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Shareholder Activism Threatens Closed-End Funds and Their Investors

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Middle-Class Investment Tool

Over the past 80 years, closed-end funds (CEFs) have helped millions of Americans achieve their long-term financial goals. Representing $252 billion in assets as of year-end 2022, CEFs are professionally managed, subject to a robust regulatory framework, and have several unique features that have made them a popular product for many middle-class investors.

CEFs can invest across public and private markets, providing access to less liquid assets, often those with higher yields. Exposure to these assets offers shareholders the potential for greater diversification and steady distributions. Given their orientation toward income-producing assets, CEFs are favored by retirees, small business owners, and other investors in need of consistent cash flow.

Unlike open-end mutual funds, CEFs typically issue a fixed number of shares listed on a stock exchange or traded over the counter. Because supply and demand and other market forces drive their share prices, CEFs frequently trade at a discount or premium to their net asset value (NAV), meaning an individual share's price can be less than its asset value. This differential offers investors access to dividends at a bargain—i.e., paying discounted market prices for CEF shares while receiving outsized dividends based on the shares' NAV. Moreover, the way CEFs are traded gives individual investors greater control over the timing and price at which they transact shares.

Rising Shareholder Activism

Discounted market prices, however, also open the door for “activist” investors. Deep-pocketed activists, often operating through hedge funds, are able to amass CEF shares at below-NAV prices, then use their newfound voting power to cause harmful liquidity events—liquidating the CEF, forcing it to repurchase its shares at inopportune times, or converting it to an open-end fund, just to name a few. Such tactics enable activist investors to generate short-term gains at the expense of long-term shareholders.

More recently, activists have replaced entire fund boards with directors associated with the activists, replaced a fund’s investment adviser with an affiliate of the activists, and drastically changed a fund’s investment strategy—all to benefit the activists’ exploitative agenda.

Troublingly, hostile takeover attempts of CEFs have become more common and concentrated in recent years, according to ICI research. 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 fewer exchange-listed CEFs. In fact, 95 percent of these filings were concentrated among just five activist shareholders. That figure compares with 53 percent for the top five activist shareholders from 1998 to 2002.

Harm to Investors

ICI data also show that roughly four out of five CEFs traded at a discount at the end of 2022, with bond and equity CEF discounts averaging 5.0 percent and 5.7 percent, respectively, during the year. Those discounts widened in the latter months of 2022, making CEFs more susceptible to attacks harming the interests of long-term shareholders.

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.

Leveling the Playing Field

ICI has published a comprehensive set of options to help CEFs protect their long-term shareholders. The options detail available corporate defense tools recognized under state laws. While the options may help fend off some hostile takeover attempts, activists have become more sophisticated and aggressive in their attacks. To address these growing threats, ICI has called upon Congress and the Securities and Exchange Commission to protect CEFs by closing loopholes and strengthening the ability of CEFs’ long-term shareholders to control their own fate.

One particular bill—the Increasing Investor Opportunities Act, bipartisan legislation introduced by Representatives Gregory Meeks (NY-05) and Ann Wagner (MO-02)—would cap the stake in a CEF that activist investors and their affiliates can acquire through hedge funds at 10 percent. This cap, which is the same that registered funds are subject to, would prevent activists from securing a controlling interest in a CEF. It would also help ensure that retail investors using CEFs to save for their long-run financial goals can do so without worry of being derailed by professional, short-term traders.

Through prudent action, policymakers can save CEFs from an unfair, existential threat and preserve these funds for the millions of Americans who depend on them.

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