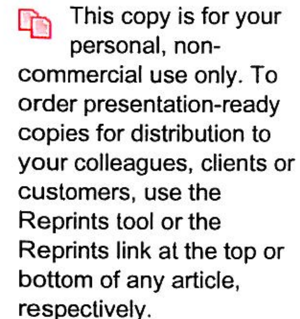

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He expressed those concerns Oct. 11 at a closed-end-fund workshop in New York, which was sponsored by the Investment Company Institute of Washington.

Mr. Donohue said a fund company can "erode its reputation and ultimately its business by implying a promised return that cannot be met."

He urged the fund industry to "consider not just what will sell in the closed-end-fund space but also, and more importantly, to consider what will properly serve investors' needs."

Industry observers agree that closed-end funds tend to come out when their strategies are marketable, which is usually also the wrong time to buy that particular asset class or strategy.

Mr. Donohue also raised warnings flags about managed-distribution plans.

Under such plans, funds get exemptive relief from the SEC in order to pay out more than they earn from income and realized gains.

Professional holders of closed-end funds generally like the big payouts that managed-distribution plans provide as a way to narrow discounts.

But Mr. Donohue said that retail investors don't always understand that they may be getting a return of capital.

Often, the reported yield on a fund includes that return of capital, he said.

"In the past, [funds] could get [exemptive relief] as matter of course, but about three years ago, the SEC stopped issuing relief" out of concern that investors didn't understand the distributions, said Cecilia Gondor, executive vice president at closed-end-fund specialist Thomas J. Herzfeld Advisors Inc. in Miami.

She said SEC staff at the meeting in New York indicated that the SEC is working to speed up approval for exemptive relief.

With a new fund or one that trades at a premium, "liquidation [through a distribution plan] is the worst thing a fund can do," because it must sell assets at less than what the fund is selling for, said Scott Miller Jr., a managing partner at Blue Bell (Pa.) Private Wealth Management LLC.

Yet some new funds want to institute payout plans, said Scott Miller Sr., also a managing partner at the firm.

For funds trading at a discount, a distribution plan can make sense, the senior Mr. Miller added. But on a new fund where investors are paying a premium, "that's where we take umbrage," he said.

Mr. Donohue said in his speech that the SEC is also concerned that funds are failing to send out required notices to shareholders alerting them that distributions contain a return of capital.

"There have been instances when disclosures were not being made, and there were fines and censures" of some funds, Ms. Gondor said. "Or [the notices were] sent to brokerage firms, and the firms were not passing them along."

Mr. Donohue also noted that closed-end funds should pay more attention to how they price portfolios.

"I have a concern [that funds] may worry less about the valuation of portfolio securities owned by closed-end funds than mutual funds," he said. "The logic seems to be that accurate valuation for closed-end funds is less important ... because closed-end fund shares are purchased and sold at market prices."

But George Karpus, president of Karpus Investment Management in Pittsford, N.Y., said that most funds are priced "pretty well."

"Sometimes we see some [prices] that are probably incorrect, but those are usually caused by a trading glitch," he added.

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