Skadden's Hardy and Colby on CEF activism

Kevin Hardy

Eben Colby

Skadden partners Kevin T. Hardy, Investment Management, and Eben P. Colby, Litigation, join Jane King in a discussion on activism in closed-end funds (CEFs), in which investors move to buy large stakes in CEFs and try to influence how they are run.

They say CEF activism is becoming more prevalent and evolving to the point where every CEF is at risk of becoming an activist target, and they suggest ways fund managers can manage that risk.

They also explore how the CEF structure is evolving beyond income generation and into other strategies.

Learn more about Skadden here

Find here the video interview.

Jane King: Skadden Arps is a New York based law firm that specializes in business, including mergers and acquisitions, IPOs, and closed-end funds. With me, Kevin Hardy, a partner in investment management, and also Eben Colby, a litigation partner, and we're going to talk specifically about closed-end funds today, and activism in that area. So start with explaining activism in closed-end funds, what does that look like?

Kevin Hardy: Yeah, sure, Jane. Thanks for having us. So basically in closed-end fund activism, investors buy into a closed-end fund, try to buy in at a discount and then take actions to force the fund to take actions that close that discount. Often by seeking to liquidate the fund or convert the fund into an open-end fund, oftentimes without regard to how that might impact the rest of the shareholders in the fund. They're looking to make that quick profit using all of the tools in a traditional proxy fight, contesting the election of the board nominees, putting in their own slate of nominees, trying to terminate the contract with the fund's manager; a wide range of activities they may take, but ultimately all at the goal of making that quick profit and moving onto the next fund.

Jane King: Interesting. Is that a relatively new thing?

Eben Colby: It's becoming a lot more prevalent.

Jane King: Okay. They've seen others do it and have some success?

Eben Colby: Yeah, it's been around for a while but the folks who are most active in it now have a really large footprint across the closed-end fund industry.

Kevin Hardy: And what it looks like has evolved. When I started doing this the concern was always those few touch points where you had to go to your shareholders, that would be a leverage opportunity for an activist to come in and disrupt that process. And then it became if you were a small undersized fund that was performing particularly poorly relative to some peers, you were at risk for an activism campaign. And now, I mean, basically every fund is potentially at risk, so just the scope of it has grown significantly.

Jane King: Is there anything that a closed-end fund manager or other shareholders can do to be aware that this is happening and counteract that?

Eben Colby: Yeah, there are a number of things, and Kevin and his colleagues in our investment management group are specialists in developing some of these defensive mechanisms. The reason why I'm here is because a lot of them have also been challenged in court, and those litigation fights are taking place on a number of fronts right now but there's certainly things that you can do to help inoculate yourself against this.

Kevin Hardy: Yeah, I would say the first thing is just to be aware of it. Like I said, every fund is potentially a target for activists these days, so a fund, its manager, its board should start thinking about it before that day comes. Really understand what's in its governing documents because those are going to set a lot of the rules of the road for how that fight is going to play out if and when it comes.

Some funds probably were launched 15-20 years ago and haven't really thought about or looked at what's in their [inaudible 0:03:29] or bylaws or whatever their governing instrument is since they were formed. And if that's the case, now's the time to take a look and see what's in there and make sure that it's sort of state of the art, that it puts the board on the best footing to make those decisions about what's in the best interest of shareholders. We can talk a little bit more about the particular techniques, there's no silver bullet but giving yourself the best footing to find the best outcome for your shareholders is really important.

Jane King: Education is the first thing.

Eben Colby: Absolutely.

Jane King: Even knowing that it's happening and knowing what's going on with the funds that you have shares in. What are some of the governance issues that are being litigated?

Eben Colby: Yeah, great question. The issue here and the reason why the activists are able to do what they do is that they and another relatively small group of minority shareholders coalesce as a voting bloc, and they're able to impose their will on funds and other shareholders by voting as a block even though that block really represents a minority of the fund overall. And so what funds have been doing on the governance side is an attempt to level that playing field and put some mechanisms in place that have the effect of if an activist is going to try to impose fundamental change on a fund, they've got to get the support of a broad base of shareholders, they've got to get the support of a wide swath of the fund, not just that concentrated minority for a specialist interests bloc.

And it's important because as Kevin said, these activists are looking for relatively short-term liquidity events, and what we see is by and large that's not necessarily what others in the fund care about. Other investors in the fund may care most about just capital preservation plus steady income and robust dividends, and they may not care so much about the day to day trading price or whether or not it's trading at a discount to NAV. That's not important to their investing concerns, and so these governance mechanisms are trying to balance those two considerations.

Jane King: How have the funds fared during these?

Eben Colby: Yeah, so really on the litigation side the activity has really fallen and centered around three different tools that funds have used. One are so-called control share provisions, which say if you are an investor in a fund and you go above a certain threshold, say 10%, that in order to vote the shares that you own above that threshold, you have to get the approval of all of the other shareholders in the fund. This is one of the democratization tools that I just talked about. Second bucket is a majority vote standard, so in a contested director election for example, you have to get the majority of all of the outstanding shares of the fund, not just the majority of the shares that vote. So again, another sort of democratization tool.

Kevin Hardy: Because oftentimes these funds are delivering what investors want, and those investors might not be that motivated to even vote their shares because the fund's doing what it's supposed to do and in their mind it's just performing as it's supposed to. And so oftentimes it's just an effort to get shareholders engaged to cast their votes, whereas the activists are here for that purpose and you know they're going to vote.

Eben Colby: Yeah, and then the last area is shareholder rights [inaudible 0:07:05], which colloquially is known as a poison pill and that's a kind of anti-takeover defense borrowed from the operating company. And so far frankly the control share provisions, courts have been skeptical of that because the Investment Company Act which governs these funds has a one-share, one-vote rule. That litigation isn't over, we're in the late innings, it's not over. The majority vote standard, we're sort of in the middle innings and we expect some important decisions on that issue in the coming year. And on poison pills, we're very early days, so stay tuned.

Jane King: Okay, really interesting. Now the New York Stock Exchange just had a rule change, or proposed a rule change that would impact closed-end funds. So tell us what that is and how would that impact the industry?

Kevin Hardy: Sure. So most companies listed on the New York Stock Exchange, and most other stock exchanges are required to have an annual meeting every year, and that's really that leverage point that activists use to try to get their directors elected and take over a fund and do what they want to do in their interest. There are extensive regulations about the composition of a board in the Investment Company Act, and mindful of that the exchanges do not require, for example, exchange traded funds to have annual meetings.

And so this rule change, if it's adopted, would level the playing field between closed-end funds and ETFs and say as long as you're complying with the Investment Company Act requirements on your board composition you don't have to hold an annual meetings, your directors can serve an indefinite term and you only have to hold a shareholder meeting to elect directors when the Investment Company Act would require it. And so there wouldn't be the expense of going to shareholders every year, so even outside of an activism scenario, it's a benefit to shareholders because you're not going to have to pay for a proxy process every year. Again, sort of leveling the playing field between closed-end funds and ETFs.

That is a proposed change, there's a whole process to go through, the public comment period just ended. Ultimately the SEC has to approve it, it's not something the NYSE can do unilaterally, and so we'll see how that process plays out. I think one thing that a number of funds need to be mindful of is even if that rule change goes into effect, funds then need to look at their governing documents. Because if your governing document says you'll hold an annual meeting, whether or not it's required, that's still in your governing documents. You would still need to do that or you would need to go to shareholders to change that. But if that rule change were to be adopted, certainly for newly formed funds who wouldn't put that in their governing documents or funds that are able to change it, it could really streamline the annual operation of a closed-end fund.

Jane King: Interesting. Is there anything that closed-end fund managers can do? Like they're seeing this going on in the industry, that can protect themselves, maybe a proactive step they can take so that an activist doesn't come in and start running things?

Kevin Hardy: I mean, look, you know, the best defense is performance, but often it's not necessarily about raw performance, it's about the trading discounts, and oftentimes that's outside of your control. But the idea of a closed-end fund being something you can launch and sort of set it and forget it and not think about it again, that's certainly not really feasible in the current activism environment, it's something that requires care and feeding and continuous marketing and getting the story of the fund out there because you do want to do everything you can to minimize that trading discount. Beyond that, it's a lot of the measures that Eben talked about, while they're being litigated, a lot of them I think still make sense to strongly consider adopting.

Jane King: Like the poison pill could be a strategy?

Eben Colby: Yeah.

Kevin Hardy: Yeah, yeah.

Eben Colby: And I think the other thing too is be actively engaged with your shareholder base at all levels before a fight like this arises. So don't wait until you have a problem and then be knocking on your shareholders' doors trying to educate them about the fact that you have offered a product with specific goals in mind and that might suit a specific investment need, and that you've been delivering that. So if you've offered them a certain profile for the fund and you're delivering that, engage with them, make sure that they understand, as Kevin said, the story of what you're delivering from an investment perspective. Engage with those shareholders, see what's on their mind and be preventative about that as well, because you're going to need their support.

Jane King: Okay. So apart from activism, are there any other trends that you're seeing in the closed-end fund industry?

Kevin Hardy: Yeah, I mean, look, it's been a tough market recently to launch listed closed-end funds, the unlisted space, interval funds, tender offer funds, there's been a lot of growth there. But I think one of the emerging trends is we've talked a little bit about closed-end funds often being an income vehicle, that's really the way most people have thought about closed-end funds historically, particularly listed funds, but I think people are starting to think about other uses of closed-end funds.

It's really a vehicle that can invest in illiquid securities, that can use a fair amount of leverage, and people thinking about different strategies that they can put into that wrapper outside of the traditional income-oriented strategy. You see that with things that are focusing on early stage private companies, investing in that in a closed-end fund. Just from talking to our clients, thinking about things, it's definitely an area that people are exploring, getting back to basics and what else could we use this vehicle for? It's always about finding the right wrapper for the right investment strategy, and I think the closed-end fund is a more flexible wrapper than people maybe have historically thought about it as.

Jane King: And what about the SEC and how it regulates closed-end funds, has that evolved? What's happening there?

Kevin Hardy: Yeah, I'll take that one and you can add your thoughts. The SEC has a couple of different mandates since its founding, it's protection of investors, it's efficient and fair capital markets, but it's also capital formation. And so even if the rules and the laws don't change, the SEC over time prioritizes different of those mandates and in different ways, and so there are times where the SEC is particularly mindful of their goal of capital formation.

A few years back I think there was a lot of excitement around the SEC of closed-end funds as potentially being a vehicle to bring retail investors into less public securities as a way to promote that capital formation goal. We're in a moment right now where I think the SEC is a little bit more focused on that investor protection goal and maybe with a mindset of viewing registered investment companies, including closed-end funds, as ideally being relatively simple products, which isn't really what closed-end funds were meant to be necessarily, so a little bit of tension maybe at the moment.

Jane King: Okay, and we're getting to an election, so who knows?

Kevin Hardy: Who knows?

Jane King: Who will be the SEC chairman at some point.

Kevin Hardy: Exactly.

Jane King: Anything to add, Eben?

Eben Colby: Yeah, a couple of things. One is one of the issues that we tend to battle against in these activist situations is the fact that the activists are able to accumulate significant control in a fund, in a target fund, across several different funds in other accounts that they manage. And there are 40 Act rules about that to prevent just this sort of thing, which is pyramiding control of a fund across a series of other funds. We'd like them to have to play by the rules in that regard, and I think the manner in which they do this, it's worth some scrutiny to ensure that they're doing it compliant with the rules. Because that type of exerting control over another fund through several funds that you control is one of the primary purposes behind the Investment Company Act of 1940 when it was first passed. This is not a new problem, there are rules to prevent it, and the rules need to be enforced.

I would also say the closed-end fund structure and a lot of the issues that we face are somewhat unique, and I think sometimes big regulatory agencies, proxy advisors and others, have these large one-size fits all rules for all funds or operating companies or something like that. There are unique dynamics and unique considerations in the closed-end fund world that probably need to be taken into account a little more.

Jane King: Okay, interesting. Okay, we will continue to watch it. Thank you so much, Eben and Kevin, for coming in and explaining all this. It's so important, thank you so much.

Eben Colby: Thanks for having us.

Kevin Hardy: Thank you, our pleasure. Thank you.

Recorded on August 20, 2024

To request a particular topic for The NAVigator please send an email to: TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/

recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).