

# Recommendations Regarding the Availability of Closed-End Fund Takeover Defenses

MARCH 2020

## **Recommendations Regarding the Availability of Closed-End Fund Takeover Defenses**

The Investment Company Institute<sup>1</sup> recommends that the Securities and Exchange Commission issue guidance clarifying the ability of closed-end funds to employ certain defenses against hostile campaigns from “activist” investors.<sup>2</sup> In 2010, the Commission’s staff issued a no-action response, *Boulder Total Return Fund, Inc.*,<sup>3</sup> that questioned whether closed-end funds could employ certain takeover defenses available under state law consistent with the Investment Company Act of 1940. Although the defense measure at issue in *Boulder* was the Maryland “control share” statute, the letter’s reasoning arguably implicates a number of defenses otherwise available to funds organized in various states. As a result, closed-end funds and their boards have been limited in their ability to defend against activists. The activist campaigns have since grown more numerous and sophisticated, harming the interests of long-term fund investors.

The conclusions of the *Boulder* letter are incorrect, and the use of several common takeover defenses authorized by state law are fully consistent with both the language of the Investment Company Act and its underlying purposes. Especially in light of the considerable negative impact of the intensified activist attacks on closed-end funds and their shareholders, we recommend that the *Boulder* letter be withdrawn, and that the Commission issue guidance clarifying that closed-end funds can employ, among others, the common takeover defenses discussed below consistent with the Investment Company Act.

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<sup>1</sup> The [Investment Company Institute](#) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s members manage total assets of US\$25.2 trillion in the United States, serving more than 100 million US shareholders, and US\$7.7 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](#), with offices in London, Hong Kong, and Washington, DC.

<sup>2</sup> We use the terms *activist investor*, *activist shareholder*, and *activist* interchangeably throughout this document.

<sup>3</sup> *Boulder Total Return Fund, Inc.*, 2010 WL 4630835, at \*1 (S.E.C. No-Action Letter Nov. 15, 2010) (*Boulder*).

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## I. Executive Summary

In recent years, activist investors have intensified their efforts to seize a controlling interest in closed-end funds to pursue a self-interested agenda to extract short-term profits. These arbitrage tactics cause serious harm to funds and work against the interests of their long-term investors, including forcing fundamental changes to the products that are contrary to what stockholders sought when making their investment. Activists also can demand actions that can cause funds to shrink in size or be liquidated altogether, thereby reducing the availability of closed-end funds to investors and increasing costs. Decreasing the number of closed-end funds harms a large demographic of closed-end fund shareholders—including retirees many of whom rely on the dividends from closed-end funds.<sup>4</sup>

If a closed-end fund board concludes that an activist’s goals are not in the best interests of the fund and its shareholders, the directors may wish to employ one or more of the common takeover defenses authorized under applicable state law.<sup>5</sup> Like registered mutual funds, closed-end funds are governed by both federal and state law, and defensive measures must therefore comply with applicable state law and the Investment Company Act. Defenses that limit a concentrated shareholder’s ability to exercise its votes potentially implicate the share voting requirements in Section 18(i) of the Investment Company Act. Section 18(i) requires that “every share of [fund] stock...be a voting stock and have equal voting rights with every other outstanding voting stock.” The question addressed in the *Boulder* letter was whether a closed-end fund’s use of Maryland’s control share statute as a takeover defense was consistent with Section 18(i)’s “voting stock” and “equal voting rights” requirements—and the staff concluded that it was not.

We believe that the *Boulder* letter’s reasoning is incorrect. There is no legal basis under the Investment Company Act to restrict closed-end funds’ use of certain common takeover defenses limiting the voting rights of concentrated shareholders.<sup>6</sup> Contrary to the staff’s conclusion in *Boulder*, neither the language of Section 18(i) nor the purposes underlying the Investment Company Act warrant such a limitation on the discretion of independent directors. Defensive measures limiting the ability of a given *stockholder* to exercise its votes do not strip the *stock itself* of its voting rights. Federal and state courts have correctly held that Section 18(i) and similar state law provisions guaranteeing equal voting rights to shares of stock do not limit the use of takeover defenses that differentiate among stockholders. The conclusion in the *Boulder* letter that Section 18(i) prohibits differentiation among stockholders is contrary to this authority, and is unsupported by the statute’s language and structure.<sup>7</sup> And while this letter focuses primarily on Section 18(i) and *Boulder*, other common takeover defenses unrelated to the voting rights of concentrated shareholders (*e.g.*, requiring a majority of outstanding shares to elect directors, limiting the authority of non-continuing directors) are equally consistent with the language and structure of the Investment Company Act.

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<sup>4</sup> We discuss the tactics and impact of activists in Section II, and present additional data in Appendices A, B, and C.

<sup>5</sup> See Section III and Appendix D. In making these determinations, closed-end fund directors, pursuant to their fiduciary duties, must weigh the activists’ interests, as fund shareholders, against other fund shareholders’ interests.

<sup>6</sup> See Section V.

<sup>7</sup> See Section V.A.

Moreover, and also contrary to the *Boulder* letter, the purposes underlying Section 18 and other provisions of the Investment Company Act are furthered—not frustrated—by the use of takeover defenses.<sup>8</sup> Congress’s stated concern was to prevent insiders, “other affiliated persons” (defined to include *anyone* holding 5 percent of a fund’s outstanding shares), and “other investment companies” (among others) from seizing control of funds through concentrated holdings and special voting privileges to further their personal interests. This is precisely the type of potential harm independent directors would seek to avoid by employing takeover defenses in the face of an activist campaign—*i.e.*, arbitrageurs seizing control of a closed-end fund through concentrated holdings to pursue short-term profits at the expense of long-term investors. The *Boulder* letter’s premise—that Congress was focused on preventing self-interested conduct of *insiders* only—is directly contrary to the statutory language and legislative history, as well as other parts of the statute. For example, the limitations on concentrated fund holdings in Section 12(d)(1) of the Investment Company Act clearly apply to “outsiders” acquiring funds, not just those affiliated with the target fund or its insiders. At bottom, the fact that activists may be “outsiders” rather than “insiders” in no way changes the harm they can inflict on the fund and its shareholders or the importance of empowering independent directors to prevent that harm when they determine that an activist’s agenda is not in the fund’s best interests.

Throughout the history of the Investment Company Act, its purposes have been consistently promoted by *strengthening* the ability of disinterested directors to prevent self-interested behavior detrimental to the funds they oversee. The *Boulder* letter turns this principle upside down in concluding that the Investment Company Act’s purposes are somehow promoted by *limiting* the ability of independent directors to combat such detrimental behavior by closed-end fund activists.

The closed-end fund landscape has evolved significantly since the passage of the Investment Company Act. While Congress may not have foreseen the harmful arbitrage activity that has emerged since 1940 and intensified in recent years, it did recognize the type of threat that is now posed by activists. And as early as 1948, in *In the Matter of Solvay American Corp.*,<sup>9</sup> the Commission also recognized the need for a flexible application of the “equal voting rights” requirement in Section 18(i) based on the circumstances presented. The staff’s attempt in the *Boulder* letter to limit the reasoning of the *Solvay* order to the specific facts at issue there is unavailing. Preventing independent directors from the reasonable use of defense measures that are available to their operating company counterparts is not supported by the language of the Investment Company Act, its legislative history, or its policy goals.

Under the Investment Company Act and state law, free market trading of closed-end fund shares occurs on a playing field refereed in part by independent directors, who are charged with balancing the interests of all shareholders. Both the Investment Company Act and state law recognize that this balancing of interests may result in limitations on the actions of concentrated shareholders. The *Boulder* letter, by limiting the ability of independent directors to balance shareholder interests as otherwise provided by law, has led to an uneven playing field and subverted the closed-end fund marketplace. The Commission should withdraw the *Boulder* letter

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<sup>8</sup> See Section V.B. and Appendix E (discussing legislative history).

<sup>9</sup> *In the Matter of Solvay American Corp.*, 27 S.E.C. 971 (1948) (*Solvay*).

and issue guidance to clarify that closed-end fund directors can use common takeover defense measures authorized under applicable state law.

## **II. The Negative Impact of Activist Campaigns on Closed-End Funds**

### **A. How Activists Pursue Their Self-Interested Agenda**

Like open-end funds, closed-end funds are required to periodically strike and publish a net asset value (NAV) of the fund's portfolio holdings.<sup>10</sup> Unlike with open-end funds, however, most closed-end fund shareholders do not purchase shares from the fund at NAV, and generally do not redeem their shares with the fund at NAV.<sup>11</sup> Traditional exchange-listed closed-end fund shares instead trade on the secondary market, and the share price is determined by market supply and demand, which often results in market prices being somewhat higher or lower than NAV. Activists target exchange-traded closed-end funds with share prices trading at a "discount" to NAV, and the arbitrage opportunity they seek to exploit is straightforward: they purchase a large number of fund shares at prices below NAV, and then use their concentrated voting power to try to force the fund to take actions that will allow the activists to sell their shares at prices at or near NAV—and thereby quickly capture an arbitrage profit.

#### *Strategies*

Activists employ a number of strategies to trigger share repurchases at higher prices. The following are common examples<sup>12</sup> of fund actions and/or governance changes activists may try to force, which often are pursued in combination:

- Liquidation of the fund, resulting in all shareholders receiving a cash distribution equal to NAV for all shares.
- Conversion of the fund from a closed-end structure to an open-end structure or merger into an open-end fund, resulting in all shareholders having the option to redeem their shares at NAV.
- A tender offer by the fund to repurchase up to a specified percentage of the fund's outstanding shares, at a price at or near NAV, resulting in (i) tendering shareholders capturing the higher price on the repurchased shares; and (ii) a potential short-term increase

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<sup>10</sup> To meet periodic disclosure requirements, closed-end funds must compute and provide their NAVs at least quarterly. More than 90 percent of closed-end funds calculate the value of their portfolios every business day, while others calculate their portfolio values weekly or on some other basis. See ICI, A Guide to Closed-End Funds (July 2019), available at [www.ici.org/cef/background/bro\\_g2\\_ce](http://www.ici.org/cef/background/bro_g2_ce).

<sup>11</sup> The "closed-end funds" discussed in this submission issue a fixed number of shares that are listed and traded on a stock exchange. Other types of funds, such as interval funds, which offer shares and periodic repurchases at NAV, are beyond the intended scope of this discussion.

<sup>12</sup> Appendix B discusses prior and ongoing campaigns several different activists have launched against closed-end funds in recent years, and includes examples of these strategies.

in the market price of remaining outstanding shares, which may be due to the manufactured demand spike.<sup>13</sup>

- Change of the fund investment adviser from the original sponsoring adviser to another entity affiliated with or favored by the activist, resulting in (i) major disruption to the fund and its investment program to which long-term shareholders desired to gain access in purchasing shares; (ii) the activist potentially profiting from advisory fee payments; and (iii) the activist having more direct ability to cause other fund actions discussed here (subject to board and potentially shareholder approval).
- Election to the fund board of one or more directors or trustees affiliated with or favored by the activist, to, at a minimum, strengthen the activist's hand in pressing for the fund actions discussed here, or to take voting control of the board and effectively force such actions to the detriment of long-term shareholders.
- Declassification of the fund board, such that all directors or trustees stand for reelection simultaneously, strengthening the activist's ability to seize majority control of the board at once at a single annual meeting.

Some of these actions or changes would not result in the activist taking over direct operational control of the fund, and thus might not be thought of as a corporate "takeover" in the common sense as applied to operating companies. But in the closed-end fund context, inducing these types of outcomes over the opposition of the fund's incumbent board is in fact tantamount to a takeover, given the significant negative impact of these outcomes on a fund's investment performance and fundamental character (*e.g.*, liquidating the vehicle or changing the investment structure to an open-end fund structure)—to the detriment of the fund's long-term investors (discussed further below).

### Disclosure

As an activist's fund share ownership percentage grows, the activist is subject to the same disclosure requirements applicable to concentrated holders of operating companies under Section 13 of the Securities Exchange Act of 1934 (Exchange Act). Section 13 requires any person or group of persons who directly or indirectly acquires or has beneficial ownership of more than 5 percent of a class of a fund's securities to report this beneficial ownership by filing a Schedule 13D or Schedule 13G. Schedule 13D must be used by investors holding between 5 percent and 20 percent who have the intent of changing or influencing control of the fund, or who own more than 20 percent regardless of intent. Schedule 13G (which requires disclosure of less information than Schedule 13D does) may be used by ostensibly passive investors who own between 5 percent and 20 percent and claim to have no activist intent. Schedules 13D and 13G are required to be filed within 10 days of the date on which the 5 percent ownership threshold is passed. Filers must amend

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<sup>13</sup> In the operating company context, a related strategy (often referred to as *greenmail*) is for the company to repurchase only the hostile acquirer's shares—for an amount above the market price—in exchange for the acquirer's agreement to cease its takeover efforts. However, this option is generally unavailable in the closed-end fund setting, as Rule 23c-1 prohibits the selective repurchase of fund shares at a price above the current market price, where the stock is trading at a discount to NAV. *See* 17 C.F.R. § 270.23c-1(a)(6).

Schedule 13D and 13G filings continually.<sup>14</sup> Closed-end fund activist investors sometimes file Schedule 13G initially, claiming to have no activist intent, and then switch to a Schedule 13D filing as their holding size grows further and/or they deem it the right time to disclose their activist strategy goals.<sup>15</sup>

### Concentration Limits

In addition to the concentrated holdings disclosure regime under the Exchange Act, the Investment Company Act also imposes substantive limitations on the percentage of a registered fund's shares that another fund may legally acquire. Section 12(d)(1) was enacted to prevent fund-of-funds arrangements in which one fund acquires effective control of another fund to benefit its investors at the expense of the acquired fund's investors.<sup>16</sup> The statutory limits vary somewhat based on whether the acquiring fund is a registered investment company or a private fund.

- Section 12(d)(1)(A) prohibits a *registered or private fund* (and any companies the acquiring fund controls) from obtaining more than 3 percent of an acquired registered fund's outstanding voting securities.<sup>17</sup>
- Section 12(d)(1)(C) prohibits a *registered fund*, other registered funds having the same adviser as the acquiring fund, and any companies the acquiring fund controls, from obtaining more than 10 percent of the outstanding voting securities of an acquired registered *closed-end fund*.

However, as discussed in greater length in ICI's comments to the SEC on fund-of-funds arrangements,<sup>18</sup> we do not believe the Section 12(d)(1)(A) and (C) limits are working as originally intended to limit acquiring private funds from improperly controlling acquired fund assets,

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<sup>14</sup> See Rule 13d-2(a) under the Exchange Act. Schedule 13D filings need to be updated "promptly" following a 1 percent change in ownership (or such lesser amount deemed "material" under the circumstances). Schedule 13G filings need to be updated "promptly" when holdings increase or decrease by 5 percent or exceed 10 percent.

<sup>15</sup> Appendix B includes examples of closed-end fund challenges asserted by several high-profile activists, with details drawn from public records such as Schedule 13D and 13G filings by activists; competing proxy statements from funds and activists; and litigation filings. We note that some of the information in Appendix B indicates that activists may not be complying with the requirements to update their Schedule 13D or 13G filings. Activists also may provide disclosures in proxy materials if they enter into a proxy contest with the closed-end fund issuer. Schedule 14A, which dictates the information required in a proxy statement, requires certain information about each participant in the offering.

<sup>16</sup> The legislative history of Section 12(d)(1) is discussed in Appendix E.

<sup>17</sup> Congress clearly intended to restrict private funds from obtaining more than 3 percent of a registered fund's outstanding voting securities, as it specifically referenced the Section 12(d)(1)(A) prohibition in Sections 3(c)(1) and 3(c)(7)—the sections most private funds rely on to avoid registration as an investment company (15 U.S.C. § 80a-3(c)(1) and 3(c)(7)). By contrast, a registered fund may acquire shares of unregistered private funds relying on Section 3(c)(1) or 3(c)(7) in excess of the Section 12(d)(1) limits.

<sup>18</sup> Investment Company Institute, Comment Letter on Proposed Rule on Fund-of-Fund Arrangements, File No. S7-27-18 29-30 (April 30, 2019), [www.sec.gov/comments/s7-27-18/s72718-5433908-184637.pdf](http://www.sec.gov/comments/s7-27-18/s72718-5433908-184637.pdf).



especially in the closed-end fund context.<sup>19</sup> Because the 3 percent limit (unlike the 10 percent limit) does not aggregate the holdings of funds controlled by the same adviser, activist investors have been able to create multiple private funds under common management that each invest up to the 3 percent limit in a targeted closed-end fund—effectively evading the intended limitation on concentrated voting control. Likewise, because the 10 percent limit (unlike the 3 percent limit) does not apply to private funds, many activist investors can exceed the 10 percent limit in a targeted closed-end fund through private funds.<sup>20</sup> The ability of activist investors to effectively evade these statutory limits on concentrated voting power underscores the importance of not unduly depriving independent directors of other means of protecting investors’ interests against harmful activist conduct—including in particular the takeover defenses addressed here.<sup>21</sup>

### Proxy Firms

In the same vein, the practices of proxy advisory firms, such as Institutional Shareholder Service (ISS), also substantially boost activist campaigns targeting closed-end funds, because their recommendations do not reflect a thorough understanding of closed-end funds. Many institutional investors that are significant holders of closed-end fund shares retain the services of ISS and similar firms to provide advice on proxy votes and/or to exercise discretion to vote their shares.

In making its recommendation and exercising voting discretion, ISS’s views on the quality of incumbent management frequently give significant weight to whether a closed-end fund has traded at an above-average discount. Given that it is common for closed-end funds to trade at a discount and because the exact causes of a particular fund’s discount cannot be identified with any certainty,<sup>22</sup> it is far from clear that discounts are in fact harmful to the interests of long-term investors or are the result of any actions by fund management. Accordingly, placing such significant emphasis on a fund’s discount to assess the quality of management fails to take into account other important indicators of success valued more by long-term investors. Furthermore, since funds trading at discounts are the ones most likely to be targeted by activists, this emphasis by ISS tends to favor the interests of activists over the interests of long-term investors—who typically care more about long-term performance and sustainable distribution rates than about the size of the discount and capturing short-term capital gains.

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<sup>19</sup> In a 1966 report to Congress, the SEC stated that the percentage limits in Section 12(d)(1) were intended to guard against the adverse effects on public interest and investors when investment companies are organized and operated in the interest of other investment companies or when control of investment companies is “unduly concentrated through pyramiding or inequitable methods of control.” See SEC, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337, ch. 8, at 315 (1966). See also Appendix E.

<sup>20</sup> As discussed in our fund-of-fund comments, we recommend legislative amendments to address this practice, although that recommendation is not the subject of the present submission.

<sup>21</sup> There is no private right of action under Section 12. Given the lack of transparency with respect to private fund holdings under Schedules 13D and 13G, it may be quite difficult for Commission staff to constantly monitor compliance with the Section 12(d)(1) requirements. See *supra* note 15 and *infra* notes 35 and 36. Concentrated ownership under a single activist manager provides that manager with significant influence over a closed-end fund, and there appears to be limited means for closed-end funds or the Commission staff to address that.

<sup>22</sup> See Appendix C on page 51.

Similarly, ISS also always recommends voting in favor of certain types of shareholder proposals, such as board declassification, without drawing meaningful distinctions between the relative pros and cons of such proposals for closed-end funds and operating companies.<sup>23</sup> There are a number of reasons closed-end funds choose to employ a board of directors with directors in different classes, each class of which is elected at a different time (a “classified” board). Classified boards provide stability and continuity of a fund’s long-term perspective that is focused on pursuit of the fund’s stated investment objective and aligned with the expectations of the fund’s core investor base. They protect against abrupt changes in investment philosophy from investors with short-term objectives who seek a contrary agenda. Classified boards also promote director independence from both management and activists and ensure that the board has prior experience. Additionally, classified boards are good for succession planning, allowing a closed-end fund adequate time to plan orderly changes to its board and giving new directors the opportunity to gain knowledge from experienced directors. ISS’s approach unfortunately fails to consider the frequency and negative effects of activist arbitrage efforts on the interests of the long-term closed-end fund investors and ignores the benefits that such arrangements can have for closed-end funds, such as defending against a takeover.

Moreover, in the particular context of funds featuring auction rate preferred securities (ARPS), the ARPS holders are, in many funds, dominated by brokers and other institutional holders that have delegated voting authority to ISS. ISS has historically recommended against incumbent nominees based on quantitative tests regarding, for example, the number of ARPS redeemed relative to the rest of the industry or the fund’s recent tender offer price for ARPS relative to prices offered by other closed-end funds for similar securities.<sup>24</sup> As a practical matter, therefore, an activist can purchase just a small number of shares of a closed-end fund with outstanding ARPS, nominate a director, and effectively be guaranteed to have that candidate elected because ISS will favor the challenger.

## **B. Growing Intensity of Activist Campaigns**

Activist activity aimed at closed-end funds has intensified in recent years.<sup>25</sup> A small and experienced group of professional activists seek to influence the management of closed-end funds

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<sup>23</sup> For example, ISS’s proxy voting policies state that its general recommendation for all issuers is to “vote against proposals to classify (stagger) the board” and “vote for proposals to repeal classified boards and to elect all directors annually.” See Institutional Shareholder Services, United States Benchmark Policy Recommendations (Effective for Meetings on or after February 1, 2020) at 17, available at [www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf](http://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf). ISS’s proxy voting policies state that these are its *general* recommendations, and we are unaware of any instance in which it recommended voting against declassifying a closed-end fund board. In addition, ISS penalizes director nominees that serve on boards implementing such governance structures. One policy, for example, states that ISS will generally vote against director nominees “if the directors...[c]lassified the board.” See *id* at 13.

<sup>24</sup> To fulfill their fiduciary obligations, fund directors must carefully weigh the interests of closed-end fund common shareholders and closed-end fund preferred shareholders when determining whether to redeem outstanding ARPS. Under the Investment Company Act, preferred stockholders, voting as a class, have the right to elect at least two directors at all times. In addition, they may elect a majority of the directors at any time when dividends on the preferred shares are unpaid in an amount equal to two full years’ dividends. See Section 18(a)(2)(C) of the Investment Company Act.

<sup>25</sup> See Rachel Levy, “Boaz Weinstein’s Hedge Fund Battle with Neuberger Berman Gets More Heated,” *Wall Street Journal* (Oct. 9, 2019) (summarizing recent activist actions against one closed-end fund); Gretchen Morgenson, “Saba

with a singular focus on inducing a liquidity event to generate a quick profit on the fund shares they have purchased at a discount to NAV. The vast majority of these arbitrage campaigns are carried out by a small handful of activist hedge fund managers.<sup>26</sup>

The number of closed-end fund activist campaigns—as measured by the number of beneficial ownership (Schedule 13D) and contested proxy solicitation (Schedule 14A) filings—has fluctuated over time.<sup>27</sup> In 2010, activists engaged in the most activity, making 43 individual filings (40 of which were from three known activist investors). This activity could be attributable to the 2007–2009 financial crisis when average discounts across equity and bond closed-end funds widened significantly.<sup>28, 29</sup> In addition, during that time, the head of the SEC’s Division of Investment Management gave a 2009 speech questioning the legality of takeover defenses,<sup>30</sup> followed by the 2010 *Boulder* letter.<sup>31</sup> Since 2010, the number of these filings has continued to fluctuate. More recently, however, there were 37 in 2017 and 36 filings in 2019, with 89 percent of the filings in these two years coming from five activist investors.

Perhaps just as significant as the *number* of activist actions are the sophistication and aggressive nature of the methods activists employ. The ICI survey results show that the range of actions by known activists include proposals recommending the election of trustees, fund tender offers, declassifications of fund boards, terminations of fund advisers, and “open-ending” or

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Can Nominate Slate to BlackRock Fund Boards, Delaware Court Says,” *Wall Street Journal* (June 28, 2019) (summarizing recent activist actions against two closed-end funds).

<sup>26</sup> Between 2015 and 2019, five firms filed 82 percent of all beneficial ownership (Schedule 13D) and contested proxy solicitation (Schedule 14A) filings (*see* Figure C.4). According to a survey distributed to ICI members on closed-end funds (“ICI survey”), 85 percent of shareholder proposals or proxy contests in the past five years for survey participants were from just four shareholders. ICI received data on 48 shareholder proposals from 17 respondents representing 69 percent of closed-end fund assets and 62 percent of the total number of closed-end funds. *See* Appendix A on page 35 for more information about the ICI survey. *See also* Tim Leemaster and Ben Sheng, “The Funds and Firms Pursuing Closed-End Fund Activism,” *Fund Directions* (Feb. 13, 2020).

<sup>27</sup> *See* Figure C.3 in Appendix C. Some filings downloaded from EDGAR were deleted from the final dataset, including: Schedule 13D filings by certain banks with no formal intent, Schedule 13D filings that appeared to be amendments to a previously filed Schedule 13D, Schedule 13D or PREC14A filings by affiliated persons, duplicate Schedule 13D or PREC14A filings made on the same day, and Schedule 13D and PREC14A filings that were duplicates of each other (*i.e.*, their intent was assumed to be the same). Data may include a small number of Schedule 13D filings where shareholders did not disclose an activist intent. The number of activist campaigns may not reflect the true extent of recent activism, because there may be a number of campaigns from shareholders who own less than 5 percent of a closed-end fund’s shares and, accordingly, were not required to provide public disclosures about those campaigns.

<sup>28</sup> For more information, *see* James Duvall, “The Closed-End Fund Market, 2018,” *ICI Research Perspective* 25, no. 2 (April 2019), available at [www.ici.org/pdf/per25-02.pdf](http://www.ici.org/pdf/per25-02.pdf).

<sup>29</sup> This is likely because of market perceptions and investor sentiment, which are two reasons funds may trade at a discount. For more information, *see* Charles Lee, Andrei Schleifer, and Richard Thaler, “Investor Sentiment and the Closed-End Fund Puzzle,” *Journal of Finance* 46, no. 1 (1991): 75–109.

<sup>30</sup> Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission, Keynote Address at the Independent Directors Council Investment Company Directors Conference (Nov. 12, 2009) (“2009 Donohue speech”), available at [www.sec.gov/news/speech/2009/spch111209ajd.htm](http://www.sec.gov/news/speech/2009/spch111209ajd.htm). Further discussion of the SEC’s interpretation of Section 18(i) and Mr. Donohue’s address is located in Appendix F.

<sup>31</sup> Further analysis of the *Boulder* letter may be found in Appendix F.

“liquidating” funds.<sup>32</sup> Further, 17 percent of the shareholder proposals by known activists contained multiple recommendations in the same proposal or included conditions to liquidate based on a specified tender offer amount.<sup>33</sup> Additionally, activist investors more frequently are using hedge funds and separately managed accounts that have more resources and financial incentives to attack a fund.<sup>34, 35</sup> Similarly, activists increasingly are using exchange-traded funds (ETFs) and fund-of-fund structures to generate greater assets to deploy in these activist strategies.<sup>36</sup>

### C. **The Negative Effect of Activist Campaigns on Funds and Long-Term Investors**

Independent directors of a closed-end fund may, and often do, conclude that the actions an activist investor proposes (described above) are not in the best interests of the fund and its long-

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<sup>32</sup> See Figure A.5 in Appendix A.

<sup>33</sup> See Appendix A at page 35 for more information about the survey.

<sup>34</sup> Their resources exceed those from the pension fund shareholder activists that were active during the 1990s. See Joel Slawotsky, *Hedge Fund Activism in the Age of Global Collaboration and Financial Innovation: The Need for a Regulatory Update of United States Disclosure Rules, Review of Banking and Financial Law* 35 (2015): 272, 288–292.

<sup>35</sup> As noted above, Section 12(d)(1)(A)(i), which prohibits an investment company from owning more than 3 percent of the total outstanding voting stock of any registered investment company, subjects private funds to its restrictions. See *supra* note 17. We note that some activists publicly disclose that they are exceeding the Section 12(d)(1)(A)(i) limits through individual private funds. For example, in a recent Schedule 13D filing, a private fund reported owning 4.27 percent of a registered closed-end fund and, thus, appeared to be in violation of the Section 12(d)(1)(A)(i) limit. See [www.sec.gov/Archives/edgar/data/1222922/000106299320000292/formsc13d.htm](http://www.sec.gov/Archives/edgar/data/1222922/000106299320000292/formsc13d.htm) (reporting that Saba Capital Master Fund, Ltd. owned 4,958,431 shares of a registered closed-end fund’s referenced 116,147,018 shares of total outstanding common stock as of September 30, 2019). In a similar vein, we note that activists often file proxy materials used in proxy contests on behalf of multiple private funds. See *supra* note 15. Although Schedule 14A requires this information regarding each “participant” in the offering, these proxy materials often do not provide any transparency into the holdings of each of the individual private fund. See Item 5(b)(1) of Schedule 14A.

<sup>36</sup> See, e.g., Prospectus of Saba Closed-End Funds ETF (dated April 1, 2019), available at [etcapi.net/uploads/afdb99149f0b47e6b15deaded7269428.pdf](http://etcapi.net/uploads/afdb99149f0b47e6b15deaded7269428.pdf); Prospectus of the Special Opportunities Fund, Inc. (dated June 30, 2019), available at [specialopportunitiesfundinc.com/wp-content/uploads/sites/40/2018/12/Prospectus.pdf](http://specialopportunitiesfundinc.com/wp-content/uploads/sites/40/2018/12/Prospectus.pdf). Recent SEC filings include an accusation by a closed-end fund that the Saba Closed-End Funds ETF failed to adhere to its exemptive order conditions during a recent proxy battle. See, e.g., [www.sec.gov/Archives/edgar/data/1487610/000089843219001126/defc14a.htm](http://www.sec.gov/Archives/edgar/data/1487610/000089843219001126/defc14a.htm). In addition, activists that use registered funds to invest in registered closed-end funds could be failing to properly adhere to Section 12(d)(1)(F) of the Investment Company Act to acquire shares in excess of the Section 12(d)(1) limits. Section 12(d)(1)(F) permits a registered fund to avoid certain limits of Section 12(d)(1)(A) if, among other conditions, immediately after the purchase of securities, the acquiring registered fund and all of its “affiliated persons” do not collectively own more than 3 percent of the outstanding securities of the acquired fund. Based on Schedule 13D filings, we understand that certain registered funds of funds along with their affiliates own greater than 3 percent of several acquired closed-end funds. See, e.g., [www.sec.gov/Archives/edgar/data/899752/000150430419000021/thirda.txt](http://www.sec.gov/Archives/edgar/data/899752/000150430419000021/thirda.txt) (Schedule 13D filing showing that Bulldog Investors, LLC, the investment adviser to Special Opportunities Fund, Inc., owned and controlled with power to vote more than 5.59 percent of the outstanding shares of a closed-end fund in October 2019) and [www.sec.gov/Archives/edgar/data/897802/000089853119000488/sof-ncsrs.htm](http://www.sec.gov/Archives/edgar/data/897802/000089853119000488/sof-ncsrs.htm) (Form N-CSR filing showing that Special Opportunities Fund, Inc., a registered fund, owned shares of the same closed-end fund at least as of June 30, 2019). See also Schedule 13D (Dec. 14, 2015) (filed by Bulldog Investors, LLC) (disclosing Bulldog’s investments in closed-end funds through various private funds). Further activist strategies are discussed in Appendices B and C.

term shareholders. The harm done by activist arbitrage is best understood by looking at the key features of closed-end funds that make them attractive to the long-term investors who own them:

- *Dividend income.* Closed-end funds distribute their earnings on portfolio holdings (interest, dividends, capital gains) in the form of regular dividends—often providing fund shareholders with yields far above market interest rates, with returns enhanced by the use of leverage and less-liquid holdings (discussed below). Compared with open-end fund investors, shareholders in closed-end funds are generally more focused on the fund’s total return and less on share price growth in isolation.<sup>37</sup>
- *Use of leverage.* Closed-end funds frequently use leverage to enhance investment returns. Closed-end funds have more flexibility to use leverage under the Investment Company Act than open-end funds do. Leverage can take the form of structural leverage affecting the fund’s capital structure (e.g., bank loans, debt issuance, preferred shares) or leverage from portfolio investments (e.g., derivatives, reverse repurchase agreements, tender option bonds).<sup>38</sup>
- *Long investment horizon / fully invested portfolio.* Because closed-end fund advisers do not have to manage cash reserves for daily shareholder redemptions—and thus have an essentially fixed asset base—they can fully invest the portfolio with a longer-term investment horizon. This also allows closed-end funds to invest in less-liquid instruments than open-end funds, with the corresponding opportunity for greater returns.<sup>39</sup>

The actions activists typically pursue are designed to capture windfall profits through short-term increases in fund share prices, directly undermining the core features of closed-end fund investing sought by long-term investors. Although some of the actions may allow long-term investors to share in the short-term share price bump to some extent, the changes activists would make to the fund undermine their broader investment goals and appear to have little long-term effect on closed-end fund share prices.<sup>40</sup> These actions include:

- In order to raise capital for a substantial tender offer or share repurchase, the fund manager likely will be forced to sell portfolio holdings (at potentially disadvantageous times and

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<sup>37</sup> Closed-end fund investors are typically older than mutual fund investors and more likely to be retired from their lifetime occupations. In this regard, these investors are more likely to seek closed-end funds that provide dividend income. See Investment Company Institute, *2019 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, available at [http://www.icifactbook.org/ch5/19\\_fb\\_ch5#characteristics](http://www.icifactbook.org/ch5/19_fb_ch5#characteristics).

<sup>38</sup> According to ICI data, nearly two-thirds of closed-end funds used leverage as of year-end 2019. The Investment Company Act imposes asset coverage requirements on closed-end funds that use leverage via debt issuance or preferred shares. For each \$1.00 of debt issued, the fund must have \$3.00 of assets immediately after issuance and at the time of dividend declarations (commonly referred to as 33 percent leverage). Similarly, for each \$1.00 of preferred stock issued, the fund must have \$2.00 of assets at issuance and dividend declaration dates (commonly referred to as 50 percent leverage).

<sup>39</sup> Closed-end funds are not subject to the same liquidity requirements as open-end funds, which are set forth primarily in Rule 22e-4. See 17 C.F.R. § 270.22e-4.

<sup>40</sup> See Figure C.13 in Appendix C (showing that the majority of closed-end funds that conducted activist-induced tender offers between 2016 and 2018 reverted to trading at excess discounts that were wider than the excess discounts seen prior to the tender offer).

pricing), shrink the fund’s asset base, reduce leverage, and generate potentially unfavorable tax consequences—all to the detriment of the fund’s returns and distributable income. Moreover, the reduced asset base following a tender offer will often mean that remaining shareholders are left shouldering a higher expense ratio. For example, Figure C.5 in Appendix C illustrates the effect on a fund that conducted an activist-induced tender offer for 15 percent of its outstanding shares. The tender offer caused the fund’s common share assets to drop from approximately \$124 million to approximately \$105 million. This drop in assets caused long-term fund shareholders who did not tender their shares to incur a 109 percent increase in the fund’s expense ratio. Even if retail shareholders did tender their shares for short-term gain, the tender is inconsistent with expectations of long-term shareholders and presumably the very reason why the shareholder initially invested in the fund (and why other, non-tendering shareholders remained in the fund).<sup>41</sup>

- Conversion of a closed-end fund to an open-end fund is even more fundamentally disruptive, changing the very nature of the investment product. Open-end funds must offer daily liquidity, maintain cash reserves to meet redemptions, and limit their investments to more-liquid holdings; they also are more limited in their use of leverage. In addition, converting to an open-end fund often requires adjustments to a fund’s portfolio, which can cause fund shareholders to incur unexpected taxes. The majority of closed-end funds use leverage that is not available in an open-end funds structure. Therefore, the conversion could lead to substantial deleveraging for a closed-end fund, which could affect fund earnings. Converting to an open-end fund structure enables activists to exit their positions in the closed-end fund in a single transaction, leaving remaining investors to absorb the related portfolio transaction costs associated with meeting the redemptions.
- An activist “takeover” of the fund’s board and/or advisory relationship, such that the management of the fund is focused primarily on purchasing or liquidating fund shares at a price equal to NAV, shifts the focus of the fund’s investment operations away from achieving its investment objectives and thereby undermines the investment goals of long-term investors. Figure C.7 in Appendix C illustrates how activists employ a common strategy that uses ISS’s policy of recommending proposals to de-stagger classified boards, making it easier to enact changes to the fund.
- Of course, liquidation makes the fund entirely unavailable, forcing investors to research and select a replacement investment for their portfolios, which may be less attractive than the liquidated fund. Additionally, shareholders may incur a tax burden from the realized capital gains as a result of the liquidation (both from the fund’s sales of portfolio securities to meet the liquidation and the shareholder’s sales of the fund’s shares at liquidation). Figure C.8 in Appendix C provides an example of how activists have coordinated efforts to liquidate a closed-end fund (despite price returns higher than its peers), eliminating a viable investment option and potentially subjecting investors to unexpected tax consequences.
- Whether or not an activist is successful, a proxy battle often imposes significant expense on the fund (*e.g.*, proxy solicitation fees, legal fees, printing, mailing)—which are borne

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<sup>41</sup> See Figures C.5 and C.6 in Appendix C.

by fund shareholders. According to the ICI survey, the average fund-level cost for routine proposals was \$22,000 per year compared with an average fund-level cost for contested proposals of \$623,000 per year.<sup>42</sup> Funds engaged in proxy contests and nonroutine proposals also incur significant and unexpected “time costs,” which are difficult to quantify. These involve significant internal resources from all parts of the fund complex that otherwise could be devoted to operating the fund, including from the fund’s board of directors, senior management, legal department, and operations department.

In addition to the harm done to investors in the individual funds subject to activist challenges, the activist community’s assault on the closed-end fund model negatively affects the entire market. 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. Reducing the number of closed-end funds affects the choices for retirees, many of whom rely on closed-end funds for dividend income. Since the financial crisis, more closed-end funds have merged or liquidated than have launched, with some sponsors electing to leave the space solely due to activist actions. These trends do not bode well for the long-term viability of closed-end funds, which are uniquely and ideally qualified to accomplish the Commission’s policy goal of increasing retail shareholder access to private investments.<sup>43</sup> In fact, the number of closed-end funds has fallen by about 25 percent since year-end 2007—and is about the same number of funds as there were in the mid-1990s.<sup>44</sup> The total assets in closed-end funds have accordingly stagnated, and have been vastly outpaced by the growth rates of assets in long-term mutual funds and ETFs.<sup>45</sup>

Notably, a 2016 empirical study<sup>46</sup> demonstrated positive closed-end fund share price effects from a decision by the Maryland federal district court approving the use of shareholder rights plans—commonly referred to as *poison pills* (discussed below)—and negative price effects from the 2009 Donohue speech and the 2010 *Boulder* letter calling into question the legality of takeover defenses. The results suggest that markets and closed-end fund investors reacted positively to the availability of takeover defenses, and negatively to greater legal uncertainty to such availability, as reflected in fund returns following these events. The authors (including former SEC Commissioner Robert J. Jackson) conclude that “closed-end fund shareholders *liked* the poison pill.”

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<sup>42</sup> See Figure A.7 in Appendix A.

<sup>43</sup> See *infra* Section VI (discussing how closed-end funds could help provide appropriate retail investor exposure to private investments).

<sup>44</sup> There were 500 closed-end funds in 1995, but by 2007, there were 658 closed-end funds. By year-end 2019, the market contained 494 closed-end funds, representing a 25 percent decrease from year-end 2007. See Figure A.3 in Appendix A for more information.

<sup>45</sup> See Figure A.2 in Appendix A for more information. Further data are presented in Appendix A.

<sup>46</sup> Martijn Cremers, Robert J. Jackson, and John Morley, *The Value of Takeover Defenses: Evidence from Exogenous Shocks to Closed-End Mutual Funds* (2016), 21–22.

### **III. Takeover Defenses of Potential Use to Closed-End Fund Boards**

State law recognizes a number of corporate defenses against unwanted activist campaigns, some established by statute and others sanctioned by court holdings. The recognized defenses most likely to be of practical use in the closed-end fund setting are summarized below.<sup>47</sup> Some of these defenses restrict a concentrated shareholder's ability to vote (*e.g.*, control share statutes, poison pills) and could potentially be viewed as implicating Section 18(i), including the Maryland statute at issue in the *Boulder* letter. Other defenses that a closed-end fund might employ use means *other* than a restriction on the ability to vote, and these defenses should *not* implicate Section 18(i) or other provisions under the Investment Company Act. Given that the vast majority of closed-end funds are organized under either Maryland, Delaware, or Massachusetts law, the discussion below focuses on these three jurisdictions.<sup>48</sup>

#### **Defenses Implicating Voting Rights**

- *Control share statute.* Maryland and Massachusetts have corporate “control share” statutes that allow corporations to check the power of would-be acquirers by divesting shareholders who hold a certain percentage of a company's stock of their voting rights unless those voting rights are restored by the vote of a specified number of disinterested (*i.e.*, non-concentrated) stockholders. Under the Maryland statute, a shareholder with more than 10 percent of a company's stock may not vote those shares unless approved by a two-thirds vote of all other shareholders. The Massachusetts statute is triggered at a 20 percent holding, and voting rights can be restored by a majority vote of disinterested shareholders.
- *Poison pill.* Maryland, Massachusetts, and Delaware all permit some form of a so-called poison pill defense. This defense allows a board to issue rights to stockholders to purchase additional company shares of the fund at a discount while excluding the would-be acquirer (or other high-concentration investors) from purchasing the additional shares, thus diluting the concentrated investor's interest in the company. Maryland and Massachusetts authorize poison pills by statute, while in Delaware the board's authority to implement this defense is recognized by long-standing court precedent.

#### **Defenses Not Implicating Voting Rights**

- *Classified boards.* The Maryland, Massachusetts, and Delaware corporate statutes all allow companies to classify their boards, although the mechanism for instituting a classified board varies somewhat by state. The Investment Company Act also authorizes the use of classified boards in Section 16(a): “Nothing herein shall...preclude a registered investment company from dividing its directors into classes if its charter, certificate of incorporation, articles of association, bylaws, trust indenture, or other

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<sup>47</sup> See also Appendix D.

<sup>48</sup> See also Appendix D.



instrument or the law under which it is organized, so provides and prescribes the tenure of office of the several classes....”<sup>49</sup>

- *Majority of outstanding voting shares requirement.* The Maryland, Massachusetts, and Delaware corporate statutes authorize companies to enact requirements that specified actions be approved by a majority of all outstanding voting shares rather than just a majority of the shares voted. Such a provision applying to election of directors, especially if coupled with one providing that incumbent directors remain in office until a successor is elected, can have the effect of making it more difficult for activist directors to elect their preferred board candidates.
- *Stock repurchase.* In Delaware, the board of a corporation may vote to repurchase the company’s shares from existing shareholders, thereby effectively increasing the voting power of shareholders unsupportive of a takeover and potentially preventing the would-be acquirer from acquiring enough stock to effect a takeover. While the Investment Company Act sets forth certain restrictions on the price at which a closed-end fund may repurchase its shares, stock purchases themselves are not prohibited by the statute.
- *Continuing director requirements.* The Delaware corporate statute provides that a company’s charter may grant one or more directors greater voting power than the others. In the closed-end fund setting, such a charter could provide a basis to differentiate between “continuing” directors (*i.e.*, those whose nomination is approved by current directors) and those nominated by activist investors, conferring only on the former category the ability to approve certain actions (*e.g.*, amend bylaws, engage in significant transactions, liquidate or merge the fund, determine the number of directors, fill board vacancies, waive share ownership limitations).

#### **IV. Relevant Provisions Under the Investment Company Act**

##### **A. Section 18(i)**

Section 18 of the Investment Company Act governs the capital structure of funds. Section 18(i) in particular provides in relevant part:

Except as provided in subsection (a) of this section, or as otherwise required by law, every share of stock hereafter issued by a registered management company...*shall be a voting stock and have equal voting rights with every other outstanding voting stock:* Provided, that this subsection shall not apply to...shares issued in accordance with any rules, regulations, or orders which the Commission may make permitting such issue.<sup>50</sup>

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<sup>49</sup> 15 U.S.C. § 80a-16(a).

<sup>50</sup> 15 U.S.C. § 80a-18(i) (emphasis added).

The referenced exception in Section 18(a) allows closed-end funds to issue senior securities (*e.g.*, preferred stock) under specified conditions, including when a “provision is made to entitle the holders of such senior securities, voting as a class, to elect at least two directors at all times....”<sup>51</sup>

The legislative history of the Investment Company Act and the statute’s enumerated policy goals reveal the concerns Congress intended to address in regulating the capital structure of funds. Based on the SEC’s industry study that preceded and informed the drafting of the legislation, Congress intended to eliminate harmful industry practices involving discriminatory share classes and concentrated voting power, including:

- (i) operation and management of funds in the self-interest of insiders or large external shareholders (including other investment companies), rather than in the interest of all shareholders;
- (ii) undue concentration of control through “pyramiding” or inequitable methods of control; and
- (iii) issuance of fund shares containing “inequitable or discriminatory provisions.”

Significantly, Congress’s clearly stated goal was to prevent self-interested control of funds through concentrated voting power, whether by “insiders” (*e.g.*, advisers, officers, directors) or by “outsiders” holding large ownership stakes.<sup>52</sup>

Many states have enacted equal voting rights legislation for business entities organized within their state that parallel Section 18(i) of the Investment Company Act. Among these states are the three most common jurisdictions for organization of a closed-end fund: Delaware, Maryland, and Massachusetts. For example, Delaware’s corporate statute includes the following equal voting rights provision:

Unless otherwise provided in the certificate of incorporation and subject to § 213 of this title, *each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder.* If the certificate of incorporation provides for more or less than 1 vote for any share, on any matter, every reference in this chapter to a majority or other proportion of stock, voting stock, or shares shall refer to such majority or other proportion of the votes of such stock, voting stock, or shares.<sup>53</sup>

The 2010 *Boulder* letter followed earlier notable interpretations of Section 18(i) by the Commission and a federal court. In 1948, the Commission granted a closed-end fund’s application for an order permitting it to issue preferred stock with voting rights that differed from the common shares, in ways going beyond the distinction enshrined in Section 18(a) (*i.e.*, that the preferred shareholders be entitled as a class to elect two directors). In its order, the Commission

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<sup>51</sup> 15 U.S.C. § 80a-18(a)(2).

<sup>52</sup> The legislative history of Section 18(i) is discussed further in Appendix E.

<sup>53</sup> Del. Code Ann. tit. 8, § 212(a) (emphasis added). This and other state equal voting rights provisions are discussed in more detail in Appendix G.

acknowledged that Congress did not discuss the meaning of “equal voting rights” at the time of the Investment Company Act’s enactment, and it concluded:

It is apparent that in certain cases an inflexible adherence to any rigid interpretation could produce grave distortions of the apparent intent of Congress to require a reasonably equitable distribution of voting power consistent with the applicable provisions pertaining to the different classes of stock. What might constitute a reasonable interpretation of ‘equal voting rights’ in one case might produce an extremely inequitable condition in another. We feel, therefore, that each individual case must be decided upon the particular factors involved.<sup>54</sup>

Accordingly, the Commission concluded that in the absence of a definition from Congress, the SEC would adopt a flexible approach and “rely on the general purposes of the statute” as guidance for interpretation.<sup>55</sup> In responding to a series of no-action requests in later years, the SEC staff generally followed this flexible approach in applying the “equal voting rights” requirement to various proposed voting structures.<sup>56</sup>

In 2004, a federal court in the District of Maryland held that shareholder rights agreements (*i.e.*, poison pills) do not violate Section 18(i).<sup>57</sup> There, a closed-end fund faced a challenge from activist investors who made partial tender offers seeking to acquire 50 percent of the fund’s shares, intent on changing the fund’s investment adviser and switching its investment objective.<sup>58</sup> The board took various defensive measures, including (i) opting in to the Maryland control share statute; and (ii) enacting a shareholder rights agreement that declared a dividend of one “right” for each outstanding share of common stock. The right allowed shareholders to purchase three additional shares of common stock at par value, but eliminated the rights of acquirers of more than 11 percent of the common stock after the dividend.<sup>59</sup> The court rejected the activists’ argument that this differentiation among *shareholders* under the poison pill violated Section 18(i)’s requirements that all *shares* be voting shares with equal rights:

The triggering of the poison pill...does not revoke voting rights from any shares. Although the triggering of the poison pill will result in a reduction of the Acquiring Person’s ownership interest, this is an issue of dilution of economic interest and

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<sup>54</sup> *Solvay* at \*1.

<sup>55</sup> *Id.*

<sup>56</sup> See Appendix F.

<sup>57</sup> *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust*, 342 F. Supp. 2d 371, 376 (D. Md. 2004).

<sup>58</sup> *Id.* at 372–373.

<sup>59</sup> *Id.* at 374. The board also (i) entered a stock purchase agreement that reduced the activists’ holdings to less than 10 percent, *id.* at 373; and (ii) opted in to the Maryland Control Share Acquisition Act (MCSAA), Md. Code. Ann. Corps. & Ass’ns § 3-701, that requires shareholders with more than 10 percent of the company to have their vote ratified by two-thirds of the disinterested shareholders, *id.* at 373–374.

corresponding voting power and has *nothing to do with the voting rights of the shares themselves*.<sup>60</sup>

The court reasoned that under the poison pill, each share still had equal voting power. *Id.* The court also rejected the activists' argument that the poison pill violated Section 18(d) of the Investment Company Act, which requires all rights and warrants to be issued "exclusively and ratably to a class or classes" of the fund's security holders.<sup>61</sup> In rejecting the Section 18 arguments, the court relied on a holding of the Delaware Supreme Court on closely analogous facts—applying Delaware's equal voting rights statute:

The Supreme Court of Delaware held in *Providence and Worcester Company v. Baker*<sup>62</sup> that voting restrictions applicable to shareholders with larger holdings are permissible and do not violate Delaware law requiring that all shares of stock within the same class have uniform voting rights. The court concluded:

In the final analysis, these restrictions are limitations upon the voting rights of the stockholder, not variations in the voting powers of the stock per se. The voting power of the stock in the hands of a large stockholder is not differentiated from all others in its class; it is the personal right of the stockholder to exercise that power that is altered by the size of his holding.<sup>63</sup>

Later in the same litigation, the court also ruled on the application of the Maryland control share statute in light of the timing of the activists' share purchases.<sup>64</sup> The court did not address directly whether the fund's reliance on the control share statute was consistent with Section 18(i). But the fact that it applied the terms of the control share defense in the wake of its careful analysis of Section 18(i) in the poison pill context reflects at least tacit comfort on the court's part that the control share statute likewise did not run afoul of Section 18(i).

In 2010, the SEC staff departed from the court's reasoning in *Neuberger Berman* court in responding to the Boulder Total Return Fund's request for interpretation of Section 18(i).<sup>65</sup> The fund was considering opting into Maryland's control share statute, which provides that a shareholder with more than 10 percent of a company's stock may not vote those shares unless approved by a two-thirds vote of all other shareholders. The staff concluded that doing so would be "inconsistent" with Section 18(i)'s equal voting rights provision and the Investment Company Act generally because "[s]uch a tactic would discriminate against certain shareholders by denying important voting rights and would contribute to the entrenchment of management."<sup>66</sup> The staff

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<sup>60</sup> *Id.* at 376 (emphasis added).

<sup>61</sup> 15 U.S.C. 80a-18(d).

<sup>62</sup> 378 A.2d 121 (Del.1977).

<sup>63</sup> *Neuberger Berman*, 342 F. Supp.2d at 375 (quoting *Providence and Worcester Co.*, 378 A.2d 121, 123 (Del. 1977)).

<sup>64</sup> *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust*, 485 F. Supp. 2d 631, 640-41 (D. Md. 2007).

<sup>65</sup> We note that a known activist sponsored and controlled the fund ostensibly seeking the relief in *Boulder*.

<sup>66</sup> *Boulder* at \*2.

reasoned that opting into the statute “would be inconsistent with the *wording of, and purposes underlying, Section 18(i).*”<sup>67</sup>

Regarding the “purposes underlying” Section 18(i), the letter asserted that Congress adopted Section 18(i) “to address the use of various devices of control by investment company insiders that were intended to effectively deny public shareholders any real participation in the management of their companies.”<sup>68</sup> Citing examples of actions commonly taken by “insiders” to maintain control of funds at the time of the Investment Company Act’s passage, the staff reasoned that Section 18(i) was implemented to prevent these actions by insiders, prevent entrenchment of insider control “by affording universal suffrage” to shareholders, and ensure “that each investment company shareholder has a vote proportionate to his or her stock holdings.”<sup>69</sup> The staff referred to Congress’s prefatory language in Section 1(b) of the Investment Company Act, in particular that “the provisions of the Act be interpreted ‘to mitigate and, so far as is feasible, to eliminate’ certain enumerated abuses.” The staff’s analysis emphasized that Congress adopted the Investment Company Act to protect the rights of shareholders in particular by ensuring shareholders’ ability to exercise voting rights as a check on “insiders.”<sup>70</sup>

Turning to the language of Section 18(i) itself, the letter next discussed Section 18(i)’s requirement that every share of stock issued by an investment company be “voting stock.”<sup>71</sup> Noting that the Investment Company Act does not define “voting stock,” the staff instead looked to the definition of “voting security” and “security” under Sections 2(a)(42) and 2(a)(36), respectively, noting that a *voting security* is defined as “any security presently entitling the owner or holder thereof to vote for the election of directors.”<sup>72</sup> The staff reasoned that because the definition of *security* under Section 2(a)(36) includes “any stock,” the term *voting stock* may be properly interpreted with reference to the definition of *voting security*.<sup>73</sup> Thus, the staff concluded that under Section 18(i), “every share of stock issued by an investment company must presently entitle the owner or holder to vote such share of stock for the election of directors.”<sup>74</sup> Opting in to the Maryland statute would violate this requirement in the staff’s view because a shareholder whose large holdings triggered the statute would not be entitled to vote for the election of directors.<sup>75</sup>

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<sup>67</sup> *Id.* at \*5 (emphases added). Surprisingly, the staff suggested in *Boulder* that the *Neuberger Berman* court had only considered whether the poison pill defense violated Section 18(d), and had not addressed Section 18(i) (*Boulder* at \*2 n.5) – which is clearly contradicted by the court’s 2004 decision (discussed above).

<sup>68</sup> *Id.* (quotations omitted).

<sup>69</sup> *Id.* at \*6.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at \*7.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

The staff similarly concluded that opting into the control share statute would be inconsistent with Section 18(i)'s language requiring "equal voting rights" for all shares.<sup>76</sup> Acknowledging that *equal voting rights* is not defined in the Investment Company Act, the letter again referred to the prefatory language in Section 1(b). The staff asserted that securities subject to the control share statute would contain provisions inconsistent with Section 1(b)(3) policy goal of eradicating securities with "inequitable or discriminatory provisions." By discriminating against shareholders acquiring control shares and by failing "to protect an essential privilege of share ownership—the right to vote one's shares," the fund would be inviting the very entrenchment of insiders that Section 18(i) sought to eliminate.<sup>77</sup>

Based on this analysis, the staff rejected the court's reasoning in *Neuberger Berman* that there is a distinction between the voting rights of the shares and the voting rights of the shareholders.<sup>78</sup> "The plain wording of Section 18(i), in conjunction with Sections 2(a)(36) and 2(a)(42), as described above, *clearly prohibits discrimination between or among both shares and shareholders.*"<sup>79</sup> Notably, the SEC had been invited by the court and the parties to file an amicus brief in the *Neuberger Berman* case, where the application of Section 18(i) to closed-end fund takeover defenses was being publicly litigated, yet it declined to.<sup>80</sup> Instead, the staff elected to articulate its views in the 2009 Donohue speech and the 2010 *Boulder* letter.

## **B. Other Investment Company Act Provisions**

The primary focus of this submission is takeover defenses implicating shareholder voting rights, and whether they are consistent with Section 18(i) as addressed in the *Boulder* letter. Following are additional Investment Company Act provisions of arguable relevance to a consideration of these defenses, and others described above. As discussed further below, we do not believe that any of these Investment Company Act provisions can be read to prohibit the above takeover defenses otherwise allowed under state law.

**Section 16(a)** provides that, so long as two-thirds of the directors of a registered fund (closed-end or open-end) will have been elected by shareholders, directors may fill vacancies "in any otherwise legal manner." It also expressly authorizes the use of classified boards:

No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called

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<sup>76</sup> *Id.* at \*8.

<sup>77</sup> *Id.* In its analysis, the SEC staff's focus on entrenchment seemed to assume that an investment adviser's role of managing the fund and the board of directors' role of overseeing the fund should be viewed together, rather than independently.

<sup>78</sup> *Id.* at \*10.

<sup>79</sup> *Id.* (emphasis added).

<sup>80</sup> *Neuberger Berman*, 485 F. Supp. at 639 n.8 ("In light of its overarching regulatory role in protecting shareholders, it would be curious for the SEC to maintain its inactivity if it thought violations of the federal securities laws were manifest.").

for that purpose; except that vacancies occurring between such meetings may be filled *in any otherwise legal manner* if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting.

\* \* \*

Nothing herein shall...preclude a registered investment company from dividing its directors into classes if its charter, certificate of incorporation, articles of association, bylaws, trust indenture, or other instrument or the law under which it is organized, so provides and prescribes the tenure of office of the several classes....<sup>81</sup>

**Section 2(a)(42)**, which the SEC staff referenced in the *Boulder* letter in interpreting the meaning of Section 18(i), defines “voting security” and “vote of a majority of the outstanding voting securities,” a threshold that is made applicable to *specified* actions elsewhere in the statute.

‘*Voting security*’ means any security presently entitling the owner or holder thereof to vote for the election of directors of a company. A specified percentage of the outstanding voting securities of a company means such amount of its outstanding voting securities as entitles the holder or holders thereof to cast said specified percentage of the aggregate votes which the holders of all the outstanding voting securities of such company are entitled to cast. *The vote of a majority of the outstanding voting securities* of a company means the vote, at the annual or a special meeting of the security holders of such company duly called, (A) of 67 per centum or more of the voting securities present at such meeting, if the holders of more than 50 per centum of the outstanding voting securities of such company are present or represented by proxy; or (B) of more than 50 per centum of the outstanding voting securities of such company, whichever is the less.<sup>82</sup>

**Section 23(b)** addresses the price at which closed-end funds are allowed to sell their shares:

No registered closed-end company shall sell any common stock of which it is the issuer at a price below the current net asset value of such stock, exclusive of any distributing commission or discount (which net asset value shall be determined as of a time within 48 hours, excluding Sundays and holidays, next preceding the time of such determination), except (1) in connection with an offering to the holders of one or more classes of its capital stock; (2) with the consent of a majority of its common stockholders; (3) upon conversion of a convertible security in accordance with its terms;

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<sup>81</sup> 15 U.S.C. § 80a-16(a).

<sup>82</sup> 15 U.S.C. § 80a-2(a)(42).

(4) upon the exercise of any warrant outstanding on August 22, 1940, or issued in accordance with the provisions of section 80a-18(d) of this title; or (5) under such other circumstances as the Commission may permit by rules and regulations or orders for the protection of investors.<sup>83</sup>

## V. **Takeover Defenses Are Consistent with the Investment Company Act**

The *Boulder* letter was incorrect in concluding that the Maryland control share statute is inconsistent with Section 18(i)'s voting rights requirements. There is no legal basis under the Investment Company Act to limit closed-end funds' use of the voting-related takeover defenses authorized by state law. Neither the language of Section 18(i) nor the statute's underlying purposes (which Congress expressly invoked as an interpretive guide) warrant such a limitation on the discretion of independent directors. In fact, the harm caused to closed-end funds by activist arbitrage is the very type of harm Congress sought to address: the use of concentrated voting power by large holders (whether insiders or outsiders) to control a fund in their self-interest to the detriment of the other shareholders. Independent directors are the cornerstone of the structure created by the Investment Company Act to protect the interests of long-term fund investors from such conduct. The purposes of the act are furthered by empowering boards to combat activists' short-term profit-seeking, not by tying directors' hands as the *Boulder* letter does.

### A. **Section 18(i) Does Not Prohibit the Use of Voting-Related Takeover Defenses by Closed-End Funds**

Statutory interpretation begins with the language of the statute itself. It is well established that if the language is plain and unambiguous, it is to be applied according to its terms. Section 18(i) requires that "every share of stock" issued by a fund "be a voting stock and have equal voting rights with every other outstanding voting stock." In the *Boulder* letter, the staff interpreted these requirements to mandate that every *stockholder* have identical voting rights at all times. There is no support for this extrapolation, either in the text of the statute or any legal authority applying it.

By its clear terms, Section 18(i) addresses the voting rights attached to *stock*, not the ability of a given *stockholder* to exercise those rights in specified circumstances. Defensive measures limiting the ability of a given *stockholder* to vote its shares under specified circumstances (*e.g.*, when the stockholder amasses a significant fraction of the outstanding shares) does not change the nature of the *stock* by converting it to a non-voting security. The *stock* still has its voting right; that right simply cannot be exercised by a given shareholder in a given circumstance (*e.g.*, acquisition of a concentrated holding). After all, the control share statutes allow the concentrated shareholder's voting rights to be reinstated by a vote of the other, disinterested shareholders—meaning that the concentrated holder's ability to vote may only be temporarily delayed. Moreover, if the concentrated stockholder sold the shares to a third party with smaller holdings and/or reduced its own holdings to below the triggering threshold, the stock could of course be voted. In other words, the stock itself never loses its status as voting stock simply because a given stockholder's actions may be limited or conditioned under specified circumstances. *Boulder's* reading is the equivalent

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<sup>83</sup> 15 U.S.C. § 80a-23(b).



of saying that an automobile's registration is invalidated if the owner's driver's license is suspended. But just because the owner is not allowed to drive the car for some reason does not change the car's status as one legally eligible to be driven.

For the same reason, the *Boulder* letter's reliance on the definition of *voting security* in Section 2(a)(42) of the Investment Company Act is unavailing. The letter reasons that, because a *voting security* is defined as one "presently entitling the owner or holder thereof to vote for the election of directors," Section 18(i)'s requirement that every share of stock issued by a fund be a *voting stock* is violated by a limitation on the ability of a stockholder to vote its shares under specified circumstances. In other words, the staff concluded that placing a limitation on the *stockholder's* ability to vote somehow changed the nature of *stock* itself from a voting stock to a non-voting stock. But here again, the statutory text does not support a conclusion that a limitation on the *holder* has the effect of changing the rights attached to the share itself; that share could be voted if it were in the hands of a differently situated holder.

In *Boulder*, the staff pointed to no legal authority supporting its interpretation of Section 18(i) as requiring that every stockholder have identical voting rights at all times—nor could it. The court in *Neuberger Berman* reached just the opposite conclusion, recognizing a clear distinction under Section 18(i) between the voting rights attached to stock and limitations on the stockholder's ability to exercise the vote. The poison pill at issue in *Neuberger* differentiates among holders of shares, not the shares themselves, and thus did not run afoul of Section 18(i).

Other courts have ruled the same in closely analogous settings. Like Section 18(i), the Delaware corporate statute requires equal voting rights for all shares in a class.<sup>84</sup> In a holding relied upon by the *Neuberger* court, the Delaware Supreme Court ruled that "voting restrictions applicable to shareholders with larger holdings are permissible and do not violate Delaware law requiring that all shares of stock within the same class have uniform voting rights."<sup>85</sup>

The *Boulder* letter's interpretation of Section 18(i) as requiring that every *stockholder* have identical voting rights at all times is also inconsistent with the broader statutory context. In another section of the Investment Company Act, Congress itself enshrined the distinction between the voting rights attached to *stock* and the ability of a given *stockholder* to exercise those rights. Under

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<sup>84</sup> Del. Code Ann. Tit. 8, § 212(a). This provision and other state law requirements for equal voting rights are discussed in more detail in Appendix G.

<sup>85</sup> *Providence and Worcester Co. v. Baker*, 378 A. 2d 121, 123 (Del. 1977) ("The voting power of the stock in the hands of a large stockholder is not differentiated from all others in its class; it is the personal right of the stockholder to exercise that power that is altered by the size of his holding. In the hands of smaller stockholders, unrestrained in the exercise of their voting rights, the same stock would have voting power equal to all others in the class."). See also *Realty Acquisition Corp. v. Prop Trust of Am.*, Civ. No. JH-89-2503, 1989 WL 214477 (D. Md. Oct. 27, 1989) (holding that a poison pill did not violate a trust declaration requirement that every common share in a real estate investment trust "shall be equal in all respects" to every other common share); *Williams v. Geier*, No. CIV.A. 8456, 1987 WL 11285, at \*3-4 (Del. Ch. May 20, 1987) (holding that differentiated voting rights in a corporate charter based on the length of time stockholders held their shares did not violate Delaware's equal voting rights requirement, because the charter did not "provide differing voting rights for the stock, *per se*"); *Sagusa, Inc. v. Magellan Petroleum Corp.*, No. CIV A 12,977, 1993 WL 512487, at \*2 (Del. Ch. Dec. 1, 1993), *aff'd*, 650 A.2d 1306 (Del. 1994) (holding that a "per capita" voting structure, requiring majorities of not only the shares voted but also the stockholders voting, did not violate Delaware's equal voting rights requirement).

Section 12(d)(1)(E), a fund of funds (*e.g.*, an insurance company separate account structured as a unit investment trust) may invest in underlying registered funds in amounts that exceed the Section 12(d)(1) percentage limits *if* the fund of funds only votes any proxies in the underlying acquired fund in accordance with instructions from its clients or simply “mirror votes” the proxies in proportion to all other holders.<sup>86</sup> In that circumstance, the Investment Company Act thus limits how a concentrated *stockholder* (*i.e.*, the fund of funds) is allowed to vote its shares in the underlying fund, *based on the size of its holdings*, but Congress plainly did not see this limitation as stripping the *stock* of its voting rights for purposes of Section 18(i). Otherwise, Section 18(i) and Section 12(d)(1) could not be squared.<sup>87</sup>

Similarly, outside of the Investment Company Act context, Section 13(d)(1) of the Exchange Act requires beneficial owners of more than 5 percent of registered equity securities (including closed-end fund shares) to disclose certain information to the SEC.<sup>88</sup> Rule 13d-1 thereunder provides that this information must be filed on Schedule 13D when a 5 percent holder has the intent of changing or influencing the control of the issuer, and further provides that such holders may not vote their shares until 10 days after they file Schedule 13D.<sup>89</sup> The same filing requirement and voting limitation apply to a holder of 20 percent or more of a class of equity securities, without regard to its intent as to changing or influencing control of the issuer.<sup>90</sup> Here again, the securities laws place a limitation on the ability of a given *stockholder* to vote based on the size of its holdings, but the shares themselves do not become non-voting; otherwise, Rule 13d-1 could not be squared with Section 18(i)’s equal voting rights requirement.

**B. Common Takeover Defenses Not Implicating Voting Rights Are Consistent with the Investment Company Act**

Looking beyond Section 18(i) and the control share statute that are the focus of the *Boulder* letter, we believe that the takeover defenses described above (both those that implicate shareholder voting rights and those that do not), some of which are common within the closed-end fund industry (*e.g.*, classified boards and continuing director rights), are consistent with the provisions of the Investment Company Act.

Under Section 16(a), for example, as long as two-thirds of closed-end fund directors holding office were elected by shareholders, vacancies may otherwise be filled “in any otherwise

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<sup>86</sup> See 15 U.S.C. § 80a-12(d)(1)(E).

<sup>87</sup> This inconsistency between *Boulder*’s reading of Section 18(i)—specifically, that a *stock*’s voting rights can be conflated with a *stockholder*’s ability to vote—and the broader structural context of the Investment Company Act cannot be explained away (as footnote 32 in the *Boulder* letter suggests) by referring to the generic exception to Section 18(i), *i.e.*, that the equal rights requirement in Section 18(i) shall apply “[e]xcept...as otherwise *required by law*.” 15 U.S.C. § 80a-18(i) (emphasis added). There is no way to read Section 12(d)(1) (or Rule 13d-1 discussed in the following paragraph) as Congress “requiring” shares of stock to have unequal voting rights and thus invoking the exception to Section 18(i). Rather, Section 12(d)(1) and Rule 13d-1 simply provide informative structural context that Congress did not intend that “equal voting rights” for shares of stock to guarantee identical suffrage for all shareholders in all circumstances.

<sup>88</sup> 15 U.S.C. § 78m(d).

<sup>89</sup> 17 C.F.R. § 240.13d-1(e)(2).

<sup>90</sup> 17 C.F.R. § 20.13d-1(f)(2).

legal manner.” Thus, the Investment Company Act defaults to state law requirements, subject only to the two-thirds shareholder vote requirement. Given that the “otherwise legal manner” of electing directors under state law includes provisions such as (i) requirements that directors be elected by a majority of outstanding shares and (ii) requirements that board vacancies be filled by continuing directors, these defenses are not contrary to Section 16(a).

Similarly, the specified voting threshold set forth in Section 2(a)(42) is made applicable under the Investment Company Act to particular fund actions (*e.g.*, changes to fundamental investment policies, approval of investment advisory and principal underwriting agreements, approval of certain distribution arrangements). But nothing in the statute either requires or prohibits a fund from making similar voting thresholds applicable to other actions—such as election of directors—as authorized by underlying state law.

C. **Enabling Independent Directors to Use Takeover Defenses to Prevent Detrimental Arbitrage Efforts Furthers the Purposes of the Investment Company Act**

In addition to a statute’s plain language and structure, its underlying purposes can provide additional insight as to the intended meaning of the law’s provisions. Indeed, in the Investment Company Act, Congress itself expressly contemplated in Section 1(b) that the statute’s purposes were to be used in interpreting its provisions. The *Boulder* letter’s interpretation of Section 18(i) was heavily influenced by the staff’s views about promoting the purposes underlying the “equal voting rights” requirement and other provisions of the Investment Company Act. Although the staff appropriately focused on Congress’s stated concern about funds being controlled and operated in a self-interested manner, the staff incorrectly concluded that Congress was concerned only about such self-interested conduct by *insiders*.<sup>91</sup>

Based on the findings of the SEC’s study of investment company market practices, Congress stated in the statute’s prefatory language in Section 1(b):

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.<sup>92</sup>

These adverse “conditions” listed in Section 1(b) included the following, which was the staff’s focus in the *Boulder* letter:

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, ***in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof***, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, ***or in the interest of other investment companies*** or persons engaged in

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<sup>91</sup> The legislative history of the Investment Company Act is discussed in Appendix E.

<sup>92</sup> 15 U.S.C. § 80a-1(b).

other lines of business, rather than in the interest of all classes of such companies' security holders....<sup>93</sup>

Section 2(a)(3) of the Investment Company Act in turn defines an *affiliated person* to include “any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person....” In other words, 5 percent holders are considered “affiliated persons” of the fund, and are thus included within the listed persons of concern who might seek to control the fund for their own self-interest, contrary to the interest of other shareholders.<sup>94</sup> In addition, “other investment companies” are also included in the list of persons of concern.

The *Boulder* letter misread Section 1(b) as targeting only self-interested conduct by the enumerated *insiders*. In the portion of the letter discussing Section 1(b), the staff stated: “As relevant to Section 18(i), these abuses include the organization, operation, and management of investment companies in the interest of *insiders*....”<sup>95</sup> The letter’s Section 1(b) discussion further states that the Investment Company Act’s “governance system relies heavily on the shareholders’ ability to exercise voting rights that serve as a check on investment company *insiders*.” *Id.* (emphasis added). But on its face Section 1(b) plainly does not limit such “abuses” to those favoring “insiders”—indeed, the word *insiders* does not appear anywhere in the provision. In addition to the enumerated insiders (*i.e.*, directors, officers, investment advisers, and depositors), Section 1(b) *also* expressly states Congress’s intent to protect against funds being operated in the self-interest of investors who become “affiliated persons” of the fund by purchasing a 5 percent share and of other investment companies (*i.e.*, outsiders with potentially controlling ownership interests).

Indeed, Congress’s concern about concentrated voting power in the hands of both insiders *and* outsiders is also apparent in the limitations on concentrated fund holdings in Section 12(d)(1) of the Investment Company Act. The 3 percent ownership limitation under Section 12(d)(1)(A) and the 10 percent limitation under Section 12(d)(1)(C) both apply by their terms to “outsider” acquiring funds, not just to funds that are affiliated with the target fund or the target fund’s insiders.

In any event, labels aside, the *harm* targeted by Congress is clear: the use of concentrated voting power to seize control of a fund and pursue self-interested ends is detrimental to the fund and its investors. This is precisely the type of harm independent directors seek to avoid by employing takeover defenses in the face of an activist campaign—namely, an arbitrageur seizing control of a closed-end fund through concentrated holdings to pursue short-term profits at the expense of the investment goals of long-term shareholders. The fact that the activists are “outsiders” rather than “insiders” does not change this analysis. In 1940, Congress may not have anticipated the manner in which activist “outsiders” would emerge to pose threats akin to those

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<sup>93</sup> *Id.* (emphases added).

<sup>94</sup> The term *affiliated persons thereof* cannot be read to refer to affiliated persons of the *insiders*—rather than of the investment company—as this would render the word *other* meaningless.

<sup>95</sup> *Boulder* at \*6 (emphasis added).

anticipated from management “insiders.” But the nature of the threat to the fund is substantively the same, regardless of whether the source is from “inside” or “outside.”

And whether the source of a threat is from “inside” or “outside,” the independent directors stand as the first line of defense under the Investment Company Act’s structure. The directors are the recognized cornerstone of the act’s oversight regime, and since its enactment, a consistent emphasis of congressional amendments and SEC rulemaking has been further *strengthening* the hand of independent directors in carrying out their “watchdog” role. There is no basis to conclude that the watchdog role extends only to oversight of the activities of the adviser and its affiliates. Where an activist investor threatens to do harm to the fund’s long-term interest (in the considered judgment of independent directors) through accumulation of a large percentage holding in order to pursue short-term profits, the board’s watchdog role fairly extends to such “outsiders” as well. Congress’s stated purpose of protecting the fund from such self-interested conduct is furthered by empowering the independent directors, not by limiting their options. The *Boulder* letter turned this principle on its head by concluding that the takeover defense in the Maryland control share statute would be contrary to the purposes of the Investment Company Act.

Contrary to the suggestion in *Boulder*, allowing independent directors to use defenses against activists with concentrated holdings does not have the effect of “entrenching” management insiders.<sup>96</sup> The primary and immediate effect is to protect the expectations of long-term investors that the investment product they purchased, managed by the adviser they selected, will not be changed out from under them by the short-term profit-seeking actions of an arbitrageur. As discussed above, the typical closed-end fund investor seeks strong long-term total return, with stable dividend payments. It is directly contrary to such an investor’s interests to have its closed-end fund liquidated, open-ended, shrunk via tender offer, and/or taken over or disrupted by new board members and an adviser focused on short-term share price increases.

To be sure, as *Boulder* notes, Congress expressed concern in Section 1(b) about funds “fail[ing] to protect the preferences and privileges of the holders of their outstanding securities.”<sup>97</sup> We believe the reasonable investment expectations of long-term shareholders are undeniably among the “preferences and privileges” entitled to protection. And while voting rights are certainly also among these “preference and privileges,” where an activist would use its concentrated voting power in a manner that independent directors believe is harmful to the interests of long-term investors, the use of a voting-related takeover defense to protect those investors is a reasonable balancing of those competing interests. Preventing independent directors from the reasonable use of defense measures that are available to their operating company counterparts is not supported by the language of the Investment Company Act, its legislative history, or its policy goals.

The discussion above demonstrates why the Commission’s earlier analysis of Section 18(i) in the *Solvay* order provides a more reasoned approach than *Boulder*. There, the SEC recognized that “an inflexible adherence to any rigid interpretation could produce grave distortions of the

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<sup>96</sup> Indeed, the various older “practices by which management maintained control of a fund by holding shares of stock with superior voting rights”—as identified in the SEC report (*Boulder* at \*5)—will still remain unavailable. The use of takeover defenses simply limiting the ability of concentrated holders to vote their shares will in no way open the door to these older “devices of control” identified by the SEC.

<sup>97</sup> 15 U.S.C. § 80a-1(b)(3).

apparent intent of Congress to require a reasonable equitable distribution of voting power....”<sup>98</sup>. *Solvay* was decided in the context of differentiated voting power between preferred and common share classes, which the Commission concluded was consistent with the “equal voting rights” requirement of Section 18(i). Although it did not present the factual scenario at issue here, *Solvay*’s embrace of flexibility in applying Section 18(i) based upon the facts and circumstances presented remains sound. Indeed, *Boulder*’s rigid interpretation of the “equal voting power” requirement would produce the very distortion of Congress’s intent of which *Solvay* warned.

**D. The Availability of Defenses Against Activist Campaigns Will Not Preclude Other Types of Shareholder Proposals and Initiatives**

Authorizing the use of takeover defenses against activist investors will not have the effect of quelling other forms of shareholder activism. The defenses in question are aimed at preventing an activist from taking over control of a fund and its board via accumulation of concentrated holdings, by limiting its ability to vote when its holdings reach certain triggering thresholds. Such defenses have no effect on a shareholder’s ability (regardless of the size of its holdings) to engage directly with a fund’s board to express concerns about price discounts or any other issue, and to propose to the board that it consider taking steps to address those concerns. According to the ICI survey, respondents stated that nonformal recommendations are relayed to closed-end funds in multiple ways, including phone calls, letters, email, and meetings. Further, survey participants received nonformal proposals from a mix of investors, including retail shareholders, institutional shareholders, and activist shareholders.<sup>99</sup> Courts have recognized that takeover defenses such as shareholder rights plans do not meaningfully affect shareholders’ ability to engage in successful proxy contests.<sup>100</sup>

Similarly, the ability of any shareholder to propose alternative board candidates or resolutions for shareholder consideration—either with the board’s consent or in a contested proxy—would not be affected by the board’s use of the voting-related takeover defenses discussed here. None of those rights is determined by the size of a shareholder’s holdings or (more to the point) whether or not the shareholder is currently authorized to vote its shares.<sup>101</sup> “The key variable in a proxy contest [is] the merit of the bidder’s proposal and not the magnitude of its stockholdings.”<sup>102</sup> If those candidates or proposals are strong enough to gain the support of the other shareholders, they can be voted into effect—and the incumbent board will have no ability to block that via a poison pill or control share statute, both of which likely have the effect of giving *greater* relative voting power to the non-concentrated shareholders.

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<sup>98</sup> *Solvay*, 27 SEC 971, 973

<sup>99</sup> For more information, see Appendix A on page 39.

<sup>100</sup> *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1563 (D. Del. 1995); *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985).

<sup>101</sup> See 17 C.F.R. § 240.14a-8.

<sup>102</sup> *Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586, 603 (Del. 2010); accord *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1383 (Del. 1995).

## **VI. Enabling Independent Directors to Use Takeover Defense Measures to Ensure the Availability of Closed-End Funds for Retail Investors Promotes the SEC's Policy Goals**

The SEC and its staff have expressed support as a policy matter for greater retail investor access to private offerings and other assets invested in by closed-end funds. Regulated funds, such as closed-end funds, are a highly suitable way to facilitate retail access to such investments while ensuring strong investor protections. Closed-end funds can serve as a vehicle for retail investors to access foreign country funds and other investment strategies that require a significant degree of investment in less-liquid securities.<sup>103</sup> The staff has previously recognized other benefits of retail investors investing in closed-end funds, including diversifying their portfolios through exposure to otherwise difficult-to-access markets.<sup>104</sup> Relatedly, in 2019, SEC Chairman Jay Clayton announced a goal of making it easier for retail investors to invest in private markets.<sup>105</sup> Facilitating the growth of closed-end funds can be a helpful tool for accomplishing that goal in a manner consistent with investor protection. Congress has also recognized a public interest in stemming the decline in closed-end fund offerings.<sup>106</sup>

Activist actions that result in the liquidation, open-end conversion, or contraction of fund size through tender offers reduce the availability of closed-end fund shares to investors. Indeed, the net reduction in the number of closed-end funds noted by Congress and the general stagnation in closed-end fund assets has occurred *despite* the fact that closed-end fund initial public offerings continue to be launched and are met with healthy subscriber appetite. Activist attacks in pursuit of short-term profits appear quite clearly to pose a threat to the sought-after growth of the closed-end fund industry. In addition to the sound legal reasons above to clarify that voting-related takeover defenses are consistent with the Investment Company Act, ensuring that independent directors are properly empowered to defend against activist efforts will have the additional salient benefit of improving the industry's chances for net growth.

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<sup>103</sup> While open-end funds must stand ready to repurchase tendered shares and are subject to a 15 percent limitation on the amount of illiquid securities they may hold, closed-end funds are not subject to such a limitation and may hold an unlimited amount of illiquid or less-liquid securities. *See also supra* text surrounding note 39.

<sup>104</sup> Andrew Donohue, Director, Division of Investment Management, Securities and Exchange Commission at the Luncheon Address at the 2007 ICI Closed-End Fund Workshop (Oct. 11, 2007).

<sup>105</sup> Jay Clayton, Chairman of the U.S. Securities Exchange Commission, Remarks to the Economic Club of New York (Sept. 9, 2019), [www.sec.gov/news/speech/speech-clayton-2019-09-09](http://www.sec.gov/news/speech/speech-clayton-2019-09-09). A further recognition of the value of closed-end funds in the marketplace was the SEC's proposal on March 20, 2019 to streamline the registration, communication, and offering practices applicable to closed-end funds. Securities Offering Reform for Closed-End Investment Companies, Release No. 33-10619 (March 19, 2019).

<sup>106</sup> *See* House Report No. 115-517 (2017-2018).

**VII. The *Boulder* Letter Should Be Withdrawn, and Commission Guidance Should Be Issued to Make Clear That Common Takeover Defense Measures Are Available to the Directors of Closed-End Funds**

The closed-end fund landscape has evolved significantly since passage of the Investment Company Act. While Congress may not have foreseen the closed-end fund arbitrage activity that has emerged in recent years, it did recognize the type of threat that is now posed by activists—seizure of a controlling interest through concentrated holdings in order to pursue a self-interested agenda to the detriment of the fund.

The Commission should issue guidance that closed-end funds employing the takeover defenses described above do not contravene the Investment Company Act. This guidance should include express withdrawal of the *Boulder* letter regarding voting-related defenses in particular (*i.e.*, poison pills or control share statute opt-ins under Maryland, Delaware, or Massachusetts law, or their substantive equivalents).



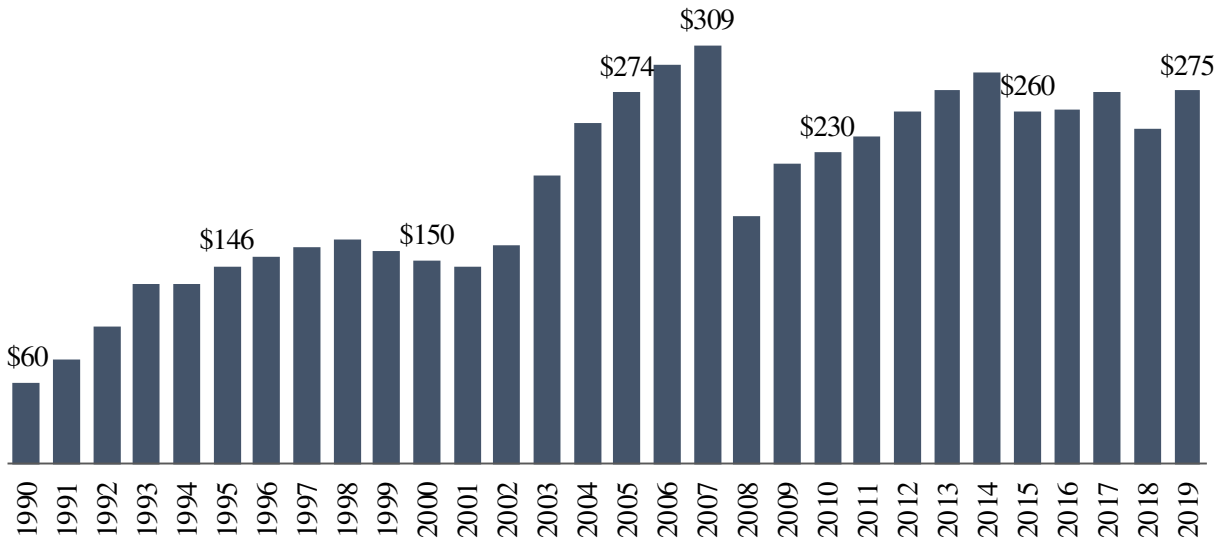
## **Appendix A: The Closed-End Fund Market and Survey Results**

### **Section 1: The Closed-End Fund Market**

Figure A.1 shows year-end total assets of closed-end funds over the past 30 years. Closed-end funds experienced periods of strong growth in the early 1990s and the early- to mid-2000s, reaching their peak of \$309 billion in 2007. Following the financial crisis, closed-end fund total assets modestly recovered, but have been relatively flat since 2015. In 2019, total assets in closed-end funds increased 11 percent to \$275 billion—largely because of exceptionally strong growth in the stock and bond markets.

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**Figure A.1**  
**Closed-End Fund Total Assets Have Stagnated\***  
Billions of dollars, year-end



\*Inflation-adjusted closed-end fund total assets are only modestly higher in 2019 than they were in the mid- to late-1990s and show an even more stagnant trend.

Note: Data exclude interval funds beginning in 2003.

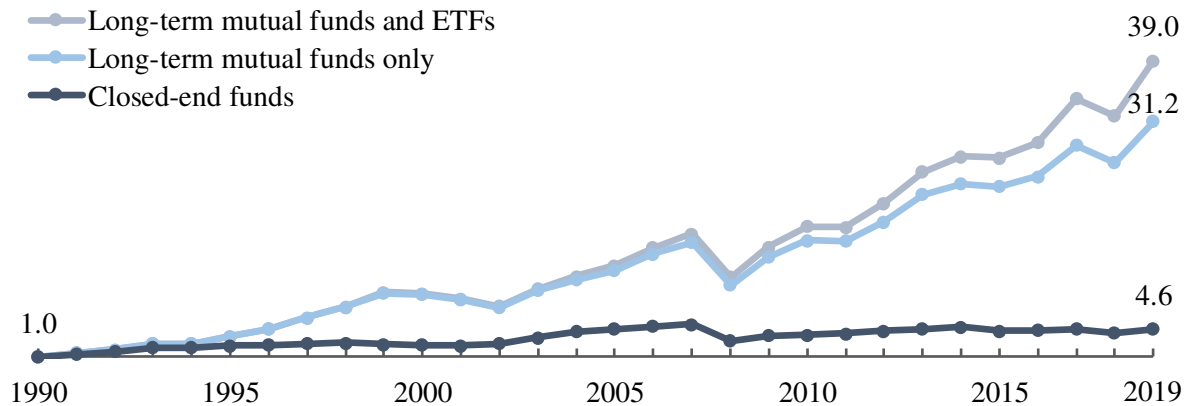
Source: Investment Company Institute

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Historical asset growth in closed-end funds has paled in comparison with the asset growth in long-term mutual funds and exchange-traded funds (ETFs) (Figure A.2). Indexing assets to one in 1990 and tracking their growth through year-end 2019, total assets of closed-end funds have increased by a factor of 4.6, while total net assets of long-term mutual funds and ETFs have increased by a factor of 39.0—a stark difference.

**Figure A.2**  
**Asset Growth in Open-End Funds Has Vastly Outpaced Asset Growth in Closed-End Funds**

Change in total assets, indexed to one in 1990



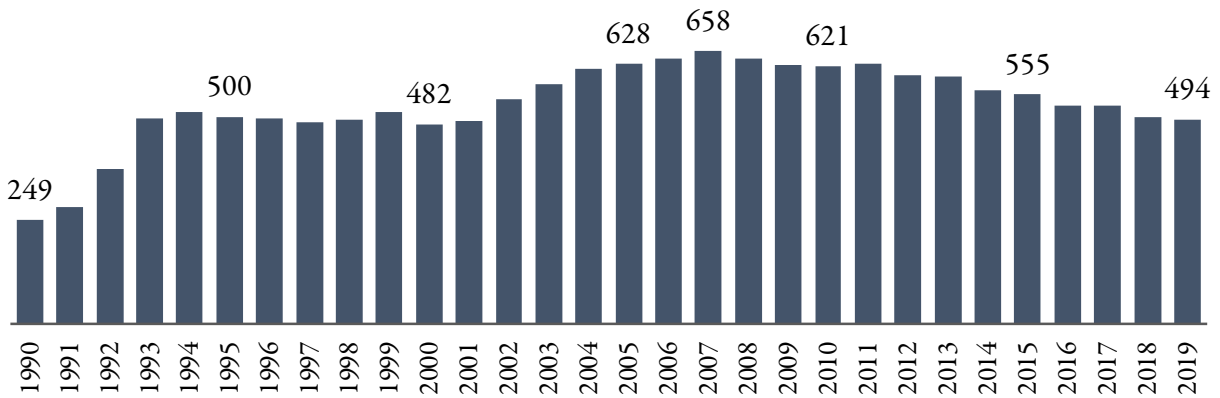
Note: Closed-end fund data exclude interval funds beginning in 2003. ETF data begin in 1993. Data exclude funds that invest primarily in other funds.

Sources: Investment Company Institute and Strategic Insight Simfund

Figure A.3 shows the number of closed-end funds at year-end since 1990. In line with total assets, the number of closed-end funds saw strong growth in the early 1990s and early- to mid-2000s. However, after the number of closed-end funds reached its peak of 658 at year-end 2007, it had steadily fallen to 494 by year-end 2019.

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**Figure A.3**  
**Number of Closed-End Funds Has Steadily Decreased Since 2007**  
Year-end



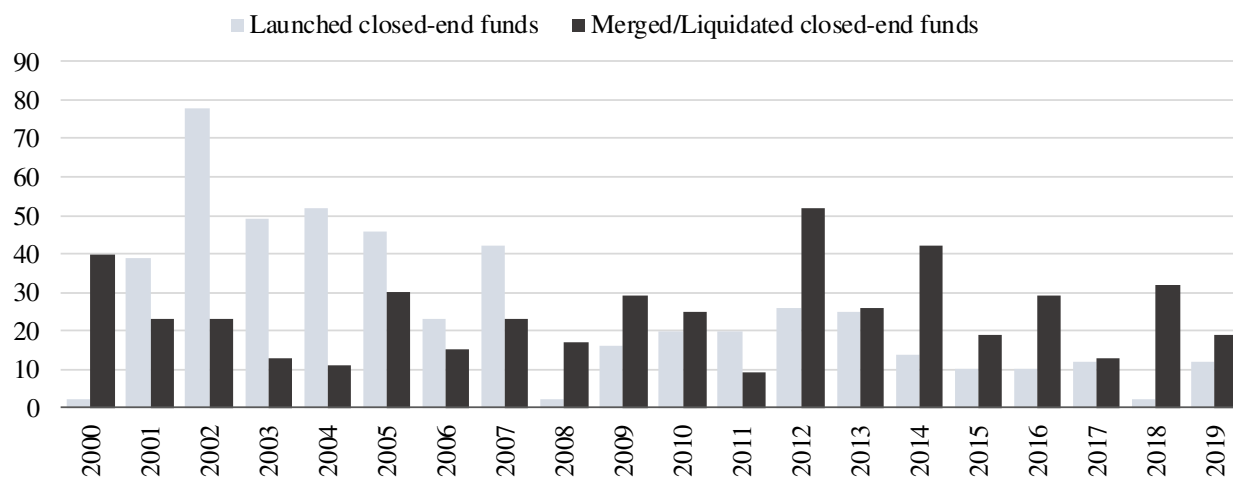
Note: Data exclude interval funds beginning in 2003.  
Source: Investment Company Institute

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Figure A.4 shows the number of closed-end funds that have launched or merged/liquidated in each year between 2000 and 2019. From 2012 through 2019, more closed-end funds were liquidated, and others converted into open-end mutual funds or exchange-traded funds, than new closed-end funds were launched. In 2019, 12 closed-end funds were launched compared with two in 2018 and 12 in 2017, while 19 closed-end funds merged or liquidated 2019 compared with 32 in 2018 and 13 in 2017.

**Figure A.4**  
**More Closed-End Funds Have Merged or Liquidated Than Launched Since the Financial Crisis**

Number of funds



Note: Data include closed-end funds that do not report statistical information to the Investment Company Institute and closed-end funds that invest primarily in other closed-end funds. Data exclude interval funds beginning in 2003. Source: Investment Company Institute

Additionally, it is important to note that sponsors typically pay underwriting costs for closed-end fund initial public offerings. With the viability of the long-term nature of the product becoming more uncertain, closed-end fund sponsors are becoming concerned that the fund may not exist long enough for the sponsor to sufficiently recoup that outlay. This dynamic may cause the closed-end fund market to shrink further.

## **Section 2: ICI Survey Results on Places of Incorporation, Fund Policies, Shareholder Proposals, Proxy Contests, Shareholder Recommendations, and Proxy Costs**

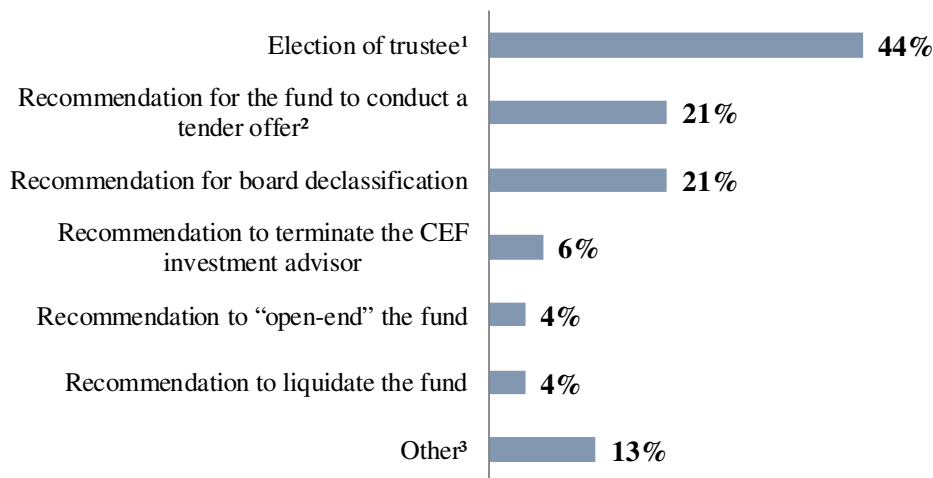
In December 2019, ICI distributed a survey to its members primarily dealing with four areas for closed-end funds registered under the Investment Company Act of 1940:

- (1) places of incorporation/establishment;
- (2) classified boards, board election standards, and various fund policies;
- (3) shareholder proposals, proxy contests, and shareholder recommendations; and
- (4) proxy costs.

ICI received 17 responses from members that sponsor closed-end funds representing 69 percent of closed-end fund total assets and 62 percent of the total number of closed-end funds as of year-end 2019.

One survey section asked participants to identify various information about shareholder proposals or proxy contests for their funds between 2015 and 2019. Figure A.5 shows the types of shareholder proposals or proxy contests for 48 shareholder proposals.<sup>107</sup> Forty-four percent of the shareholder proposals dealt with the election of trustees or directors (the vast majority of which are from one activist shareholder pursuing eight funds of one closed-end fund complex in two successive years), while 21 percent of shareholder proposals were recommendations for the fund to either conduct a tender offer or declassify its board. Other proposals included recommendations to terminate the fund’s investment adviser (6 percent), open-end the fund (4 percent), liquidate the fund (4 percent), or some other action (13 percent). Additionally, 85 percent of these shareholder proposals or proxy contests were from only four activist shareholders.

**Figure A.5**  
**Types of Shareholder Proposals or Proxy Contests**  
 Percentage of total proposals identified by survey participants



<sup>1</sup>Most of these proposals are by one activist shareholder targeting eight funds of one closed-end fund complex in successive years.

<sup>2</sup>Four of these shareholder proposals had the added criteria to liquidate the fund if more than 50 percent of the shares were subscribed to the tender offer.

<sup>3</sup>*Other* includes four recommendations to redeem outstanding auction rate preferred stock, a recommendation to redelegate the share repurchase program to someone other than the fund’s investment manager, and a recommendation to change the voting standard to a majority voting standard based on the shares present at the meeting.

Note: Data are based on survey responses representing 69 percent of closed-end fund assets and 62 percent of the total number of closed-end funds. Some shareholder proposals sought multiple actions; therefore, multiple responses are allowed.

<sup>107</sup> Data include one shareholder proposal submitted in the fourth quarter of 2014.

Many of the proposals were recommendations to either elect trustees or declassify the fund's board. These recommendations often are intended to empower activists to nominate persons to execute their self-interested agenda. This may include liquidating or open-ending the fund. Additionally, ISS's proxy voting policies state that it generally recommends that its clients "vote against proposals to classify (stagger) the board" and "vote for proposals to repeal classified boards and to elect all directors annually."<sup>108</sup> Because many shareholders vote in accord with proxy advisory firm recommendations, this policy stance helps activist shareholders achieve the requisite vote needed for their proposal to pass.

Classified boards, however, provide closed-end funds and their shareholders with benefits, including:

- › Long-term stability to pursue the fund's stated investment objective and ensure they are aligned with the expectations of the fund's core investor base
- › Protection against investors with short-term objectives that contrast with the fund's core investment philosophy
- › Director independence from both management and activist shareholders that allow directors to make decisions in the best interests of the fund and shareholders
- › Attracting qualified and experienced directors who are willing to make multiyear commitments to provide a fund their time, energy, and expertise
- › Better succession planning, allowing the fund adequate time to plan orderly changes to its board and giving new directors the opportunity to gain knowledge from experienced directors

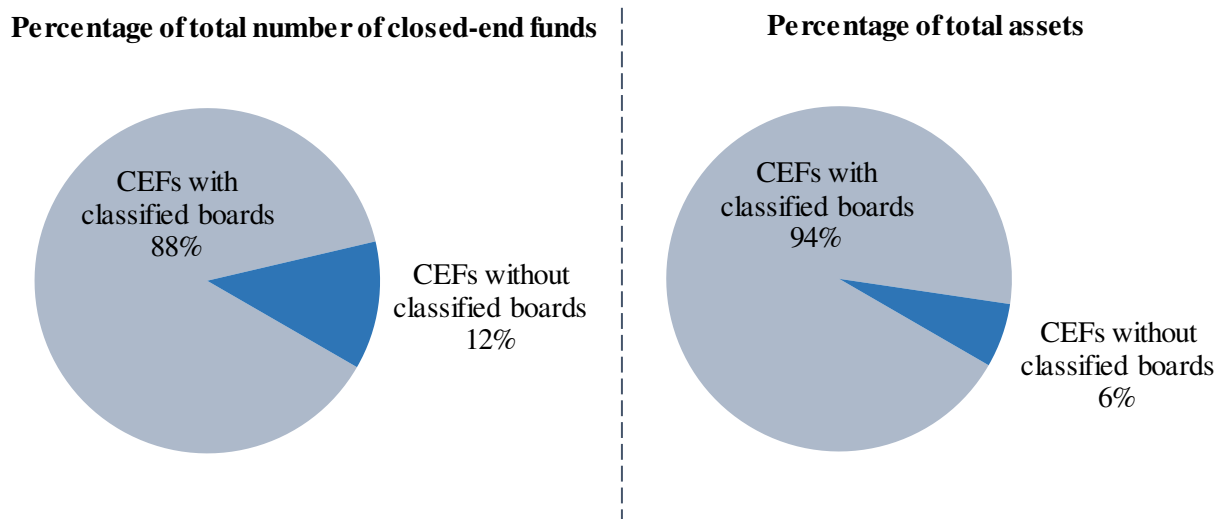
Because of the benefits they provide closed-end fund shareholders, many closed-end funds have classified boards. At year-end 2019, 88 percent of survey participants' listed closed-end funds had classified boards representing 94 percent of their total assets (Figure A.6).

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<sup>108</sup> See Institutional Shareholder Services, United States Proxy Voting Guidelines Benchmark Policy Recommendations (Effective for Meetings on or after February 1, 2020) at 17, available at [www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf](http://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf).

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**Figure A.6**  
**The Vast Majority of Survey Participant Closed-End Funds Have Classified Boards**



Note: Data are based on survey responses representing 69 percent of closed-end fund assets and 62 percent of the total number of closed-end funds. Data exclude any survey participant interval or tender offer funds.

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Another section of the survey asked participants to provide, for each closed-end fund in their complex for each of the past five calendar years (2015–2019), how much in aggregate was spent on fund proxy campaigns. Figure A.7 shows the average fund-level cost per year over the 2015–2019 period in dollars for routine, nonroutine, and contested proxy campaigns. Survey participants were asked to identify routine, non-routine, and contested campaign costs for their closed-end funds between 2015 and 2019; results for this figure are based on those responses, which cover 65 percent of participants. Routine matters for survey participants cost closed-end funds an average of \$22,000 per year compared with an average of \$623,000 for contested matters—a large difference.

Perhaps more importantly than the amounts involved, the costs from routine proposals are generally predictable and expected by both shareholders and fund advisers, and the time and resources that funds spend on these matters are built into the standard operating procedures for running the fund. Contested matters, on the other hand, are not commonplace and burden the fund with high unexpected costs that are typically borne by fund shareholders. Additionally, contested matters can be a large drain on time and resources as funds spend time engaging with shareholders and proxy advisors, which diverts employees of the fund’s investment adviser from their typical roles (such as researching investments).

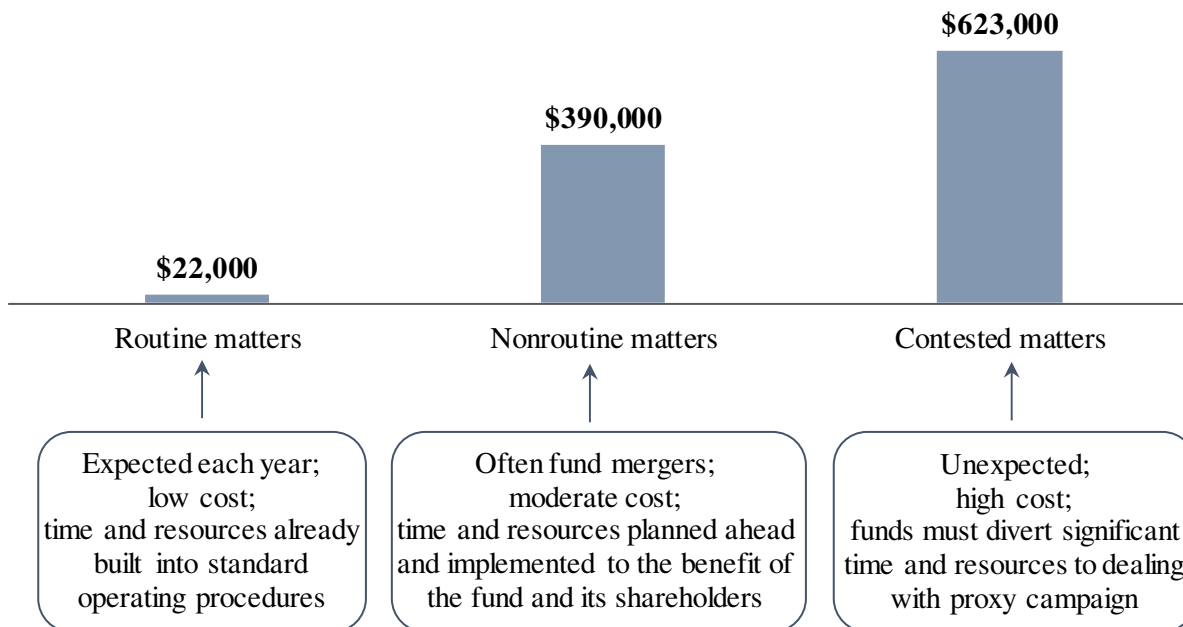
Nonroutine matters, often voluntary fund mergers, have an average fund-level cost of \$390,000 per year. But fund advisers plan for them in advance and handle them when the fund is well-equipped to do so. During a fund merger, the adviser typically covers the cost; however, sometimes the adviser and the surviving fund split those costs. One example in which merger costs are split is when the surviving fund achieves enough economies of scale to comfortably bear those

costs.<sup>109</sup> Ultimately, the time and resources spent on these matters are done in the best interest of long-term shareholders.

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**Figure A.7**  
**Contested Proxy Campaigns Cost Significantly More Than Those That Are Routine or Nonroutine**

Average annual fund-level cost in dollars, 2015–2019



Note: Data are based on survey responses from 65 percent of participants.

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The survey also asked respondents whether their closed-end funds received feedback or recommendations to change their investment operations or strategies from shareholders outside of the formal shareholder proposal or proxy contest process (nonformal recommendations). These nonformal recommendations provide shareholders the means to make suggestions they feel are in the best interests of all shareholders in the fund without needing to go through a formal shareholder proposal process.

Survey participants stated there were multiple ways for shareholders to relay their suggestions to funds, including phone calls, letters, emails, and meetings with management or representatives of the fund. According to the survey, retail shareholders, activists, and institutional investors have all submitted nonformal recommendations to funds. The majority of these nonformal proposals were from an institutional shareholder asking the fund to repurchase its

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<sup>109</sup> See Mutual Fund Directors Forum, “Practical Guidance for Fund Directors on Mutual Fund Mergers,” available at [mfd.org/images/Newsroom/Mergersweb.pdf](http://mfd.org/images/Newsroom/Mergersweb.pdf).



auction rate preferred securities. These nonformal recommendations were relayed to the funds at the end of 2016, and the funds repurchased some of the auction rate preferred stock toward the end of 2018. Most importantly, this demonstrates that the nonformal recommendation process is not one that funds simply ignore. Closed-end funds consider the nonformal recommendations they are given and act if or when it is in the best interest of all fund shareholders.

## **Appendix B: Examples of Activist Campaigns**

Discussed below for illustrative purposes are 13 examples of closed-end fund challenges asserted by five high-profile activists. Details are drawn from public records, including:

- Schedule 13D, which must be filed with the SEC within 10 days by anyone who acquires more than 5 percent of any class of a fund’s securities. The acquirer must disclose whether they have plans involving a merger, reorganization, or liquidation of the fund, among other things.
- Schedule 13G, which must be filed within 10 days by anyone who (i) acquires beneficial ownership between 5 percent and 20 percent of any class of a fund’s securities and (ii) is a “passive” investor not intending to exert control over the fund. Schedule 13G is shorter than Schedule 13D and requires disclosure of less information. An acquirer of more than 20 percent must file Schedule 13D, regardless of intent.
- Proxy statement filed by the targeted fund (on SEC Form 14A), soliciting shareholder votes for board candidates and questions supported by the incumbent directors.
- Proxy statement filed by the activist challenger (on SEC Form 14A), soliciting shareholder votes for challenger board candidates and proposals supported by the activist.
- Open letters and other public statements issued by activists or funds.
- Court filings in challenges resulting in litigation.

### **A. Saba Capital Management, L.P.**

Saba Capital Management hired experienced counsel and proceeded to engage in 33 attacks on funds from January 2016 through February 2020. Depicted below are examples of Saba’s tactics, and the associated time and cost Saba imposed on its targeted funds and their shareholders.

#### ***1. Fund A (January 2019–January 2020)***

In January 2019, Saba (and Saba’s founder) acquired an initially “passive” 5.97 percent stake in Fund A and filed a Schedule 13G.

On April 1, 2019, Saba then filed a Schedule 13D disclosing that it owned 7.87 percent of the fund and announcing an intention to present a proposal requesting that the board “take all necessary steps...in its power to declassify the board” and the nomination of four individuals for election to the board.

On May 10, 2019, Fund A sent a letter to shareholders and filed a preliminary proxy statement asking shareholders to support its nominees for the board and to reject Saba’s declassification proposal.

On May 14, 2019, Saba filed its preliminary proxy statement, asking shareholders to support its proposals because of “continued poor investment performance,” the “significant discount” to NAV, and “lack of effective management.”

On May 24, 2019, Fund A issued its definitive proxy statement, stating that the board had determined that Saba's director nominations were invalid under the bylaws.

The cochair of the fund's board subsequently sent shareholders a letter again stating that Saba's nominations were invalid and requesting that shareholders vote against the declassification proposal.

On May 28, 2019, Saba followed up with another shareholder letter and its definitive proxy statement, arguing that its nominations were "properly and timely submitted" under the bylaws.

Both parties sent several additional communications to shareholders in the following weeks.

On June 27, 2019, the Delaware Court of Chancery issued an injunction requiring the fund and its adviser to count the votes of Saba's nominees at the annual meeting.

The fund and its adviser promptly appealed this decision.

On July 18, 2019, Fund A held its shareholder meeting.

On August 28, 2019, Saba issued an open letter to Fund A's board calling for the shareholder vote results to be released.

On December 3, 2019, Saba wrote a letter, claiming victory by a "tremendous margin" on the declassification proposal (having won a plurality of the votes cast) and calling for the board to comply with its fiduciary duty "to the shareholders of the funds and to implement the measures for which they have voted overwhelmingly."

On December 4, 2019, the Delaware Supreme Court heard an expedited appeal of the Chancery Court's June 27, 2019, injunction.

On January 13, 2020, the Supreme Court overturned the injunction, agreeing with Fund A that Saba's board nominees were properly excluded under the fund's bylaws. The case was returned to the Chancery Court for further proceedings.

On January 17, 2020, Saba filed a Schedule 13D noting an increase in holdings to 12.1 percent and enclosing an additional proposal that the board consider authorizing a self-tender offer for all outstanding shares of the fund or, if more than 50 percent of the outstanding shares are submitted for the tender, to liquidate the fund or convert it into a mutual fund.

## **2. *Fund B (December 2018–December 2019)***

In December 2018, Saba first reported passively owning 5.84 percent ownership in Fund B.

In April 2019, Saba filed a Schedule 13D, noting an increase in its holdings in the fund to 10.87 percent and that it intended to nominate six individuals for election to Fund B's board and present a proposal requesting the board "consider authorizing a self-tender for all

outstanding Common Shares at or close to [NAV]; provided, however, if more than 50 percent of the Issuer's outstanding Common Shares are submitted for tender, the tender offer should be cancelled and the Issuer should be liquidated or converted into an open-end mutual fund."

Fund B subsequently filed proxy materials opposing Saba's tender offer proposal and declaring Saba's nominees to the board to be invalid because Saba failed to comply with the fund's bylaws for the same reason as the nominees were found to be invalid in Fund A's proxy contest.

Saba subsequently made several additional proxy filings.

Saba also filed a lawsuit in Maryland state court against Fund B, its board, and its investment adviser, seeking injunctive relief for the fund's refusal to recognize Saba's nominees.

On July 12, 2019, the court rejected Saba's motion for a preliminary injunction.

Fund B then declared again that "Saba Capital's nominees are invalid, and, in accordance with the judge's statements, votes for Saba Capital's nominees will not be counted at the upcoming shareholder meeting."

On July 14, 2019, Saba withdrew its motion for preliminary injunction.

In December 2019, Fund B announced that its board had approved a merger of the fund into an affiliated mutual fund.

### **3. *Fund C (May 2019–January 2020)***

On May 2, 2019, Saba filed a Schedule 13D announcing that it owned 5.18 percent of the shares of Fund C. Saba also stated that it had sent a letter to the fund informing it of Saba's intent to present a proposal for the board "take all necessary steps" to declassify the board and to nominate four persons for election to the board.

On May 20, 2019, Fund C responded to this filing in its proxy, saying that it determined that Saba's nominees to the board are invalid under the fund's bylaws.

On May 21, 2019, Saba filed its proxy materials, stating that the board has "taken significant actions to impair the rights of its shareholders," and urging the shareholders to vote for its proposals and board nominees.

On June 5, 2019, Fund C's investment adviser commented on Saba's proxy statement, discussing its views on Saba's litigation. These comments were substantively similar to the comments issued in Fund A's proxy contest.

From May 22 to July 7, 2019, Saba and the fund continued to file competing proxy materials.

On July 8, 2019, Fund C held its shareholder meeting.

On December 19, 2019, the fund announced that the board had approved a tender offer “to purchase for cash up to 10 percent of the Fund’s outstanding common shares of beneficial interest, at a price equal to 98 percent of the [NAV] per share....”

On January 2, 2020, Fund C filed the official tender offer statement.

On January 13, 2020, the Delaware Supreme Court issued the opinion discussed above.

On January 17, 2020, the fund filed a report with the SEC saying:

On January 13, 2020, the Supreme Court of the State of Delaware ruled that the trustee candidates nominated by Saba Capital Master Fund, LTD (“Saba”) were ineligible for election at...[Fund C’s] 2019 annual meeting of shareholders. Therefore, votes received for Saba’s nominees were invalid. Accordingly, the [Fund’s] nominees for trustee, who each received a plurality of the votes cast at the 2019 shareholders meeting, are duly elected as Class III trustees of the Fund....

#### **4. Fund D (September 2014–October 2019)**

Starting in September 2014, Saba filed Schedule 13G forms on a regular basis and so has been an ostensibly “passive” investor with at least 5 percent ownership in Fund D since 2014.

On March 1, 2019, three weeks after filing its most recent Schedule 13G, Saba filed a Schedule 13D noting a 16.9 percent ownership share.

On March 8, 2019, Saba filed a Schedule 13D/A, indicating that it had sent a letter to the fund containing a stockholder proposal:

requesting that the Board of Directors consider authorizing a self-tender for all outstanding Shares of the Issuer at or close to net asset value; provided, however, if more than 50 percent of the Issuer’s outstanding shares are submitted for tender, the tender offer should be cancelled, and the Issuer should be liquidated or converted into an open-end mutual fund.

The letter stated that the proposal was submitted for consideration at the next shareholders’ meeting in September 2019.

On March 18, Saba filed a Schedule 13D, which expressed its intent to nominate three persons for election to the fund’s board at the annual shareholder meeting.

On April 2, Saba filed a Schedule 13D, which stated that it had submitted a proposal requesting that the board consider terminating the investment management agreement and all other advisory and management agreements with Fund D and noting that Saba would be nominating an additional director.

On April 11, Saba filed a Schedule 13D, which reflected an increased number of shares, bringing its ownership to 19.13 percent.

On April 12, 2019, Saba filed a fourth successive Schedule 13D, which consolidated the previous requests. The new Schedule 13D withdrew prior proposals and instead announced an intent to:

([i]) present a proposal requesting the board consider authorizing a self-tender offer for all outstanding Common Shares of the Issuer at or close to net asset value (“NAV”) and that if more than 50 percent of the Issuer’s outstanding Common Shares are submitted for tender, the tender offer should be cancelled and the Issuer should be liquidated or converted into an open-end mutual fund (the “Proposal”)...([ii]) nominate...three of [the] Nominees...to the Board...[and (iii) include] a new stockholder proposal...requesting the Board consider the termination of the Management Agreement and all other advisory and management agreements between the Issuer and the Manager.

On May 23, 2019, Saba filed its preliminary proxy statement.

On August 12, Fund D sent a letter to stockholders emphasizing the importance of the upcoming annual meeting and noting that a “hedge fund managed by Saba Capital Management, L.P. has taken a position in the fund and announced its intention to seek election of three new nominees to the Board of Directors of the Fund...and has also submitted two self-serving proposals, which seek to leave the fund without an investment manager and to significantly damage the fund.”

On August 28, 2019, Saba filed its Definitive Proxy Statement for Contested Solicitations and sent a letter to fund shareholders. The letter to shareholders accused Fund D of failing to address the average 14.5 percent discount at which the fund traded in 2018, charging high advisory fees, and engaging in a general campaign of disinformation against Saba. The proxy solicitation requested shareholders: (i) elect Saba’s slate of directors, (ii) terminate the management agreement between Fund F and its investment adviser, and (iii) request the board to authorize a self-tender offer for all outstanding shares of the fund at or close to NAV.

Saba and the fund continued to send several letters to shareholders addressing each other’s positions.

On October 3, 2019, Fund D held its shareholder meeting.

Following the meeting, the fund announced that (i) Saba’s nominees to the board were not elected (despite winning a plurality of the votes cast), as they failed win the support of a majority of all outstanding shares; (ii) Saba’s proposal to terminate the investment management agreement similarly failed to win the required majority vote (despite winning a plurality of votes cast); and (iii) the “nonbinding proposal to consider conducting a tender offer” was approved, which the fund’s board and the investment adviser’s board each said they will “carefully review.”

Following the fund’s description of the voting results, Saba accused the fund of “blatantly mislead[ing] shareholders about the outcome of this important election.” Furthermore, “a

lawyer at an outside law firm advising Saba said [Fund D's] investment adviser broke [SEC] rules by allegedly mischaracterizing the voting results" in its press release.

#### **5. Fund E (July 2018–September 2019)**

In July 2018, Saba first disclosed its position in Fund E in a Schedule 13G, disclosing an ostensibly "passive" 5.17 percent stake in the fund.

In March 2019, Saba filed a Schedule 13D noting an increased position to approximately 16 percent ownership in the fund.

In April 2019, Saba announced that it had submitted a proposal that would require the board to take all necessary steps to declassify the board and elect all directors on an annual basis.

On July 29, 2019, Saba amended its proposal to include nominations of three individuals for election to the Fund E's board.

On August 27, 2019, Fund E issued its preliminary proxy statement calling for the reelection of the board's incumbent directors and the rejection of Saba's "nonbinding proposal" to declassify the board.

Fund E asserted in that proxy statement that Saba's mismanagement of the Saba Closed-End Fund ETF likely violates the Investment Company Act's requirements relating to affiliated parties engaging in transactions with a registered investment company, such as Saba Closed-End Funds ETF. For example, Section 17(d) of the 1940 Act and Rule 17d-1 thereunder, which prohibits first-tier and second-tier affiliates of a registered fund (in this case, the Saba Closed-End Fund ETF is the registered fund, and the Saba hedge fund[s] and Saba Capital Management being affiliated persons), acting as principal, from engaging in a joint arrangement with such fund.

On August 28, 2019, Saba filed its preliminary proxy statement calling for the election of its two director nominees and requesting declassification of the board.

On September 6, 2019, the fund and Saba each filed definitive proxy statements.

On September 9, 2019, the fund's board sent a letter to shareholders asking shareholders to reject Saba's nominees and declassification proposal and providing details on the fund's nominees and board structure.

On September 10, 2019, Saba sent a letter to shareholders to warn them of a "campaign to deceive you with false and misleading information" and also criticized the fund's performance, fees, and discount to NAV.

The fund's board sent several additional letters to stockholders and press releases discussing the qualifications of its directors, as well as its concern that Saba's nominees were solely focused on Saba's short-term agenda.

Following the shareholder meeting, the fund announced that the incumbent directors were reelected, while Saba's "nonbinding" declassification proposal was approved by a vote of 18.35 million to 9.15 million.

**6. Fund F (June 2018–September 2019)**

In June 2018, Saba first reported “passive” ownership of 5.45 percent of Fund F.

In December 2018, Saba increased its position to 10.09 percent ownership.

On March 14, 2019, Saba filed a Schedule 13D noting 12.21 percent ownership in the fund.

In April 2019, Saba submitted a proposal requesting that the “Board take all necessary steps in its power to declassify the Board so that all directors are elected on an annual basis....”

On August 27, 2019, the fund issued the preliminary proxy statement requesting election of its nominated directors and the rejection of the board declassification proposal.

On August 28, 2019, Saba filed its preliminary proxy statement requesting election of its nominated directors and passage of the board declassification proposal.

On September 6, 2019, definitive proxy statements were filed.

At the October shareholder meeting, the incumbent nominees for director positions were reelected, and Saba’s “nonbinding” declassification proposal also passed with a vote of 25 million to 19.6 million.

**B. Bulldog Investors**

**1. Fund G (September–December 2019)**

On September 9, 2019, Bulldog Investors, LLC’s owner, Phillip Goldstein, sent a letter to the fund’s secretary proposing a self-tender for the outstanding common shares of the fund. The letter proposed that if more than half of the outstanding common shares voted in favor of the tender, that the tender offer be cancelled, and the fund be either liquidated or converted to an exchange-traded or open-end mutual fund. Mr. Goldstein stated that the reason for his proposal was that the fund’s common stock had been trading at a discount of more than 15 percent.

On September 30, 2016, Bulldog filed a Schedule 13D disclosing Bulldog’s interest in Fund G, noting that Bulldog itself owned 4.94 percent of outstanding shares and two of Bulldog’s owners, Phillip Goldstein and Andrew Dakos, each owned 6.02 percent of the fund’s outstanding shares.

On December 19, 2019, Mr. Goldstein sent another letter to the fund’s corporate secretary notifying him that Mr. Goldstein intended to present three nominees for director at the 2020 shareholder meeting. Mr. Goldstein also submitted a nonbinding proposal for consideration requiring a majority of shareholder votes to be cast in a majority election “to minimize the possibility of...holdover directors.”

**2. Fund H (May–August 2019)**

On May 29, 2019, Fund H was first listed.



On June 21, 2019, the fund filed its proxy statement with two proposals: (1) to approve a new investment advisory agreement with the fund's existing investment adviser; and (2) to reelect an incumbent independent trustee at the August 30, 2019, annual meeting.

On July 29, 2019, Bulldog filed a Schedule 13D disclosing its ownership of more than 5 percent of the fund's shares. On the same date, it filed a proxy statement soliciting votes against the fund's proposed renewal of the investment advisory agreement and opposing reelection of the incumbent trustee.

On August 15, 2019, the chairman of the fund's board issued a statement warning its shareholders of Bulldog Investors' efforts to solicit proxies for the purpose of liquidating the fund. The letter warned shareholders that Bulldog was a recent investor and the three-month-old Fund H had not yet had an opportunity to determine its trading value.

The statement characterized Bulldog's efforts as "risky and incorrect" and motivated by "short-term trading profit."

Bulldog withheld its votes for shareholder meetings originally scheduled for August 30, 2019, to prevent the fund from obtaining a quorum, causing the meeting to adjourn to September 4 and 12, 2019, respectively.

The chairman then stated that if the fund does not obtain a quorum for a meeting on September 30, 2019, that the fund "does not plan to adjourn the Annual Meeting past this date." In that statement, the chairman also criticized Bulldog for blocking the quorum:

Despite promising shareholders who vote on Bulldog's proxy card that their votes will not be withheld for quorum purposes if shareholders vote "against" this proposed scheme, Bulldog failed to attend, or have its proxies voted at, the Annual Meeting on the originally scheduled date of August 30, 2019. Bulldog disenfranchised these shareholders and demonstrated that it cannot be trusted to follow shareholders' voting instructions.

After the second postponement of the annual meeting, Bulldog continued to solicit proxies and filed another proxy requesting shareholders return Bulldog's enclosed proxy card. When the annual meeting was finally held, both of the fund's proposals were approved: the investment advisory agreement was approved by a vote of 4.5 million "for" to 729,484 "against"; the independent trustee was reelected by a vote of 4.6 million "for" to 992,481 "against."

### **3. *Fund I (October 2019–present)***

On October 14, 2019, Bulldog Investors, LLC, Ancora Holdings, Inc., and Ancora Advisors, LLC (collectively "the activists") filed a Schedule 13D that disclosed they collectively held 6.83 percent of the Fund I's outstanding shares. The activists represented that the fund's shares were undervalued and wished to address the disparity between the market price and the net asset value of the fund with the board of directors.

As of November 6, 2019, the activists increased their holdings of common stock to 8.4 percent of the outstanding shares.

As of December 11, 2019, the activists increased their holdings of common stock to 9.43 percent of the outstanding shares.

To date, the activists have not put forth any proposed changes to the fund.

#### **4. *Fund J (December 2015–December 2016)***

On December 3, 2015, Bulldog Investors, LLC filed a schedule 13D disclosing that it owned 6.13 percent of the outstanding common stock of Fund J.

On January 4, 2016, Bulldog disclosed it owned 6.94 percent of Fund J’s outstanding stock and indicated its intent to appear at the fund’s 2016 annual meeting to propose “a plan to afford stockholders an opportunity to realize net asset value.” Bulldog also proposed four candidates for the board of directors.

On May 13, 2016, in response, the fund and its investment adviser entered into a standstill agreement with Bulldog. Bulldog agreed to withdraw its proposals submitted in its January 4, 2016 filing, and to refrain from submitting shareholder proposals until December 31, 2018. In return, the fund agreed to hold a shareholder meeting to reorganize the fund to merge into an open-end fund also managed by the fund’s investment adviser.

Fund J’s shareholders voted on November 8, 2016; November 30, 2016; and December 29, 2016, and the reorganization was approved and a new subadvisory agreement put in place.

### **C. *City of London Investment Management Company Limited***

#### **1. *Seven Funds (Funds K–Q) (October 2017–April 2018)***

Prior to October 2017, Funds K–Q consistently traded at below their net asset values.

On October 4, 2017, these funds announced that they had entered into a standstill agreement with the City of London Investment Management Company Limited. Under the terms of the agreement, the funds would issue a tender offer of up to at 99 percent of the net asset value with a distribution of up to half the net asset value. In exchange, the City of London agreed to tender all its shares in the funds, vote in favor of the funds’ nominees and proposals, and remain in the standstill until December 31, 2019.

On April 30, 2018, Funds K–Q were reorganized into a single new closed-end fund, Fund R.

### **D. *Dryden Capital***

#### **1. *Funds S–Z (hereinafter referred to collectively as the funds) (July 2018–December 2018)***

The nine funds have two trustees that are elected only by the preferred shareholders.

On July 20, 2018, the each of the funds conducted a tender offer for its auction rate preferred shares (ARPS) at 85 percent of their liquidation preference.

In October 2018, Dryden Capital nominated T. Matthew Buffington as a preferred shares trustee for its closed-end funds. Dryden Capital owned less than 1 percent of the funds’

ARPS at the time of the proposal. To support its proposal, Dryden noted that the funds' ARPS should be redeemed to provide greater liquidity and better financing options and criticized the July 20, 2018, tender offer for ARPS at 85 percent of their liquidation preference as inadequate.

Dryden later submitted a presentation to shareholders arguing the funds had "lowballed" preferred shareholders.

On December 11, 2018, proxy advisory firm ISS recommended that preferred shareholders vote for Dryden Capital.

The funds responded that the current trustees consider many factors, including leverage and liquidity in their decisionmaking, and noted that they had recently offered Dryden the opportunity to tender all of its shares.

On December 19, 2018, Mr. Buffington was elected as a trustee in a contested election by the preferred shareholders of the funds. The trustee who was unseated in the contested election with Mr. Buffington was then reappointed by the board as a trustee elected by common and preferred shareholders voting together as a single class.

## **E. Karpus Investment Management (November 2016–February 2017)**

### **1. *Fund AA***

On November 14, 2016, Karpus Investment Management owned 19.6 percent of Fund AA and submitted a shareholder proposal requesting that the fund issue a tender offer for all common stock at the net asset value. Karpus's rationale for the need for the tender offer was that the fund's shares were trading at a discount of more than 15 percent, and it argued that the fund had offered insufficient buybacks.

In February 2017, in response, the fund and its investment adviser entered a standstill agreement with Karpus in which Karpus agreed to tender all its shares in a tender offer, vote for the fund's recommended proposals, and refrain from filing new shareholder proposals. Karpus was also required to rescind its pending shareholder proposals. In return for the standstill agreement, the board of trustees approved a tender offer of 25 percent of the fund's outstanding shares at 98 percent of the net asset value.

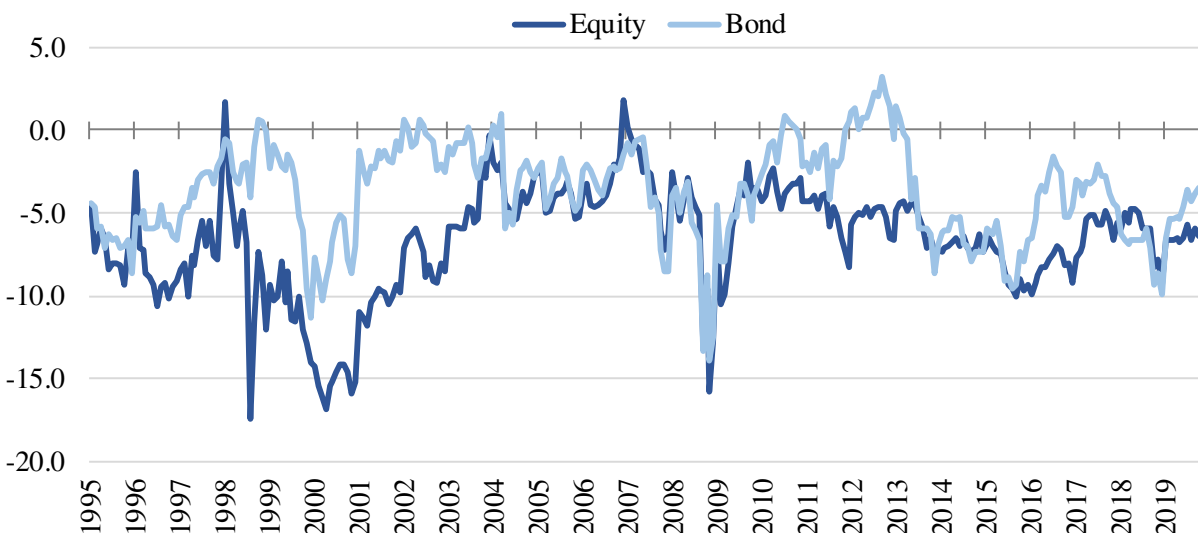
## **Appendix C: Closed-End Fund Pricing, Activist Shareholder Activity, and Case Studies**

### *Closed-End Fund Pricing*

Because a closed-end fund's shares often trade in the stock market based on investor demand, the fund may trade at a price higher or lower than its net asset value (NAV). A closed-end fund trading at a share price higher than its NAV is said to be selling at a "premium" to the NAV, while a closed-end fund trading at a share price lower than its NAV is said to be selling at a "discount." Equity and bond closed-end funds (CEFs) generally trade at a discount (Figure C.1). From 1995 through 2019, the average discounts for equity and bond CEFs were 6.7 percent and 3.8 percent, respectively.

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**Figure C.1**  
**Closed-End Fund Discounts Tend to Persist Over Time**  
Percent, month-end



Note: The premium/discount rate is the simple average of the difference between the share price and NAV at month-end.

Source: Investment Company Institute tabulations of Bloomberg data

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The presence and persistence of CEF discounts over time—the “closed-end fund puzzle”—has been thoroughly examined in academic literature.

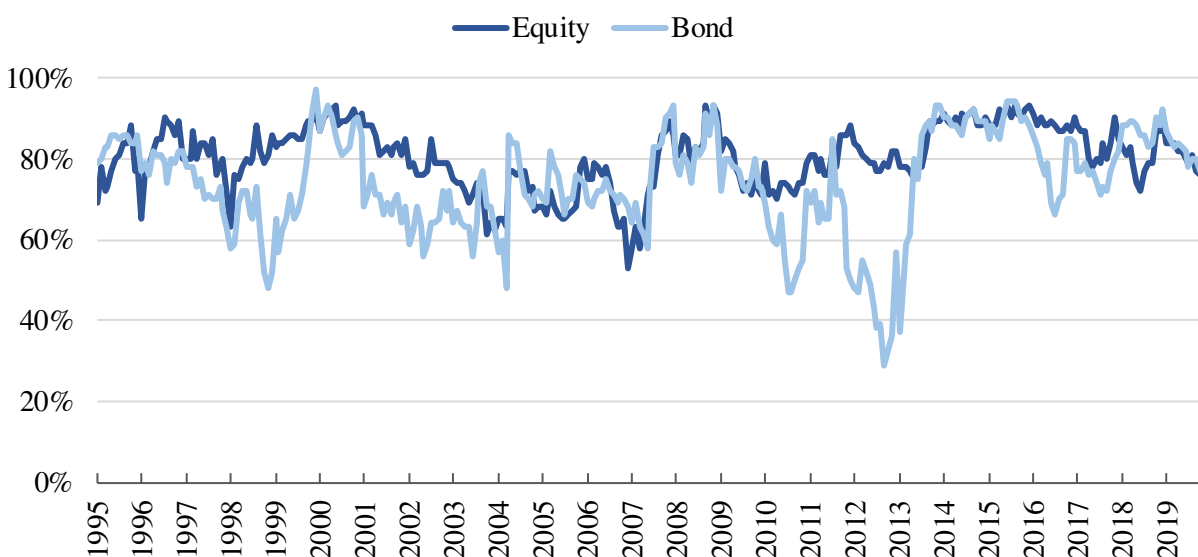
Some reasons for persistent CEF discounts that have been studied include management fees (Ross 2002), overhanging tax liabilities (Day, Li, and Xu 2011), liquidity of underlying assets (Cherkes, Sagi, and Stanton 2009), managerial ability (Berk and Stanton 2007), and investor sentiment (Lee, Shleifer, and Thaler 1991). Further, other papers have explored the effects of reducing discounts through various means, including managed distribution policies (Cherkes, Sagi, and Wang 2014), stock buybacks/share repurchases (Porter, Roenfeldt, and Sicherman 1999), and restructuring into an open-end fund (*i.e.*, “open-ending”) (Brauer 1984).

The majority of equity and bond closed-end funds trade at a discount in any given month (Figure C.2).

Over the 1995–2019 period, the percentage of *equity* closed-end funds trading at a discount ranged between 53 percent to 93 percent of funds and averaged 80 percent. Over the same period, the percentage of *bond* closed-end funds trading at a discount ranged between 29 percent and 97 percent and averaged 74 percent. These data seem to support the notion that a closed-end fund trading at a discount to its NAV is inherent to, and a feature of, the product.

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**Figure C.2**  
**Generally, the Majority of Closed-End Funds Trade at a Discount**  
Percentage of total closed-end funds trading at a discount, monthly



Note: The premium/discount rate is the simple average of the difference between the share price and NAV at month-end.

Source: Investment Company Institute tabulations of Bloomberg data

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Closed-end fund discounts may benefit secondary market investors because they are able to access the closed-end fund’s investment strategy and income stream at a discount. In other words, long-term shareholders can obtain a steady stream of income for less than its actual value. In sharp contrast, activist shareholders seize on closed-end fund discounts to achieve individual short-term profits.

#### *Measuring Activist Shareholder Activity*

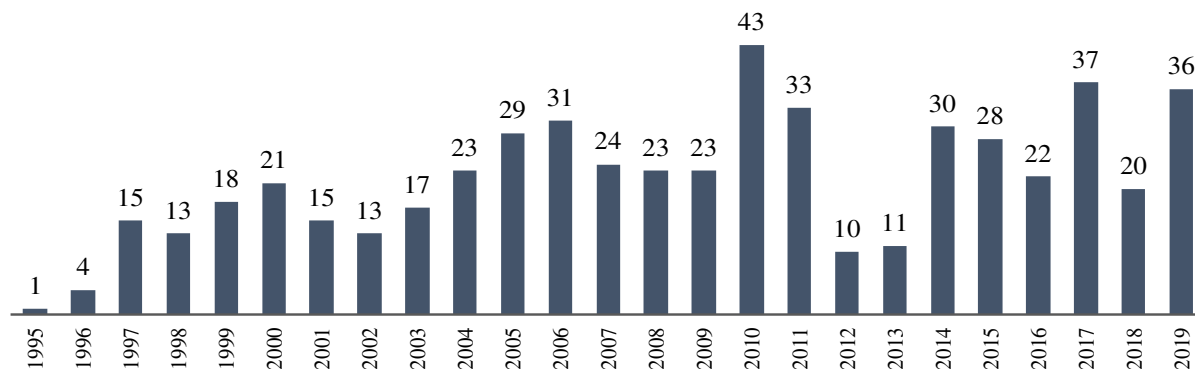
Section 13 of the Exchange Act requires any person (or group of persons) who directly or indirectly acquires or has beneficial ownership of more than 5 percent of a class of a fund’s securities to report this beneficial ownership by filing a Schedule 13D or the more-abbreviated Schedule 13G.

Investors holding between 5 percent and 20 percent who have the intent of changing or influencing control of the fund must file Schedule 13D. Investors who own more than 20 percent regardless of intent also must file Schedule 13D. Passive investors who own more than 5 percent but no more than 20 percent and claim to have no activist intent may file Schedule 13G. Investors must file Schedules 13D and 13G within 10 days of the date on which they exceed the 5 percent ownership threshold. Filers must amend Schedule 13D and 13G filings continuously.

Closed-end fund activist shareholders sometimes file Schedule 13G initially, claiming to have no activist intent, and then subsequently file a Schedule 13D as their holding size grows and/or they deem it the right time to disclose their activist strategy goals.

We used the SEC’s Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system to count the number of Schedule 13D and Schedule 14A<sup>110</sup> (PREC14A) filings activist shareholders made regarding their investments in closed-end funds that were operating between 1995 and 2019. Figure C.3 shows the number of these filings, annually, since 1995.<sup>111</sup> There was a peak in 2010 with 43 filings, of which 40 were from just three activists.

**Figure C.3**  
**Number of Beneficial Ownership and Contested Proxy Solicitation Filings**  
 Annual



Note: In this figure, *beneficial ownership* filings refer to Schedule 13D and *contested proxy solicitation* filings refer to Schedule 14A (PREC14A).

Source: Investment Company Institute tabulations of SEC EDGAR data

<sup>110</sup> Schedule 14A sets forth the requirements that filers must include in their proxy statements.

<sup>111</sup> There were a number of filings downloaded from EDGAR that were deleted from the final dataset, including: Schedule 13D filings by certain banks with no formal intent, Schedule 13D filings that appeared simply to be amendments to a previously filed Schedule 13D, Schedule 13D or PREC14A filings by affiliated persons, duplicate Schedule 13D or PREC14A filings made on the same day, and Schedule 13D and PREC14A filings that were duplicates of each other (*i.e.*, their intent was assumed to be the same). Data may include a small number of Schedule 13D filings where shareholders did not disclose an activist intent.

Most importantly, the number of these filings generally has increased recently, and Figure C.4 groups the total number of filings into five periods between 1995 and 2019. There were only 51 beneficial ownership and related contested proxy solicitation filings during the 1995–1999 period compared with 147 over the 2015–2019 period. Sometimes the same activist shareholder(s) made filings regarding the same fund in successive years or different activist shareholders each made filings in the same year with respect to the same fund. Looking at just the distinct closed-end funds with beneficial ownership and contested proxy solicitation filings, activists targeted 37 funds between 1995 and 1999. This compares to them targeting 117 funds between 2015–2019. To put this in perspective, recall from Figure A.3 that there were 500 funds at year-end 1995 and 494 funds at year-end 2019. Clearly, this demonstrates that over these periods activist shareholders have been targeting a larger percentage of distinct closed-end funds.

**Figure C.4**  
**Shareholder Proposals Were Highly Concentrated Among Only a Few Activist Shareholders Between 2015–2019**

<b>Period</b>	<b>Number of filings</b>	<b>Number of distinct CEFs targeted</b>	<b>Five activists with most filings</b>	<b>Other shareholder filings</b>
1995–1999	51	37	67%	33%
2000–2004	89	60	56%	44%
2005–2009	130	92	82%	18%
2010–2014	127	102	87%	13%
2015–2019	147	117	82%	18%

<b>Activist</b>	<b>Percentage of total filings<sup>1</sup></b>
Bulldog	28%
Saba	27%
Karpus	18%
City of London	14%
Dryden Capital	13%

Source: Investment Company Institute tabulations of SEC EDGAR data

Additionally, shareholder filings tend to be concentrated among only a few activist shareholders, and by grouping certain related filings together,<sup>112</sup> we can examine the activity of the most active shareholders over time. In the two periods before 2005, the five activist shareholders with the most filings were 67 percent of all filings during 1995–1999 and 56 percent

<sup>112</sup> For example, “Bulldog Investors,” “Bulldog Investors General Partnership,” “Bulldog Investors, LLC,” “Full Value Advisors LLC,” “Goldstein Phillip,” and “Opportunity Partners LP” were grouped together as “Bulldog.”

of all filings during 2000–2004 (Figure C.4). Since 2005, the activist shareholders with the most filings have been much more concentrated—the five activist shareholders with the most filings represented at least 82 percent of all filings in each period.

### *Case Studies*

Activist shareholders' Schedule 13D filings frequently disclose that they want the fund to conduct a tender offer to buy back all, or some portion of, shares at a value equal or close to NAV. This is one common tactic that activist shareholders use to attempt to realize short-term profits—the activist shareholder steadily builds up a large stake in the fund at a discount and then seeks to have the fund buy those shares back at a higher price.

Figure C.5 shows an example of a closed-end fund targeted by an activist shareholder that led to a tender offer. On April 12, 2017, the activist shareholder filed a Schedule 13D stating it owned 25.2 percent of the fund's outstanding shares, and that it was requesting the fund to hold a tender offer for all outstanding common shares at or close to NAV. The investment adviser entered into a standstill agreement<sup>113</sup> with the activist shareholder—the shareholder withdrew their proposal, and in exchange, the fund held a tender offer for 15 percent of its outstanding shares that expired September 6, 2017. By September 30, 2017, total common share assets of the fund were 15.4 percent lower than on August 31, 2017.

With lower assets to spread across the fund's fixed costs, the fund's expense ratio doubled, from 1.1 percent to 2.3 percent. It is important to note that this increase in the expense ratio did not come from fund managers imposing a higher management fee,<sup>114</sup> but instead on the percentage increase in fixed costs and liability payments from the decreased total assets.<sup>115</sup>

This strategy is common: activist shareholders initially request that the closed-end fund either make a tender offer for all shares, open-end, or liquidate, and then agree to enter into a standstill agreement if the fund makes a partial tender offer. Fund directors ultimately choose the course to follow, typically based on significant input and analysis from the investment adviser, evaluating various options and choosing the one that is in the best interest for the fund and its shareholders.

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<sup>113</sup> See Appendix D, Section B (8) for the definition of a standstill agreement.

<sup>114</sup> In dollar terms, the management fees collected by the fund actually decreased in 2017.

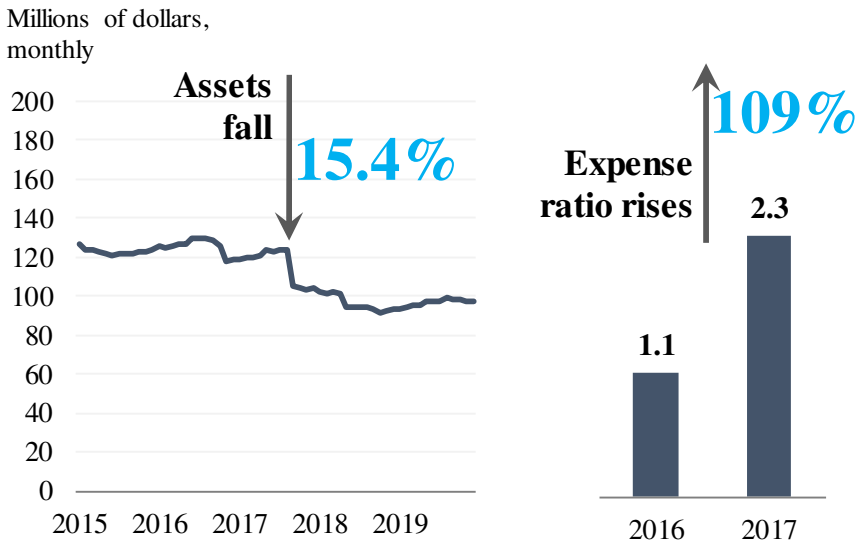
<sup>115</sup> The reduction in assets also affects the interest expense paid by common shareholders. With less assets to buy securities and earn yield, more fees must be collected from common shareholders to cover preferred share class liabilities.



**Figure C.5**

**Tactic: Activist-Induced Tender Offer—A Short-Term Profit Opportunity That Burdens Long-Term Shareholders with Higher Expense Ratios**

Tender offer date: September 2017



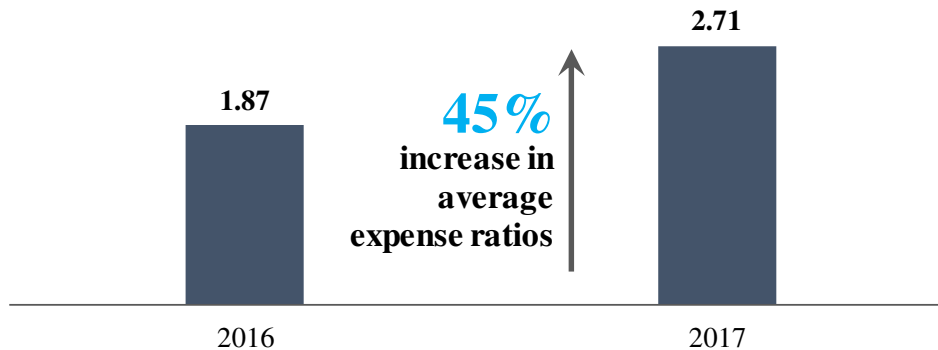
Sources: Morningstar Direct and EDGAR

The example in Figure C.5 shows just one fund’s expense ratio rising after a tender offer. Figure C.6 generalizes this to show how the simple average expense ratios for the 10 funds we identified that made activist-induced tender offers changed from 2016 to 2017. For these 10 funds, the simple average expense ratio was 1.87 percent in 2016 compared with a simple average expense ratio of 2.71 percent in 2017—an increase of 45 percent.

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**Figure C.6**  
**Simple Average Expense Ratio for CEFs with Activist-Induced Tender Offers**  
**Rose 45 Percent in 2017**

Closed-end funds with tender offers in 2017\*



\*Data include 10 closed-end funds targeted by activists in 2017—three of which merged in 2018.

Source: Investment Company Institute tabulations of Morningstar Direct data

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Another tactic used by activist shareholders to realize short-term profits is to submit a shareholder proposal requesting that a closed-end fund declassify its board—an expensive, time-intensive, multiphase process that is tilted in the activist shareholder’s favor. Figure C.7 shows the evolution of a typical declassified board proposal combined with ICI survey results of actual shareholder proposals to declassify boards (*see* Appendix A on page 35 for more information).

In the first phase, one or more activist shareholders submit a proposal requesting that the fund declassify its board. The fund reviews the proposal. Assuming there is no basis under Exchange Act Rule 14a-8 to exclude the proposal, the closed-end fund’s proxy statement will include the shareholder proposal, as well as the views and recommendations of the fund’s board—at the expense of all fund shareholders. The proxy advisor subsequently issues a voting recommendation to its clients pursuant to its voting guidelines, and the proxy advisor will recommend in favor of the activist shareholder’s proposal (Figure C.7).<sup>116</sup>

In the second phase, the fund spends a significant amount of time and resources communicating with long-term shareholders, activist shareholders, and proxy advisory firms. In 2019, just one activist shareholder submitted nine proposals (one proposal per fund) to five distinct

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<sup>116</sup> For example, ISS’s proxy voting policies state that its general recommendation for all issuers is to “vote against proposals to classify (stagger) the board” and “vote for proposals to repeal classified boards and to elect all directors annually.” *See* Institutional Shareholder Services, United States Proxy Voting Guidelines Benchmark Policy Recommendations (Effective for Meetings on or after February 1, 2020) at 17, *available at* [www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf](http://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf). ISS’s proxy voting policies state that these are its *general* recommendations, and we are unaware of any instance in which it recommended voting against declassifying a closed-end fund board.

fund complexes.<sup>117</sup> Two funds engaged with the activist shareholder prior to the proposal's submission, five funds engaged with the activist shareholder after the proposal was submitted, and two funds engaged both before and after the proposal was submitted.

Funds engaged with the proxy advisor regarding all six proposals that were not withdrawn.<sup>118</sup> Yet —despite funds' efforts to engage with proxy advisors—the proxy advisor applied its uniform voting policy and recommended that shareholders vote in favor of declassifying the board in all six cases (Figure C.7).

In the last phase, the proxy advisor considers whether to issue a new recommendation (based on engagement with the fund) and shareholders vote on the proposal. If the proposal passes, the closed-end fund's board determines whether acting on the proposal is in the fund's best interest.

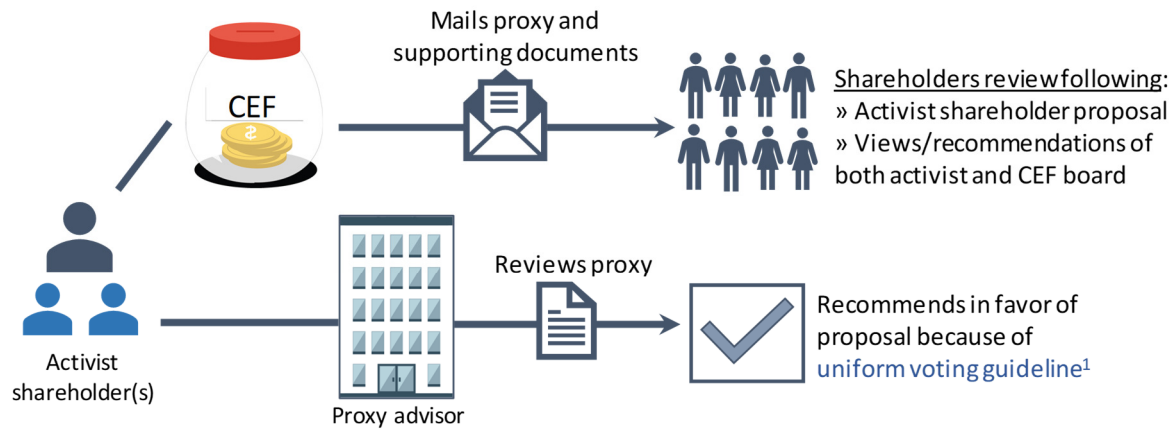
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<sup>117</sup> Data are based on survey participant responses and exclude one shareholder proposal that was too recent and therefore did not include enough information.

<sup>118</sup> Three shareholder proposals were withdrawn because of standstill agreements for each one.

**Figure C.7**  
**Tactic: Board Declassification—An Expensive, Time Consuming, Multiphase Process**

Phase 1: One or more activist shareholders submit proposal to declassify board

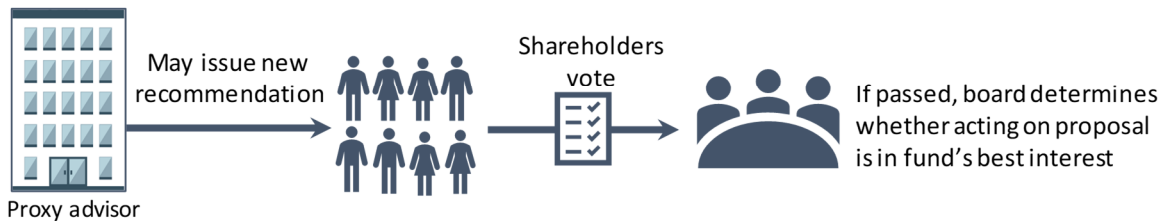


Phase 2: Fund communicates with shareholders, activists, and proxy advisory firms

ICI survey results:<sup>2</sup>

- 9 = Number of board declassification proposals
- 9 = Number of funds that engaged with activist
- 6 = Number of funds that engaged with proxy advisor<sup>3</sup>
- 6 = Proxy advisor recommendation **in favor of proposal**<sup>3</sup>

Phase 3: Shareholders vote on proposal



Board declassification proposals are costly in both time and resources (ICI survey results)<sup>2</sup>

\$952,000 = Average CEF cost during board declassification proposal

\$22,000 = Average CEF cost for routine proposal

<sup>1</sup>See Institutional Shareholder Services, United States Proxy Voting Guidelines Benchmark Policy Recommendations (Effective for Meetings on or after February 1, 2020) at 17, available at [www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf](http://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf).

<sup>2</sup>Survey results are those from an ICI survey distributed to its members and concluded in January 2020. See Appendix A on page 35 for more information.

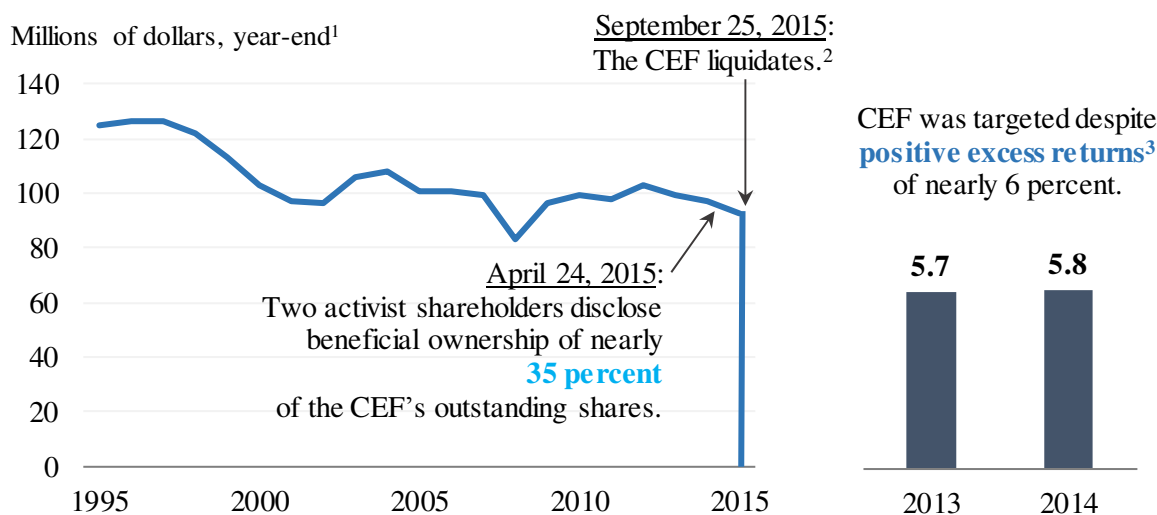
<sup>3</sup>Three shareholder proposals were withdrawn because of standstill agreements for each one.

Another tactic activist shareholders use to realize short-term profits is to have the fund liquidate or “open-end”—effectively allowing the activist shareholders to redeem all of their shares at NAV. Figure C.8 shows an example of a closed-end fund that launched on September 22, 1989, and was targeted by two activists in 2015 and liquidated in the same year.

In another example, on April 24, 2015, Karpus and Bulldog—two known activist shareholders—disclosed (via separate Schedule 13Ds) beneficial ownership of the fund totaling 35 percent of its outstanding shares. In particular, Karpus cited poor performance as one of the reasons for recommending terminating the investment adviser. However, the fund’s excess price return (*i.e.*, the return of the fund less the simple average return of similar funds) was nearly 6 percent in 2013 and 2014.

Likely to avoid imposing all or some of the high costs of a proxy contest on fund shareholders, the fund’s board chose to liquidate the fund to return as much capital as possible back to all shareholders. Shareholders received their final distribution on September 25, 2015, losing access to a fund that was providing solid performance relative to its peers and a strategy that sought to provide high income with the added flexibility to invest both domestically and internationally. Additionally, those shareholders were burdened with an unexpected potential tax burden.

**Figure C.8**  
**Tactic: Liquidation—Pressure from Activist Shareholders Forces Liquidation Despite Positive Excess Price Returns**



<sup>1</sup>Data availability begin in 1995. Data for 2015 are just before liquidation in September.

<sup>2</sup>The fund’s objective was to seek high income but with the flexibility to consider capital appreciation and to invest in securities both domestically and internationally.

<sup>3</sup>Excess return is the price return of the fund at year-end less the simple average price return of all other funds with the same Morningstar CEF classification name.

Sources: Morningstar Direct and EDGAR

Figures C.5 and C.6 showed some of the impacts that a tender offer, spurred by activism, can have on the closed-end fund's long-term shareholders. Figures C.9 through Figure C.12 demonstrate how closed-end fund shareholders—and activist shareholders in particular—typically respond during tender offers. Generally, during a tender offer, the closed-end fund notifies shareholders that it is going to buy back some percentage of shares from investors over some period. The tender offer period is usually about a month, and funds typically offer to buy back between 10 and 20 percent of the fund's outstanding shares during this time. Once the tender offer concludes, the fund notifies shareholders of the specific date and price at which it will buy back shares; and if the tender offer is oversubscribed, how much of each shareholder's tendered shares will be bought back.

Figure C.9 shows statistics for 30 tender offers between 2016 and 2019. For example, one fund (F0T1) issued a tender offer for 15 percent of the fund's common shares. On September 7, 2017, the tender offer concluded, and the fund disclosed that holders of 37.2 percent of the outstanding common shares requested to tender. The tender offer was therefore oversubscribed, so the fund prorated the repurchase of shares and bought back 40 percent of each shareholders' total tendered shares. On average, between 2016 and 2019, tender offers were oversubscribed by 23 percent of the fund's outstanding shares. As a result of these oversubscriptions, closed-end funds, on average, prorated about 43 percent of shareholders' tender-subscribed shares. This indicates that participation in tender offers tends to be strong relative to the amount of shares the fund intends to buy back.

**Figure C.9**  
**Tender Offers Typically Oversubscribe**  
Tender offers completed between 2016 and 2019<sup>1</sup>

Identifier <sup>2</sup>	Tender offer expiration date	Percentage of outstanding shares—for the tender offer—that were:			Memo:
		Actually purchased by the closed-end fund	Subscribed to by shareholders	Oversubscribed	Proration amount <sup>3</sup>
FIT1	05/26/2016	15.0%	39.0%	24.0%	38.5%
FJT1	05/26/2016	15.0%	43.9%	28.9%	34.2%
FIT2	12/23/2016	5.0%	34.1%	29.1%	14.7%
FJT2	12/23/2016	5.0%	29.1%	24.1%	17.2%
F9T1	03/03/2017	14.9%	50.4%	35.6%	29.5%
FMT1	05/11/2017	15.0%	46.1%	31.1%	32.5%
F8T1	06/23/2017	25.0%	50.4%	25.4%	49.7%
FIT3	06/23/2017	5.0%	26.9%	21.9%	18.6%
FJT3	06/23/2017	5.0%	6.1%	1.1%	82.1%
F2T1	07/11/2017	32.5%	53.9%	21.4%	60.0%
F6T1	08/11/2017	20.0%	36.7%	16.7%	54.5%
FKT1	09/06/2017	15.0%	37.2%	22.2%	40.4%
F0T1	09/07/2017	15.0%	37.2%	22.2%	40.0%
F1T1	09/07/2017	15.0%	46.0%	31.0%	33.0%
F7T1	09/28/2017	15.0%	33.5%	18.5%	44.8%
F3T1	11/10/2017	32.5%	48.2%	15.7%	67.0%
F4T1	11/10/2017	37.5%	57.0%	19.5%	66.0%
F5T1	11/10/2017	37.5%	61.4%	23.9%	61.0%
FLT1	04/17/2018	10.0%	44.6%	34.6%	22.0%
FKT2	05/02/2018	7.5%	33.0%	25.5%	22.7%
FBT1	11/07/2018	25.0%	33.1%	8.1%	75.6%
FDT1	11/16/2018	65.0%	68.8%	3.8%	94.5%
FCT1	03/18/2019	57.0%	57.0%	0.0%	100.0%
FLT2	04/15/2019	5.0%	41.3%	36.3%	12.1%
FET1	05/17/2019	10.0%	37.8%	27.8%	26.4%
FAT1 <sup>4</sup>	08/21/2019	20.0%	51.8%	31.8%	38.7%
FFT1	12/05/2019	20.0%	39.9%	19.9%	50.1%
FGT1	12/05/2019	15.0%	58.4%	43.4%	25.7%
FHT1	12/05/2019	15.0%	50.2%	35.2%	29.9%
FET2	12/13/2019	5.0%	30.7%	25.7%	16.3%
<b>Average</b>		<b>19.3%</b>	<b>42.8%</b>	<b>23.5%</b>	<b>43.2%</b>

<sup>1</sup>Data only include tender offers that directly resulted from shareholder activism (or any subsequent tender offers per some condition in a standstill agreement).

<sup>2</sup>The first two characters of the identifier represent a closed-end fund and the last two characters indicate the tender offer (*i.e.*, one fund may have multiple tender offers).

<sup>3</sup>The proration amount is the number of outstanding shares actually purchased by the fund divided by the number of outstanding shares that were subscribed to by shareholders. Each shareholder receives cash equal to this percentage of their tendered shares at the specified tender offer price.

<sup>4</sup>This fund includes data from two activists that filed separate proposals.

Source: Investment Company Institute tabulations of SEC EDGAR data

Based on supporting EDGAR documents around tender offers, there is substantial evidence that activist shareholders fully subscribe to tender offers (Figure C.10). For eight of the 30 tender offers (Panel A), the activist shareholder filed a Schedule 13D (or amended Schedule 13D) before the tender offer was completed and then filed an amended Schedule 13D after it was completed. In a Schedule 13D, the filer must disclose all transactions that have occurred in the past 60 days. The activists' post-tender offer filings explicitly identify how much was sold at the tender offer purchase price. For each tender offer, the amount sold is within 2 percent of the prorated amount purchased by the closed-end fund. One reason this is not exact is because the activist may transact in fund shares outside of the tender offer during this time. Discounts usually narrow during a tender offer. Therefore, the activist shareholder likely can sell shares at a price higher than their purchase price.

For 15 of the 30 tender offers, the activist shareholder filed a Schedule 13G following the tender offer, meaning they did not have to disclose how many shares they tendered (Figure C.10, Panel B).

However, we can estimate how much they sold based on the number of shares held in the pre-tender offer Schedule 13D filing and the post-tender offer Schedule 13G filing. On average, the change in the number of shares held by the activist as a percentage of their original shares is within 5 percent of the prorated amount purchased by the fund. While this difference is greater than when a Schedule 13D reveals the exact amount tendered, they are similar enough to conclude that in each of these cases, the activist fully subscribed to the tender offer.

Lastly, we are also able to determine whether the activist shareholder sold the remainder of their shares following the fund's most recent tender offer.<sup>119</sup> Of the 23 tender offers in Figure C.10, 14 activist shareholders sold the remainder of their shares within one year—demonstrating that they were only in the fund to generate a short-term profit. Additionally, six activist shareholders still held some shares of the closed-end funds they pursued.<sup>120</sup> This is not surprising. The activist shareholder needs to sell their shares at a higher price than their purchase price to maximize their investment, and as such, hold on to the remaining shares until this occurs.

Figure C.10 helps demonstrate that activist shareholders use tender offers as short-term profit-seeking opportunities. This is important because activist-induced tender offers temporarily transform the focus of the fund from long-term generation of income or capital gains to satisfying tenders. This short-term focus may be detrimental to the fund's long-term prospects, especially if the fund invests in private markets. Private market investments are often less liquid but higher yielding than other types of assets. Because closed-end funds typically do not expect to repurchase or redeem their issued shares, they may be substantially invested in private market holdings. Forcing a closed-end fund to sell some of those assets to meet a liquidity event, such as a tender offer, could cause the fund to make these sales at inopportune times that are inconsistent with the

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<sup>119</sup> Some closed-end funds experience multiple tender offers, which is usually the result of a clause in a standstill agreement that would trigger a subsequent tender offer.

<sup>120</sup> Data were collected from SEC Form 13F filings. Three tender offers are identified as N/A because they occurred in the middle of December 2019.



fund's long-term strategy, and may erode some of the future gains long-term investors would have experienced.

## Figure C.10 Activist Shareholders Use Tender Offers to Extract Short-Term Profits

*Panel A: activist shareholders that disclosed amount purchased by fund after tender offer*

Identifier	Tender offer proration purchase by fund	Actual shares sold by activist as a percentage of original shares held	Did activist shareholder sell all shares within one year of most recent tender offer? <sup>1</sup>
F8T1	49.7%	-48.5%	No
F9T1	29.5%	-27.1%	Yes
FAT1_A1	38.7%	-38.2%	Yes
FDT1	94.5%	-92.8%	No
FET1	26.4%	-26.2%	No
FET2	16.3%	-16.1%	N/A
FIT1	38.5%	-37.2%	Yes
FJT1	34.2%	-33.0%	Yes

*Panel B: activist shareholders' public filings for other funds with tender offers<sup>2</sup>*

Identifier	Tender offer proration purchase by fund	Change in shares held by activist before and after tender offer as percentage of original shares held	Did activist shareholder sell all shares within one year of most recent tender offer? <sup>1</sup>
F0T1	40.0%	-49.1%	Yes
F1T1	33.0%	-40.6%	Yes
F2T1	60.0%	-65.1%	Yes
F3T1	67.0%	-69.9%	Yes
F4T1	66.0%	-69.1%	Yes
F5T1 <sup>3</sup>	61.0%	-63.6%	Yes
F6T1	54.5%	-54.1%	No
F7T1	44.8%	-57.9%	Yes
FBT1	75.6%	-77.3%	Yes
FCT1	100.0%	-100.0%	No
FFT1	50.1%	-57.0%	Yes
FGT1	25.7%	-29.0%	N/A
FHT1	29.9%	-33.2%	N/A
FKT1	40.4%	-45.6%	No
FMT1	32.5%	-44.7%	Yes

<sup>1</sup>Data were collected from SEC Form 13F filings. Three tender offers are identified as N/A because they occurred in the middle of December 2019.

<sup>2</sup>There are no disclosed post-tender offer data for seven funds.

<sup>3</sup>This fund also had disclosed transactions but did not disclose the purchase of shares by the fund when the tender offer was completed.

Note: The first two characters of the identifier represent a closed-end fund and the last two characters indicate the tender offer (*i.e.*, one fund may have multiple tender offers).

Source: Investment Company Institute tabulations of SEC EDGAR data

Assuming activist shareholders tender all of their shares, Figure C.11 shows the shares activists tendered as a percent of the total shares tendered in each offer. During one tender offer (FKT1), the tendered shares of the activist shareholder were two-thirds of the total number of shares tendered by all shareholders. In another example (FDT1), the activist shareholder represented only 8 percent of total number of shares tendered by all shareholders. On average, activist shareholders typically constitute 31 percent of the total number of tendered shares during a tender offer.

**Figure C.11**  
**Activist Shareholders Typically Are 31 Percent of Total Shares Tendered**

<b>Identifier</b>	<b>Activist shares owned prior to tender offer</b>	<b>Total CEF shares tendered</b>	<b>Percentage of total tendered shares subscribed to by activist</b>
FKT1	2,903,257	4,304,310	67%
F6T1	1,320,970	2,562,139	52%
FBT1	4,572,642	9,236,910	50%
FKT2	1,566,493	3,253,219	48%
FIT1	3,201,669	7,825,033	41%
FET2	9,901,660	24,509,363	40%
FAT1*	1,388,409	3,560,562	39%
F8T1	3,353,417	8,693,400	39%
F3T1	1,814,145	4,998,066	36%
FFT1	1,175,456	3,240,669	36%
F1T1	5,192,780	14,817,666	35%
FET1	11,189,550	33,920,082	33%
FMT1	6,124,755	18,987,662	32%
F0T1	2,625,329	8,775,224	30%
F7T1	820,026	2,748,438	30%
FLT1	7,796,375	26,225,806	30%
FCT1	1,988,616	7,365,350	27%
F9T1	3,591,771	13,514,847	27%
F4T1	2,546,667	10,052,547	25%
F5T1	7,379,266	31,646,419	23%
FJT1	3,089,661	13,953,207	22%
FIT2	1,244,757	5,817,988	21%
FGT1	21,826,069	105,117,523	21%
FHT1	7,182,796	37,165,804	19%
F2T1	1,340,954	7,334,932	18%
FIT3	1,001,287	6,104,416	16%
FJT2	1,178,099	7,861,481	15%
FLT2	2,878,777	21,792,955	13%
FDT1	2,131,302	26,085,768	8%
		<b>Average:</b>	<b>31%</b>

\*For this fund, *activist shares owned prior to tender offer* include data from two known activists that both filed a Schedule 13D.

Note: The first two characters of the identifier represent a closed-end fund and the last two characters indicate the tender offer (*i.e.*, one fund may have multiple tender offers). Data assume that activists tender all of their shares.

Source: Investment Company Institute tabulations of SEC EDGAR data

The results of C.11 raise the question of who else is participating in tender offers. Figure C.12 shows an example of a fund with multiple large shareholders (each filing Schedule 13Ds or 13Gs), three activist shareholders, and two large institutional shareholders. Comparing the number of shares after the tender offer with the number of shares they would have under a strict pro rata fund purchase, it is clear that each of these shareholders tendered all of their shares. This behavior is expected for the activist shareholders because their primary goal is to realize short-term profits.

**Figure C.12**  
**Who Participates in Tender Offers?**

<b>Shareholder</b>	<b>Number of shares pre-tender<sup>1</sup></b>	<b>Number of shares post-tender</b>	<b>Number of shares if fully subscribed under a proration = 94.45%</b>
Bulldog	3,095,641	168,673	292,383
Karpus <sup>2</sup>	1,439,032		135,917
1607 Capital Partners	4,085,051	245,969	385,833
Institutional investor 1	7,581,310	586,599	716,055
Institutional investor 2	3,303,739	150,837	312,038
<b>Total</b>	<b>19,504,773</b>	<b>1,152,078</b>	<b>1,842,226</b>
Outstanding shares before tender offer	37,906,028		
Total shares subscribed	26,085,768		
Total shares actually tendered	24,638,918		
Outstanding shares after tender offer	13,267,110		
Total holder % of tendered shares	75%		
Total holder % of outstanding shares	51%		

<sup>1</sup>The fund distributed all accrued capital gains prior to the tender offer. These distributions were estimated and prorated across investors based on the percentage of shares Bulldog stated they received prior to tender offer. The number of shares pre-tender are estimated based on the distribution estimate.

<sup>2</sup>Karpus did not file a Schedule 13G following the tender offer—it was not legally required to since its holdings were likely less than 5 percent.

Source: Investment Company Institute tabulations of SEC EDGAR data

We offer one possible reason for the behavior of the two institutional investors, who we are assuming are intermediaries investing on behalf of their retail clients.

The intermediary/institutional investors' clients are likely retail shareholders seeking long-term income. Participating in the tender offer may seem contradictory to this, but the intermediary likely is an investment adviser or a broker-dealer. The investment adviser has a fiduciary duty to act in the best interest of its clients, and the broker-dealer has a duty under Regulation BI to act in the best interest of its retail clients.<sup>121</sup> When an activist shareholder successfully forces the fund to

<sup>121</sup> Although at the time the tender offers took place Regulation BI was not in effect, broker-dealers now would be required to adhere to the regulation's requirements.

hold a tender offer, it sends a signal to other investors in the market that the fund will get smaller. As such, institutional investors will expect the costs of the closed-end fund to increase and may determine that it is in the best interest of their clients to tender their shares. As a result of the tender, those clients may be left with a gap in their portfolios, and any replacement investment may not provide the same yield, distribution rate or total return.

Activist shareholders most commonly use a closed-end fund's discount as the reason to support their proposed action. However, there does not seem to be any definitive evidence (one way or the other) that activist involvement improves a closed-end fund's discount in the long term. One way to investigate this is to look at average excess discounts—the simple average discount of a closed-end fund less the simple average discount of all funds with the same investment objective—during four periods of a tender offer: (1) one year prior to the initial Schedule 13D filing by the activist; (2) the period between the initial Schedule 13D filing and the tender offer start date; (3) the tender offer period; and (4) one year after the tender offer conclusion date.

Figure C.13 shows average excess discounts over the four periods previously specified for 15 closed-end funds with activist-induced tender offers. For eight funds (highlighted in blue), the excess discount during the one-year period after the tender offer is wider when compared with the one-year period before the initial Schedule 13D activist filing. For these funds, the intrusion of the activist, which harmed long-term investors with higher expense ratios, did not have a lasting impact on the funds' excess discount.

For the other seven funds highlighted in yellow, the excess discount narrows during the one-year period after the tender offer when compared with the one-year period prior to the initial Schedule 13D filing. The excess discount narrowed significantly for four of these funds. The most likely reason for this is that when the tender offer was announced, the activist shareholder pushed for, and each of these four funds also announced, a managed distribution plan to be in place for multiple years. Managed distribution plans are considered one method to reduce closed-end fund discounts because they promise a stable distribution rate that closed-end fund shareholders typically seek (Cherkes, Sagi, and Wang 2014). This is also consistent with survey participant responses to an ICI survey in 2019 on closed-end fund discounts. The majority of respondents indicated that managed distribution plans helped to narrow discounts in the long term.

Last, one common trend more obvious for some of the funds in Figure C.13 is that activist-induced tender offers generally narrow the excess discount in the short term. Since the fund is about to realize a price for its shares at or close to NAV, it makes sense for the secondary market price to get closer to NAV as well. These results also are consistent with the ICI survey in 2019 on closed-end fund discounts. The majority of respondents indicated that tender offers and stock buybacks/share repurchases had short-term effects in reducing discounts for their funds but did not materially affect the discount in the long term.

**Figure C.13**  
**No Evidence That Tender Offers “Unlock Long-Term Value” for CEF Shareholders**  
 Excess discount over specified period<sup>1</sup>

Excess discount widened after tender offer				
Excess discount narrowed after tender offer				
CEF	One year prior to initial 13D filing by activist	Period between initial 13D filing and tender offer	Tender offer period	One year after tender offer period
FBT1 <sup>2</sup>	-1.5%	-1.8%	-2.9%	-6.1%
F8T1	-2.2%	-1.6%	-2.2%	-5.9%
FCT1 <sup>2</sup>	-0.8%	-2.7%	0.4%	-4.4%
F0T1 <sup>3</sup>	-4.1%	-3.1%	-4.1%	-7.2%
F2T1	-2.7%	-2.0%	-0.8%	-5.3%
FAT1 <sup>2</sup>	-2.9%	-1.1%	0.3%	-3.7%
FET1 <sup>3</sup>	-3.8%	-4.2%	-2.7%	-4.5%
FDT1 <sup>2</sup>	-0.7%	1.1%	6.9%	-1.4%
F6T1 <sup>2</sup>	-4.0%	-2.8%	-1.8%	-3.5%
F7T1 <sup>2</sup>	-9.2%	-5.1%	-3.5%	-8.0%
F9T1	-3.0%	-1.1%	-0.8%	-1.1%
F1T1 <sup>2,4</sup>	-6.0%	-2.0%	0.0%	-3.7%
F3T1 <sup>4</sup>	-6.0%	0.6%	1.9%	-0.7%
F5T1 <sup>4</sup>	-7.6%	-1.6%	1.0%	-2.0%
F4T1 <sup>4</sup>	-6.1%	-0.1%	0.9%	0.9%

<sup>1</sup>*Excess discount* is the simple average discount of the given CEF over the specified period minus the simple average discount of all funds in the same investment objective over the specified period.

<sup>2</sup>Some funds liquidated or merged within one year following the tender offer. In these cases, the “one year after tender offer period” is the excess discount over the period in which the fund was active. Similarly, this same thing is done for any fund whose tender offer period was after September 30, 2018.

<sup>3</sup>One or more funds merged into these funds at some point during the overall period of the sample.

<sup>4</sup>In addition to a tender offer, the fund also implemented a managed distribution plan to last multiple years. Managed distribution plans are considered one method to reduce closed-end fund discounts. For more information, see Cherkes, Sagi, Wang 2014.

Note: Data include closed-end funds targeted by activists and held a tender offer between 2016 and 2018.

Sources: Investment Company Institute and Bloomberg

## Appendix C References

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## **Appendix D: Takeover Defenses Authorized by State Law**

State law expressly recognizes a number of defensive measures that may be employed by companies and their boards facing unwanted activist efforts. While in some cases state legislatures have codified these defenses, others have been authorized instead by decisions of state courts.

Given the often unique circumstances of activist efforts in the closed-end fund setting, some commonly recognized defense strategies that operating companies employ are not likely to be of practical use to a closed-end fund board. For example, activist investors do not typically seek to take control of a closed-end fund via a merger of the target fund with another fund controlled by the activist. Accordingly, defenses built around making a merger less attractive or soliciting an alternative merger candidate are not likely to be of use to a closed-end fund. Discussed below are several commonly recognized takeover defenses that might realistically be of practical use to a closed-end fund facing an unwelcome challenge. We have not attempted here to provide an exhaustive catalog of all variations on defensive measures that fund boards have used or could seek to use.

The defenses discussed below are loosely divided into two groups—those that could be seen as potentially implicating the “equal voting rights” provision in Section 18(i) of the Investment Company Act, and those that realistically could not.

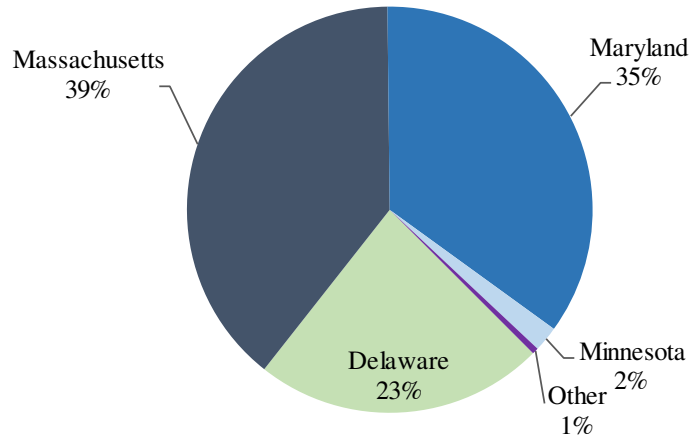
As of year-end 2019, 39 percent of closed-end funds were domiciled in Massachusetts, 35 percent were domiciled in Maryland, 23 percent were domiciled in Delaware, and the remainder were domiciled in Minnesota (2 percent) or elsewhere (1 percent) (Figure D.1).



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**Figure D.1**  
**Ninety-Seven Percent of Closed-End Funds Are Domiciled in Massachusetts, Maryland,**  
**and Delaware**

Percentage of funds, year-end 2019



Note: Data include closed-end funds that do not report statistical information to the Investment Company Institute but exclude interval funds and business development companies.

Source: Investment Company Institute

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Given that the vast majority of mutual funds are organized under the law of either Maryland, Delaware, or Massachusetts, the discussion below focuses on these three jurisdictions. Maryland funds are normally organized as corporations, whereas Delaware and Massachusetts funds are sometimes organized as corporations and sometimes as trusts (commonly referred to as “statutory trusts” in Delaware and “business trusts” in Massachusetts). Notably, statutory and decisional law regarding statutory and business trusts is in many areas not as well-developed as in the corporate setting. The courts of Delaware and Massachusetts will frequently (though not uniformly) apply principles established in the corporate setting to cases involving trusts.

**A. Takeover Defenses Implicating Voting Rights**

**1. Control Share Statutes**

Maryland and Massachusetts each have corporate “control share” statutes that allow corporations to check the power of would-be acquirers by divesting shareholders who hold a certain percentage of a company’s stock of their voting rights unless those voting rights are restored by the vote of a specified number of disinterested stockholders. The concentration of holdings required to trigger these statutes, as well as the number of disinterested shareholders that must authorize restoration of rights, differs by state.

In Maryland, a board of directors can elect for a fund to be subject to the Maryland Control Share Acquisition Act (MCSAA), which provides, in part, that holders of control shares (defined

as holding (i) 10 percent or more of a corporation's stock with less than one-third of all voting power, (ii) one-third or more of a corporation's stock but less than a majority of all voting power, or (iii) a majority or more of all voting power) "acquired in a control share acquisition have no voting rights with respect to the control shares except to the extent approved by the stockholders...by the affirmative vote of two-thirds of all the votes entitled to be cast on the matter, excluding all interested shares."<sup>122</sup> Md. Code Ann. Corps. & Ass'ns §§ 3-701, 3-702.<sup>123</sup>

Likewise under Massachusetts corporate law, A holder of (i) 20 percent or more of a corporation's stock with less than one-third of all voting power, (ii) one-third or more of a corporation's stock but less than a majority of all voting power, or (iii) a majority or more of all voting power, has no voting rights with respect to such stock unless a majority of the stock held by disinterested stockholders is voted in favor of restoring such rights. Mass. Gen. Laws Ann. ch. 110D, §§ 1, 5; Mass. Gen. Laws Ann. ch. 110E §§ 1, 5. This statute does not apply expressly to Massachusetts business trusts. While Massachusetts courts have frequently held provisions within the state's corporate statute to apply to business trusts where the trust statute is otherwise silent, no court has apparently weighed in on whether the control share statute applies to business trusts.

Delaware does not have an analogous control share statute.

## **2. Poison Pill / Shareholder Rights Plan**

Maryland, Massachusetts, and Delaware all permit some form of a so-called poison pill defense, which is also often referred to as a "shareholder rights plan." This defense allows a board to issue rights to stockholders to purchase additional company shares of the fund at a discount while excluding the would-be acquirer (or other high-concentration investors) from purchasing the additional shares, thus diluting the concentrated investor's interest in the company. The defense may be triggered when a shareholder acquires a certain percentage of holdings in the fund.

Under the Maryland corporate statute, the board of directors may set the "terms and conditions of rights, options or warrants under a stockholder rights plan" and "issue rights, options or warrants under a stockholder rights plan to designated persons or classes of persons." Md. Code Ann. Corps. & Ass'ns §2-201(c)(1). In addition, the board is expressly authorized to include in the rights plan any "limitation, restriction, or condition that...precludes, limits, invalidates, or voids the exercise, transfer, or receipt of the rights, options, or warrants by designated persons or classes of persons in specified circumstances..." *Id.* at §2-201(c)(2)(i). *Neuberger Berman Real Estate Income Fund, Inc.*, 342 F. Supp. 2d at 374-76.

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<sup>122</sup> The divestment of voting rights occurs each time a "control share acquisition" would increase the holder's shares into one of the ranges of voting power provided in the definition of "control shares." *See* Md. Code Ann. Corps. & Ass'ns §§ 3-701(e)(1)(i)-(iii). Thus, if an existing shareholder previously held between one-tenth and one-third of voting power and had that voting power approved by a two-thirds vote of non-interested shareholders, but engages in a control share acquisition that would increase that to between one-third and one-half of all voting power, Section 3-702(a)(1) would be triggered anew, divesting that shareholder of voting rights unless those voting rights except as provided by the statute.

<sup>123</sup> The MCSAA is the subject of the decision in *Neuberger Berman Real Estate Income Fund, Inc. v. Lola Brown Trust No. 1B*, 342 F. Supp. 2d 371, 373-74, n. 3 & 4 (D. Md. 2004), discussed in Appendix E.

Similar to Maryland, under the Massachusetts corporate statute:

The terms and conditions of any rights or options...may include, without limitation, restrictions or conditions that preclude or limit the exercise, transfer, receipt or holding of such rights or options by any person owning or offering to acquire a specified number or percentage of the outstanding stock or other securities of the corporation, or any transferees of any such persons, or that preclude or limit such actions based on such other factors, including the nature or identity of such persons, as the directors determine to be reasonable and in the best interests of the corporation.

Mass. Gen. Laws Ann. ch. 156B § 32A.

Although Delaware has no legislative authorization of poison pills, the Delaware Supreme Court has found that a board of directors may authorize the use of a shareholder's rights plan as a legitimate exercise of business judgment. *Moran v. Household International, Inc.*, 500 A.2d 1346, 1348 (Del. 1985) (permitting a shareholder rights plan entitling common stockholders to the issuance of one Right per common share when (1) there is an announcement of a tender offer for 30 percent of the company's shares or (2) 20 percent of the company's shares are acquired by a single entity or group). The court found that the board was authorized to adopt the shareholder rights plan under Delaware law and under the board's inherent powers to manage the corporations "business and affairs." *Id.* at 1353. Furthermore, "[c]omparing the Rights Plan with other defensive mechanisms, it does less harm to the value structure of the corporation than do the other mechanisms." *Id.* at 1354. Because the "Directors adopted the plan in the good faith belief that it was necessary to protect [the corporation] from coercive acquisition techniques" and the board "has demonstrated that the Plan is reasonable in relation to the threat posed," the adoption of the plan was protected by the business judgment rule. *Id.* at 1357. *See also Account v. Hilton Hotels Corp.*, 780 A.2d 245, 247-48 (Del. 2001) (affirming the lower court's ruling that "attack on the mechanism and format of the Rights Plan was foreclosed by a consistent body of law beginning with the seminal decision in *Moran*...upholding so-called 'poison pill' defenses bottomed on rights plans").

## **B. Defenses That Do Not Implicate Voting Rights**

### **1. Classified Boards**

The Maryland, Massachusetts, and Delaware corporate statutes all allow companies to classify their boards, although the mechanism for instituting a classified board varies somewhat by state. The Investment Company Act also authorizes the use of classified boards: "Nothing herein shall...preclude a registered investment company from dividing its directors into classes if its charter, certificate of incorporation, articles of association, bylaws, trust indenture, or other instrument or the law under which it is organized, so provides and prescribes the tenure of office of the several classes...." *See* 15 U.S.C. § 80a-16(a).

The board of directors of a Maryland corporation with a class of equity securities registered under the 1934 Act and at least three independent directors or trustees may elect to classify itself

notwithstanding any contrary provision in the charter or bylaws and without a stockholder vote. Md. Code Ann. Corps. & Ass'ns §§ 3-802, 3-803.

In Massachusetts, corporate directors may be divided into classes by the articles of organization or amendment to the articles by two-thirds vote (or a larger vote if provided for in the articles), provided the classes are elected from one to five years and at least one class's term ends each year. Mass. Gen. Laws ch. 156 § 22. There is no equivalent provision in the Massachusetts trust statute nor any cases specifically applying this provision to business trusts.

In Delaware, the charter, an *initial* bylaw, or a bylaw *adopted by a stockholder vote*, may divide the directors into as many as three classes, whose terms of office expire in successive years beginning with class 1 at the first annual meeting after the classification becomes effective. Del. Code tit. 8, § 141(d). This charter or bylaw provision, as the case may be, may authorize the board then in office to assign its members to the newly created classes. *Id.* There is no equivalent provision in the Delaware trust statute nor any cases specifically applying this provision to business trusts.

## **2. Requiring Majority of Outstanding Shares**

The Massachusetts corporate statute specifically states that a corporation's articles of organization or bylaws are controlling “[w]henever, with respect to any action to be taken by the stockholders of a corporation, the articles of organization or bylaws require the vote or concurrence of all of the shares, or of any class or series of shares thereof, or a greater proportion thereof than required by this chapter with respect to such action....” Mass. Gen. Laws. ch. 156B, § 8. Massachusetts courts have also expressly upheld “majority of outstanding” bylaws. *See W. Inv., LLC v. Deutsche Multi-Market Income Tr.*, No. SUCV20163082BLS1, 2017 WL 1103425, at \*1-3 (Mass. Super. Feb. 6, 2017) (dismissing a complaint alleging that a bylaw requirement that directors be elected by a majority of outstanding shares violated the duties of loyalty and good faith, was unconscionable, and violated the 40 Act).

Although the Delaware corporate statute provides by default that an affirmative vote of the majority of shares present at a stockholder meeting is sufficient to transact business on a subject, Delaware law also allows a company's certificate of incorporation or bylaws to specify the number of shares required for any action at a stockholder meeting and does not preclude a “majority of outstanding shares” requirement. Del. Code Ann. tit. 8 § 216(3). Indeed, for certain matters (mergers, charter amendments, sales of substantially all assets, and dissolutions), the default under Delaware law is to require approval of a majority of outstanding shares. *See, e.g.*, Del. Code Ann. tit. 8 §§ 242(b)(1), 251(c), 271(a), & 275(b).

Maryland law provides the same default voting provision as Delaware law, but also allows amendment of the votes required to approve a matter through the corporations' charter. Md. Code Ann. Corps. & Ass'ns § 2-506(a).

## **3. Continuing Director Provisions**

The Delaware corporate statute expressly authorizes differentiation among the voting power of directors:

The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected separately by the holders of any class or series of stock may be greater than or less than those of any other director or class of directors. In addition, the certificate of incorporation may confer upon 1 or more directors, whether or not elected separately by the holders of any class or series of stock, voting powers greater than or less than those of other directors. Any such provision conferring greater or lesser voting power shall apply to voting in any committee, unless otherwise provided in the certificate of incorporation or bylaws.

#### **4. Antitakeover Statutes**

Maryland, Massachusetts, and Delaware corporate statutes all include what are referred to as “antitakeover statutes” that are intended to deter hostile takeover efforts by prohibiting shareholders holding a certain percentage of a corporation’s stock from engaging in a business combination with the corporation for a set length of time after obtaining the requisite percentage of stock.

In Maryland, an owner of 10 percent or more of a corporation’s outstanding voting stock is prohibited from engaging in a business combination within five years after the person acquired such ownership, unless the combination is approved by: (1) the board of directors; (2) two-thirds of the outstanding voting stock not held by that person; *and* (3) “80 percent of the votes entitled to be cast by outstanding shares of voting stock of the corporation....” Md. Code Ann. Corps. & Ass’ns §§ 3-601, 3-602.

In Massachusetts, an owner of 5 percent or more of a corporation’s stock may not engage in a business combination with the corporation within three years after the person acquired such ownership, unless, among other options, the board approved the transaction that resulted in the person exceeding 5 percent ownership or the business combination is approved by two-thirds of the outstanding voting stock of non-interested stockholders. Mass. Gen Laws Ann. ch. 110F §§ 1, 3. There is no equivalent provision in the Massachusetts trust statute nor any cases specifically applying this provision to business trusts.

In Delaware, an owner of 15 percent or more of a corporation’s outstanding voting stock at the time of the transaction may not engage in a business combination with the corporation within three years after the transaction, unless: (1) the board approved the business combination or the transaction that resulted in the person exceeding 15 percent ownership or the business combination; (2) the interested stockholder owned at least 85 percent of the voting stock outstanding at the time the transaction is commenced; or (3) the business combination is approved by two-thirds of the outstanding voting stock of the non-interested stockholders. Del. Code tit. 8, § 203(a). There is no equivalent provision in the Delaware trust statute nor any cases specifically applying this provision to business trusts.

## **5. Stock Repurchase**

In Delaware, the board of a corporation may vote to repurchase the company's shares from existing shareholders, thereby effectively increasing the voting power of shareholders unresponsive of the takeover and potentially preventing the would-be acquirer from acquiring enough stock to effect a takeover. *See* Del. Code tit. 8, § 160(a); *see also* *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1388 (Del. 1995) (“A selective repurchase of shares in a public corporation on the market, such as Unitrin’s Repurchase Program, generally does not discriminate because all shareholders can voluntarily realize the same benefit by selling.”).

## **6. Shark Repellent**

Delaware court precedent permits corporations to include so-called shark repellent provisions in the corporation’s bylaws or articles of incorporation “to deter a bidder’s interest in that company as a target for a takeover.” *Unitrin*, 651 A.2d at 1377 n. 19. For example, a Delaware court has upheld a provision requiring transactions with shareholders holding more than 15 percent of the vote to be approved by 75 percent of the other shareholders or by the majority of the directors. *See id.* at 1378.

## **7. Greenmail**

Greenmail involves the practice of “buying out a takeover bidder’s or dissident’s stock at a premium that is not available to other stockholders” to prevent a takeover. *Polk v. Good*, 507 A.2d 531, 537 n.3 (1986). Delaware courts have expressly permitted corporations to repurchase the activist investors’ stock to prevent insurrection “[u]nless the primary or sole purpose was to perpetuate the directors in office.” *See id.* at 536. Research revealed no statutes or case law in Maryland or Massachusetts prohibiting this practice. However, this option is generally unavailable in the closed-end fund setting, as Rule 23c-1 prohibits the selective repurchase of fund shares at a price above the current market price, where the stock is trading at a discount to NAV. *See* 17 C.F.R. § 270.23c-1(a)(6).

## **8. Standstill Agreement**

In Delaware, corporations may execute a standstill agreement with activist investors in which the activist investors agree to not purchase further shares during an agreed upon period of time. *See Ivanhoe Partners v. Newmont Min. Corp.*, 535 A.2d 1334, 1337 (Del. 1987). Research revealed no statutes or case law in Maryland or Massachusetts prohibiting this practice.

## **Appendix E: Legislative History of Investment Company Act Provisions**

Section 18(i) of the Investment Company Act was enacted in 1940 and has not been substantively amended in the 80 years since. *See* Pub. L. No. 76-768, 54 Stat. 789.

### **A. Background of Investment Company Act of 1940**

Although Congress had enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, these Acts “were essentially designed to protect investments by the public in traditional types of securities....They were not geared to the protection of those who invest in mutual funds or other types of investment companies.” Walter P. North, *Brief History of Federal Investment Company Legislation*, 44 Notre Dame L. Rev. 677, 677 (1969) (hereinafter “*Investment Company Legislation*”).

As such, in Section 30 of the Public Utility Holding Company Act of 1935, Congress directed the SEC to:

make a study of the functions and activities of investment trusts and investment companies, the corporate structures, and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to Congress....

15 U.S.C. § 79z-4 (1935). The final report, titled *Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies*, was presented to Congress in several parts starting in 1938 and made a part of the congressional record. *Investment Company Legislation* at 678 n.7; H.R. Doc. No. 76-279 (hereinafter (“SEC Report”). In conjunction with the SEC Report, the SEC submitted to Congress a draft bill entitled, in relevant part, “[t]o provide for the registration and regulation of investment companies,” which was introduced in the Senate as S. 3580 on March 14, 1940.

Although S. 3580 underwent substantial amendment prior to the eventual enactment of the Investment Company Act of 1940 (eventually introduced as a substitute bill, S. 4108), S. 3580 was the precursor to the eventual Investment Company Act and analysis of the bill and the accompanying SEC Report inform the purposes behind the Investment Company Act and Section 18(i). *See Investment Company Legislation* at 680. The SEC Report noted that voting securities were commonly held by fund insiders, while securities with limited voting power were held by the public, creating two classes of shareholders with a significant imbalance of power. SEC Report at 1594. In particular, it was common for investment advisers to issue preferred stock with limited to no voting power. *Id.* at 1573. Issuing stock that had little or no voting power allowed a fund’s management to consolidate control of the company because fewer funds were needed to purchase a majority of the voting stock and retain control of the corporation. *Id.* at 1582.

The SEC and Congress expressed concern about this inequity. Specifically, they feared that an insider would hoard the voting stock, rendering him “the arbiter of the affairs of the company, which power he may exercise to his personal advantage.” *Id.* at 1641. Moreover, the Report noted that even the limited voting rights of preferred stock had “been evaded and nullified by practices

of existing managements,” who could make decisions to drive down the value of the corporation without the input of the shareholders with the right to vote on ultimate issues such as the liquidation of the company. *Id.* at 1709. The SEC noted in Senate hearings that unbalanced voting rights contributed to common industry problems such as risky investments, securities dumping, and mergers that could have been prevented by “more representative and democratic voting privileges...” *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 1034 (1940) (hereinafter “*Hearings*”).

In introducing the final bill, S. 4108, the Senate further recounted the issues that gave rise to the need for regulation in this area, namely to protect individual investors from those trying to exploit the fund for personal gain:

Basically the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies....

Sen. Rep. No. 76-1775 at 6 (1940).

## **B. Section 18(i)**

Section 18(i) requires that “every share of stock...shall be a voting stock and have equal voting rights with every other outstanding voting stock...” 15 U.S.C. § 80a-18(i). This section appears within the broader Section 18 titled “Capital structure of investment companies,” which was enacted to address structural inequities within investment funds. 15 U.S.C. § 80a-18. The SEC Report contained a similarly titled section—“Problems in Connection with Capital Structure”—revealing the underlying issues in the investment industry that Congress sought to address through the enactment of Section 18(i)—namely, disenfranchisement of the “public” (*i.e.*, retail investors). SEC Report at 1563.

Although the legislative history does not reflect substantial discussion of Section 18(i), S. 3580 contained a precursor to the modern Section 18(i), which provided that each security “is a voting security, and has equal voting rights with every voting security of such company...” *Hearings* at 1034. SEC Commissioner Robert E. Healy remarked during the hearings on S. 3580 that “too often investments trusts and investment companies were organized and operated as adjuncts to the business of the sponsors and insiders to advance their personal interest at the expense of and to the detriment of the stockholders.” *Id.* at 37. An SEC memorandum submitted to the Senate during the 1940 Hearings discussed the constitutionality of Section 18, and identified the actions of unscrupulous insiders as the motivation behind providing equal voting rights to shareholders. *Id.* at 1019-1020. “The centralization of control in small minorities has been used



for the purpose of manipulation and overreaching. No one has a ‘vested right’ in the perpetration of a scheme of voting privileges which permits such practices....” *Id.*

After the enactment of the Investment Company Act, the SEC confirmed that “[m]any provisions of the act are attempts to insure [*sic*] that the companies shall be honestly run *in the interests of all classes of shareholders.*” *SEC Legislation: Hearings Before a Subcomm. on the Committee on Banking and Currency, 86th Cong. 484 (1959)* (staff memorandum on amendments to the Investment Company Act) (emphasis added).

The policy goals of the Investment Company Act generally—and Section 18’s capital structure requirements in particular—were made more concrete in the statute’s prefatory language as enacted in Section 1. Section 1(a) set forth various “findings” regarding the need for federal regulation of investment companies, based upon the record before Congress (and in particular the SEC’s Report). *See* 15 U.S.C. § 80a-1(a). Based upon the same record, Section 1(b) in turn listed a set of eight investment company-related “conditions” by which “the national public interest and the interest of investors are adversely affected.” 15 U.S.C. § 80a-1(b). The listed “conditions” potentially relating to capital structure and voting rights are the following:

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies’ security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

\* \* \*

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders ....

*Id.* Having enumerated these detrimental conditions, the statute’s overarching policy was then articulated as follows:

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

*Id.* Significantly, while the language of the SEC Report and discussion in the 1940 Hearings referred in many instances to concerns over undue control by “insiders,” when articulating this concern in Section 1(b)’s policy statement, the description of the relevant actors of concern was expanded. Section 1(b)(2) of both versions of the Senate bill and the final statutory language included certain “outsiders” as candidates for exercising undue control over investment companies in their own self-interest:

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, *or other affiliated persons thereof*...rather than in the interest of all classes of such companies’ security holders.

15 U.S.C. § 80a-1(b)(2) (emphasis added). Both versions of the Senate bill and the final statutory language in turn defined “affiliated persons” to include “any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person.” 15 U.S.C. § 80a-2(a)(3). Hence, in addition to the enumerated insiders (*i.e.*, directors, officers, investment advisers and depositors), the statute *also* expressly states Congress’s intent to protect against funds being managed in the interest of investors who become “affiliated persons” of the fund by purchasing a 5 percent share (*i.e.*, outsiders with potentially controlling ownership interests).

### C. Section 12(d)(1)

Congress’s purpose to guard against self-interested control by both management insiders and “outsiders” with concentrated holdings is confirmed by other provisions of the Investment Company Act, in particular Sections 12(d)(1)(A) & (C). *See* 15 U.S.C. § 80a-12(d)(1). The modern language of Sections 12(d)(1)(A) & (C) was implemented in 1970, although a precursor to the modern Section 12(d)(1)(A) also appeared in the 1940 version of the Investment Company Act. *Id.*; Pub. L. 91-547, § 7, 84 Stat. 1417 (1970). The current version of Section 12(d)(1)(A) of the Investment Company Act provides that:

It shall be unlawful for any registered investment company (the “acquiring company”) and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the “acquired company”), and for any investment company (the “acquiring company”) and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the “acquired company”), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate—

- (i) more than 3 per centum of the total outstanding voting stock of the acquired company;
- (ii) securities issued by the acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or

(iii) securities issued by the acquired company and all other investment companies (other than treasury stock of the acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of the acquiring company.

15 U.S.C. § 80a-12(d)(1)(A). The current version of Section 12(d)(1)(C) further provides that:

It shall be unlawful for any investment company (the “acquiring company”) and any company or companies controlled by the acquiring company to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition the acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own more than 10 per centum of the total outstanding voting stock of such closed-end company.

15 U.S.C. § 80a-12(d)(1)(C). This language has been in place since 1970, the only time that Section 12(d)(1)(A) and Section 12(d)(1)(C) were substantively amended. *See* Pub. L. 91-547, § 7, 84 Stat. 1417 (1970).

The original language of Section 12(d)(1) enacted in 1940 contained somewhat different restrictions than what was implemented in the 1970 amendment. The Investment Company Act originally differentiated between an investment company purchasing or acquiring securities in another investment company based on the policy of the target company: “if the policy of [the acquired] company is the concentration of investments in a particular group or industry,” then the acquiring company could not obtain more than 5 percent of the total outstanding voting stock; if the policy “is not the concentration of investments in a particular industry or group of industries,” then the acquiring company could not obtain more than 3 percent of the total outstanding voting stock. Pub. L. 76-768 c. 686, Title I, § 12(d)(1)(A), 54 Stat. 808-09 (1940). The initial statute did not contain the prohibition on owning securities in the acquired company (1) with a value of more than 5 percent of the value of total assets of the acquiring company or (2) with a value in excess of 10 percent of the total assets of the acquiring company, nor did the initial statute contain the prohibition on owning more than 10 percent of the total outstanding voting stock of a closed-end company.

The bill as initially introduced in the Senate, S. 3580, contained even more restrictive language: with limited exceptions, “[i]t shall be unlawful for any registered investment company to purchase or otherwise acquire any security issued by, or any other interest in the business of—any other investment company....” S. 3580, 76th Cong. § 12(c)(1) (1940). The prohibition stemmed from the idea that there is “no useful function served by pyramiding one company upon the other...[and] that it is a distinct disadvantage to the stockholders.” *Hearings* at 180.

In essence, pyramiding is nothing but a device whereby insiders get control of substantial amounts of the public’s funds without any substantial investment on their own part. All they have to do is to get control of one company and then use the funds of that company to buy another, and use the funds of that company to buy another.

*Id.* In Senate testimony on S. 3580, Chief Counsel of the SEC called this a “flat prohibition.” *Id.* at 237. It is clear from the context that the “insiders” referred to here are the insiders of the *acquiring* company, who are presumably “outsiders” of the acquired company in the typical case.

The total prohibition was criticized in the hearings, including by the president of an open-end mutual fund who called out the prohibition for “not permit[ing] the inclusion of listed securities of investment companies, no matter how attractive they might be.” *Id.* at 664. Others submitted proposed edits to Section 12, suggesting that the prohibition should be on investment companies purchasing more than a certain percent (either 5 or 10 percent) of the stock of another investment company, which would “put an end to pyramiding” but still “make it practically possible for general investment companies to hold stock in an investment company specializing in a particular industry” so that the investing company need not diversify its investments itself or “incur the substantial expense of maintaining a specialized research department for the purpose” of diversifying investments in a specialized industry. *See, e.g., id.* at 1055, 1063.

After discussions and negotiations with industry stakeholders, the SEC submitted a revised bill to the Senate that had the approval of the SEC and the industry. *Id.* at 1106. At this point, Section 12 had been amended to remove the blanket prohibition of an investment company purchasing the securities of another investment company and instead include a provision such that “one investment company may own the securities of any investment company to the extent of 3 percent of the outstanding voting securities of the investment company, *which means that in reality the acquiring company has no effective voice in the other investment company.*” *Id.* at 1114 (emphasis added). The purpose of allowing some investment in other investment companies was that industry representatives “felt that if one investment company’s securities happened to be a good buy, another investment company should be able to acquire such securities although they were conscious of the fact that pyramiding should not be any longer permitted.” *Id.* Thus, the compromise permitted limited investments in other investment companies when such investments made economic sense while attempting to ensure that the acquiring company was not able to obtain a disproportionate voice in the acquired company.

In a 1966 report to Congress, the SEC stated that the percentage limitations in Section 12(d)(1) were intended to guard against the abuses mentioned in Sections 1(b)(2) and 1(b)(4), namely adverse effects on public interest and investors when investment companies are organized and operated in the interest of other investment companies or when control of investment companies is “unduly concentrated through pyramiding or inequitable methods of control.” *See* SEC, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337, ch. 8, at 315 (1966) (citing 15 U.S.C. 80a-1(b)(2)-(4)).

The SEC Report further emphasized that “fund holding companies...pose a real potential for the exercise of undue influence or control over the activities of portfolio funds.” *See* SEC Report at 315. The risk stems from two potential threats: “the possibility of large-scale redemptions inherent in the ownership of large blocks of mutual fund shares by a fund holding company” and the threat that even under the 12(d)(1) limitations:

[A] single management group could attempt to organize several related fund holding companies. If each held 3 percent of the outstanding voting securities of the same registered mutual fund, the management of that portfolio fund, aware of

the possibility of simultaneous liquidation, might find itself in a difficult position....This potential for control, basic to the fund holding company structure, carries with it obvious dangers to investors in registered investment companies. The management of a fund holding company may, by threat of redemption, induce deviations from the investment program or policy of registered companies subject to its influence. Should such influence be exercised, and to the extent it is so exercised, the management of the portfolio companies concerned would pass to persons other than those chosen by the stockholders to perform that function.

*Id.* at 316.

Emphasizing the growth of fund holding companies since 1962, the SEC stated that “the organization and operation of a registered fund holding company whose primary purpose is the acquisition of shares of other registered investment companies, even within the percentage limitations presently permitted by section 12(d)(1), raises issues of substantial concern,” including that “it is doubtful whether a fund holding company serves any really useful function for the investor.” *Id.* at 322. This conclusion led the SEC to recommend “that section 12(d)(1) of the [Investment Company] Act be amended so as to prevent the creation and operation of fund holding companies.” *Id.* at 323. In the context of closed-end funds, the SEC noted the additional risk that “the power to vote a significant block of stock of a closed-end company may represent potential for exercise of control.” *Id.* at 324.

Congress subsequently amended the Investment Company Act in 1970 to adopt the current language of Section 12(d)(1)(A) and (C). In doing so, House Subcommittee on Commerce and Finance recounted the potential harms of fund holding companies, noting that “[t]he existence of fund holding companies as large shareholders in other investment companies creates a potential for harm which could be especially marked when the portfolio of the fund holding company consists of mutual fund shares.” *Hearings on H. 9510 before the House Subcomm. on Commerce & Finance, 90th Cong., 1st Sess. at 77 (1967)*. The harms included the potential for the holding company’s manager to gain undue influence over the managers of the underlying funds as a result of their concentrated holdings (such as the ability to demand redemption of the fund at any time). *Id.* The bill as introduced in the House sought to “prohibit fund holding companies[] while avoiding interference with the exercise of the investment judgment of investment company managers for *occasional limited purchases of securities issued by other investment companies.*” *Id.* at 78 (emphasis added).

Congress also emphasized that the purpose was “to limit the creation and operation of new fund holding companies and the further enlargement of existing companies of this type.” *Hearings on S. 34 before the Senate Comm. on Banking and Currency, 91st Congress, 1st Sess. at 1514 (1969-70)*. With respect to closed-end companies, Congress noted the particular opacity with respect to fund ownership:

The stock of closed-end companies is usually bought and sold in the secondary trading markets rather than through the issuance of new shares as in the case of open-end companies. Because of this fact, it would be much more difficult for a buyer or a seller to know how much of a closed-end company’s stock was owned by investment companies generally. Therefore, in this case, it is appropriate to have

the prohibition [on acquiring more than 10 percent of the fund] apply to the buyer...and to apply the 10-percent test only to the holdings of the acquiring company, other investment companies with the same investment adviser, and companies controlled by such investment companies.

*Id.* Thus, as with Section 18(i), the inclusion of Section 12(d)(1) in the Investment Company Act indicates that Congress was concerned not just with the threats and abuses of management “insiders,” but also the threat posed by other funds obtaining concentrated holdings in a fund to the detriment of individual shareholders.

## **Appendix F: SEC and Court Interpretations of Section 18(i)**

Section 18 of the Investment Company Act governs the capital structure of investment companies. Section 18(i) provides in relevant part as follows:

Except as provided in subsection (a) of this section, or as otherwise required by law, every share of stock hereafter issued by a registered management company (except a common-law trust of the character described in section 80a-16(c) of this title) *shall be a voting stock and have equal voting rights with every other outstanding voting stock*: Provided, That this subsection shall not apply to...shares issued in accordance with any rules, regulations, or orders which the Commission may make permitting such issue.

15 U.S.C. § 80a-18(i) (emphasis added). This version of the provision was enacted as part of the original statute in 1940, and it has not been substantively amended in the interim.

The referenced exception in Section 18(a) allows closed-end funds to issue senior securities (e.g., preferred stock) under specified conditions, including that “provision is made to entitle the holders of such senior securities, voting as a class, to elect at least two directors at all times...” 15 U.S.C. § 80a-18(a)(2).

In 1948, the Securities and Exchange Commission responded to an application under Section 18(i) from the Solvay American Corporation, a closed-end fund, for an order permitting it to issue preferred stock containing certain protective provisions and voting rights. *In the Matter of the Solvay Am. Corp.*, 27 S.E.C. 971 at \*1 (Apr. 12, 1948). Solvay wished to require two-thirds of the outstanding preferred stock to consent by a two-thirds vote to various actions of the fund that would adversely affect their interests and prohibit preferred shares from voting for the directors that must be elected by the common stockholders. *Id.* The SEC concluded that “equality of voting rights [under Section 18(i)] does not require that they be given an opportunity to vote for directors other than the directors to whom they are entitled to elect by a class vote” under Section 18(a). *Id.* at \*2. It also noted that all shares had equal voting rights other than for the election of directors and the issues of “particular interest” to preferred shareholders. *Id.* The SEC granted Solvay’s application to enact these measures. *Id.* at \*3.

In *Solvay*, the Commission acknowledged that Congress did not discuss the meaning of “equal voting rights” at the time of the Investment Company Act’s enactment. *Solvay Am. Corp.*, 27 S.E.C. 971 at \*1.

It is apparent that in certain cases an inflexible adherence to any rigid interpretation could produce grave distortions of the apparent intent of Congress to require a reasonably equitable distribution of voting power consistent with the applicable provisions pertaining to the different classes of stock. What might constitute a reasonable interpretation of ‘equal voting rights’ in one case might produce an extremely inequitable condition in another. We feel, therefore, that each individual case must be decided upon the particular factors involved.

*Id.* at n.9. Accordingly, the Commission concluded that in the absence of a definition from Congress, the SEC would adopt a flexible approach and “rely on the general purposes of the statute” as guidance for interpretation. *Id.*

In 1989, a closed-end fund sought no-action relief under Section 18(i) in order to issue auction rate preferred shares (“ARPS”) in staggered auction periods. *Allstate Mun. Premium Income Tr.*, Fed. Sec. L. Rep. P. 79,316 at \*1 (S.E.C. No-Action Letter July 14, 1989). This auction structure was designed to provide lower dividend rates to stockholders; despite the staggered offering, each share would have one vote. *Id.* The SEC staff recommended no enforcement action based on the closed-end fund’s representation that no series of ARPS would have priority over another for distribution of assets. *Id.*

Also in 1989, another closed-end fund requested the staff’s interpretation of Section 18(i) in connection with its proposed offer of taxable rate preferred stock (TARPS) valued at 10,000 its common stock. *Drexel Burnham Lambert Inc.-Tarps*, Fed. Sec. L. Rep. P 79,317 at \*1 (S.E.C. No-Action Letter June 14, 1989). Under this plan, each common stock would have one vote per share and the TARPS would have “one vote per share or one vote per \$1,000 of liquidation preference (*i.e.* 100 votes per share).” *Id.* The SEC staff recommended no enforcement action because TARPS stockholders would likely be sophisticated or institutional investors due to the \$100,000 minimum purchase requirement, and both classes of stock would have voting rights. *Id.* at \*2.

In 1992, the SEC staff recommended that no enforcement action be taken against a fund that sought “to provide shareholders with one vote for each dollar of net asset value per share.” *Sentinel Grp. Funds, Inc.*, Fed. Sec. L. Rep. P 76,431 at \*1 (S.E.C. No-Action Letter Oct. 27, 1992). This initiative would bind voting power to the value of the investment rather than the number of shares held. *Id.* The staff’s letter noted that since the net asset value of each stock within a class would be the same, relative voting power within the class would remain the same. *Id.*

In 1994, the SEC staff recommended that no action be taken against a business development company that sought to issue “participating securities” with no voting rights to the US Small Business Administration (SBA). *Philadelphia Ventures Liberty Fund, L.P.*, 1995 WL 153603, at \*1 (S.E.C. No-Action Letter Feb. 14, 1995). The no-action letter stated that because the SBA had regulatory authority over the business development company, there was no need for the SBA to also receive voting rights. *Id.* at \*2. The SEC’s decision was based on the “general purposes of the statute.” *Id.* at \*1.

In 1995, the Commission adopted Rule 18f-3 that created a limited exemption from Rule 18(i) and allowed open-end funds to issue multiple classes of shares while limiting the potential differences between classes as to voting rights. 17 C.F.R. § 270.18f-3. It also provided that matters exclusively affecting one class of the fund must be voted on by only shareholders of the affected class. Exemption for Open-End Mgmt. Inv. Cos. Issuing Multiple Classes of Shares; Disclosure by Multiple Class & Master-Feeder Funds; Class Voting on Distribution Plans, Release No. 7143 at \*7 (Feb. 23, 1995).

Although courts have not had frequent occasion to interpret Section 18(i), the District of Maryland held that stock purchase agreements (*i.e.*, poison pills) do not violate Section 18(i). *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust*, 342 F. Supp. 2d 371, 376



(D. Md. 2004). There, a closed-end fund faced a challenge from activist investors who made partial tenders offers seeking to acquire 50 percent of the fund's shares, intent on changing the fund's investment adviser and switching its investment objective. *Id.* at 372-73. In response to the activist shareholders' tender offer, the board entered a stock purchase agreement that reduced the activist holdings to below ten percent. *Id.* at 373. The board also opted in to the Maryland Control Share Acquisition Act (MCSAA), Md. Code. Ann. Corps. & Ass'ns § 3-701, that requires shareholders with more than 10 percent of the company to have their vote ratified by two-thirds of the disinterested shareholders. *Id.* at 373-74. Finally, the board enacted a shareholder rights agreement (or poison pill) that declared a dividend of one "right" for each outstanding share of common stock. The right allowed shareholders to purchase three additional shares of common stock at par value, but eliminated the rights of acquirers of more than 11 percent of the common stock after the dividend. *Id.* at 374.

The activist shareholders argued that the poison pill violated Section 18(i) of the Investment Company Act because the statute restrains their right to purchase three shares and exercise those shares' voting rights under the shareholder rights agreement. *Neuberger Berman Real Estate Income Fund Inc.*, 342 F. Supp. 2d at 375-76. The District of Maryland rejected that argument:

The triggering of the poison pill...does not revoke voting rights from any shares. Although the triggering of the poison pill will result in a reduction of the Acquiring Person's ownership interest, this is an issue of dilution of economic interest and corresponding voting power and has *nothing to do with the voting rights of the shares themselves.*

*Id.* at 376 (emphasis added). The court reasoned that under the poison pill, each share still had equal voting power. *Id.* The court also rejected the activists' argument that the poison pill violated Section 18(d) of the Investment Company Act, which requires all rights and warrants to be issued "exclusively and ratably to a class or classes" of the fund's security holders. 15 U.S.C. 80a-18(d). In rejecting the Section 18 arguments, the court relied on a holding of the Delaware Supreme Court on closely analogous facts:

The Supreme Court of Delaware held in *Providence and Worcester Company v. Baker*, 378 A.2d 121 (Del.1977), that voting restrictions applicable to shareholders with larger holdings are permissible and do not violate Delaware law requiring that all shares of stock within the same class have uniform voting rights. The court concluded:

In the final analysis, these restrictions are limitations upon the voting rights of the stockholder, not variations in the voting powers of the stock per se. The voting power of the stock in the hands of a large stockholder is not differentiated from all others in its class; it is the personal right of the stockholder to exercise that power that is altered by the size of his holding.

*Id.* at 375 (quoting *Providence and Worcester Co.*, 378 A.2d at 123).

In 2009, the Director of the SEC's Division of Investment Management gave a speech suggesting that poison pills "may be inconsistent with federal law and not in the best interest of

the fund and its shareholders.”<sup>124</sup> He also asserted that state control share statutes were inconsistent with Section 18(i) of the Investment Company Act and that they deny shareholders with controlling interests the right to vote those shares, which “may violate the fundamental requirement that every share of fund stock be voting stock.” *Id.*

In 2010, the SEC staff—in particular, the Office of Chief Counsel of the Division of Investment Management—responded to the Boulder Total Return Fund’s request for interpretation of Section 18(i). *Boulder Total Return Fund, Inc.*, 2010 WL 4630835, at \*1 (S.E.C. No-Action Letter Nov. 15, 2010). The closed-end fund was considering opting into the MCSAA to prevent a potential activist challenge, but was “concerned” that “the MCSAA, when implemented as an antitakeover measure for the Fund...might result in a violation of Section 18(i) of the Act.” *Id.* at \*13.

The staff acknowledged “that directors of [closed-end funds] such as the Fund must often perform a difficult balancing function when faced with the prospect of a takeover attempt.” *Id.* at \*2. The staff opined that “the use of the MCSAA by the Fund to restrict the ability of certain shareholders to vote ‘control shares’...would be inconsistent” with Section 18(i)’s equal voting rights provision and the Investment Company Act generally because “[s]uch a tactic would discriminate against certain shareholders by denying important voting rights and would contribute to the entrenchment of management.” *Id.* The staff reasoned that opting into the MCSAA “would be inconsistent with the *wording of*, and *purposes underlying*, Section 18(i).” *Id.* at \*5 (emphases added).

The staff noted that the purpose of the MCSAA was to “seek to compel prospective acquirers to deal directly with a corporation’s management, rather than obtaining significant voting power through market purchases of such corporation’s shares.” *Id.* at \*3. The letter emphasized that Congress adopted Section 18(i) “to address the use of various devices of control by investment company insiders that were intended to effectively deny public shareholders any real participation in the management of their companies.” *Id.* (quotations omitted). Citing examples of actions commonly taken by “insiders” to maintain control of funds at the time, the staff reasoned that Section 18(i) was implemented to prevent these actions by insiders, prevent entrenchment of insider control “by affording universal suffrage” to shareholders, and ensure “that each investment company shareholder has a vote proportionate to his or her stock holdings.” *Id.* at \*6.

The letter continued its discussion of the purposes underlying Section 18(i) by looking to Congress’s prefatory language in Section 1(b) of the Investment Company Act, in particularly that “the provisions of the Act be interpreted ‘to mitigate and, so far as is feasible, to eliminate’ certain enumerated abuses.” According to the staff:

As relevant to Section 18(i), these abuses include the organization, operation and management and of investment companies in the interest of insiders and the issuance of securities that contain inequitable or discriminatory provisions, or that

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<sup>124</sup> Keynote Address, Andrew J. Donohue, Independent Directors Council Investment Company Directors Conference (Nov. 12, 2009), [www.sec.gov/news/speech/2009/spch111209ajd.htm](http://www.sec.gov/news/speech/2009/spch111209ajd.htm).

fail to protect the preferences and privileges of the holders of an investment company's outstanding securities.

*Id.* at \*6 (footnotes omitted). The staff's analysis emphasized that Congress adopted the Investment Company Act to protect the rights of shareholders in particular by ensuring shareholders' ability to exercise voting rights as a check on insiders. *Id.*

Turning to the language of Section 18(i), the letter next discussed Section 18(i)'s requirement that every share of stock issued by an investment company be "voting stock." *Id.* at \*7. Noting that the Investment Company Act does not define "voting stock," the staff instead looked to the definition of "voting security" and "security" under Sections 2(a)(42) and 2(a)(36), respectively, noting that a voting security is defined as "any security presently entitling the owner or holder thereof to vote for the election of directors." *Id.* The staff reasoned that because the definition of "security" under Section 2(a)(36) includes "any stock," the term "voting stock" may be properly interpreted with reference to the definition of "voting security." *Id.* Thus, the staff concluded that under Section 18(i), "every share of stock issued by an investment company must presently entitle the owner or holder to vote such share of stock for the election of directors." *Id.* Opting in to the MCSAA would violate this requirement because a shareholder whose large holdings triggered the statute would not be entitled to vote for the election of directors. *Id.*

The staff similarly concluded that opting into the control share statute would be inconsistent with Section 18(i)'s language requiring "equal voting rights" for all shares. *Id.* at \*8. Acknowledging that "equal voting rights" is not defined in the Investment Company Act, the letter again referred to the prefatory language in Section 1(b). The staff asserted that securities subject to the control share statute would contain provisions inconsistent with Section 1(b)(3) policy goal of eradicating securities with "inequitable or discriminatory provisions." By discriminating against shareholders acquiring control shares and by failing "to protect an essential privilege of share ownership—the right to vote one's shares," the fund would be inviting the very entrenchment of insiders that Section 18(i) sought to eliminate. *Id.*

Finally, the staff anticipated and rejected certain potential counter-arguments. The letter distinguished the Commission's order in *Solvay* and "the various no-action letters," which the staff characterized as concerning voting rights as *between* share classes—whereas the MCSAA which established differential voting rights *within* a class. *Id.* at \*9. "If it is to provide meaningful protection against unfair discrimination, the equal voting rights requirement in Section 18(i) must prescribe more than equal voting rights at the point of issuance—any alternate reading would invite undue stockholder disenfranchisement and management entrenchment." *Id.* at \*10. The staff also rejected the court's reasoning in *Neuberger Berman* that there is a distinction between the voting rights of the shares and the voting rights of the shareholders. *Id.* at \*10. "The plain wording of Section 18(i), in conjunction with Sections 2(a)(36) and 2(a)(42), as described above, clearly prohibits discrimination between or among both shares and shareholders." *Id.*

## **Appendix G: State Equal Voting Rights Provisions**

Several states have enacted equal voting rights legislation for business entities organized within their state that parallel Section 18(i) of the Investment Company Act. Among these states are the three most common jurisdictions for organization of a closed-end fund: Delaware, Maryland, and Massachusetts.

### **Delaware**

Delaware's equal voting provision applicable to corporations states in relevant part:

Unless otherwise provided in the certificate of incorporation and subject to § 213 of this title, *each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder*. If the certificate of incorporation provides for more or less than 1 vote for any share, on any matter, every reference in this chapter to a majority or other proportion of stock, voting stock or shares shall refer to such majority or other proportion of the votes of such stock, voting stock or shares.

Del. Code Ann. tit. 8, § 212(a) (emphasis added). The principle of one vote per share of stock dates to the nineteenth century, and was formerly enshrined in the Delaware Constitution from 1897-1903. *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 123 (Del. 1977). Notably, although Delaware's Section 212(a) establishes one vote per stock as the default, it permits other voting structures if incorporated into the corporation's charter. Del. Code Ann. tit. 8, § 212(a). "Although Section 212(a) sets forth the 'one share/one vote' default rule, Section 212(a) does not prohibit stockholders from agreeing upon the manner in which such shares will be voted." *Salamone v. Gorman*, 106 A.3d 354, 383 (Del. 2014). Shareholders may therefore limit the voting power of some shareholders through the company's certificate of incorporation "or other form of resolution." *Winston v. Mandor*, 710 A.2d 835, 839 (Del. Ch. 1997).

Delaware law does not contain a similar equal voting provision directly applicable to statutory trusts, although a trust's governing instrument may:

grant to (or withhold from) all or certain trustees or beneficial owners, or a specified class, group or series of trustees or beneficial owners, the right to vote, separately or with any or all other classes, groups or series of the trustees or beneficial owners, on any matter, such voting being on a per capita, number, financial interest, class, group, series or any other basis.

Del. Code Ann. tit. 12, § 3806(b)(4). Furthermore, the Delaware Court of Chancery has recognized that "[v]iewed in their business reality [the ordinary business corporation and a common-law business trust] are for our purposes the same." *Saminsky v. Abbott*, 185 A.2d 765, 771 (1961). Delaware statutory trusts may therefore, as with the common-law trust, be subject to Delaware corporate law, although no decision appears to have held Section 212 to be applicable to a statutory trust.

### **Maryland**

Maryland's equal voting provision applicable to corporations states that:

Unless the charter provides for a greater or lesser number of votes per share or limits or denies voting rights, *each outstanding share of stock, regardless of class, is entitled to one vote on each matter submitted to a vote at a meeting of stockholders.*

Md. Code Ann., Corps. & Ass'ns § 2-507 (emphasis added). Maryland's version of the equal voting provision demonstrates an explicit focus on equal voting powers of stock between the classes, conferring voting rights "regardless of class." *Id.* There is little case law interpreting this provision, but Maryland courts consider Delaware's interpretation of corporate law to be "highly persuasive." *Kramer v. Liberty Prop. Tr.*, 968 A.2d 120, 134 (2009); *see also Oliveira v. Sugarman*, 152 A.3d 728, 736 n.4 (2017).

Maryland law does not contain a similar equal voting provision directly applicable to statutory trusts, although a trust's governing instrument may:

grant to, or withhold from, all or certain trustees or beneficial owners, or a specified class, group, or series of trustees or beneficial owners, the right to vote, separately or with any or all other classes, groups, or series of trustees or beneficial owners, on any matter, such voting being on a per capita, number, financial interest, class, group, series, or any other basis.

Md. Code Ann., Corps. & Ass'ns § 12-207(b)(5). The case law interpreting the rights and powers of Maryland statutory trust shareholders has not been very well-developed by Maryland courts.

### **Massachusetts**

Massachusetts' equal voting legislation applicable to corporations provides:

*Stockholders entitled to vote shall...have one vote for each share of stock owned by them; provided, that in corporations having two or more classes of stock, the voting powers of the different classes may be fixed in the manner provided by section fourteen.*

Mass. Gen. Laws Ann. ch. 156, § 32 (emphasis added). Section 14 in turn states:

Every corporation in its agreement of association, or in the case of a corporation created by special law, in its articles of organization, or in an amendment to said agreement or articles which may be adopted as hereinafter provided, *may create shares of stock with or without par value and may create two or more classes of stock with such preferences, voting powers, restrictions and qualifications thereof as shall be fixed in said agreement or articles or in such amendment.*

Mass. Gen. Laws Ann. ch. 156, § 14 (emphasis added). Read together, the Massachusetts corporate voting structure provides a default rule that each share is entitled to one vote, but that corporations may alter the default rule of one vote per share through their foundational documents. *Id.*; Mass. Gen. Laws Ann. ch. 156, § 32. The Massachusetts equal voting provision also has little case law interpreting it, but as in Maryland, Massachusetts courts consider Delaware court decisions on

matters of corporate law to be instructive. *Piemonte v. New Bos. Garden Corp.*, 387 N.E.2d 1145, 1150 (1979).

Although there is no equal voting rights provision solely applicable to business trusts under Massachusetts law, Massachusetts courts have frequently applied Massachusetts corporate law to Massachusetts business trusts. Massachusetts law considers them “in practical effect” analogous to corporations. *Swartz v. Sher*, 344 Mass. 636, 639 (1962); *see also Brigade Leveraged Capital Structures Fund Ltd. v. PIMCO Income Strategy Fund*, 466 Mass. 368, 369 n.4 (2013). “The sum total of these distinctive features of a business trust has brought trusts into such close resemblance to corporations that they have been frequently considered as corporations, sometimes by virtue of constitutional or statutory provisions and sometimes without such provision.” *State St. Tr. Co. v. Hall*, 311 Mass. 299, 303 (1942). The Supreme Judicial Court has applied Massachusetts corporate law relating to derivative actions to an open-end fund organized as a business trust. *Halebian v. Berv*, 457 Mass. 620, 620 & 623 (2010).



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