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CLOSED-END FUND ACTIVISM: HOW TO LEVEL THE PLAYING FIELD

The dramatic increase in the scope, tone, tactics, goals and impacts of closed-end fund shareholder activism is strangling an important investment product for middle-class *retail investors, including retirees. In this article, the author discusses areas where either Congress or the SEC can act to protect retail closed-end fund investors, including by passing H.R. 2627, The Increasing Investor Opportunities Act, or through public guidance and rulemaking.*

By Kenneth E. Burdon *

The Investment Company Act of 1940 regulates investment companies offered to and purchased by public retail investors. The Act is the result of a comprehensive effort following the 1929 stock market crash to eliminate abuses in the securities industry and is the product of a congressionally ordered study conducted by the Securities and Exchange Commission. The historical context of abuses out of which the Investment Company Act grew was so important that Congress inserted, as Section 1 of the Act, an enumeration of these abuses and a statement that the "policy and purposes" of the Investment Company Act are "to mitigate and, so far as is feasible, to eliminate" the abuses enumerated in Section 1, and that the provisions of the Investment Company Act "shall be interpreted" in accordance with such policy and purposes.[1]

Key abuses enumerated in Section 1 of the Act include:

> (b)(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of . . . affiliated persons thereof, . . . or in the interest of other investment companies . . ., rather than in the interest of all classes of such companies' security holders; . . . [or] (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.

Of note, an "affiliated person" of an investment company is defined in section 2(a)(3)(A) of the Act to include individuals or entities who directly or indirectly own, control, or hold with power to vote, 5% or more of the outstanding voting securities of the investment company. Therefore, a key policy objective of the Act is to protect retail shareholders of investment companies from overreaching, or undue influence, by concentrated shareholders who may seek to enrich themselves at the expense of retail shareholders — and these concentrated shareholders may exercise such undue influence with as little as a 5% holding.

[1] Investment Company Act § 1(b).

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FORTHCOMING

● ***NAVIGATING THE SEC'S NEW CYBERSECURITY DISCLOSURE REGIME***

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Closed-end investment companies are a unique type of investment company. They differ from open-end funds (i.e., mutual funds — what most people think of when conceptualizing an investment company) in that they do not redeem their shares on a daily basis, but rather trade on a stock exchange to provide their investors with liquidity. This characteristic allows for the creation of unique offerings for retail investors. Because closed-end funds do not redeem their shares, they can remain more fully invested (i.e., there is less "cash drag" on returns), they can enhance returns through the use of leverage, and they can offer investment strategies that focus on more illiquid asset classes. These characteristics give retail investors the opportunity to earn the greater returns that have historically come with leveraged strategies and illiquid asset classes that, on their own, are not otherwise accessible to retail investors. Key examples are closed-end funds that invest in opportunistic credit strategies or in private equity. These strategies can earn significant returns, but it is only in the closed-end fund wrapper that retail investors can access the professional expertise, management, and diversification needed to make participation in such strategies viable for them.[2]

Closed-end funds, however, are also uniquely suited to falling victim to the abusive tactics that gave rise to the Investment Company Act. Before the 1929 stock market crash, closed-end funds were much more popular than open-end funds, and their shares tended to trade at a premium to their net asset value (in other words, the stock price per share on the exchange exceeded the value of the fund's underlying assets).[3] After the crash, closed-end funds suffered sharp losses and certain investors exploited the situation.[4] In one common tactic, an investor would first gain control of a fund by acquiring a large portion of the fund's now-discounted outstanding shares. The investor would then use its concentrated position to influence the fund's investment policies in its own self-interest, and then sell its shares at a profit. These actions conflicted with the interests of ordinary, non-concentrated stockholders because many closed-end funds are "designed primarily for long-term investors," not for short-term strategies and quick gains.[5] Ordinary, non-concentrated investors — who were often left with unrecognizable investments after concentrated investors took hold — were generally unable to fight back.[6] Moreover, these closed-end fund raiders were able to maintain control even with minority holdings, and the SEC noted that these concentrated holders were just as responsible for the development and continuance of abuses in the fund industry that precipitated the Investment Company Act as conflicted fund managers and other insiders.[7]

Nearly 100 years later, the closed-end fund industry continues to face these abusive tactics from concentrated minority shareholders. Today, these shareholders are well-funded activist managers of private funds who use the veneer of "good governance" and "looking out for the little guy" to reap significant profits and, as has become more common, take over closed-end fund boards and install themselves as advisers to the fund to further enrich themselves with a stream of management

[2] *See*, e.g., Concept Release on Harmonization of Securities Offerings, 84 FR 30460, 30512 (Jun. 26, 2019):

> Retail investors who seek a broadly diversified investment portfolio could benefit from the exposure to issuers making exempt offerings, as these securities may have returns that are less correlated to the public markets. . . . Some types of registered investment companies, such as closed-end funds, are better suited to holding less liquid securities obtained in exempt offerings because they are not redeemable and therefore are not subject to the same rules on liquidity risk management as open-end funds.

[3] H.R. Doc. No. 279, 76th Cong., 1st Sess. (1940) ("SEC Report III"), at 1568; H.R. Doc. No. 70, 76th Cong., 1st Sess. (1939) ("SEC Report II"), at 179, 276; Report on Investment Trusts and Investment Companies, H.R. Doc. No. 707, 75th Cong., 3d Sess. (1939) ("SEC Report I"), at 3, 35-36.

[4] SEC Report III at 1019-22.

[5] I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 762 (2d Cir. 1991) (citation omitted).

[6] SEC Report II at 1024-26.

[7] SEC Report II at 401 & 403 n.69; SEC Report III at 32.

fee income, all at the expense of the long-term retail holders of closed-end fund shares.

THE PROBLEM OF CLOSED-END FUND ACTIVISM

Unlike in the 1920s, in the 2020s shares of closed-end funds often trade on an exchange at a discount to their net asset value and this discount has increasingly led activist managers to target closed-end funds in an effort to capture the "spread" between the discount at which the shares are purchased and the fund's net asset value. The activist manager starts by purchasing shares in the market and then agitating for "changes." These "changes" are typically some kind of "liquidity" event at or near net asset value, such as a conversion to an open-end fund, liquidation, or large tender offer that can shrink the fund substantially. The activist manager may use a variety of tactics to achieve this aim, such as proxy contests, shareholder proposals, seeking to replace directors, or seeking to terminate the closed-end fund's advisory contract, together with related lawsuits if the closed-end fund resists too hard. The common thread, however, is that a "liquidity" event often settles the matter and results in the withdrawal of whatever coercive proposals or activities have been put forward. The activist manager and its high-net-worth investors then profit from the difference between the discounted price at which the closed-end fund shares are purchased and the price at which the "liquidity" event occurs.[8]

The predictable end result here usually confirms that such proxy contests, shareholder activism, and related lawsuits are not about "good governance" or any other salutary purpose, but rather about coercing closed-end funds that cannot adequately protect themselves into delivering a short-term profit for the activist manager, its other like-minded allies, and their high-net-worth investors, at the expense of the long-term retail investing public. This activity harms long-term, retail closed-end fund investors because portfolio securities may have to be sold at fire-sale prices to raise cash to fund the liquidity event and the fund will likely need to de-lever at the same time.[9] These sales may also force the fund to realize capital gains at inopportune times, the taxes on which are allocated to remaining (presumably, retail) shareholders, which can force them to make cash tax payments they never intended when purchasing the fund. This can leave the fund with a smaller, less liquid, and harder-to-value portfolio. It can also substantially increase the fund's expense ratio, further harming long-term shareholders and endangering the viability of a fund structure that is beneficial to market stability and long-term investors.

Moreover, a new goal of activist managers appears to be the full takeover of closed-end funds. In a full takeover of a closed-end fund: the activist succeeds in obtaining a majority of the board seats; typically any remaining directors not affiliated with or nominated by the activist resign; the new board terminates the fund's existing adviser and hires a manager affiliated with the activist (or the activist itself); and the new board and adviser radically change the fund's investment strategy.[10] This benefits the activist by providing a profitable new stream of fee revenue and another vehicle to support further activism.

This activity is particularly troubling because it reduces available investment options for retail investors, while allowing activist managers and their high-net-worth investors to profit at their expense. Closed-end fund investors are decidedly retail and middle class. Among households owning closed-end funds, the median age of the head of household is 50 and the median household income is $100,000; 39% are retirees.[11]

The closed-end fund investment option disappears if the fund is liquidated or converted into a mutual fund. If the closed-end fund survives, but conducts a "liquidity" event such as a tender offer, its smaller asset base can lead to higher expenses, even larger trading discounts and an eventual determination that the fund is not viable and needs to liquidate. Closed-end funds are the only pooled investment vehicle by which retail investors can gain diversified access to less liquid asset classes that could provide enhanced returns, such as privately offered securities, given the liquidity constraints

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[8] Fund of Funds Arrangements, 84 FR 1286, 1295-96 & n.95 (Feb. 1, 2019) ("Since the mid-1990s, closed-end funds that have traded at a discount to NAV have been the target of proxy contests initiated by large investors in those funds, including other funds.").

[9] Most closed-end funds use some type of leverage in an effort to boost returns for common shareholders. *See*, e.g., 2023 Investment Company Fact Book, at ch.5 (Investment Company Institute 2023) ("At year-end 2022, 274 funds, accounting for 62 percent of closed-end funds, used structural leverage, some

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types of portfolio leverage (i.e., tender option bonds or reverse repurchase agreements), or both as a part of their investment strategy.") ("2023 ICI Fact Book").

[10] Two recent examples of this are Saba Capital Management, L.P.'s takeover of closed-end funds in 2021 and 2023.

[11] 2023 ICI Fact Book, at ch. 5.

imposed on mutual funds and the wealth standards imposed on investors in hedge funds or venture capital/private equity funds.[12]

The SEC recognizes the danger these activist managers pose,[13] as does the Investment Company Institute ("ICI").[14] These tactics, executed through amassing concentrated minority positions in closed-end funds, are leading to the same types of abuses that precipitated the Investment Company Act.

The solution for retail investors, however, cannot be to "just go along" with the coerced "liquidity" event. A myriad of reasons exist for why a retail investor may not want to dispose of a closed-end fund investment on an activist manager's timetable. Long-term holders may like the fund, its strategy, and the income it produces. The retail investor may not want to realize a taxable disposition of the investment at that particular time. Divesting may be inconsistent with the retail investor's strategy and allocations. The retail investor may not like the prospect of reinvesting the proceeds from the "liquidity" event in a higher-cost or lower-yielding investment. In particular, the argument often touted by the activist managers of investors being "stuck" or "captive" to a closed-end fund's trading discount from net asset value is a red herring.[15] Retail investors may have purchased the fund for its consistent stream of income. They may not be focused on any gain on disposing of the closed-end fund, because that is not the retail investor's objective, and the retail investor may very well expect to out-earn any such discount over the course of his or her holding period. Moreover, a retail investor purchasing in the market likely purchased the closed-end fund at a discount and therefore is enjoying an enhanced yield on his or her investment as compared to investing at a higher net asset value.

Activists are Emboldened and are Endangering Closed-End Funds as a Product

According to the ICI, hostile activist activity has become more common and concentrated. The ICI notes that compared with the prior four-year period, the number of beneficial ownership and contested proxy solicitation filings indicating shareholder activism increased from 2018 to 2022, despite there being fewer exchange-listed closed-end funds. A more telling statistic from the ICI is that 95% of these filings were concentrated among only five activists, compared to 53% of the filings coming from the top five activists from 1998 to 2002.[16]

This indicates that the "business" of closed-end fund activism is consolidating and growing, particularly given the substantial financial resources of this new breed of activists. Saba Capital Management, L.P., a well-known activist, reports over $9.7 billion in assets under management in 2023,[17] and data presented at the ICI's 2023 Closed-End Fund Conference indicates that regulated investment companies account for over $2.8 billion in its portfolio. Deep pockets allow activist managers to finance multiyear campaigns, sophisticated media strategies, and protracted litigation against closed-end funds as a means to both apply pressure on boards to capitulate in the face of mounting costs and to achieve full takeovers of closed-end funds.

This sustained assault is predicably leading to the slow death of closed-end funds as an asset class. At

[12] Concept Release on Harmonization of Securities Offerings, 84 FR 30460, 30512-14 (Jun. 26, 2019). Investors in hedge funds and venture capital/private equity funds must generally meet the high wealth standard of a "qualified purchaser" (generally, hold $5 million in investments). Moreover, mutual funds must limit illiquid investments to 15% of net assets in accordance with Rule 22e-4 under the Investment Company Act.

[13] Fund of Funds Arrangements, 84 FR 1286, 1295-96 & n.95 (Feb. 1, 2019) ("A 3% threshold for the voting condition is particularly important because our proposal would allow funds to acquire shares of closed-end funds under proposed rule 12d1-4. Closed-end funds historically have been the target of proxy contests.").

[14] *ICI Viewpoints*, "Shareholder Activism Threatens Closed-End Funds and Their Investors" (May 24, 2023) ("Depending on what actions activists force, CEFs' long-term shareholders may find themselves invested in a radically different product with an entirely new strategy, the same product but with fewer assets and correspondingly higher fees and expenses, or no product at all. Moreover, asset management firms have been reticent to launch new CEFs given growing activist threats, raising concerns among ordinary investors about the sustainability of the CEF market.").

[15] *See, e.g.*, Eagle Growth and Income Opportunities Fund, Preliminary Proxy Statement on Schedule 14A, filed on

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September 3, 2019, and Dividend & Income Fund, Definitive Proxy Statement on Schedule 14A, filed on May 13, 2019.

[16] *ICI Viewpoints*, "Shareholder Activism Threatens Closed-End Funds and Their Investors" (May 24, 2023).

[17] Saba Capital Management, L.P., Form ADV, Item 5.

year-end 2007, there were 662 closed-end funds.[18] Closed-end funds have steadily declined since. At year-end 2017, there were 532 closed-end funds.[19] By year-end 2022, there were only 441 closed-end funds.[20] By September 30, 2023, there were only 426 closed-end funds.[21] This is approximately a 35% decline from the 2007 peak. The ICI observes, "In recent years, more closed-end funds were liquidated, merged, or converted into open-end mutual funds or ETFs than were launched."[22] The initial public offering market for new exchange-listed closed-end funds has been virtually dormant for nearly two years. While broader economic factors may be contributing to this lack of new issuance, it is also telling that, over the past year, activist managers have increasingly attacked newer products with shorter track records.[23]

COMBATING ABUSIVE ACTIVISM: FIX SECTION 12(D)(1)

Section 12(d)(1)(A) of the Investment Company Act prohibits a registered fund (and any company it controls) from (1) acquiring more than 3% of another fund's outstanding voting securities; (2) investing more than 5% of its total assets in any one fund; or (3) investing more than 10% of its total assets in funds generally. While registered funds are subject to all of these limitations, the Investment Company Act only makes private funds[24] subject to the limitation in Section 12(d)(1)(A)(i) regarding the acquisition of more than 3% of a registered fund's outstanding voting securities.[25]

Section 12(d)(1)(C) of the Investment Company Act prohibits any investment company (the "acquiring company") and any company or companies controlled by the acquiring company from purchasing or otherwise acquiring any security issued by a registered closed-end fund, 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, would own more than 10% of the total outstanding voting stock of such closed-end fund. A private fund is not an "investment company" for purposes of Section 12(d)(1)(C), even though it is an "investment company" for purposes of the 3% limit in Section 12(d)(1)(A)(i).[26]

The primary textual differences between Section 12(d)(1)(A)(i) (the "3% Limitation") and Section 12(d)(1)(C) (the "10% Limitation") are summarized as follows: (1) the 3% Limitation applies to both private funds and registered funds investing in registered funds, whereas the 10% Limitation only applies to registered funds investing in registered closed-end funds and (2) for purposes of applying the 3% Limitation, holdings of the investment company and any company it controls are aggregated, whereas for purposes of applying the 10% Limitation the holdings of all investment companies (and companies they control) sharing a common investment adviser are aggregated.

Activist managers take advantage of this textual difference by (1) not being subject to the 10% Limitation and then (2) creating multiple "clone" funds and accounts, having substantially the same investment objectives and investment policies, that jointly invest in a closed-end fund target, each up to the 3% limit.[27] Often

[18] 2018 Investment Company Fact Book, at ch.5 (Investment Company Institute 2018), *available at* https://www.ici.org/pdf/2018_factbook.pdf.

[19] 2023 ICI Fact Book, at ch.5.

[20] *Id.*

[21] Investment Company Institute, *Closed-End Fund Assets and Net Issuance, Third Quarter, 2023* (Nov. 27, 2023), *available at* https://www.ici.org/research/stats/closedend/cef_q3_23.

[22] 2023 ICI Fact Book, at ch.5.

[23] For example, in 2023 activists are running contests against funds that IPO'd in 2021.

[24] "Private funds" refers to issuers that are excepted from the definition of "investment company" by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. These types of funds are usually referred to as "hedge funds," "private equity funds," or "venture capital funds."

[25] The statutory terms of the exceptions for private funds contained in Section 3(c)(1) and Section 3(c)(7) specifically

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make private funds "investment companies" for purposes of the restriction in Section 12(d)(1)(A)(i) governing the purchase or other acquisition by such private fund of any security issued by any registered investment company.

[26] Sections 3(c)(1) and 3(c)(7) of the Investment Company Act only make private funds relying on them "investment companies" for purposes of the limitations in Sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i) governing the purchase or other acquisition by such private fund of any security issued by a registered investment company and the sale of any security issued by any registered open-end investment company (mutual fund) to any such private fund.

[27] "For example, six entities advised by Saba Capital Management, L.P. owned in the aggregate 14.44 percent of Clough Global Equity Fund at the time it entered into a settlement agreement with that fund. As part of that settlement,

an activist manager can control well in excess of 10% of a closed-end fund in this manner, in direct conflict with the policy objectives expressed in the legislative history of Section 12(d)(1) discussed below. The activist managers believe this is legal because Section 12(d)(1)(A) does not expressly require investment companies with the same investment adviser to aggregate their collective holdings for purposes of the 3% Limitation and does not apply to separate accounts, whereas Section 12(d)(1)(C) does expressly require investment companies with the same investment adviser to aggregate their collective holdings for purposes of the 10% Limitation (to which private funds are not subject).

This is not the first call to fix Section 12(d)(1).[28] However, with legislation currently pending in Congress,[29] the hope is that this call can provide some key reminders and additional momentum.

The 12(d)(1) Loophole Is an Oversight Congress Should Fix

The historical restrictions on fund of funds arrangements arose out of Congress' concern that such arrangements could lead to "'pyramiding', a practice under which investors in the acquiring fund could control the assets of the acquired fund and use those assets to enrich themselves at the expense of acquired fund shareholders."[30] Such "[c]ontrol could be exercised either directly (such as through the voting power of a controlling interest) or indirectly (such as coercion through the threat of large-scale redemptions)."[31] These concerns are reflected in the declarations of policy included in the Investment Company Act discussed above.

Congress added Sections 12(d)(1)(A) and 12(d)(1)(C) to the Investment Company Act in the Investment Company Amendments Act of 1970.[32] These provisions were added to the Act to address the emergence of the "fund holding company" — or, in other words, "fund on funds" arrangements where an investment company's portfolio consisted either entirely or largely of securities of other investment companies.[33] While fund of funds arrangements were not novel, the form they had taken by the mid-1960s and their emergence was considered a "striking development" at the time.[34] Of particular concern was that fund holding companies "pose a real potential for the exercise of undue influence or control over the activities of portfolio funds."[35] Notably, this policy position was not based solely on a concept of "control," but also on a concept of "undue influence," with the PPI Report using the terms interchangeably. One of the dangers of the fund holding company structure identified in the PPI Report was the inducement of deviations from the investment program or policies of registered companies subject to the influence of the fund holding company, and that such influence could cause management of the fund to pass to persons other than those chosen by shareholders to perform that function.[36] While much of this discussion in the PPI Report focused on how the threat of large scale redemptions in mutual funds could give rise to the potential harms of a fund holding company structure, it also expressly stated, "Although the acquisition of the stock of closed-end companies does not pose the same problem of control through the right of redemption, the power to vote a significant block of stock of a closed-end company may represent potential for exercise of control."[37]

The 3% Limitation reflects the concerns expressed in the PPI Report for registered investment companies generally, and the inclusion of the 10% Limitation in the

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the activist agreed to withdraw its nominees for directorships on the fund board in exchange for the fund's agreeing to tender for 37.5 percent of its shares at 98.5 percent of net asset value and paying a dividend over the following two years equal to 10 percent of the fund's average net asset value." Rose F. DiMartino, *Protecting Closed- End Fund Investors: A Call to Amend 1940 Act Section 12(d)(1)(A)*, The Investment Lawyer (Jan. 2019), at 24 (footnotes omitted).

[28] Rose F. DiMartino, *Protecting Closed- End Fund Investors: A Call to Amend 1940 Act Section 12(d)(1)(A)*, The Investment Lawyer (Jan. 2019).

[29] Increasing Investor Opportunities Act, H.R. 2627, 118th Congress.

[30] Fund of Funds Arrangements, 84 FR 1286, 1287 (Feb. 1, 2019).

[31] *Id.*

[32] Pub. L. No. 91-547, 84 Stat. 1413, 1417 (1970).

[33] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337 (1966), at 311 ("PPI Report"); H.R. Rep. No. 91-1382 to Accompany H.R. 17333 (Aug. 7, 1970), at 23-24; Sen. Rep. No. 91-184 to Accompany S. 2224 (May 21, 1969), at 30-31; Sen. Rep. No. 1351, 90th Congress to Accompany S. 3724 (Jul. 1, 1968), at 28 (collectively, the "1970 Legislative Reports").

[34] PPI Report, at 311.

[35] *Id.* at 315.

[36] *Id.* at 316.

[37] *Id.* at 324.

Investment Company Amendments Acts of 1970 reflects a congressional determination that closed-end funds need to be protected from other funds acquiring a "significant block of stock" of a closed-end fund. The PPI Report was part of the foundation of this legislation,[38] and the 1970 Legislative Reports accompanying the various bills that ultimately became the Investment Company Amendments Act of 1970 reflect this concern. In particular, in discussing Section 12(d)(1)(C), the 1970 Legislative Reports state:[39]

> 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 apply to the buyer (rather than the seller as in the case of open-end companies) 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.

The import of this rationale is that limiting the voting influence of any one investment company manager in a closed-end fund to 10% is necessary to guard against the "potential for exercise of control"[40] that could in turn lead to the undue influence and resulting harms reflected in the PPI Report. Section 12(d)(1)(C), as enacted, reflects a balance in the reality of who should be subject to that limitation given the availability of ownership information to the purchaser.

In 1992, the SEC's Division of Investment Management published the Protecting Investors Report,[41] which studied the investment company industry and made recommendations for updating and improving the regulatory regime. In this report, the Division made an important recommendation regarding Section 12(d)(1) after discussing the Section 3(c)(1) exclusion for private funds: "In order to protect the public shareholders of registered investment companies, however, the restrictions of section 12(d)(l) should apply to all investments by private issuers in registered investment companies. This approach also should be incorporated in the proposed 'qualified purchaser' exception."[42] The Division also expressed the same concern as Congress over 20 years earlier: "Private issuers, excepted from regulation under the [Investment Company] Act, could acquire controlling interests and exert undue influence over registered funds, disrupting their portfolio management through the threat of redemption."[43]

Congress implemented a number of the recommendations from the Protecting Investors Report in the Investment Company Act Amendments of 1996.[44] Among the amendments adopted were the addition of the "qualified purchaser" private fund exception in Section 3(c)(7) and language making private funds relying on Sections 3(c)(1) or 3(c)(7) subject to the 3% Limitation.[45] Curiously, however, the 10% Limitation was not made applicable to these private funds. This appears to be a clear oversight, given the recommendations in the Protecting Investors Report, Congress' historical concerns governing the potential for undue influence by unregistered and unregulated funds over both open- and closed-end funds, the Division of Investment Management's continuing belief in the seriousness of those concerns as applied to a more

[38] *See*, e.g., Sen. Rep. No. 1351, 90th Congress to Accompany S. 3724 (Jul. 1, 1968), at 1 ("This bill represents a 14-month effort on the part of the committee to deal with the problems described in the 1962 Wharton School of Finance and Commerce Study of Mutual Funds, the 1963 Special Study of the Securities Markets made by the Securities and Exchange Commission and the Commission's 1966 Report on Public Policy Implications of Investment Company Growth.").

[39] Sen. Rep. No. 1351, 90th Congress to Accompany S. 3724 (Jul. 1, 1968), at 29; *accord* H.R. Rep. No. 91-1382 to Accompany H.R. 17333 (Aug. 7, 1970), at 23-24; Sen. Rep. No. 91-184 to Accompany S. 2224 (May 21, 1969), at 30-31.

[40] PPI Report, at 324.

[41] Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation* (1992), *available at* https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf ("Protecting Investors Report").

[42] Protecting Investors Report, at 105. The "proposed qualified purchaser" exception became the Section 3(c)(7) exclusion from the definition of "investment company" that the vast majority of private funds rely on today.

[43] *Id.* at 109. As discussed above, Congress has historically viewed the power to vote a significant block of stock of a closed-end company as the equivalent of the threat of redemption for an open-end fund. *See*, e.g., PPI Report, at 324.

[44] Pub. Law 104-290, 110 Stat. 3416.

[45] *Id.* at § 209(a).

modern version of the private fund industry as reflected in the Protecting Investors Report, and the fact that private funds were made subject to Section 12(d)(1)(B)(i), which covers the "other side of the transaction involving open-end investment companies."[46]

While this history does not address "shareholder activism" as the market understands that term today, it reflects an obvious concern regarding the undue influence that can be had on registered investment companies generally, and on closed-end funds in particular, by other funds and fund managers that hold large positions in those registered investment companies and closed-end funds. In fact, of particular concern was the ability of unregulated funds to accumulate large positions in registered funds and wield undue influence. The PPI Report dedicates a substantial part of its discussion to the dangers of unregistered investment companies not being subject to Section 12(d)(1)'s limitations,[47] and the 1970 Legislative Reports cite this as the rationale for the 1970 amendments to Section 12(d)(1).[48] In the mid-1960s, this danger was wrought by foreign-based unregistered investment companies.[49] Today, with the proliferation of private funds, this danger is being wrought by those similarly unregulated and unregistered funds that are also taking advantage of the same kind of "gap in the statutory scheme"[50] that prompted the 1970 amendments to Section 12(d)(1). The type of shareholder "activism" in the closed-end fund industry described above is not "activism" in the sense of promoting "good governance" or seeking to improve operating efficiencies; rather, it more akin to the "corporate raider" strategies of the 1980s, which is precisely the type of undue influence against which Section 12(d)(1) is intended to protect registered investment companies.

Congress has a bill in front of it presently that will fix this oversight and subject private funds to Section 12(d)(1)(C) and the 10% Limitation — The Increasing Investor Opportunities Act.[51] Congress should pass it and put an end to the abusive tactics of activist managers investing in closed-end funds.

If Congress Does Not Act, the SEC Should

The SEC does not need Congress to act to fix this Section 12(d)(1) loophole. Rather, the plain language of the Investment Company Act, applied to the facts discussed herein, is sufficient to stop aggressive and wealthy activist managers and their investors from destroying an important middle-class and retiree investment product.

Section 12(d)(1)(A) applies to an "investment company," which is in turn defined by reference to an "issuer."[52] An "issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.[53] A "person" is a natural person or a company.[54] A "company" is defined to include any organized group of persons[55] whether incorporated or not.[56] A "security" includes an "investment contract."[57] Applying these plain definitions

[46] H.R. Rep. No. 104-622 to Accompany H.R. 3005 (Jun. 17, 1996), at 50. Section 12(d)(1)(B)(i) of the Investment Company Act prohibits an open-end fund from selling its securities to another investment company if, to the knowledge of the seller, the 3% Limitation would be violated immediately after such sale.

[47] PPI Report, at 311-24.

[48] *See, e.g.,* Sen. Rep. No. 1351, 90th Congress to Accompany S. 3724 (Jul. 1, 1968), at 28; H.R. Rep. No. 91-1382 to Accompany H.R. 17333 (Aug. 7, 1970), at 23-24; Sen. Rep. No. 91-184 to Accompany S. 2224 (May 21, 1969), at 30-31.

[49] PPI Report, at 312-19.

[50] Sen. Rep. No. 1351, 90th Congress to Accompany S. 3724 (Jul. 1, 1968), at 28; H.R. Rep. No. 91-1382 to Accompany H.R. 17333 (Aug. 7, 1970), at 23-24; Sen. Rep. No. 91-184 to Accompany S. 2224 (May 21, 1969), at 30-31.

[51] H.R. 2627, 118th Congress.

[52] Investment Company Act § 3(a)(1).

[53] Investment Company Act § 2(a)(22).

[54] Investment Company Act § 2(a)(28).

[55] A "person" can be a natural person or a company.

[56] Investment Company Act § 2(a)(8).

[57] Investment Company Act § 2(a)(36). The U.S. Supreme Court, in *SEC v. W.J. Howey Co.*, defined an investment contract for purposes of the Securities Act of 1933 as a scheme that "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U.S. 293, 301 (1946). The SEC has taken the view that an investment advisory program could satisfy the common enterprise element of the *Howey* test if the accounts are discretionary, the investors receive the same or substantially overlapping investment advice, and the investment advice is not "individualized." Status of Investment Advisory Programs under the Investment Company Act of 1940, 60 FR 39574 (Aug. 2, 1995), at n.15 and accompanying text; *see also* Individualized Investment Management Services, 45 FR 69479 (Oct. 21, 1980), at n.12 and accompanying text (explaining that the concept of individualization has a basis in the term "investment

included in the Investment Company Act, an organized group of private funds and separate accounts jointly investing in a closed-end fund target and taking coordinated collective action with respect to that closed-end fund is one "investment company" to which the 3% Limitation applies, since that "issuer" is engaged in the business of investing, reinvesting, or trading in securities.[58] Moreover, this "investment advisory program" being run by an activist manager across its managed private funds and separate accounts is a quintessential example of an arrangement that satisfies the common enterprise element of the *Howey* test — the activist manager has discretionary investment authority over the managed private funds and separate accounts, all clients receive the same or substantially overlapping investment advice and the investment advice is not individualized.

Ample precedent exists for applying the foregoing "company" and "look-through" analyses to circumstances where investor protection concerns have arisen. A directly analogous example is the application of Section 3(c)(1) of the Investment Company Act. Section 3(c)(1) is an exclusion from the definition of "investment company" that can be used by private funds with no more than 100 investors. The SEC staff has long taken the position that private fund managers cannot evade Section 3(c)(1)'s 100 investor limit by creating "clone" funds, all with no more than 99 investors, and operate these funds as one joint investment program.[59] In prohibiting this practice, the SEC staff has asserted that Section 48(a) of the Investment Company Act gives the SEC the authority to "look through" a transaction or a multi-tiered structure if it is a sham or conduit formed or operated for no purpose other than circumventing the requirements of the Investment Company Act.[60]

Moreover, the "company" analysis itself has played a major role in shaping two important areas of investment company regulation: variable annuities and "wrap fee" programs. In *Prudential Life Insurance Co. of America v. S.E.C.*,[61] the court considered whether the Investment Company Act "applies to the Investment Fund resulting from the sale of variable annuity contracts to members of the public by The Prudential Insurance Company of America."[62] The "Investment Fund" was in essence a pooled account holding equity securities that funded the variable annuity contract obligations. The court agreed with the SEC's following analysis:[63]

> The Commission determined that the variable annuity contracts constitute the purchasers an "organized group of persons"; that they create a "trust" held by Prudential for these purchasers; and, more importantly, that the separate Investment Fund resulting from the sale of the variable annuity contracts is a "fund" within the statutory definition. Based upon this last decisive holding, the Commission then concluded that the Investment Fund is the "issuer" of the variable annuity securities, and that it is an "investment company" subject to the [Investment Company] Act.

In agreeing with this analysis, the court explained:[64]

> In these circumstances we reject Prudential's argument that the broad statutory phrase "a trust, a fund, or any organized group of persons whether incorporated or not" refers only to recognizable business entities. On the contrary, the legislative history compels the conclusion that Prudential's Investment Fund is a "fund" as that term is used in the statute.

Similarly, the existence of Rule 3a-4 under the Investment Company Act, which is a safe harbor rule permitting the operation of certain types of discretionary investment advisory programs, often structured as "wrap fee" programs,[65] is premised on an analysis of multiple

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supervisory services" which is defined in Section 202(a)(13) of the Investment Advisers Act of 1940 as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client").

[58] Investment Company Act § 3(a)(1)(A).

[59] Cornish & Carey Commercial, Inc., SEC Staff No-Action Letter (Jun. 21, 1996) ("[T]he staff will require 'integration' of ostensibly separate 3(c)(1) Entities if it appears that the separate offerings do not present investors with materially different investment opportunities.").

[60] *Id.*

[61] 326 F.2d 383 (3d Cir. 1964), *cert. denied*, 377 U.S. 953 (1964).

[62] *Id.* at 384.

[63] *Id.* at 386.

[64] *Id.* at 387.

[65] A wrap account is an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions. These programs typically are designed to

accounts being considered one "investment company" under the Investment Company Act as a result of being managed in a coordinated manner.[66]

The SEC therefore has ample authority and precedent to interpret Section 12(d)(1) in this manner and should assert these conclusions in public guidance. The SEC's Division of Investment Management describes itself as follows: "The Division of Investment Management supports the Commission in its mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. . . . The work of the Division of Investment Management touches the lives of Main Street investors. We oversee mutual funds and other investment products and services that investors may use to help them buy a home, send kids to college, or prepare for retirement."[67] This mission would be directly served by stopping activist managers, backed by billions of dollars in capital, from strangling the closed-end fund industry for their own short-term enrichment, because closed-end funds are an important investment product that helps Main Street investors buy a home, send kids to college, and prepare for (and fund) retirement.

COMBATING ABUSIVE ACTIVISM: APPLY RULE 17D-1

The SEC also has another tool to combat this assault on closed-end funds and their retail investors: Rule 17d-1. Section 17(d) of, and Rule 17d-1 under, the Investment Company Act broadly prohibit "affiliated persons" of an investment company (and affiliated persons of such persons) from engaging in joint transactions with that investment company, absent an exemptive order from the SEC. The purpose of this prohibition is to ensure fair dealing and no overreaching between first- and second-tier affiliated persons and an investment company.[68] The SEC has applied these provisions broadly to police conflicts of interest and to prevent affiliated persons of registered investment companies from exerting undue influence on the registered investment company for the affiliate's benefit.[69]

The Investment Company Act defines an affiliated person of another 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,"[70] and "any person directly or indirectly controlling, controlled by, or under common control with, such other person."[71] Activist managers and the funds they manage typically are affiliated persons of the closed-end funds they target because the manager controls in excess of 5% of the closed-end fund's voting securities, and the manager's individual private funds are second-tier affiliates of the closed-end funds they target since the activist manager controls them. Activist managers may also use registered closed-end funds they manage as part of the group owning a target fund — in this case the activist manager and its private funds are all affiliated persons of the activist-managed closed-end fund since the activist manager controls its managed closed-end fund and the private funds. Activist managers' demands for at-or-near net asset value "liquidity," tender offers, increased distributions, liquidations, and other transactions, as well as their takeover tactics of replacing the closed-end

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provide professional portfolio management services to a large number of individual clients. *See* Status of Investment Advisory Programs under the Investment Company Act of 1940, 60 FR 39574, 39575 (Aug. 2, 1995).

[66] *Id.*, 60 FR 39574, 39575-6 (Aug. 2, 1995) (proposing Rule 3a-4 under the 1940 Act, which was adopted in 1997 (62 FR 15098)).

[67] https://www.sec.gov/investment-management.

[68] Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess. 256 (Apr. 9, 1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission, Investment Trust Study)

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(indicating that the purpose of SEC rules to be promulgated under Section 17(d) (originally drafted as Section 17(a)(4)) is to "insure fair dealing and no overreaching").

[69] In the Matter of Sequoia Partners, L.P., Inv. Co. Act Rel. No. 20644 (Oct. 20, 1994) ("Section 17(d) of the Act was designed to prevent affiliated persons from exerting undue influence over investment companies by causing them to engage in transactions that confer disparate benefits on such persons. As the leader of a 13D Group that controlled more than 25% of Fund's common stock, Sequoia had the power to obtain undue concessions from Fund.") ("Sequoia Partners"); Protecting Investors Report, at 496-97 (May 1992) ("Indeed, those joint transactions reviewed by the Commission in which the fund and an affiliate do not participate on the same side of the table often involve complex business arrangements. Our experience in reviewing such arrangements suggests that close examination continues to be necessary, especially for those transactions where an investment company and an affiliate will experience different economic consequences.").

[70] Investment Company Act § 2(a)(3)(A).

[71] Investment Company Act § 2(a)(3)(C).

fund's board with friendly directors, who then hire the activist manager to run the fund, raise serious issues and concerns under Section 17(d) and Rule 17d-1.

The SEC has recognized the overreaching behavior of activist managers who are affiliated persons of targeted closed-end funds in the context of closed-end fund proxy contests. To date, the SEC has focused only on transactions where an affiliated activist manager is reimbursed for its proxy expenses:[72]

> [T]he Commission takes this opportunity to remind the fund industry of the importance of the requirements of section 17(d) and rule 17d-1 particularly in the context of an agreement to reimburse the costs of a proxy contest. These provisions broadly prohibit certain joint transactions or arrangements between registered investment companies and their affiliates without the Commission's advance approval. Approval must be sought from the Commission prior to investment companies engaging in reimbursement agreements of this type.

The SEC's seminal statement on this topic is the *Sequoia Partners* case.[73] In *Sequoia Partners*, the SEC made clear reimbursement for proxy expenses would provide the affiliated activist manager with a benefit not shared by all shareholders — namely, that by virtue of the reimbursement, if the bargained-for "liquidity" event were a tender offer, the affiliated activist manager would receive a price closer to net asset value than that received by other shareholders. The SEC characterized this as an "undue concession[] from the Fund" that "unjustifiably benefit[ed] a single shareholder or group of shareholders at the expense of others." Somewhat more importantly, the SEC also expressly recognized that it was "questionable whether . . . stockholders who did not tender their shares received any material benefit from [the activist manager's] activities." In this case, the SEC denied the activist manager's application for an exemption from Section 17(d) and Rule 17d-1 to allow the expense reimbursement, and these observations from the SEC could not be more important today.

If the reimbursement of proxy expenses to an affiliated activist manager can give rise to a prohibited joint transaction under Section 17(d) and Rule 17d-1, surely the current takeover and other strategies employed by affiliated activist managers likewise can give rise to prohibited joint transactions. Today, there are conceivably multiple joint transactions occurring, all with different implications. Disproportionate enrichment to an affiliated activist manager similar to the reimbursement of proxy expenses also occurs in "liquidity" events because the retail middle-class investors who hold closed-end funds typically do not participate in these "liquidity" events, like tender offers, because they like their funds, their yield, and want the strategy exposure. Moreover, there is another joint transaction that can occur among an activist-managed closed-end fund, the activist manager and the activist's private funds when they use their collective resources to target a third-party closed-end fund. Imagine the overreaching of investors that occurs when an activist manager uses the assets of a registered closed-end fund it manages to target, with affiliated private funds, a third-party closed-end fund for a takeover where the targeted closed-end fund's board is replaced with the activist manager's hand-picked directors, who then promptly install the activist manager as the targeted closed-end fund's manager. The activist manager, in this scenario, has arguably used the assets of the registered closed-end fund it manages to help it secure a lucrative new revenue stream from additional management fees, and another entity to repurpose to further its activism strategy.

Section 17(d) and Rule 17d-1 of the Investment Company Act are prophylactic provisions that require joint transactions to be entered into pursuant to exemptive relief from the SEC or pursuant to a rule adopted by the SEC. Section 17(d) of the Investment Company Act gives the SEC the authority to promulgate rules regarding joint transactions for the purpose of limiting or preventing participation in the joint transaction by a registered investment company on a basis different from or less advantageous than that of any other participating affiliated person. Additionally, Section 6(c) of the Investment Company Act gives the SEC the authority to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Investment Company Act or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act. With this authority, the SEC can address both the oversight in Section 12(d)(1)(C) and the abuses occurring in these affiliated transactions by adopting a new safe harbor rule under Section 17(d) exempting certain transactions that may be executed as a result of the influence of an

[72] The Mexico Fund, Inc., Inv. Co. Act Rel. No. 25729 (Sept. 13, 2002).

[73] Inv. Co. Act Rel. No. 20644 (Oct. 20, 1994); *supra* note 69.

affiliated activist manager, provided that the 10% Limitation of Section 12(d)(1)(C) is complied with, together with any other requirements necessary to ensure fair dealing and no overreaching by the affiliated activist manager.

CONCLUSION

Activist managers are strangling the closed-end fund industry and harming the retail investors who invest in closed-end funds for what they are meant to provide — consistent income, attractive yields, and exposure to more illiquid asset classes that can produce higher returns — as opposed to investing in closed-end funds for short-term arbitrage gains. The loopholes these activist managers use were never intended by Congress and they strike at the heart of what the Investment Company Act was written to eliminate. Congress and the SEC should use their authority to fix these abuses and level the playing field so that the closed-end fund industry can continue to thrive. ■