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Closed-End Fund Activism:

An overview of recent developments in law, legislative proposals, and case law

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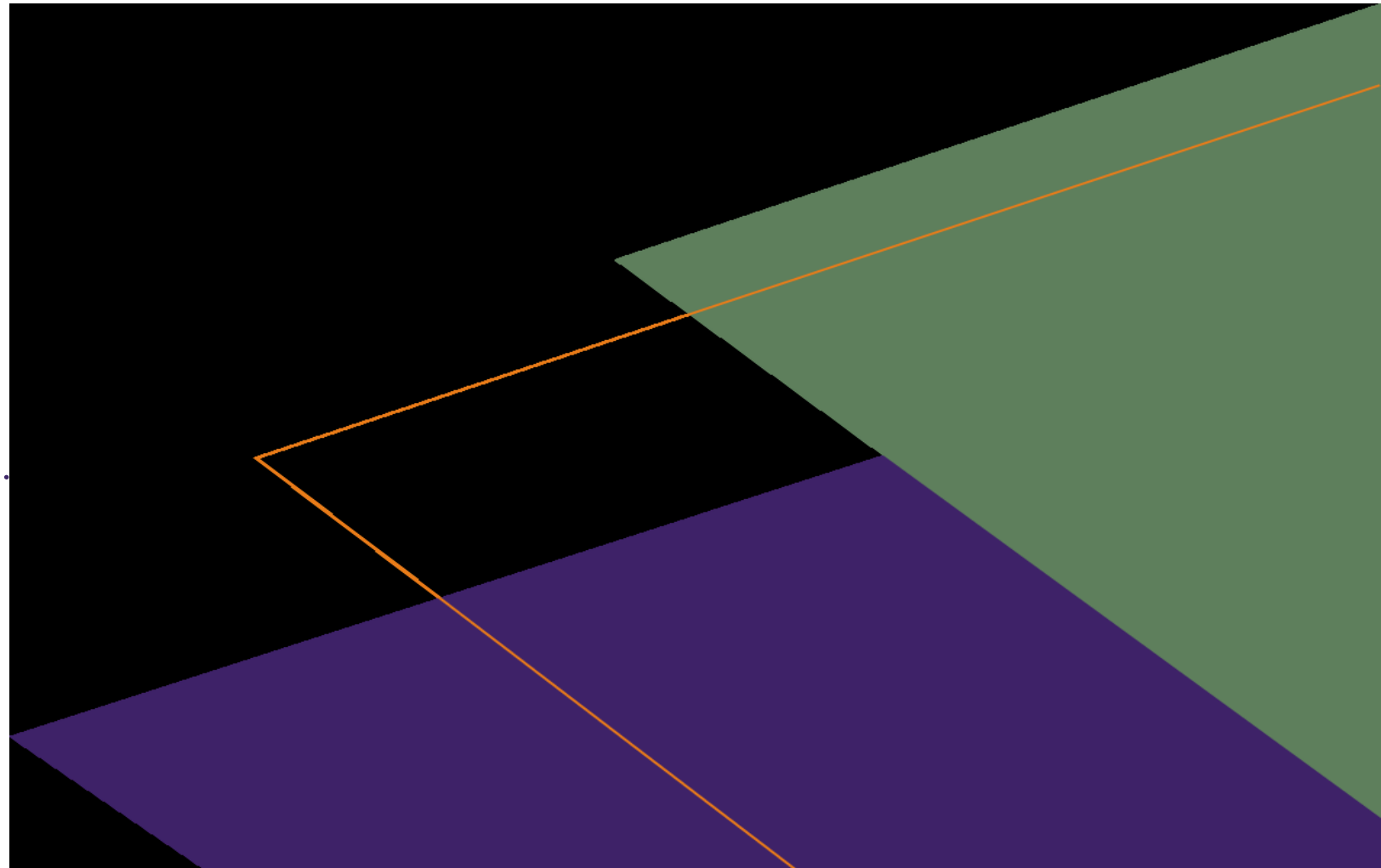

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Agenda

- Factors that may put CEFs at risk of activist attacks
- Proposed legislation to close the 12(d)(1)(C) loophole
- State response: Control share statutes
- Recent litigation by activists
- ISS/Glass Lewis policies
- Next steps

Factors that May Put CEFs at Risk of Activist Attacks

- A significant discount between the price at which a closed-end fund's (CEF) common stock trades in the market and its NAV per share.
- The ability of the activist to accumulate a significant stake in the CEF (e.g., smaller funds).
- Upcoming transactions that otherwise require a shareholder vote (e.g., approval of a new advisory contract, a merger, etc.).
  - In these circumstances, an activist may be able to avoid a proxy contest by pressuring the CEF to agree to a negotiated settlement (normally involving a liquidity event) in order to secure the activist's commitment to appear at the meeting in order to achieve quorum.
- A shareholder base that would welcome or is otherwise conducive to the activist's agitation for action by the CEF and would be willing to support the activist in the event of a proxy context.

Proposed Legislation to Close the 12(d)(1)(C) Loophole

- Section 12(d)(1) of the Investment Company Act limits the ability of investment companies to acquire shares of other investment companies.
  - Section 12(d)(1)(A)(i), for example, prohibits an investment company from acquiring more than 3% of the total outstanding voting stock of another investment company.
- Section 3(c) of the Investment Company Act excludes certain issuers from the definition of investment company, including private funds beneficially owned by not more than 100 persons (a Section 3(c)(1) exemption) and private funds whose outstanding securities are owned exclusively by qualified purchasers (a Section 3(c)(7) exemption) (collectively, "Private Funds").
- Sections 3(c)(1) and 3(c)(7) provide, however, that these Private Funds are still included in the definition of investment company for purposes of the limitations imposed by Sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i).
  - In other words, Private Funds cannot individually acquire more than 3% of a registered fund's outstanding voting stock.

Proposed Legislation to Close the 12(d)(1)(C) Loophole

- Activist investors get around this 3% limitation by using multiple Private Funds to individually acquire up to 3% of a target fund notwithstanding the fact that voting power is collectively exercised by their shared or affiliated investment adviser.
- Section 12(d)(1)(C) places a limit on the ability of a fund to acquire more than 10% of a registered CEF's outstanding voting stock.
  - Specifically, Section 12(d)(1)(C) makes it unlawful for any investment company (and any companies it controls) to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition that investment company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own more than 10% of the total outstanding voting stock of such closed-end company.
- Because Private Funds are not deemed to be investment companies for purposes of Section 12(d)(1)(C), activists may use these funds to accumulate voting stock in a CEF without regard to the 10% limitation.

Proposed Legislation to Close the 12(d)(1)(C) Loophole

- Bipartisan legislation has been introduced in Congress to close this loophole.
- The *Increasing Investor Opportunities Act* was originally introduced in the House of Representatives on June 30, 2021 by Rep. Anthony Gonzalez (R-Ohio)* and Rep. Gregory Meeks (D-NY). But it did not make it out of Committee.
- It was reintroduced on April 13, 2023 by Rep. Ann Wagner (R-Mo.) and Rep. Meeks.
  - The legislation would amend Section 3(c) of the Investment Company Act by making the exemption from the definition of "investment company" in Sections 3(c)(1) and 3(c)(7) inapplicable to Section 12(d)(1)(C) in addition to Sections 12(d)(1)(A) and (B).
  - This change would make Private Funds "investment companies" for purposes of Section 12(d)(1)(C) and therefore subject both the funds and any other investment companies with the same investment adviser to the 10% limit.
- On March 7, 2024, it was passed as an amendment to the *Expanding Access to Capital Act of 2023*, sponsored by House Financial Services Committee Chair Patrick McHenry (D-NC). Remains to be seen if it will pass the Senate.

* Congressman Gonzalez did not seek re-election in 2022.

Proposed Legislation to Close the 12(d)(1)(C) Loophole

- In order to receive bipartisan support, the legislation seeks to expand retail access to Private Funds made through an investment in a registered fund.
- The legislation would amend the Investment Company Act to prohibit the SEC from limiting a CEF from "investing any or all of the [company's] assets in securities issued by private funds."
- The legislation would also prohibit the SEC from imposing rules limiting "the listing of the securities of a closed-end company on a national securities exchange" where the company "invests, or proposes to invest, in securities issued by private funds."
- These provisions are aimed at a long-standing informal position by the SEC staff to refuse to allow a CEF's registration statement to go effective if part of its strategy involves investing significantly (e.g., more than 15% of its assets) in Private Funds (with certain exceptions). Listing exchanges impose a similar informal position to refuse to list a CEF intending to make such investments.
  - The staff has allowed registration statements to become effective if the fund limits the sale of its shares to accredited investors.

Control Share Statutes

- Some states have passed control share statutes to try to offer CEFs a means of ensuring discussion with an activist that may attempt to force its own agenda on a fund through substantial ownership.
- Control share statutes generally provide that a shareholder who acquires beneficial ownership of shares in excess of a specified percentage of the company's total outstanding shares (usually starting at 10%) has no voting rights with respect to the excess shares and cannot vote them unless approved by the other shareholders.
- Control share statutes may be difficult to apply in practice.
  - Proxies are submitted by record holders, who may not be the activists themselves.
    - Activists may hold their shares with several different record holder custodians, or a single record holder custodian may submit a proxy representing multiple stockholders.
  - Inspectors of Election are generally limited to confirming a proxy is valid on its face without looking further into individual shareholder instructions.
  - CEFs suspecting that an activist is attempting to vote in excess of a control share act threshold limit may need to seek court action to disqualify votes.

Control Share Statutes

- Maryland Control Share Acquisition Act (the "MCSAA")
  - The MCSAA was amended in 2000 to authorize CEFs organized as corporations to opt-in to the statute if the Board adopted a resolution to do so.
  - The SEC Staff issued a no-action letter in 2010 stating its view that a CEF opting into the MCSAA would be inconsistent with Section 18(i) (the "Boulder Letter").
    - The Boulder Letter was withdrawn in 2020.
  - In 2023, Maryland amended its Code to make the MCSAA automatically apply to statutory trusts formed on or after October 1, 2023, and retroactively applicable to statutory trusts that had opted-in prior to that date.
- Delaware Statutory Trust Act was amended, effective August 1, 2022, to include control share acquisition provisions (the "Delaware CBIA")
  - The Delaware CBIA *automatically* applies to Delaware statutory trusts that are registered as CEFs under the Investment Company Act and have their shares listed on an exchange.
  - However, the Delaware CBIA allows a statutory trust's governing instrument or board of trustees to provide exemptions from the statute's limitations.
  - The Delaware CBIA also requires acquiring persons to disclose to the CEF any control share acquisition within 10 days of the acquisition.

Activists Use Litigation To Advance Their Agenda – Control Share Statutes

- *Saba Capital CEF Opp. 1 Ltd. v. Nuveen Floating Rate Income Fund*
  - In January 2021, Saba brought suit against a collection of Nuveen CEFs organized as Massachusetts business trusts. Saba alleged that the adoption of control share bylaw provisions violated Section 18(i) of the Investment Company Act and sought rescission.
  - Section 18(i) states that "[e]xcept . . . 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."
  - The Second Circuit found that the control share bylaw provisions violated Section 18(i) because they converted the stock into non-voting stock and created unequal voting rights.
- *Saba Capital Master Fund, Ltd. v. Clearbridge Energy Midstream Opp. Fund et al.*
  - In June 2023, Saba brought suit against CEFs organized as Maryland corporations and statutory trusts that had opted in to the MCSAA. Saba alleged that the restrictions authorized in the MCSAA violated Section 18(i) of the Investment Company Act and sought rescission.
  - The funds argued that once they adopted the resolution, the restrictions were "required by law."
  - The SDNY held that because the funds had to opt in, they were not "otherwise required" by law. The SDNY therefore held that rescission was "compelled" by *Nuveen*.
  - The case is currently being appealed to the Second Circuit, with argument in April 2024.
- No case has yet been brought challenging the Delaware Control Share Act

Activists Use Litigation To Advance Their Agenda – Majority Vote Bylaw

- *Eaton Vance Senior Income Trust v. Saba Capital Master Fund Ltd.* (Mass. Super.)
  - In August 2020, Eaton Vance Senior Income Trust ("ESVI") sued Saba in Massachusetts Superior Court to declare valid a bylaw that required board nominees to receive an affirmative vote of the majority of all outstanding shares in contested elections.
  - Saba then counterclaimed for breach of contract, seeking to invalidate the majority vote bylaw along with a separate bylaw purporting to create control share provisions.
  - The Court ruled that the control share provisions were invalid under the Investment Company Act. However, it determined that it could not resolve the majority vote issue on summary judgment as a matter of law, and the case is proceeding toward a trial in September 2024.

- *Saba Capital Master Fund, Ltd. v. BlackRock ESG Capital Allocation Trust* (SDNY)
  - In March 2024, Saba sued ECAT, a Maryland CEF with a bylaw requiring board nominees to receive an affirmative vote of the majority of all outstanding shares in contested elections.
    - Saba alleges that the bylaw violates Section 16 of the Investment Company Act, because it results in failed elections and holdovers, and therefore deprives shareholders of a meaningful opportunity to elect trustees annually.
    - Saba also alleges that the bylaw violates Section 18(i) because it gives disproportionate voting rights to the shares cast in favor of incumbent trustees.
  - Defendants have moved to dismiss the action on multiple grounds.

Activists Use Litigation To Advance Their Agenda – Poison Pill

- In light of these SDNY and Second Circuit decisions calling in to question control share provisions, some CEFs have considered adopting shareholder rights plans (i.e., poison pills) as an alternative way to ensure an activist cannot force its agenda on to a fund without engaging with the board.
  - Once adopted, a shareholder rights plan triggers significant dilution for a shareholder that acquires voting shares of the CEF without board approval in excess of a threshold amount determined by the board, typically 10 to 20% of outstanding shares.
  - Upon the rights being triggered, all shareholders, other than the triggering party, may buy additional shares in the CEF at a substantial discount to the then-current market price.
- Section 18(d) of the 1940 Act prohibits any registered fund from issuing any warrant or right to subscribe to or purchase securities of the fund, except those expiring not later than 120 days after their issuance which are issued exclusively and ratably to a class or classes of the fund's shareholders.
- Furthermore, Section 23(b) of the 1940 Act generally prohibits a closed-end fund from selling its common stock at a price below net asset value unless a specified statutory exception applies. One statutory exception, contained in Section 23(b)(4), is upon the exercise of any warrant issued in accordance with the provisions of Section 18(d).
- Exchange listing rules may also impose limitations.

Activists Use Litigation To Advance Their Agenda – Poison Pill

Previous federal court cases have concluded that:

- A closed-end fund's use of a shareholder rights plan does not violate Section 18(d), 18(i) or 23(b) of the Investment Company Act. See *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust No. 1B*, 342 F. Supp. 2d 371 (D. Md. 2004) (*Lola Brown I*) ("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.").
- A closed-end fund did not violate Section 18(d) of the Investment Company Act by serially adopting a shareholder rights plan every 120 days. See *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust No. 1B*, 485 F. Supp. 2d 631 (D. Md. 2007) (*Lola Brown II*).
- However, courts in the SDNY or the Second Court could reach a different result.
- ASA Gold & Precious Metals, Ltd. adopted such a poison pill in December 2023, and Saba bought an action against them in January 2024. The case is proceeding slowly.
    - Saba claims that the pill violates Section 23(b)(4) which says that "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," except, as relevant, "upon the exercise of any warrant . . . issued in accordance with the provisions of section 80a–18(d) of this title." 15 U.S.C. § 80a-23(b)(4)
    - Section 80a-18(d), in turn, requires that any such subscription rights must be "issued exclusively and ratably to a class or classes of such company's security holders." 15 U.S.C. § 80a-18(d)

Other Litigation Considerations: Section 47(b)

- Section 47(b) states that "[a] contract that is made, or whose performance involves, a violation of [the 1940 Act] is unenforceable by either party . . . unless a court finds that . . . enforcement would produce a more equitable result . . . and would not be inconsistent with the purposes of [the 1940 Act]."
- The SEC has exclusive jurisdiction to enforce the 1940 Act (with one exception). In 2019, however, the Second Circuit (in *Oxford University Bank v. Lansuppe Feeder LLC*) held Congress' intent in enacting Section 47(b) was to grant contracting parties a right to sue for rescission of a contract that allegedly violates the 1940 Act.
- Activists have used 47(b) in the Second Circuit to seek rescission of bylaws by arguing that they (as shareholders) are parties to an illegal contract (because a funds' governing documents, including its bylaws, are a contract between the fund and its shareholders).
- The Third Circuit and others, however, have held that Section 47(b) does not create a private right of action to seek rescission, creating a circuit split.
    - May be worth reviewing forum selection provisions in fund bylaws.
- The question of how to resolve the inconsistency is preserved in the Saba v. ClearBridge case discussed above and, depending on the outcome of that appeal, the Supreme Court may be asked to review the issue.

ISS/Glass Lewis Policies (2024)

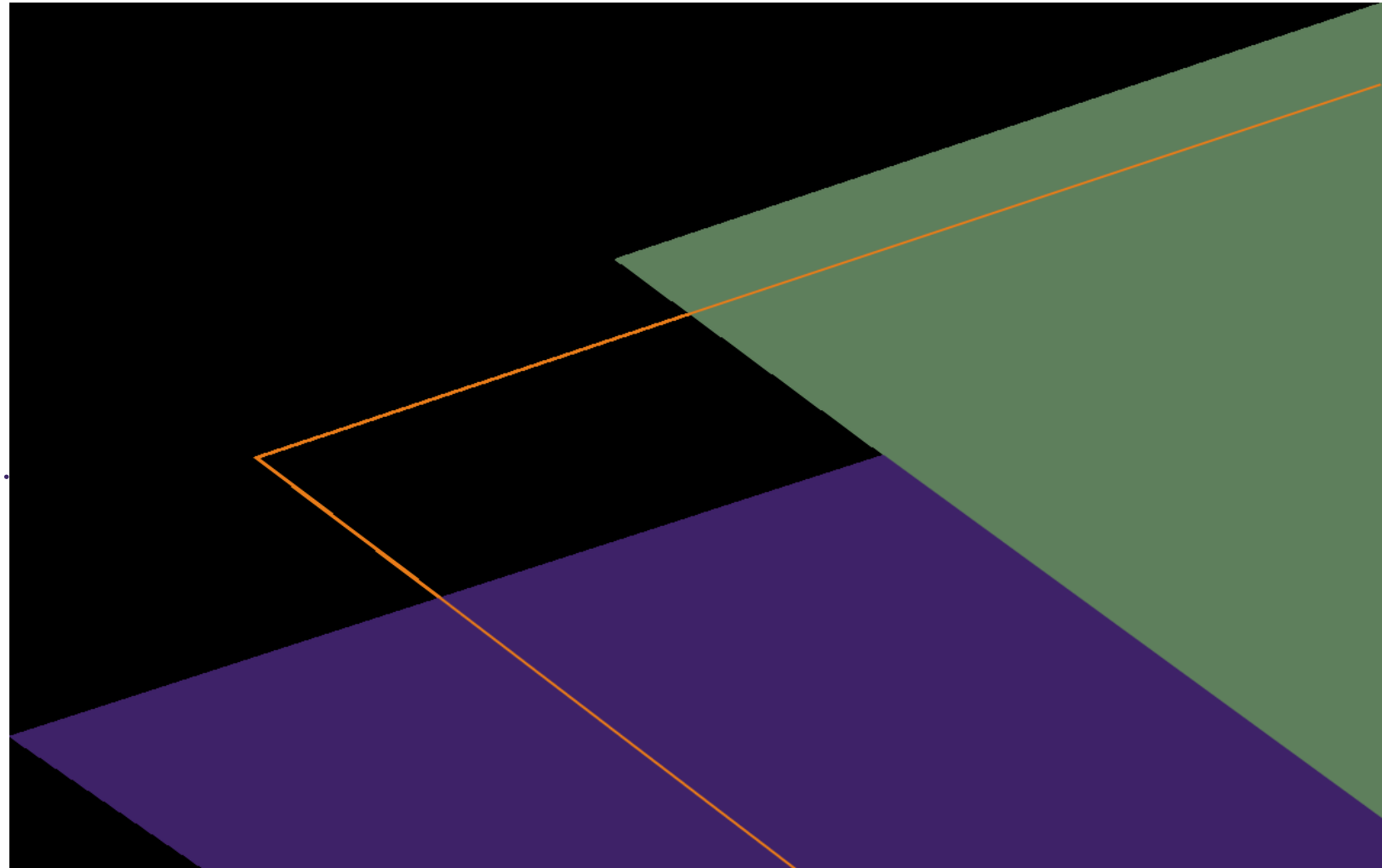
- Control Share Statutes
  - Vote against or withhold from nominating/governance committee members (or other directors on a case-by-case basis) at CEFs that have not provided a compelling rationale for opting-in to a Control Share Statute, or submitted a by-law amendment to a shareholder vote.
- Unilateral Bylaw/Charter Amendments and Problematic Defenses
  - Generally vote against or withhold from directors individually, committee members, or the entire board if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders.
  - Unless the amendment is reversed or submitted to a binding shareholder vote, in subsequent years vote case-by-case on director nominees. Generally vote against if the directors: (i) Classified the board; (ii) Adopted supermajority vote requirements to amend the bylaws or charter; or (iii) Eliminated shareholders' ability to amend bylaws.
  - Case by case on nominees if the board adopts an initial short-term pill without shareholder approval, considering the rationale for adoption, the trigger, and other factors.
- Responsiveness
  - At the previous board election, any director received more than 50 percent withhold/against votes of the shares cast and the company has failed to address the issue(s) that caused the high withhold/against vote.

Future of Protecting CEFs and Their Investors

- Although control share statutes have the potential to be effective, and we believe the correct conclusion is they are consistent with the Investment Company Act, the application of the statutes by the inspectors of elections and Saba's persistent litigation injects a measure of uncertainty into their long-term efficacy. Additionally, in light of the restrictions imposed by the Investment Company Act, and certain difficulties in administration, poison pills may not be practical in all cases.

- What else can closed-end funds consider doing?
  - Additional preferred share directors beyond the minimum two required.
  - Shareholder voting rights limited to defined matters in governing documents (works best for trusts).
  - Review and amend exclusive forum provisions to expressly reference the Investment Company Act.
  - Robust shareholder communication efforts before a threat even arises.
  - Consider periodic liquidity events.
  - If practical, maintain a steady dividend.

Questions?



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Patrick (Jay) Spinola, Jr. is a partner in the Asset Management Department with over 20 years of experience counseling registered investment companies, their boards and their sponsors. Jay focuses on the organization and offering of registered investment companies, and counseling funds and their sponsors in all aspects of their ongoing operations. He has significant experience advising clients that offer specialized investment funds, such as exchange-traded funds (ETFs), registered funds of private funds, interval funds and novel investment products. He provides advice to clients on the full range of issues that funds, their boards and advisers encounter day-to-day, including regulatory and compliance matters, contract approvals, disclosure issues, and restructuring and financing transactions. He frequently advises closed-end funds regarding secondary offerings and other capital markets transactions, along with strategies to address market discounts and dealings with activist investors.

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Vanessa has represented public and private corporations, boards of directors, individual directors and officers, and securities underwriters in federal and state courts across the country, including the Delaware Court of Chancery. She regularly advises on corporate governance matters, particularly those involving mergers and acquisitions, and has represented investors and corporations in connection with activist matters and proxy contests.

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