

ICI Urges the SEC to Strengthen the Ability of Closed-End Funds to Defend Against Activist Campaigns

Current Limits on Funds' Defenses Favor Arbitrageurs at Expense of Main Street Investors

Washington, DC; March 12, 2020—The Investment Company Institute (ICI) made a [submission](#) to the Securities and Exchange Commission (SEC) today recommending that the SEC issue guidance on the defenses that closed-end funds may use against professional activist campaigns. Specifically, ICI asked the Commission to withdraw a 2010 [SEC staff no-action response](#), *Boulder Total Return Fund, Inc.*, and issue guidance clarifying that closed-end funds can employ common takeover defenses. ICI believes that the conclusions of the *Boulder* letter are incorrect and that the use of several common takeover defenses authorized by state law are fully consistent with both the language and underlying purposes of the Investment Company Act.

“Professional activist investors, often hedge funds, are intensifying their campaigns to extract short-term profits from closed-end funds, causing significant harm to funds and their long-term investors,” says ICI President and CEO Paul Schott Stevens. “These activists’ use of concentrated voting power for arbitrage gain is the very type of harm that Congress sought to prevent in the Investment Company Act. To protect the interests of long-term shareholders against short-term arbitrageurs, the SEC should withdraw the staff position and provide guidance on takeover defenses for closed-end funds.”

Targeted by professional activists, a significant portion of the closed-end market is at risk of liquidation or conversion to open-end structures. Since the financial crisis, more closed-end funds have merged or liquidated than have opened. Only 494 traditional exchange-listed closed-end funds were in operation at year-end 2019, a 25 percent decline from year-end 2007. Closed-end fund sponsors are becoming increasingly reluctant to launch new funds and up-front related costs if their products are at risk to activist attacks.

Professional Arbitrageurs Target Closed-End Funds for Short-Term Gains

Unlike with open-end funds, most closed-end fund shareholders do not purchase or redeem their shares directly from the fund. Instead, their shares trade on the secondary market. Depending on supply and demand at any given time, the market price of shares of a closed-end fund can be higher or lower than its net asset value (NAV), which is calculated on the value of the fund’s portfolio.

Activists seeking arbitrage opportunities purchase large numbers of shares at a discount to NAV and use their voting power to force the fund into actions that enable them to sell shares at or near NAV to reap a quick profit. The actions could include a forced liquidation of the fund, enabling shareholders to receive a cash distribution equal to NAV for their shares; conversion of the fund to an open-end structure, giving shareholders the option to redeem their shares at NAV; and other measures. Some actions, such as partial tender offers, drive up fund shareholder expenses and force fundamental changes that affect the fund’s ability to deliver on its original investment objective.

'40 Act Protects Against Concentrated Voting Power Harmful to Other Shareholders

The Investment Company Act of 1940 gives funds and their independent directors the ability to guard against the use of concentrated voting power by insiders and large shareholders to control a fund in their self-interest to the detriment of other shareholders. That was a cornerstone principle of the legislation at enactment.

The use of several common takeover defenses authorized under state law are fully consistent with the Investment Company Act and supported by court decisions and interpretations of the Investment Company Act. Yet, the SEC staff’s Boulder letter reaches a different conclusion, holding that the Act limits the ability of independent directors to combat behavior of these arbitrageurs.

Closed-End Funds Are Valuable to Retail Investors

Closed-end funds have key features that are attractive to investors and are a highly suitable vehicle for facilitating the SEC’s goal of [enabling retail investors greater access to private capital markets](#).

Current SEC rules limit most retail investors from investing in the private capital markets, meaning retail investors miss some investment opportunities.

Closed-end funds have greater latitude than open-end funds to invest more of their assets in less-liquid securities, including private companies. As a result, these funds can offer retail investors exposure to these investments with the protections that publicly traded, regulated funds provide under the Investment Company Act.

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