February 22, 2022

SEC Staff Report to Congress Regarding the Study on Threshold Limits Applicable to Diversified Companies

This report is submitted pursuant to section 107, Division Q of the Consolidated Appropriations Act, 2021, which directs the U.S. Securities and Exchange Commission ("SEC" or "Commission") to carry out a study on threshold limits applicable to diversified companies ("Section 107"). Specifically, Section 107 states, in relevant part, that:

> (a) IN GENERAL.—The Securities and Exchange Commission shall carry out a study of the 10 per centum threshold limitation applicable to the definition of a diversified company under section 5(b)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a– 5(b)(1)) and determine the impacts of such threshold limits upon the protection of investors, efficiency, competition, and capital formation. (b) CONSIDERATIONS.—In carrying out the study required under subsection (a), the Commission shall consider the following: (1) The size and number of diversified companies that are currently restricted in their ability to own more than 10 percent of the voting shares in an individual company. (2) How the investing preferences of diversified companies have shifted over time with respect to companies with smaller market capitalizations and companies in industries where competition may be limited. (3) The expected impact to small and emerging growth companies regarding the availability of capital, related impacts on investor confidence and risk, and impacts on competition, if the threshold is increased or otherwise changed. (4) The ability of registered funds to manage liquidity risk. (5) Any other consideration that the Commission considers necessary and appropriate for the protection of investors.

As noted below, a "diversified" investment company must satisfy certain requirements under the Investment Company Act of 1940. The staff of the Division of Economic and Risk Analysis and the Division of Investment Management of the Commission has prepared this report in response to the above request.[1]

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[1] This is a report of the Staff of the U.S. Securities and Exchange Commission. Staff reports, Investor Bulletins, and other staff documents represent the views of Commission staff and are not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of these documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations for any person. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

Section I of this report provides the background on the legal requirements under the Investment Company Act of 1940 and the Internal Revenue Code. Section II discusses the data on the diversified and non-diversified investment companies. Section III considers the impacts on small and emerging growth companies regarding the availability of capital. Sections IV and V discuss the ability of registered funds to manage liquidity risk and other considerations, respectively.

I. Background

A. Diversification Requirements under the Investment Company Act of 1940 (the "Act")

Section 8(b)(1) of the Act requires each management[2] investment company to disclose in its registration statement whether it is "diversified" or "non-diversified."[3] If an investment company states that it is "diversified" in its registration statement, then it must satisfy the diversification requirements set forth in section 5(b)(1). Specifically, section 5(b)(1) requires a diversified investment company to meet the following requirements:

> [a]t least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets[[4]] of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.

If an investment company does not satisfy these requirements, it is a "non-diversified" company under section 5(b)(2).[5] However, a diversified company that is adversely affected by market

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[2] Pursuant to section 5(a) of the Act, registered "management companies" are divided into open-end and closed-end companies. "Open-end company" means a registered management company which is offering for sale or has outstanding any redeemable security of which it is the issuer. "Closed-end company" means any registered management company other than an open-end company. For purposes of this report, "investment company" or "fund" refers to "management investment company" hereinafter.

[3] See Form N-1A, Item 2; and Form N-2, Item 8.

[4] Rule 5b-1 under the Act defines "total assets" to mean the gross assets of the investment company at the end of the fiscal quarter of the company last preceding the date of computation. The effect of this definition of "total assets" in rule 5b-1 is that an investment company can "disregard changes in its total assets between fiscal quarter-ends, insofar as such changes bear upon its classification as a diversified or non-diversified company." Investment Company Act Release No. 178 (Aug. 6, 1941).

[5] Section 13(a)(1) of the Act provides that no registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities, change its sub-classification from a diversified to a non-diversified company.

movements will not lose its diversification status, so long as any discrepancy existing immediately after an acquisition of assets is neither wholly nor partly the result of such acquisition.[6]

The purpose of section 5(b) of the Act is to ensure that registered investment companies that describe themselves to investors as having a "diversified" portfolio are in fact adequately diversified.[7] Thus, section 5(b)(1) limits the amount that a fund may invest in any one issuer to 5% of such fund's total assets and to 10% of such issuer's voting securities, with respect to 75% of the fund's total assets.

B. Diversification Requirements under the Internal Revenue Code

In addition to the diversification test under section 5 of the Act, many investment companies also seek to satisfy the Internal Revenue Code's ("the Code") diversification test to qualify as a regulated investment company ("RIC").[8] Funds generally elect to be treated as RICs under section 851 of the Code in order to take advantage of pass-through tax treatment.[9] The other 25% of the fund's total assets are not subject to the section 5(b)(1) limit, and therefore a fund could exceed the 10% limit for some investments.

In order to qualify as a RIC under the Code, an investment company must satisfy a two-part diversification standard.[10] Section 851(b)(3)(A) under the Code requires that on the close of each quarter of the taxable year at least 50% of the investment company's total assets are invested in cash, cash items (including receivables), Government securities, securities of other

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[6] Section 5(c) of the Act.

[7] Senate Hearing before the Subcommittee of the Committee on Banking and Currency at 188, 192 (statement of David Schenker, Chief Counsel, SEC) (Apr. 3, 1940). ("[A] diversified company must have at least several different securities in its portfolio, and cannot make investments which will put them in a controlling position in the company in which they made the investment." Id., at 188).

[8] In addition, to qualify as a RIC under Subchapter M of the Code, an investment company must derive at least 90% of its gross income from dividends, interest, and gains from the sale of securities. Section 851(b)(2).

[9] To qualify for the pass-through tax treatment of Subchapter M, a RIC also must distribute to its shareholder for each taxable year at least 90% of the sum of its investment company taxable income. Section 852(a)(1). While as a general matter, the Act sets a stricter quantitative diversification test than the Code for investment companies that elect to be diversified, in practice, most investment companies that elect to do so are significantly more diversified than required by Section 5(b)(1). *See* Alan R. Gedrick & David F. Roeber, Modern Compliance Volume II: Best Practices for Securities & Finance (2017).

[10] There are exceptions to the diversification requirements for market fluctuations, distributions or redemptions as well as a 30 day-grace period at the end of the taxable quarter if the failure to satisfy the diversification requirement is wholly or partly the result of an acquisition. Section 851(d). Further, the RIC Modernization Act of 2010 added two additional cure provisions (*e.g.*, *de minimis* failures or other inadvertent failures).

RICs, and investments in other securities, provided that no more than 5% may be invested in the securities of any one issuer and the investment company may not own more than 10% of the outstanding voting securities of any one issuer.[11] Additionally, section 851(b)(3)(B) requires that no more than 25% of the investment company's total assets are invested in securities (other than government securities or securities of other RICs) of any one issuer or two or more issuers which the fund controls and which are engaged in the same or similar trade or business.

II. Number and Size of Diversified Companies

We use Form N-CEN data to identify the investment companies that reported to be diversified for the years 2018-2020.[12] Table 1 shows the total number of investment companies, as well as the number of diversified and non-diversified investment companies, separated by investment companies that registered on Forms N-1A, N-2 and N-3, respectively.[13] The majority of investment companies have elected to be classified as diversified. The percentage of diversified investment companies has further been relatively stable over the time period from 2018 to 2020; it ranged from 77% in 2018 and 2019 to 79% in 2020.

Table 2 presents analogous results in terms of total assets. For the years 2018 to 2020, diversified companies accounted for the vast majority of assets among all funds; ranging from 87% in 2018 to 91% in 2019 and 2020.

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[11] The 50% diversification requirement is modified for investment companies acting as business development companies ("BDCs"). *See* section 851(e). Specifically, a BDC may use the basis of its stock in a corporation rather than the value of its stock to determine the limit on its investment in the corporation. While an investment company normally may not rely on its stock ownership in single corporations to meet the 50% test unless the value of the stock is 5% or less of the value of its total assets, a BDC may qualify as a RIC if the 5% threshold is not exceeded by the basis of its stock or own more than 10% of the voting stock in the corporation.

[12] Form N-CEN is used by registered investment companies to file annual reports with the Commission. Before Form N-CEN was introduced in 2018, an investment company would report whether it is diversified on Form N-SAR.

[13] Open-end management investment companies register on Form N-1A, closed-end management investment companies register on Form N-2, and separate accounts offering variable annuity contracts which are registered under the Act as management investment companies register on Form N-3. There were some closed-end management investment companies for which there was no information reported on Form N-CEN regarding whether they were a diversified investment company. This applied to 24 funds in 2018 and 2019 as well as 15 funds in 2020. We treated these funds as non-diversified for purposes of our analysis.

Table 1 Number of Diversified and Non-Diversified Investment Companies

Type	Year	Total	Diversified	Non-Diversified	% Diversified
N-1A (open-end funds)	2018	9,658	7,584	2,074	79%
	2019	12,082	9,528	2,554	79%
	2020	11,753	9,315	2,438	79%
N-2 (closed-end funds)	2018	502	272	230	54%
	2019	698	376	322	54%
	2020	687	393	294	57%
N-3 (certain registered separate accounts)	2018	14	11	3	79%
	2019	14	11	3	79%
	2020	14	11	3	79%
All funds	2018	10,174	7,867	2,307	77%
	2019	12,794	9,915	2,879	77%
	2020	12,454	9,719	2,735	78%

Table 2 Total Assets ($ bn) of Diversified and Non-Diversified Investment Companies

Type	Year	Total	Diversified	Non-Diversified	% Diversified
N-1A (open-end funds)	2018	$19,378	$16,890	$2,487	87%
	2019	$22,245	$20,395	$1,851	92%
	2020	$24,079	$22,046	$2,033	92%
N-2 (closed-end funds)	2018	$231	$151	$80	65%
	2019	$314	$198	$116	63%
	2020	$311	$212	$99	68%
N-3 (certain registered separate accounts)	2018	$224	$224	$0.05	>99%
	2019	$216	$216	$0.05	>99%
	2020	$218	$218	$0.05	>99%
All funds	2018	$19,833	$17,265	$2,568	87%
	2019	$22,775	$20,808	$1,967	91%
	2020	$24,609	$22,476	$2,132	91%

III. Impacts on Small and Emerging Growth Companies Regarding the Availability of Capital

Size and number of diversified companies currently restricted to 10 percent

Section 107 directs the Commission, in conducting the study, to consider, "[t]he size and number of diversified companies that are currently restricted in their ability to own more than 10 percent of the voting shares in an individual company." We understand this to refer to the size and number of investment companies that have elected to be diversified under the Act and would be limited from acquiring more than 10% of the voting shares of a portfolio company.

A key consideration in assessing the size and number of diversified investment companies that are currently restricted in their ability to own more than 10 percent of the voting shares of an individual company is whether the legal limit is likely to be an economically, rather than just legally, binding constraint in the investment company's portfolio choice. To inform this question, staff analyzed the portfolios of diversified companies using holdings information from Morningstar,[14] market capitalization data from Bloomberg[15] and Compustat,[16] and data on the portfolio companies that investment companies invested in during the course of 2020 from the Center for Research in Security Prices ("CRSP").[17]

Based on this analysis, we estimate that there were 136 diversified investment companies that were close to the 10% limit with regard to some individual holdings in the sense that they had at least some holdings of more than 8 percent of the voting shares in an individual company during 2020. However, none of these funds had holdings in excess of the 10 percent limit in a combined amount that exceeded 20% of the fund's NAV. Therefore, because the 10 percent limit applies only to 75% of a fund's total assets, we believe that the 10% limitation is unlikely to represent a meaningful constraint on diversified investment companies' portfolio choices.

We note that even if we had observed that an investment company consistently owned just under 10% of the voting securities of each issuer, the 10% limit may not necessarily be the limiting factor that explains this holdings amount. For example, an investment company may choose to hold a small position in all of the issuers in which it invests because that best achieves the

[14] Source: Morningstar (2021), including Morningstar Direct and Morningstar Investment Company Holdings databases.

[15] Source: Bloomberg (2021).

[16] Source: Compustat North America (2021), available through Wharton Research Data Services (WRDS).

[17] The analysis is based on data from Daily Stock File ©2021, Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business.

investment company's investment strategy. In that case, even absent the 10% limit, we would not expect to see the investment company shift from this optimal portfolio.

Changes in investing preference of diversified companies

Section 107 directs the Commission to consider how the investing preferences of diversified companies have shifted over time with respect to companies with smaller market capitalizations and companies in industries where competition may be limited.

To study how investing preferences have shifted over time with respect to companies with smaller market capitalizations, we extend our analysis from the prior section to examine the size of portfolio companies held by diversified investment companies.[18] As there are only three years of historical filings available on Form N-CEN, we recognize that the time series is limited and may not show any meaningful changes in portfolio composition with respect to the size of portfolio companies.

Table 3 shows the distribution of portfolio companies' market capitalizations based on Morningstar size categorizations.[19] We find that the proportion of assets held in small portfolio companies ranged from 36% in 2019 to 39% in 2020 for diversified investment companies. This proportion was consistently larger for diversified investment companies compared to non-diversified investment companies, where it ranged from 32% in 2018 to 36% in 2020.

Table 3 Distribution of Portfolio Companies' Market Capitalization

Year	Fund Type	Morningstar Size Categories			
		Giant	Large	Medium	Small
2018	Diversified	10%	22%	32%	37%
	Non-diversified	10%	24%	33%	32%
2019	Diversified	10%	22%	32%	36%
	Non-diversified	10%	24%	33%	34%
2020	Diversified	9%	22%	32%	39%
	Non-diversified	9%	23%	32%	36%

[18] This analysis uses data from Morningstar, Bloomberg, Compustat, and CRSP from 2018 to 2020. *See also supra* notes 14 to 17 and accompanying text.

[19] Giant-cap stocks are defined as stocks with market capitalization ranking in the top 40% based on the issuer's country of domicile; large-cap stocks represent the next 30%; mid-cap stocks represent the next 20%; and small-cap stocks represent the bottom 10%.

We were unable to analyze how investing preferences of diversified companies have shifted over time with respect to companies in industries where competition could be limited due to limitations in available data.[20]

Expected impacts from a change in diversification limit

Section 107 directs the Commission to consider, "[t]he expected impact to small and emerging growth companies regarding the availability of capital, related impacts on investor confidence and risk, and impacts on competition, if the threshold is increased or otherwise changed." We have conducted searches for, but are not aware of, any academic literature that has studied the potential effects of a change to the 10% threshold on small and emerging growth companies or the availability of capital more generally. As discussed above, we believe that the legal 10% limit is not likely to represent a binding economic constraint for diversified investment companies. Increasing the threshold would therefore be unlikely to affect how these funds invest. As a consequence, we would not expect any meaningful effects of an increase in the limit on the amount of capital available to small and emerging growth companies or related impacts on competition.

We also note that investors who prefer less diversified portfolios can already invest in non-diversified investment companies or, depending on the issuer and the investor, reduce the diversification of their own portfolios by making direct investments in issuers. As a result, even if the 10% threshold were to operate as a binding economic constraint in the future, investor demand for investment companies that disclose that they are diversified but hold positions greater than 10% of an individual issuer's voting securities may be limited.

On the other hand, it is possible that increasing the 10% threshold would reduce investor confidence in funds because the funds that represent themselves as diversified may not be as diversified as investors expected. This could result in shifting the burden to investors to investigate and monitor the actual diversification of individual funds, which may increase investment and monitoring costs as well. An increase in the threshold may also result in investors taking on greater risk than they anticipate to the extent that it enables investment companies to hold larger positions in fewer issuers. Depending on how the threshold is changed, however, these effects may be limited for the same reasons explained above with respect to effects on capital formation.

[20] We do not have access to data that would allow us to link individual fund holdings to markets for products that represent economic substitutes. Such a mapping would be required to define product markets to which standard measures of competition could be applied.

IV. Ability to Manage Liquidity Risk

Redeemability is a defining featuring of open-end funds.[21] When the Act was "enacted it was understood that redeemability meant that an open-end fund had to have a liquid portfolio."[22] Under rule 22e-4, open-end funds are required to manage their liquidity risks by creating a written liquidity risk management program.[23] These programs must include policies and procedures reasonably designed to incorporate the following elements:

- assessment, management and periodic review of the open-end fund's liquidity risk;[24]
- classification of the liquidity of each of the open-end fund's portfolio investments;[25]
- determining and periodically reviewing a highly liquid investment minimum ("HLIM") and adopting and implementing policies and procedures for responding to a shortfall below its HLIM.[26]

In addition, rule 22e-4 limits an open-end fund's investments in illiquid investments to 15% and provides for board oversight.[27]

The requirements of section 22(e) and rule 22e-4 apply to both diversified and non-diversified open-end funds and are independent of the Act's diversification requirements under section 5(b). Accordingly, a change in the diversification test under section 5(b) would not affect the ability of an open-end fund to manage its liquidity. On the other hand, even if the threshold in section 5(b) were to be changed, the requirement for an open-end fund to manage its liquidity may restrict the ability of the fund to take significant investment positions in individual issuers, depending on the trading and other economic characteristics of the issuer's securities.

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[21] *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)] at n. 2 and accompanying text.

[22] *See id.,* at text following n. 2; *id.* at 8 ("We believe that it is in the interest of funds and fund investors to create a regulatory framework that would reduce the risk that a fund will be unable to meet its redemption obligations and minimize dilution of shareholder interests by promoting stronger and most effective liquidity risk management across open-end funds.").

[23] 17 C.F.R. 270.22e-4 (hereinafter "Rule 22e-4").

[24] Rule 22e-4(b)(1)(i).

[25] Rule 22e-4(b)(1)(ii).

[26] Rule 22e-4(b)(1)(iii).

[27] Rule 22e-4(b)(1)(iv) and rule 22e-4(b)(2), respectively.

Unlike open-end funds, closed-end funds generally do not offer their interests to investors on a continuous basis and they may be listed on an exchange or unlisted.[28] Unlike open-end funds, closed-end funds are generally not required to repurchase shares from investors upon request (*i.e.*, their shares are not redeemable).[29] As a result, closed-end fund managers generally do not have to manage their liquidity in anticipation of needing to satisfy investor redemptions as do open-end fund managers. Closed end funds (including business development companies) are not, therefore, subject to the same requirements as open-end funds to manage their liquidity risks.[30]

V. Other Considerations

As discussed above, a number of factors may inform whether a diversified investment company would purchase more than 10% of the voting securities of an issuer. These include, for example, the investment company's own risk analysis and portfolio optimization, the investment company's understanding of its investor's preferences, an investment company's compliance with certain requirements of the Code for achieving pass-through tax treatment and the requirements of the investment company's liquidity risk management program.

In addition, other legal requirements that may be applicable to investment companies may also determine whether an investment company would purchase more than 10% of the voting securities of an issuer. For example, for funds that are exchange-traded funds ("ETFs") and thus trade on an exchange, they must also comply with the diversification requirements of the exchange's applicable listing standards. In this regard, the major U.S. stock exchanges generally have consistent requirements for complying with the listing standards set forth in the applicable rules under section 6 of the Securities Exchange Act of 1934. For example, NYSE ARCA, NASDAQ, and CBOE each require that an index-based domestic equity ETF hold at least 13 constituents.[31]

Additionally, certain transactions by asset managers (such as those that advise investment companies), including minority acquisition of voting securities above certain dollar thresholds, may implicate pre-merger notification requirements under the Hart-Scott Rodino Act of 1976 and require filings with the Federal Trade Commission and the Antitrust Division of the

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[28] SEC's Office of Investor Education and Advocacy Investor Bulletin: Publicly Traded Closed-End Funds, (Sept. 25, 2020).

[29] *Id.*

[30] *Id.* While closed-end funds generally do not have to maintain a specific level of portfolio liquidity, interval funds are required under Rule 23c-3 of the Act to offer investor liquidity on a periodic basis by buying back its shares from shareholders.

[31] *See e.g.,* Nasdaq Listing Guide: Exchange-Traded Products, Effective Nov. 2020.

Department of Justice as well as associated fees.[32] Moreover, investors that purchase securities of issuers in regulated industries may face additional requirements when investing over certain thresholds. For example, when an investor (or group of investors) acquires control of a banking holding company or state-member bank, the bank holding company must seek and receive the Federal Reserve's approval.[33]

As discussed in this section, and elsewhere in this report, a variety of factors may affect the decision of an investment company that represents that it is diversified to acquire a more concentrated position in the voting securities of a given issuer. At the same time, investment companies that do not hold themselves out as diversified are not subject to the 10 percent threshold and may currently invest in more concentrated positions where consistent with their objectives, strategies and other legal obligations.

Based on this review, it appears that the 10 per centum threshold limitation applicable to the definition of a diversified company under section 5(b)(1) of the Act is not currently acting as a limiting constraint on the ability of diversified investment companies to invest in small and emerging growth companies. Moreover, the ability of investors who prefer less diversified portfolios to invest in non-diversified investment companies or, depending on the issuer and the investor, reduce the diversification of their own portfolios by making direct investments in issuers, suggest that investor demand for investment companies that disclose that they are diversified but hold positions greater than 10% of an individual issuer's voting securities may be limited.

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[32] *See* 16 CFR 801.1 *et. seq*.

[33] *See e.g.,* 12 C.F.R. Part 225 and 238, Federal Reserve, Final Rule, Control and Divestiture Proceedings (Jan. 30, 2020). The Board of Governors of the Federal Reserve System (the "Fed") adopted this final rule to clarify when a company has the ability to exercise "control" or a "controlling influence" under the Bank Holding Company Act and the Home Owners' Loan Act. 12 CFR 225.41(a) generally provides that any person acing directly or indirectly or in concert with one or more persons give 60 days' written notice to the Fed before acquiring "control" of a state member bank or bank holding company unless the acquisition is exempt. Under 12 CFR 225.41(c)(2), the Fed presumes the acquisition of BHC stock constitutes "control" if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 10% or more of any class of voting securities of the institution, and if (1) the institution has securities registered with the SEC; or (2) no other person will own, control or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction.