

# Investment Management Alert

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## Impact of Rule 14a-8 Amendments on Closed-End Funds

On September 23, 2020, the Securities and Exchange Commission (SEC) adopted amendments to the procedural requirements and resubmission thresholds relating to shareholder proposals submitted for inclusion in fund proxy statements pursuant to Rule 14a-8 of the Securities Exchange Act of 1934 (Exchange Act).

In light of the increase in activism activity in the closed-end fund industry,<sup>1</sup> certain of these Rule 14a-8 amendments may provide closed-end funds with increased protection against short-term investors that acquire shares of closed-end funds at a discount and pursue disruptive shareholder proposals to force some type of “liquidity” event at or near net asset value.

**Overview of Rule 14a-8 Amendments.** The amendments to Rule 14a-8 will make it more difficult for certain shareholders to submit proposals for inclusion in a fund’s proxy materials in connection with the fund’s special or annual meeting of shareholders. These amendments (i) replace the current ownership requirements with a tiered approach taking into account both the amount of shares owned and the length of ownership; (ii) require certain documentation when a proposal is submitted by a representative on behalf of a proponent; (iii) require a proponent to provide information regarding the proponent’s availability for engagement with the fund; (iv) end the ability of representatives to submit multiple proposals on behalf of other shareholders for the same meeting; and (v) raise the levels of support that a proposal must receive to be resubmitted at future shareholder meetings. For a detailed summary of the Rule 14a-8 amendments, including applicable compliance dates, see our September 25, 2020, client alert, “[SEC Adopts Amendments to Shareholder Proposal Rules](#).”

**Tiered Ownership Requirements.** Currently, in order to be eligible to have a proposal included in a fund’s proxy materials pursuant to Rule 14a-8, a proponent must have owned at least \$2,000, or 1%, of the fund’s securities entitled to vote on the proposal continuously for at least one year. Under the new rules, a proponent will be required to satisfy one of three alternative tests. To be eligible to submit a proposal under Rule 14a-8, a shareholder will need to have continuously held at least:

- \$2,000 of the fund’s securities entitled to vote on the proposal for at least three years;
- \$15,000 of the fund’s securities entitled to vote on the proposal for at least two years; or
- \$25,000 of the fund’s securities entitled to vote on the proposal for at least one year.

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<sup>1</sup> See ICI, [Recommendations Regarding the Availability of Closed-End Fund Takeover Defenses](#) (March 2020).

# Investment Management Alert

The SEC eliminated the 1% test.<sup>2</sup> In addition, under the amendments, shareholders will no longer be permitted to aggregate their shares with other shareholders for the purpose of meeting the applicable minimum ownership thresholds to submit a proposal under Rule 14a-8.

Shares of closed-end funds often trade at a discount to their net asset value, which has increasingly led activist investors to target closed-end funds trading at a discount in search of short-term profits for themselves, often to the detriment of a closed-end fund's retail long-term shareholders. As discussed in the ICI Report, the vast majority of shareholder activities in the past five years have been carried out by a small, experienced group of professional activists.<sup>3</sup> The range of direct and indirect tactics used by activists includes proxy contests and shareholder proposals seeking to replace trustees, declassification of a fund board, termination of the fund's investment advisory agreement and approval of a direct liquidity event, such as an open-ending, liquidation, substantial tender offer or a commitment to make fixed distributions irrespective of earned income. These tactics pressure funds to implement often drastic changes to fund management, investment strategies and/or capital structure that ultimately undermine the funds' broader investment mandates with minimal long-term effect on funds' share prices.<sup>4</sup>

Although the Rule 14a-8 amendments may have some deterrence effect on individual shareholders and nonprofessional dissidents, these amendments are unlikely to have much impact on professional activist investors. The Rule 14a-8 amendments may have the effect of deterring certain short-term profit-seeking activists by better aligning the interests of the shareholder proponent with those of the fund's long-term shareholders. As the SEC stated in the adopting release, "We believe having a longer holding period is particularly important if the dollar value of the ownership interest is minimal, including in terms of a company's market capitalization, and may help address concerns related to misuse of the shareholder-proposal process, while ensuring that smaller investors have access to the proxy statements of companies in

<sup>2</sup> The SEC noted in the adopting release that it had proposed eliminating the 1% test because this test has not generally been utilized and the vast majority of shareholders who use Rule 14a-8 do not hold 1% or more of a company's shares.

<sup>3</sup> See *id.* The ICI noted in its report that "[a]ccording to a survey distributed to ICI members on closed-end funds ... 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."

<sup>4</sup> See *id.* for a discussion of the negative effect of activist campaigns on closed-end funds and long-term shareholders.

which they have a demonstrated continuing interest." However, as noted above, the vast majority of recent activist campaigns have been carried out by a small handful of activist hedge fund managers who often accumulate large positions in targeted closed-end funds in excess of the \$25,000 ownership threshold. Accordingly, these amendments are unlikely to deter professional activist investors from continuing to submit disruptive shareholder proposals using the Rule 14a-8 process.

**Resubmission Thresholds.** Rule 14a-8(i) provides 13 bases upon which a fund can exclude a shareholder proposal. Rule 14a-8(i)(12) currently provides a basis for exclusion of a proposal if the fund addresses substantially the same subject matter as a proposal or proposals included in the fund's proxy materials within the preceding five years. In order for the exclusion to apply, the most recent vote must have occurred within the preceding three years and the proposal must have received less than 3, 6 or 10% of votes cast if voted on once, twice, or three or more times, respectively.

The amendments will increase the level of shareholder support that a proposal must receive to be eligible for resubmission. A proposal dealing with substantially the same subject matter as a previous proposal or proposals included in the fund's proxy materials within the preceding five years may be excluded under the amended rules if the most recent vote was within the preceding three years and was:

- Less than 5% of the votes cast if previously voted on once;
- Less than 15% of the votes cast if voted on twice; and
- Less than 25% of the votes cast if voted on three or more times.

These amendments to the resubmission thresholds will likely decrease the number of resubmissions by activist investors and reduce the associated burdens of addressing such resubmissions on the funds and their shareholders. The SEC, however, did not adopt changes to the vote-counting methodology for resubmissions recommended by certain commenters. These amendments therefore do not fully address the unique concerns of closed-end funds and their investors, including closed-end funds' continued struggle with low shareholder turnout. The "votes cast" standard, which discounts shareholders who have chosen not to vote, may not reflect "meaningful support" for a shareholder proposal by the fund's broader shareholder base. It remains to be determined how much of an impact these increases to the resubmission thresholds will have on resubmissions to closed-end funds by professional activist investors.

# Investment Management Alert

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**SEC and SEC Role in the Rule 14a-8 Process.** In the proposing release, the SEC solicited comments with respect to possible areas within the Rule 14a-8 process for improvement. The SEC acknowledged commenters' concerns regarding the need for a consistent application of Rule 14a-8 but noted that "although the staff strives to apply the rule in a consistent and transparent manner, participants in the shareholder-proposal process 'should not consider the prior enforcement positions of the staff on proposals submitted to other issuers to be dispositive of identical or similar proposals submitted to them.'"

With respect to shareholder voting rights, a topic of recent interest in connection with no-action letters submitted by Dividend and Income Fund, the SEC reiterated that "while Rule 14a-8 provides a federal process for proxy voting and solicitation with respect to a shareholder proposal, matters of corporate organization such as voting rights and whether a proposal is a proper subject for action remain governed by state law."

The SEC noted that it will consider comments received in connection with any future rulemaking or modifications to the no-action process.

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We understand that the SEC is continuing to consider the effects of activist campaigns on the closed-end fund industry. Market participants who wish to protect closed-end funds and their long-term shareholders from activist investors thus may have an opportunity to continue to engage with the SEC on this topic.

*Associate Michelle Huynh assisted in the preparation of this client alert.*