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Financial Service Consolidation: The Case of Closed-End Funds*

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Abstract: *Understanding accounting rules is important, as the spectacular failure of Enron clearly demonstrates. For financial advisers, even subtle accounting effects are relevant if they could alter the recommendations made to clients. For example, a recent accounting rule change requires advisers of closed-end funds to expense (rather than amortize) commissions they pay to underwriters at the fund's initial public offering. This change greatly increases earnings volatility for "independent" asset managers, those who are advisers but not underwriters. Independent advisers have tended to offer the majority of equity closed-end funds. Consolidation, departure, or nonentry of independent advisers could reduce competition and impact costs for equity closed-end funds, which tend to invest in special situations or in illiquid stocks.*

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Introduction

Enabled by recent legislation,[1] the financial service industry continues to consolidate with the goal of providing clients with integrated advice and "one-stop shopping." Consolidation could also enhance scale economy and other competitive advantages such as improved access to capital and technology. But convergence in the financial service industry also occurs for subtle reasons. In addition, consolidation doesn't always benefit the client. Along with the larger trends, financial service professionals should understand these subtle issues as they can also lead to restructuring, to changes in competition and cost visibility, and ultimately to changes in recommendations they make to clients.

This article examines a controversial accounting ruling by the Financial Accounting Standards Board (FASB) in late 1998 that requires advisers of closed-end funds to expense (rather than amortize) commissions they pay to underwriters for sale of shares to the public.[2] Comment letters to the FASB decried the change, predicting the demise of closed-end funds in the United States as a result. Reports of the death of closed-end funds as an investment vehicle at the hands of this new rule are exaggerated. However, the new rule will increase earnings volatility for advisers who do not underwrite their own offerings.

Although not its express purpose, the new rule

*Data used in this study are available in electronic form from C.S. Ciccotello.

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encourages the closed-end fund adviser and underwriter to consolidate and become the same business entity. FASB "Statement of Concepts No. 2: Qualitative Characteristics of Accounting Information," establishes a hierarchy of accounting qualities that makes information useful for decision making.[3] One of these qualities is neutrality. According to "Concepts No. 2," "To be neutral, accounting information must report economic activity as faithfully as possible, without coloring the image it communicates for the purpose of *influencing behavior in some particular direction.*"[4] While the ruling indirectly encourages consolidation of adviser and underwriter, the FASB concluded in "Concepts No. 2" that fears of this type "could not be allowed to stand in the way of what the Board and others considered to be *a gain in the relevance and reliability of financial statements.*"[5]

This analysis has three major implications for financial service professionals. First, consolidation pressures will exist more in closed-end equities where independent advisers are prevalent, as opposed to debt where most advisers are also underwriters. Consolidation alters competition, and the benefits of competition in closed-end fund equities are important. Closed-end equity funds often hold special situations or highly illiquid stocks, such as those in emerging markets. In both cases, expenses can be quite high.

Second, any convergence among underwriter and adviser in closed-end funds is likely to make costs more opaque and thus harder to compare. It is easier to assess separate commission and management fee costs across companies than it will be to assess the combined cost within a company. The specific illustration using closed-end funds provides another example of the continuing movement in the financial service industry toward institutional opacity.

Third, the analysis shows that it is dangerous for financial service professionals to ignore even the "arcane" accounting issues in their industry. Those advising institutional investors should be especially concerned in this case since their clients might well be buying large stakes in closed-end initial public offerings (IPOs). Even individual investors can be served if their financial adviser recognizes how the rule changes might impact costs and cost visibility in the closed-end fund product.

Closed-End Funds

The FASB rule change in 1998 caught the closed-end industry in the midst of a slump. Similar to other financial products, closed-end funds have had their ups and downs. Over much of the 1990s, growth in the number of new closed-end funds has been slow. Despite this waning growth, closed-end funds offer unique advantages to investors, such as the opportunity to own part of a portfolio of illiquid investments.[6]

Indeed, closed-end funds have had a long and interesting history as an investment vehicle. Researchers have encountered puzzles in closed-end funds that defy easy solution. Malkiel, for example, wrestled with explaining why seasoned closed-end funds often trade at a persistent discount to net asset value (NAV).[7] Nearly 20 years later, Malkiel noted that the reasons for this apparent anomaly continued to be interesting research issues.[8]

Discounts *per se* are not necessarily bad for investors. A common piece of investment advice is to purchase a closed-end fund at a discount and wait for its market value to return to the no-arbitrage NAV. Prior to the early 1990s, however, advisers sold initial offerings of closed-end funds to investors at a *premium.*

Peavy and Weiss studied the traditional IPO process for closed-end funds.[9] Using samples of offerings during the 1985-1987 period, they observed that investors directly bore the costs of the underwriter's spread (commission). Immediately after the issuance of the shares, the offering costs were charged to paid-in-capital of the fund, resulting in a decrease in the fund's NAV. As a result, each fund was initially priced in excess of its original NAV by an amount equal to the underwriters' offering costs.

With the rotation from a premium at the initial offering to a discount in a seasoned fund, purchasing the shares of a closed-end fund IPO was not an optimal strategy. Investors eventually came to realize that shares could often be bought in the secondary market for a lower price than at the offering. This investor recognition made the successful launching of closed-end funds difficult.

To sell to a better-informed public, closed-end fund advisers turned to new offering methods. Starting in about 1992, advisers began to pay the commissions them-

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selves rather than have the public purchase the IPO shares at a premium to NAV. In turn, the advisers recovered the commissions in the form of an increased advisory fee charged to investors over time. Over the past five to seven years, this practice of "fronting" commissions has become virtually uniform in the closed-end fund industry.

Rule Changes

The FASB's Emerging Issues Task Force (EITF) eventually came to address the issue of how the adviser of a closed-end fund should account for the fees paid to underwriters for the sale and distribution of the shares of the fund.[10] The opinion of the FASB staff was that these expenditures of the adviser were start-up costs and did not meet the definition of an asset. Quoting from the FASB Staff Announcement:

"...the staff believes that the costs incurred by the closed-end fund advisor are start-up costs, which should be accounted for (effective for fiscal years beginning after December 15, 1998) in accordance with AICPA Statement of Position 98-5, Reporting the Costs of Start-Up Activities. Accordingly, the staff has concluded that offering costs incurred by an investment advisor in connection with the distribution of shares of a closed-end fund should be expensed as incurred by the advisor."[11]

Prior to this ruling, most advisers had amortized the commission expenses over a 5-10-year period. The new rule requires the use of a "cumulative effect of an accounting change" methodology. Along with expensing all future commissions, any unamortized commissions from previous IPOs must be fully expensed in the year the accounting change becomes effective.[12]

Numerous comment letters to the FASB argued against the change on the basis of accounting merits. They maintained that the amortization treatment matches revenues (advisory fees) that are expected for a number of years in the future with expenses (amortized cost of commissions). The following excerpt from a comment letter was typical:

"We believe that the commission payment is made with the intention of acquiring a long-lived revenue stream, namely the advisory fees from management of the closed-end fund. Based on that definition, the commission payment should be capitalized as an amortizable asset."[13]

Along with these accounting arguments, opponents asserted that the rule would severely damage the domestic closed-end fund industry. The following quote was representative:

"Such a rule, if adopted by the Commission, will thwart development of new closed-end investment companies and will put U.S. fund sponsors at a serious competitive disadvantage to foreign sponsors. These results will subvert the policies underlying the 1940 Act and are contrary to the interests of investors and the public at large, world capital markets, and U.S. fund sponsors."[14]

Another criticism of the new rule was that it would greatly increase the volatility of adviser earnings. Comment letters argued that smooth earnings are the hallmark of investment advisers, and that the added volatility would undermine the market's assessment of adviser value. The following was a typical argument:

"Sponsors would be required to list single quarter expenses reaching $50 million or more in the cases of several recent billion-dollar offerings (with little or no offsetting income at the time). The proposal would also create high earnings volatility for sponsors of closed-end funds. Consistency of earnings is vital to asset management companies."[15]

Questions and Answers

Given the rule change and the opposition to it, this article addresses two questions. First, how will this rule change affect the closed-end fund industry? Second, how will this rule change impact closed-end fund advisers?

Data

The data includes all firm commitment offerings of closed-end funds on the NYSE, the AMEX, and NASDAQ from 1992 to 1997 with an initial offering price of at least $1. The year 1992 marks the approximate time when advisers began to fund underwriting commissions themselves. The data ends in 1997 to capture the industry (and company) position prior to the accounting change. Obtained from Securities Data Corporation and from individual offering prospectuses, the

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data includes the offering date, the name and initial market value of the fund, and the principal underwriters. Data from Lipper Analytical Services reveals the adviser and investment objective.[16]

The intersection of the IPO and Lipper data allows the identification of closed-end funds where the investment adviser is also one of the principal underwriters. This information is critical to the analysis of the effects of the accounting change. If the adviser is also the underwriter, then the commission expenditures incurred by the adviser are revenue to the underwriter. At the limit, if the adviser is the sole underwriter, the net cost to the entity is zero.[17] This means that the accounting change has no impact on the entity that underwrites its own closed-end offerings. If the adviser is not an underwriter, then the change is meaningful since the expense is borne by the adviser organization.

Impact on the Closed-End Fund Industry

Table 1 shows a breakdown of closed-end fund offerings from 1992-1997. Offerings where the adviser is one of the principal underwriters are called "integrated." Offerings where the adviser is not one of the principal underwriters are called "independent." Table 1A shows that 60 percent of all offerings are integrated over the 1992-97 time frame. On a proceeds basis, offerings by integrated advisers also outweigh those by independent advisers. Since integrated advisers already offer and manage the majority of closed-end funds, one immediate inference is that the accounting change is not likely to eliminate closed-end funds as an investment vehicle.

Tables 1B and 1C break out the sample by type of offering. Debt offerings make up about 80 percent of the closed-end offerings over the 1992-97 time frame. Interestingly, integrated advisers manage nearly three-quarters of the debt offerings but only about one-third of the equity offerings.

Since independent advisers manage the majority of recent closed-end equity offerings, the effects of the rule change could be significant for the equity sector of the closed-end fund industry. IPOs of equity closed-end funds tend to have higher underwriting commissions than debt offerings.[18] Since the total earnings charge is the underwriting spread percentage applied to the market value of the offering, independent advisers face legitimate concerns about larger equity offerings' impact on their financial statements. But for many closed-end equity funds, such as those in emerging markets, a large fund size is essential to provide managers with reasonable opportunities to invest, diversify, and operate with economies of scale.

Table 2 shows that offerings by independent advisers have been larger, on average, than those done by integrated advisers (an average of $182.9 million versus $138.9 million) over the 1992-1997 period. Underwriting commissions tend to be lower on a percentage basis for larger offerings, so an independent adviser should try to reduce costs by having fewer (but larger) offerings. Under the new accounting treatment, this strategy will result in a more volatile earnings stream for the adviser. The burden of direct expense of the offering costs appears to reduce independent adviser offering flexibility.

Impact on Closed-End Fund Advisers

Table 2 shows the leading integrated and independent advisers of closed-end fund offerings over the 1992-1997 period. Among the integrated advisers, John Nuveen has the highest number of offerings, although they tend to be smaller in size than others like Merrill Lynch. It is apparent that large integrated advisers such as Merrill and Morgan Stanley are very prominent in closed-end funds.

The rule change has little impact on large underwriter advisers like Merrill Lynch if these advisers tend to underwrite most of the closed-end offerings themselves. Merrill Lynch is the sole lead underwriter on about 90 percent of its 42 closed-end offerings over the 1992-1997 period. Moreover, any commissions paid to other syndicate members are miniscule relative to Merrill's massive revenue and profit base.

Independent advisers have no underwriting spread revenue to offset the costs that must now be expensed as of the offering. Some independent advisers face less financial statement impact since they are a subsidiary of a much larger entity. Blackrock, for example, is a subsidiary of PNC. Other advisers, such as Putnam, remain private and do not face the public scrutiny of earnings variability. Private entities still may face problems with debt covenants

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TABLE 1

Summary of Closed-End Fund IPOs: 1992-1997

*A: Total IPOs (debt and equity)**

Year	Total IPOs			Percent Integrated**	
	Number of offerings	Total ($M)	Average ($M)	Number of offerings	Dollar Value ($M)
1992	88	$15,809.2	$179.7	66%	60%
1993	111	$16,140.4	$145.4	62%	52%
1994	38	$5,395.6	$142.0	45%	39%
1995	2	$102.0	$51.0	0%	0%
1996	4	$162.9	$40.7	25%	61%
1997	6	$988.5	$164.8	83%	86%
Total 1992-1997	249	$38,598.6	$155.0	60%	54%

B: Debt IPOs

Year	Total IPOs			Percent Integrated**	
	Number of offerings	Total ($M)	Average ($M)	Number of offerings	Dollar Value ($M)
1992	74	$14,697.4	$198.6	73%	63%
1993	95	$14,045.5	$147.8	69%	58%
1994	12	$1,351.3	$112.6	67%	61%
1995	0	0	0	N/A	N/A
1996	0	0	0	N/A	N/A
1997	5	$847.5	$169.5	100%	100%
Total 1992-1997	186	$30,941.7	$166.4	72%	62%

C: Equity IPOs

Year	Total IPOs			Percent Integrated**	
	Number of offerings	Total ($M)	Average ($M)	Number of offerings	Dollar Value ($M)
1992	11	$873.6	$79.4	36%	24%
1993	11	$1,415.6	$128.7	27%	13%
1994	19	$2,316.7	$121.9	47%	55%
1995	1	$69.0	$69.0	0%	0%
1996	4	$162.9	$40.7	25%	61%
1997	1	$141.0	$141.0	0%	0%
Total 1992-1997	47	$4,978.8	$105.9	36%	35%

* **A** includes 16 closed-end IPOs that could not be classified as debt or equity in **B** and **C** due to unavailability of the prospectus for those funds.

** "Integrated" is when the fund's investment adviser is also one of the principal underwriters in the offering.

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TABLE 2

Advisers in Closed-End Fund IPOs: 1992-1997

A: Integrated Advisers*

	Number of offerings	Proceeds size ($M)	Average offer ($M)
Nuveen	47	$4,500.7	$95.8
Merrill Lynch	42	$7,009.1	$166.9
Morgan Stanley Dean Witter	18	$3,314.6	$184.1
Piper Jaffray	9	$1,542.5	$171.4
Paine Webber	9	$1,442.3	$160.3
All others	25	$3,030.9	$121.2
Total	150	$20,840.1	$138.9

B: Independent Advisers

	Number of offerings	Proceeds size ($M)	Average offer ($M)
Blackrock	14	$3,162.3	$225.9
Putnam	8	$886.5	$110.8
Delaware Management	8	$582.1	$72.8
Alliance Capital	7	$1,661.0	$237.3
Franklin Templeton	6	$1,137.4	$189.6
All others	39	$7,567.8	$194.0
Total	82	$14,997.1	$182.9

*"Integrated" is when the fund's investment adviser is also one of the principal underwriters in the offering.

triggered by more volatile profitability and leverage ratios.

Publicly held independent advisers provide an opportunity to directly assess the financial statement impacts of the accounting change. Figures 1 and 2 present the results of a reconstruction of the financial statements of two prominent publicly held independent closed-end advisers, Alliance Capital and Franklin-Templeton, respectively. To illustrate the effects of the new accounting rule, the figures show the percentage change in the firm's actual quarterly net income that would have occurred if commissions had been expensed since the beginning of 1992.[19]

Both companies would have had lower income in the first quarter of 1992. This is due to the effects of the cumulative change in accounting principle. It requires all prior amortized commissions to be expensed in the quarter that the change becomes effective. Beyond the initial effect, the volatility impacts of the rule change remain very apparent. Alliance Capital had seven closed-end fund offerings over the 1992-1997 period. Three of the offerings were in 1993, where decreases of nearly 50 percent in quarterly income would have occurred in the third quarter. Under the new rule, clustered offerings create lumpy charges that result in higher earnings volatility.

Figure 2 illustrates a similar pattern for Franklin-Templeton, who had a total of six offerings over this period. The biggest percentage change in income occurs during the third quarter of 1993. This is because Franklin launched two large funds, Templeton China World, and Templeton Emerging Markets, during that third quarter.

The effects on Alliance and Franklin-Templeton are noticeable even though these advisers are quite large. Alliance, the smaller of the two, had total revenues of approximately $1 billion in 1997. Despite these advisers' size, closed-end commission charges appear to be large

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enough to influence the timing and size of offerings. Arguably, these added constraints make it more difficult for independent advisers to compete with integrated advisers.

The financial statement impacts of the accounting change would be more severe on smaller independent closed-end fund advisers. The comment letter criticism that the accounting change would deter new independent entrants into closed-end funds seems to be especially appropriate. The accounting change thus appears to deter entry into the closed-end fund industry and encourage consolidation of existing independent advisers with underwriting institutions.

FIGURE 1

Accounting Change Impact on Quarterly Net Income for Alliance Capital: 1992-1997

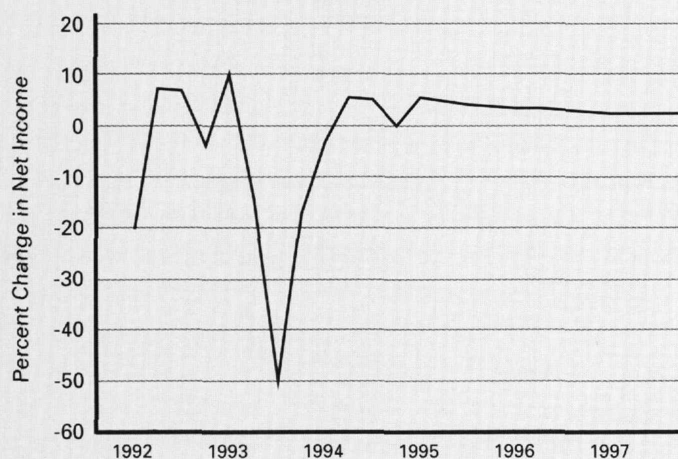
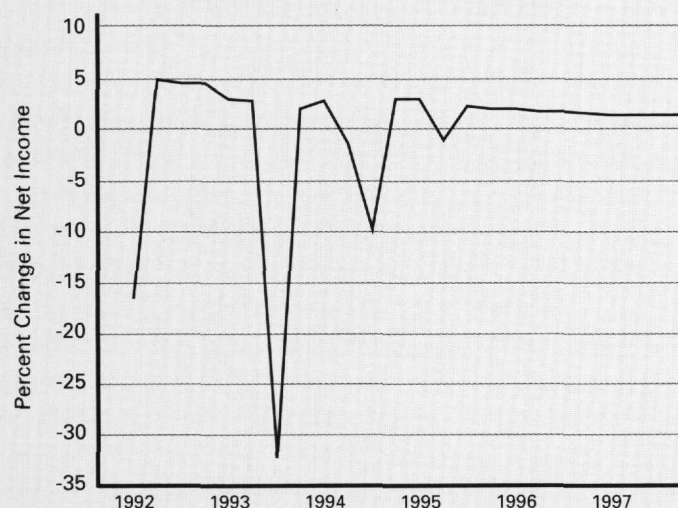


FIGURE 2

Accounting Change Impact on Quarterly Net Income for Franklin Templeton: 1992-1997



Concluding Observations—Why Should Advisers Care?

Despite strong opposition to the change, advisers of closed-end funds must now expense the commissions paid to underwriters to sell the fund's shares. The analysis in this article suggests it is unlikely that this accounting change will eliminate closed-end funds as an investment vehicle in the United States. This is because integrated advisers (those who both underwrite and advise) have already established a prominent position in the industry.

The rule could have differing impacts in the debt and equity sectors of the industry, however. During the period from 1992 to 1997, integrated advisers conducted the super-majority of debt offerings. But during this same time frame, independent advisers conducted about two-thirds of the equity closed-end fund IPOs.

Under the rule, independent advisers will face increased earnings volatility, especially if they are small in size or have large and/or clustered offerings. Independent advisers could time and size offerings to reduce the impact of the change on their financial statements. Such reductions in flexibility would arguably make them less competitive. Although not its purpose, the accounting change by the FASB creates incentives for existing independent advisers to merge with underwriters—or leave the industry. Consistent with comment letter claims, the rule change will also deter entry by those advisers who do not underwrite offerings themselves.

Turbulent markets have chilled both domestic and international equity markets over the last few years. Thus, linking closed-end equity advisers' actual merger or exit decisions to the rule change in 1998 is difficult. Any inactivity or consolidation could be market driven, as well as rule driven. Regardless, financial service professionals who

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advise their clients to invest in closed-end equity funds should be aware of the ongoing impact. Competition among closed-end equity funds is very important since these vehicles often hold portfolios of special situations or highly illiquid securities. Fewer independent advisers could thus hurt cost competition as well as reduce cost visibility. The bottom line is that issues impacting the reported profitability of firms in the financial services industry can affect industry structure and should matter to those who earn their living as a financial adviser. ■

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(1) John Hogan, "Financial Services Reform: The Gramm-Leach-Bliley Act and Its Implications for Insurance," *Journal of Financial Service Professionals* 55 (January 2001): 30-38.

(2) FASB, "Accounting for Commissions Paid by Advisors of Closed-End Funds" (Norwalk, CT: 1998); FASB, "Accounting by Advisors for Offering Costs Paid on Behalf of Funds, When the Advisor Does Not Receive Both 12b-1 Fees and Contingent Deferred Sales Charges, Subsequent Development" (Norwalk, CT:1999).

(3) FASB, "Statement of Financial Accounting Concepts No.2: Qualitative Characteristics of Financial Statements" (Norwalk, CT: 1980).

(4) *Id.*

(5) *Id.*

(6) A. Lappen, "Why Closed-End Funds Will Survive," *Institutional Investor* (October 1, 1998): 220-221.

(7) Burton Malkiel, "The Valuation of Closed-End Investment Company Shares," *Journal of Finance* (June 1977): 847-859.

(8) Burton Malkiel, "The Structure of Closed-End Fund Discounts Revisited," *Journal of Portfolio Management* (Summer 1995): 32-38.

(9) John Peavy, "Closed-End Fund IPOs: Caveat Emptor," *Financial Analysts Journal* 45 (May/June 1989): 71-74; John Peavy, "Returns on Initial Public Offerings of Closed-End Funds," *Review of Financial Studies* (Winter 1990): 695-709; Kathleen Weiss, "The Post-Offering Price Performance of Closed-End Funds," *Financial Management* (Autumn 1990): 57-67.

(10) The FASB formed the EITF in 1984 to provide timely financial reporting guidance on emerging issues that affect financial reporting.

(11) FASB, Staff Announcement: "Accounting for Commissions Paid by Advisors of Closed-End Funds" September 23-24, 1998.

(12) On July 22, 1999, the FASB concluded that closed-end funds that incur distribution-related fees (similar to 12b-1 fees) and impose early withdrawal charges (similar to contingent deferred sales charges) may continue to amortize distribution fees. This ruling, however, affects very few closed-end funds. According to J. Maier and J. Brown, "All About Closed-End Funds," *Paine Webber Industry Overview* (March 24, 2000), closed-end funds generally do not charge 12b-1 fees. A rare exception is Eaton Vance in two of their continuously offered loan-participation funds. According to Don Cassidy, over 490 of the 532 closed-end funds that he tracks at Lipper Analytical Services are exchange traded and therefore not affected by the July 22, 1999 FASB ruling.

(13) Letter to the FASB by Osbert M. Hood, senior vice president and CFO of John Hancock Funds, September 1, 1998.

(14) Letter to the chief accountant of the Securities and Exchange Commission by G. Moffett Cochran, chairman, DLJ Asset Management Group, September 21, 1998.

(15) Letter to the chief accountant of the SEC and the FASB by Nora M. Jordan of the law firm of Davis, Polk, and Wardwell, September 23, 1998.

(16) Data provided by Don Cassidy from Lipper Analytical Services.

(17) If the integrated adviser syndicates the offering, then it incurs a net commission cost. Whether that cost is transferred to the asset management division or kept within underwriting is left to internal cost allocation rules. Part of the underwriting commission is paid to employees and represents a cost under either the amortization or direct expense accounting treatment.

(18) Underwriting commissions in debt offerings average about three percent of the market value of the offering. The corresponding average underwriting commission in equity offerings is approximately six percent.

(19) Underwriting costs are assumed to be three (six) percent of offering in the debt (equity) context. Reconstruction of the financial statements is done using the cumulative effect of an accounting change methodology as required by the FASB. This requires an immediate expensing of any previously unamortized commissions at the time the rule becomes effective.

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