# THE FIGHT TO VOTE

THE SEC'S WITHDRAWAL OF THE BOULDER LETTER HAS SPARKED A FIGHT BETWEEN ACTIVISTS AND CLOSED-END FUND INVESTMENT MANAGERS, WRITES IURI STRUTA.

Closed-end fund managers got a pleasant surprise on May 27 when the Securities and Exchange Commission (SEC) withdrew the Boulder letter, a 2010 guidance that had prevented them from using state law provisions as a defense against activist investors and hostile acquirers. From now on, the SEC indicated, closed-end funds could opt into state control share statutes without repercussions, allowing them in some jurisdictions to limit the voting rights of a single shareholder to 10%.

> "THE PRIMARY REASON FOR THE SLOWDOWN IN CLOSED-END FUND INITIAL PUBLIC OFFERINGS IS PROBABLY LOW-COST ETFS AND INDEX FUNDS."

Closed-end funds have already started to take advantage of the SEC move. A score of them already opted into the Maryland control share acquisition statute, including funds managed by Legg Mason, Duff & Phelps, Prudential, and Nuveen. Observers reckon most other funds will eventually take the step, while those incorporated in Delaware, which does not provide the provision, could move to Maryland or Massachusetts.

That's bad news for activists who have made a specialty of taking large stakes in the worst performing closed-end funds and demanding an elimination of valuation gaps via liquidations, tender offers, or open-ending. According to *Activist Insight Online* data, the number of closed-end funds targeted by activists rose from 12 in 2015 to a peak of 28 in 2019. This year, 25 closed-end funds have already been subjected to dissident demands.

The SEC cited "market developments" since the letter was made public for its decision to lift it. Indeed, the number of closed-end funds has dropped from 621 in 2010 to 494 in 2019, while inflation-adjusted assets under management rose modestly from $230 billion in 2010 to $275 billion, a fraction of the growth seen in other fund categories such as exchange-traded funds and mutual funds, according to data from Investment Company Institute (ICI), an industry lobby.

"With activist campaigns targeting dozens of closed-end funds—putting a substantial portion of the market under threat of being liquidated or converted to an open-end structure—the availability of closed-end fund investments has contracted," ICI said in a 95-page research piece on why the Boulder letter should be withdrawn.

Historically, the advantage of closed-end funds has been that it allowed investors access to illiquid instruments such as venture investments and bonds, hard to reach public equities like Asia and Latin America, and leverage.

## BLAME GAME

Activists, however, say they are being unfairly blamed for market changes they did not cause, and that institutional and retail investors in closed-end funds will be the ones to suffer from the change in regulation.

"The primary reason for the slowdown in [closed-end fund initial public offerings] is probably low-cost ETFs and index funds," Bulldog Investors' Phil Goldstein told *Activist Insight Monthly*.

Saba Capital Management, the second-most prolific activist in the space, also blamed "the increasing prominence of the ETF model" for the fall in the number of closed-end funds, arguing in a SEC submission that the negative effect of the withdrawal will transcend shareholder activism. It will lead to larger discounts to net asset value (NAVs), making the product even less attractive for investors.

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And while supporters of the SEC's decision say that activists are diminishing the market, activists argue that they provide investors a way out from underperforming investments at or close to net asset value.

"You need to permit the closed-end fund market to operate efficiently. To the extent poor performers are eliminated by market forces, even if it's many funds, investors are better off. To the extent investors want a closed-end fund product, then they will be able to invest in better closed-end funds with smaller discounts and superior returns," Adam Finerman, a partner at securities law firm Olshan Frome Wolosky, told *Activist Insight Monthly*.

## DEFENSIBILITY

Whether closed-end funds can use state laws to defend themselves against activists over the long term is open to debate. The Investment Company Act of 1940 (ICA), – a federal law adopted in response to management abuses of shareholders – states every share has an equal voting right. The Boulder letter made clear that opting into state control share statutes is a violation of the federal law since some shares can lose their right to vote.

ICI disagreed with that interpretation, saying control share statues "do not strip the stock itself of its voting rights," but rather their owner for ownership above the 10% threshold. In a submission to the SEC, Goldstein retorted: "Voting rights can only be exercised by human beings and the ICA was intended to protect investors, not inanimate objects."

> "WHETHER CLOSED-END FUNDS CAN USE STATE LAWS TO DEFEND THEMSELVES AGAINST ACTIVISTS OVER THE LONG TERM IS OPEN TO DEBATE."

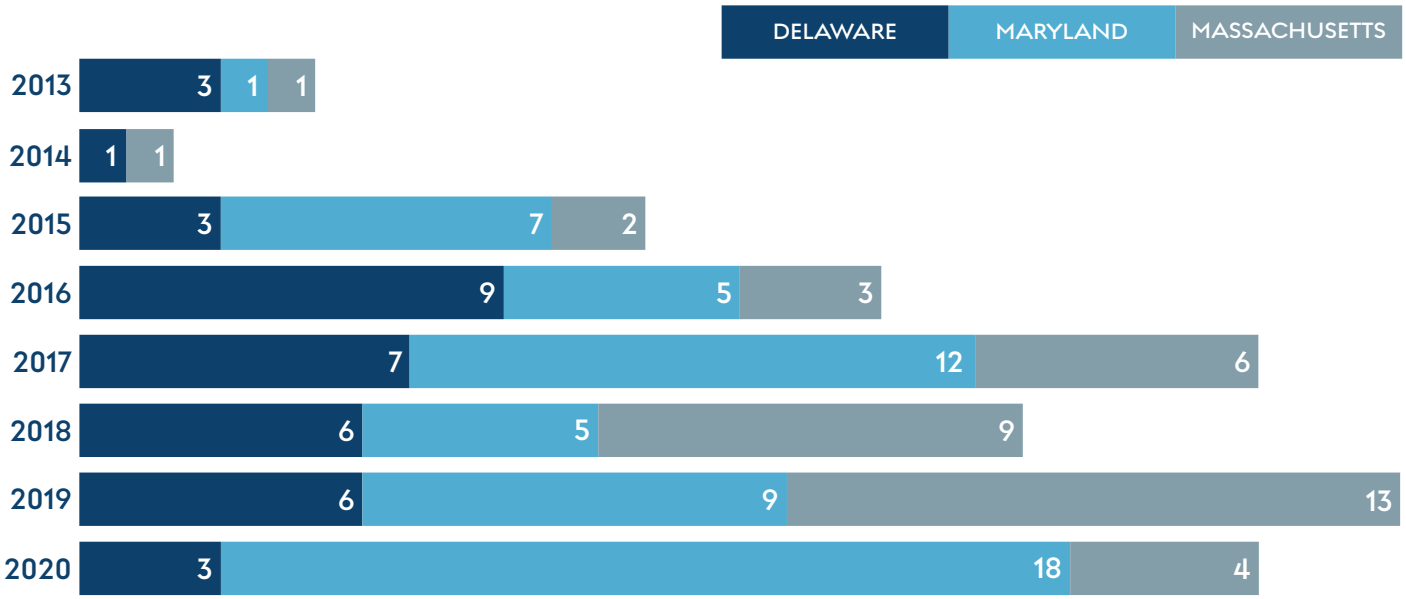
So while the withdrawal will have a chilling effect on activism over the short-term, it will not stop it, Brian Schaffer from communications firm Prosek Partners told *Activist Insight Monthly*. "It puts the pressure on the activists to engage more with other shareholders, or negotiate with management, as opposed to running up a 25% position and winning the fight before it even starts," Schaffer said.

## ASSET MANAGERS OPTING IN TO CONTROL SHARE ACQUISITION STATUTES

**LEGG MASON**
**DUFF & PHELPS**
**PGIM & PRUDENTIAL FINANCIAL**
**EATON VANCE**
**HIGHLAND FUNDS**
**ALL STAR FUNDS**

ASSET MANAGERS AT WHICH AT LEAST ONE CLOSED-END FUND HAS SOUGHT CONTROL SHARE ACQUISITION STATUTES AS OF SEPTEMBER 23, 2020.
SOURCE: ACTIVIST INSIGHT ONLINE

## CLOSED-END FUND TARGETS




NUMBER OF CLOSED-END FUNDS TARGETED BY ACTIVISTS BY STATE OF INCORPORATION. 2020 DATA AS OF SEPTEMBER 23.
SOURCE: ACTIVIST INSIGHT ONLINE