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Key Takeaways – Investment Trusts and Activist Funds: What UK Companies Need To Know

On 15 February 2024, Skadden partners Kenneth Burdon, Robert Chaplin, Eben Colby and Greg Norman presented the webinar “Investment Trusts and Activist Funds,” which outlined recent trends in shareholder activism in publicly listed investment funds and key lessons that UK investment trusts can learn from parallel issues in US closed-end funds. As wide discounts draw activist investors in, it is important for sponsors of investment trusts to be aware of the risk of activist campaigns, as well as possible defensive strategies.

Below are the key points explored in the webinar. [A recording of the event is available here.](#)

What are investment trusts, and why do they exist?

As extensively discussed in Skadden’s previous client alert, investment trusts have a long lineage stretching back to the 19th century. These investment vehicles are not actually trusts, but rather closed-ended investment funds structured as public limited companies and traded on a stock exchange. Importantly, if HM Revenue & Customs approves a company as an investment trust, it is exempt from UK tax on any capital gains it realises. The key advantages of investment trusts include favourable tax treatment, liquidity offered by tradeable securities, the benefit of a professional investment manager and the ability to hold more illiquid assets without being subject to liquidity pressures faced by open-ended funds.

Why are investment trusts targets for activist campaigns?

The key factor behind the activist interest is the historically wide gap, or “discount,” between the investment trusts’ share prices and the net asset value (NAV). For the first time since 2008, the average trust’s discount is in the double digits, averaging 15%. High discounts mean that potential entry is cheap, and there is a good chance for a relatively quick payout as activists push for other liquidity events that enable them to cash out at, or close to, the NAV. This is why some activists refer to this trade as arbitrage they can “control.”

Another factor is a feature of the regulatory regime applicable to these vehicles. UK rules allow relatively small shareholders to require a general meeting to be called, to circulate a members’ statement or to table a resolution (*e.g.*, to remove a director) before a general meeting. Additionally, a dispersed and docile shareholder base allows a small shareholder to effectively sway the votes using their small but concentrated holding. Lastly, the recent listing rule regime changes maintain a requirement for shareholder votes on several key issues, preserving a useful tool for activist investors.

Strategies deployed by activists

Activists attempt to use their concentrated minority positions to impose their desired outcomes, particularly where the shareholder body may be relatively disengaged. To this end, activist investors may use derivatives and leverage to acquire voting rights economically; votes may then be cast via the investment banks who are counterparties to those derivatives and who own the actual shares to back their derivative exposure. For example, US activist Saba Capital built up positions in 24 UK investment trusts

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using total return swaps, allowing it to gain exposure to the shares without having to own them.

Usual demands of activist investors will revolve around replacing the manager and board members, exiting investments or calling for other liquidity events, such as tender offers, buy-backs or even liquidation. The focus of activist campaigns will frequently be a corporate inflexion point, such as a key shareholder vote. Since UK investment trusts frequently have periodic continuation votes, they present alluring focal points for such campaigns. For example, activist investors in one prominent UK-listed investment trust mounted a campaign to persuade shareholders to vote against the continuation of the fund, as well as to replace the chairman and several board members, which culminated in the board losing the continuation vote.

The threat of such a vote may compel the board of directors of an investment trust to explore different ways of returning capital to investors, whether through share buy-backs, dividends or otherwise to shore up investor support for a continuation vote.

Facing activists: Lessons from the US closed-end funds

While not every method successfully deployed in the US will translate to the UK, the boards of US closed-end funds have developed a range of defensive strategies. These may be instructive to sponsors and boards in the UK.

In terms of governance measures, the US funds often have staggered terms for board members, which remove the ability for the entire board to be replaced at once, forcing the activist to hold their interest for longer. Advance notice and special procedure requirements are introduced to govern shareholder resolutions. Additionally, a supermajority shareholder approval may be required for key transactions, such as conversion to open-end status or liquidating the fund.

In terms of more innovative techniques, a fund may have so-called “poison pills” provisions, which give shareholders — other than those who acquired the above-threshold stake — rights to purchase shares at a hefty discount, which are exercisable if any shareholder’s interest crosses a predetermined threshold. Additionally, some US states have “control share statutes,” which require supermajority approval from disinterested shareholders before any shareholder who acquired shares above a predetermined threshold may vote their shares. These laws, however, are currently being hotly litigated, and their legality under the US Investment Company Act is being challenged.

Finally, consistent and active shareholder engagement well in advance of any activist challenge is critical to success once such a challenge arises.

Conclusion

Activist campaigns against UK investment trusts are becoming more common. The economic and structural factors may intensify activist interest, putting even more pressure on fund managers and boards. Boards should remain alert to early defensive steps, such as increased engagement with shareholders, reviewing disclosure practices, instituting a discount/premium control mechanism or reconsidering the investment policy.