Board Oversight of Closed-End Funds

Mutual Fund Directors Forum
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CONTENTS

• Duties of Directors
• Regulation of Closed-End Funds
• The Underwriting Process
• Leverage
• Common Shareholder Liquidity
• Exchange Listing Requirements
• Illiquid Investments
• Director Transactions in Fund Shares
• Trading at a Discount
• “Activist” Investors
• Fund Reorganizations
• Board Consolidations
DUTIES OF DIRECTORS

- Directors of closed-end funds and other investment companies must ensure that their funds are operating in conformity both with applicable state law and with the special requirements of the Investment Company Act of 1940 (the “1940 Act”)

- The obligations imposed by the 1940 Act are in addition to those imposed by state law and do not preempt the duties imposed upon a director by state law except if there were to be a conflict

- A director’s duties under the 1940 Act and state law are the same for a closed-end fund as for a mutual fund – but sometimes must be applied to facts and circumstances unique to closed-end funds
REGULATION OF CLOSED END FUNDS – OVERVIEW

• What is a closed-end fund?
  − Any registered management investment company that does not issue “redeemable securities”
  − A redeemable security is any security, other than short-term paper, that may be redeemed by the holder upon presentation to the fund

• Why a closed-end fund?
  − Illiquid investments
  − Stability of assets: no need to manage daily inflows and outflows
  − Leveraged strategies
• Directors of closed-end funds must ensure that their funds are operating in conformity with:
  - Applicable state law
  - Special requirements of the 1940 Act
  - Exchange listing requirements (if applicable)
  - Organizational documents of the fund
  - Objectives, strategies and restrictions set out in the fund’s prospectus and SAI
THE UNDERWRITING PROCESS – OVERVIEW

- Lack of continuous issuance or redemptions; exchange listing
  - Shares generally not continuously offered for sale
  - Typically trade on a secondary market, such as NYSE or NASDAQ, and bought and sold in the open market (not purchased or redeemed by the fund)
  - Share price determined by market and may be greater or less than NAV
  - Some closed-end funds are continuously offered and provide liquidity through periodic repurchases
THE UNDERWRITING PROCESS – TRADITIONAL FIRM COMMITMENT IPO

• Firm commitment underwriting
  - Led by one or more managing investment banks (FINRA member)
  - Syndicate of co-managers, underwriters and dealers
  - Distribution dependent on third parties
  - Limited calendar slots

• Typical offering terms
  - Sales load: 4.5% of offering price
  - Structuring fee payments by adviser to lead underwriters
  - Offering expenses cap: 0.20% of offering price
  - Initial NAV equal to 95.3% of offering price

• Underwriting agreement generally approved in person by board
THE UNDERWRITING PROCESS – TRADITIONAL FIRM COMMITMENT IPO (CONT.)

• Underwriters cannot trade with the fund during the course of the offering
• Identity of underwriters may impact a director’s independence during the course of the offering
THE UNDERWRITING PROCESS – POST IPO

- Underwriter stabilization
  - Over-allotment option
  - Syndicate short position
  - Penalty bids
- Distribution management
- Ongoing marketing and analyst education
THE UNDERWRITING PROCESS – ADDITIONAL OFFERINGS

- Secondary offerings of common shares
  - Underwritten offerings
  - At-the-market offerings
  - Direct placements
  - Rights offerings

- Boards must consider
  - Needs for premium to NAV
  - Costs
  - Dilution of existing shareholders
  - Timing/Investment opportunities
LEVERAGE – OVERVIEW

- Ability to use leverage as part of investment strategy
- More flexibility to use leverage relative to mutual funds
- Structural leverage
  - Preferred Shares
  - Borrowings
  - Debt Securities
- Portfolio leverage
  - Reverse repurchase agreements
  - Tender option bonds (TOBs)
  - Derivatives with embedded leverage
- Compliance policies and procedures for use of leverage
LEVERAGE – PREFERRED SHARES

• May issue one class of preferred shares (but multiple series)
• Preferred shareholders have exclusive right to elect two directors and typically vote, jointly with common shareholders, to elect remaining directors
  – The 1940 Act sets out separate vote requirements by preferred shareholders for certain matters (change in certain fundamental investment policies, approval of a reorganization adversely affecting preferred shareholders, etc.)
  – Preferred shareholders have right to elect majority of directors if the fund does not pay preferred share dividends for two years
• Neither 1940 Act nor jurisdictions in which most closed-end funds are organized assign distinct fiduciary duties to preferred directors
Preferred directors owe a fiduciary duty to the fund to act in a manner that protects the interests of all shareholders, both common and preferred.

For each $1.00 of preferred shares issued, the fund must have $2.00 of assets at issuance and dividend declaration dates (200% asset coverage), including assets attributable to proceeds from preferred share issuances.

Additional contractual restrictions.

Various types of preferred shares:
- Publicly offered or privately placed
- Fixed or variable rate
- Previously, mainly Auction Market Preferred Shares (AMPS)
- Currently, Variable Rate Demand Preferred Shares (VRDPS) and Variable Municipal Term Preferred Shares (VMTPS)
LEVERAGE – DEBT

• Generally may issue one class of debt

• 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 (300% asset coverage), including assets attributable to proceeds from debt and preferred share issuances
  – If a fund fails to maintain 100 percent asset coverage for 12 consecutive months, debt holders have the right to elect a majority of directors
  – If a fund fails to maintain 100 percent asset coverage for 24 consecutive months, it is deemed an event of default

• Additional contractual restrictions
LEVERAGE – PORTFOLIO LEVERAGE

- Portfolio leverage results from certain portfolio investments
  - Certain types of derivatives
  - Reverse repurchase agreements
  - TOBs
- May involve a senior security, because a counterparty may have a future claim to the fund’s assets that is superior to the rights of fund shareholders
- If a fund has “covered” its obligations under these types of transactions, the fund is not deemed to have issued a senior security.
  - A fund may “cover” the transaction by segregating liquid assets on its books that are sufficient to satisfy 100% of the fund’s obligations under the transactions or by entering into transactions that offset the fund’s obligations
COMMON SHAREHOLDER LIQUIDITY

- Shares not redeemable, but investors want liquidity
- Trade on a secondary market, such as NYSE or NASDAQ
- Interval Funds: Periodic Repurchase Offers (Rule 23c-3)
  - Fundamental policy to repurchase 5-25% of outstanding common stock at periodic intervals pursuant to repurchase offers made to all common shareholders; purchase price must be the fund’s NAV determined as of a specified date, which may be subject to a repurchase fee of up to 2% of the proceeds
  - Typically daily or monthly
- Tender Offer Funds
  - Periodic tenders at the discretion of the board
  - Typically quarterly
EXCHANGE LISTING REQUIREMENTS

• Stock exchange listing rules
  - Initial listing requirements
  - Ongoing listing requirements
    » Annual shareholder meetings to elect directors
    » Director independence
    » Audit committee requirements (written charter; at least three members; all independent directors; review audited and other financial statements)
    » Corporate governance requirements (annual certification)
  - Prompt notification of material events
    » Exchange rules
    » Regulation FD
ILLIQUID INVESTMENTS

- SEC limits open-end funds to investing no more than 15% of their assets in illiquid investments
- Closed-end funds may invest without limit in illiquid investments
- An "illiquid" security generally is considered to be a security that cannot be sold within seven days at the approximate price used by the fund in determining NAV
- Special board considerations
  - Valuation/NAV
  - Increased dependence on judgment of advisor
  - Increased selling costs
  - Possible ineligibility to serve as collateral or segregated assets
DIRECTOR TRANSACTIONS IN FUND SHARES

- Section 16 Reporting Requirements
  - Initial reports
  - Transaction reports

- Short-swing profits
  - Any profit from purchase and sale within six months must be disgorged to fund

- Insider trading restrictions
  - Director may not trade while in possession of material nonpublic information
  - Subject to same Code of Ethics requirements as open-end funds
A closed-end fund’s shares trading on an exchange may trade:
- At a price equal to NAV
- At a price above NAV (at a “premium”)
- At a price below NAV (at a “discount”)

Historically, many funds have traded at persistent discounts
TRADING AT A DISCOUNT – CLOSING THE DISCOUNT

• No 1940 Act requirement that a board seek to close a discount
• Board may wish to do so in the interests of shareholders of the fund
• Methods employed to close the discount:
  - Tender offers
  - Open market repurchases
  - After market support
  - Dividend management (level dividends; increased leverage)
  - Mergers
“ACTIVIST” INVESTORS – OVERVIEW

- Differences between the closed-end fund structure and open-end fund structure make closed-end funds uniquely susceptible to “Activist” activity
  - Public market trading and value
  - Absence of fund-provided liquidity
  - Annual proxy statement forum and election of directors
  - Easy identification of institutional shareholders (Sch. 13D)

- “Activist” activity has primarily focused on:
  - Trading market discounts to NAV
  - Auction Market Preferred Share liquidity
  - Investment adviser relationship
“ACTIVIST” INVESTORS – OBJECTIVES AND METHODS

- “Activist” objectives include:
  - Open-ending or liquidating closed-end funds
  - Share buybacks or tender offers
  - Usurping investment adviser role
  - Investment policy or corporate governance changes (often to facilitate above objectives)

- “Activist” methods include:
  - Coordination with other large holders
  - Direct communication with management
  - Withholding of proxies and votes for quorum and approval purposes
  - Shareholder proxy proposals and proxy contests
  - Director nominations and board membership
  - Disparaging comments to regulators and public
  - Litigation
“Activist” objectives and methods often are at odds with the interests of long-term investors, distracting to the board and management, costly and potentially injurious to the fund

- Not all “activism” is bad
- Healthy dialogue with investors is good governance

As a result, it is appropriate to consider means to protect the fund from detrimental activism and enhance the ability to implement the fund’s long-term objectives
“ACTIVIST” INVESTORS – MEASURES TO CONSIDER

• Measures Boards may consider:
  - Staggered boards (typically three year terms)
  - Advance notice for shareholder proposals and board nominations
  - Limiting ability to call special meetings or act by written consent
  - Strict board member qualification and removal standards
  - Limiting election of directors to annual meeting
  - Super-majority voting requirements
  - Reduced quorum provisions
  - Elective indemnification
  - Loser pays costs litigation provision
  - Organizational document anti-pyramiding and anti-conflict provisions
  - Organizational document-based right of fund to sue to enforce 1940 Act
  - Ability to reorganize fund with another fund without shareholder approval
“ACTIVIST” INVESTORS – MEASURES TO CONSIDER (CONT.)

• Measures Boards may consider (continued):
  - Ability to terminate fund without shareholder approval
  - Reorganizing a fund with another to create a larger fund
  - Exchange offer for back-end load open-end fund shares
  - “White knight” preferred or debt
  - Rights plans
  - Share ownership limitations

• Protective Measures in Event of Activist Board Membership
  - Clear director conduct rules and meeting procedures with consequences
  - Procedures to prevent access to information about other funds in the complex, such as combined committees but separate meetings
  - Information access standards
  - Trading restrictions
“ACTIVIST” INVESTORS – LEGAL STANDARDS

• Standard for Approval
  - Primarily a Business Judgment Rule Standard: A court will not second-guess the judgment of a director who was sufficiently free of self-interest and was well informed as to the matters at hand if the director acted with due care and in good faith in what he or she believed to be the best interests of the fund and its shareholders
  - Possible overlay of Unocal-like standard: Shifting of presumption, requirement that the action taken was reasonable in relation to the threat posed and not draconian
    » Possibility of higher standard under some circumstances

• Smooth Sailing on Clear Days
  - Regardless of the articulation of the standard, it is far better to act in a deliberate fashion prior to the existence of any particular activist threat; courts give greater deference in this circumstance
• Heightened scrutiny or less deference likely accorded to actions taken to thwart a particular activist threat; many defensive actions will still withstand scrutiny, but better to be proactive than reactive if Board has such luxury.

• In light of extreme threat posed by relatively easy structural ability of activist to disrupt long-term objectives of closed-end model, fairly severe protective measures should withstand scrutiny:
  - Particularly in the case of well-performing Boards without appearance of conflicts, good succession plans, strong self-evaluation practices and history of arms-length dealings with adviser generally.

• Strong measures adopted in good faith can have significant deterrent benefits even if upon challenge they might ultimately be struck down as disproportionate.
• The “E” Word: Entrenchment
  - Legal scrutiny not the only scrutiny
  - The particular vulnerability of closed-end funds to injurious “activism” is not well understood
  - Press, analysts, “good governance” bodies may criticize these protective measures and ISS or other voting services may recommend against any such actions requiring shareholder approval
  - Shareholder and public relations groups should be well prepared
FUND REORGANIZATIONS

• Generally, board considerations are the same as for open-end fund reorganizations (benefits to shareholders, efficiency, cost structure, etc.)

• Primary difference is relative market value vs. premium or discount to NAV
  – Frequency and duration
  – Magnitude
  – Relative fund size
  – Fund-based attributes
  – Overall potential market benefit of larger fund
BOARD CONSOLIDATION

- Factors to consider include:
  - Benefits to shareholders
  - Increased complexity and director work load
  - Structural efficiencies, elimination of redundancy
  - Culture
  - Cost structures
QUESTIONS?

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