November 30, 2017

Unusual Conversion of a Mutual Fund to a Closed-End Fund

In an unusual move, a mutual fund converted to a closed-end fund with the same investment objective and strategy. As described below, the conversion was approved by the fund's board of trustees ("Board") and by a majority of shareholders in unusual circumstances to protect the interests of the fund's long-term shareholders. Shares of the fund now trade on the New York Stock Exchange (the "NYSE").

Background. Since 2011, the Highland Floating Rate Opportunities Fund (the "Fund") and its predecessor fund operated as a mutual fund, with an investment objective of providing a high level of current income, consistent with preservation of capital, by investing directly (and, indirectly, through derivatives) in floating rate loans.

The Fund's adviser, Highland Capital Management Fund Advisors, L.P. ("Highland"), commenced litigation in 2013 against an investment bank on behalf of the Fund and other accounts advised by Highland. Highland claimed that the investment bank had fraudulently caused a real estate appraiser to inflate the valuation of properties collateralizing a loan arranged by the investment bank to induce the Fund and the other Highland accounts to invest in the loan. In 2015, a Texas trial court ordered the investment bank to pay nearly $300 million to the Fund and the other Highland accounts. The Fund disclosed that Highland expected approximately $279 million of the judgment to be allocated to the Fund, subject to reduction for attorney fees and other litigation-related expenses. However, the investment bank appealed the trial court's judgment to a Texas state appellate court, which has yet to issue its ruling. If the judgment is upheld, the judgment would constitute more than 30% of the Fund's net assets.

Issues Faced by the Fund's Board. Under GAAP, the Fund cannot include the judgment as a Fund asset until the asset is no longer contingent, which normally occurs upon the exhaustion of the legal appeals process. Consequently, as of September 2017, the Fund had not recorded the judgment as an asset because the judgment remained subject to appeal. These facts created two potential problems.

- If the Fund remained a mutual fund, current shareholders could be diluted by third parties who invest in the Fund solely to speculate on the outcome of the litigation.
- If the appeals court affirmed the trial court's judgment, recognition by the Fund of a substantial award could cause a "liquidity mismatch" for the period between the date that the judgment, following GAAP, is included as a Fund asset, and the date that the Fund actually receives cash or liquid securities from the investment bank. This delay in receipt could have caused the Fund to have to liquidate otherwise advantageous positions to meet a high volume of shareholder redemption requests.

After reviewing numerous options, the Board, upon recommendation from Highland, determined that the best way to protect the interests of the Fund and its shareholders was to convert the Fund to a closed-end structure.

Conversion to a Closed-End Fund. The Fund could not convert to a closed-end fund without shareholder approval and, accordingly, beginning October 11, 2017, the Fund solicited proxies for a special shareholder meeting to occur on November 3, 2017 to approve the conversion. Among other things, the proxy statement explained that the conversion of the Fund to a closed-end fund and listing the Fund on a stock exchange before a conclusion of the litigation would diminish the potential for speculators to dilute the interests of long-term shareholders. Specifically, speculators would only be able to invest in the Fund by purchasing shares from existing shareholders at a price determined by the market, rather than at NAV. The market price of the Fund's shares presumably would reflect the expected value of the judgment, even if GAAP did not permit the Fund to reflect that expected value in its NAV.

At the November 3 meeting, the Fund's shareholders approved the proposal authorizing the Fund's Board to convert the Fund from a mutual fund to a closed-end fund. The conversion of the Fund occurred immediately after the closing of the NYSE on November 3, 2017. As part of the conversion, the Fund effected a reverse stock split and its existing three classes of shares were converted into a single class of common shares, with the conversion ratios reflecting the slight differences among the classes' per-share NAVs.

Shares of the Fund began trading on the NYSE on November 6, 2017. The Fund's pre-conversion NAV was approximately $1.09 billion as of the close of business on November 2, 2017. Following the conversion, at the close of the first day of the Fund's shares trading on the NYSE, the Fund's shares traded at a premium of approximately 3% to their NAV.

Ropes & Gray LLP served as legal counsel to the Fund and Highland in the conversion.

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.