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Landmark Supreme Court Decision Is A Game-Changer For Investor Activism

The 6-3 ruling in FS vs. Saba eliminates activists' primary federal legal weapon, reaffirms independent directors as the true guardians of CEF shareholders, and could open the door to a new wave of listed closed-end fund launches.

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Chuck Jaffe, in this episode of The NAVigator podcast, interviewed Ken Burdon, Partner in the registered fund practice at Simpson Thacher & Bartlett. Chuck and Ken discuss the Supreme Court's recent ruling against activist investor Saba Capital, a decision that could have a chilling effect on shareholder activism in the future. Burdon says the decision removes a key path based on the Investment Company Act of 1940 that activists took in pursuing cases over fund fees and structure. It doesn't stop the activists from pursuing cases, but makes it harder to do so, forcing them into state courts. Critics of activism have long held that professional arbitrageurs used federal courts to pressure closed-end funds into transactions that benefit activists' short term profit agenda at the expense of the long-term returns and investment objectives that the majority of investors pursued when buying into a specific closed-end fund.

IN THIS EPISODE

- The Supreme Court issued a 6-3 ruling in FS Investment Corporation vs. Saba Capital Management
- Section 47(b) of the ICA does not grant activists a private right of action against fund governance decisions
- Activists used federal courts to pressure CEFs into short-term transactions at the expense of long-term shareholders Governance disputes now belong in state court, not federal court
- Independent directors are the ICA-mandated fiduciaries protecting all fund shareholders
- Activist positions above 5% create conflicts of interest under the ICA
- The SEC is reaffirmed as the primary regulator of the fund industry
- Activism in CEFs may adapt through state court actions or proxy campaigns rather than meaningfully decline
- Reduced litigation risk is reigniting interest in listed CEF IPOs, including one of the largest launches in years

The discussion is educational in nature and intended to help investors and advisors better understand the tools, trade-offs, and data points involved in evaluating income-focused strategies.

EXPLORE THE DATA REFERENCED IN THIS INTERVIEW:

– Free CEF & BDC profile pages: cefdata.com
– 40+ CEF & BDC indexes: cefdata.com/index

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THE CONVERSATION

CHUCK JAFFE

We're talking about a Supreme Court decision that could reshape activism in closed-end funds forever with Ken Burdon, a partner in the Registered Funds Group at Simpson Thacher & Bartlett, welcome to The NAVigator.

This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, an industry organization representing the entire closed-end fund business from investors and users up to fund managers, sponsors, and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction.

Today it's pointing us in the direction of some news that broke recently, with a recent Supreme Court decision that could dramatically change the way activist investors approach closed-end funds, and we're doing it with Ken Burdon. He's a partner in the Registered Funds Group at Simpson Thacher & Bartlett, you can learn about the firm at STBlaw.com, but they have a white paper that they wrote up on the decision that was made in mid-June, and it's linked up in the show notes for today's episode, so you can directly to more information on what we are discussing.

You also can learn more generally about closed-end funds, interval funds, and business-development companies at AICAlliance.org, that's the website for the Active Investment Company Alliance. Ken Burdon, it's great to have you back on The NAVigator.

KEN BURDON

Well, thanks, Chuck. Thanks for having me back, I'm excited to be here to talk about the FS vs. Saba case.

CHUCK JAFFE

Yeah, this is really big breaking news in the closed-end fund space, which is why the general public has not heard one word about it, but even in the closed-end fund industry, I think people heard about it but they don't necessarily know the nuances and the potential impact. So lay the case out, explain what was happening and what the decision was, and we'll go from there.

KEN BURDON

Yeah, sure, happy to. So as I think most in the closed-end fund world know, Saba sued a variety of Maryland-domiciled closed-end funds a few years ago alleging that their opt-in to the Maryland Control Share Acquisition Act violated the Investment Company Act. That case went to a decision on a summary judgment motion with the Southern District of New York, importantly the lawsuit was filed in federal court in the Southern District, that court held that the opt in to the Maryland Control Share Acquisition Act violated the Investment Company Act.

The fund defendants appealed, the Second Circuit upheld the Southern District of New York, and then the fund defendants appealed further to the Supreme Court. Not on the substance of the issue but on a procedural point, which is whether the Investment Company Act authorized Saba to bring that claim under the Investment Company Act in federal court to begin with.

That's where we get to Section 47(b), which you will hear a lot of as we're talking about this, Section 47(b) is a section that says, "Contracts are unenforceable by either party if they violate any provision of the Investment Company Act," and the question is whether a private plaintiff can sue to invalidate contracts that allegedly violate the Investment Company Act. So that's how we got here and that's what the Supreme Court was looking at, whether that private right of action existed in the first place.

CHUCK JAFFE

When we started this interview I said, "This case could affect activism in closed-end funds forever." From everything you said and everything I know, I think that's the right description, but am I right about that? How big a game-changer is this?

KEN BURDON

I think it's a big game-changer, because the majority opinion in the case is important to the entire fund industry because it confirms that Congress empowered the SEC as the primary regulator of the fund industry and fund managers. So those constituencies can now build their businesses around a rationalized regulatory framework, that it's not at risk of significant disruption through private litigation in federal court.

And so then let's take a little bit of a step back, which is that disruption could have existed if this case went the other way, because funds are externally managed entities that operate through a series of contracts. Not just closed-end funds, open-end funds to ETFs. The ruling confirms that private litigants can't disrupt fund businesses by alleging those contracts are unenforceable because they allegedly violate some provision of the Investment Company Act.

So this provides important certainty to fund managers that they can look at the body of law that the SEC has developed over more than 80 years and be confident in their business arrangements and their compliance with the law. What this doesn't do though is it doesn't foreclose private plaintiffs from continuing to bring the types of cases that they've brought for a long time, which are excessive fee suits under Section 37(b) of the Investment Company Act; but it does require them to queue to the established framework of Section 36(b) claims and to not seek to pursue what are fundamentally those excessive fee claims through other less tested and more disruptive fees.

So when we're talking about what the broader impact is, the broader impact is the court looked at the Investment Company Act and said, "Hey, you have an express private right of action here and we're not going to go imply a private right of action that could be incredibly expansive when there just wasn't enough evidence in the text of the statute to do so."

CHUCK JAFFE

From the perspective of corporate activism, does this hamper, hinder, or end the actions that are cloaked under, "You got high fees," but what they really are is, "You got a wide, wide, wide discount and we want to profit by narrowing it, so we're going to put pressure on you to narrow it"?

KEN BURDON

What it does is it forecloses the principal avenue by which activists have sought to use federal courts to pretty easily pressure closed-end funds into transactions that benefit the activist's short-term profit agenda at the expense of the long-term returns and the long-term investment programs that a vast majority of closed-end fund investors sought by investing in the fund in the first place.

Now I said it forecloses a principal and easy avenue, because the strategy has been sue in federal court, move for summary judgment, just have a decision on the law, right? As opposed to getting into discovery, getting into more expensive types of litigation. So what this does is it takes that straight federal avenue away, it says, "Look, if you're going to go pursue governance related claims, go pursue them in state court," which is kind of where they belong.

So can the activists still bring cases? Yes, they can still bring cases. Could they still allege that a contract is unenforceable because it violates the Investment Company Act? Yes, they can still do that, but they have to do it pursuant to a claim that they were entitled to bring. Typically something in state court such as the allegation of breach of fiduciary duty, some type of common law fraud, state securities law claims, claims around more traditional corporate governance theories rather than this direct, "I'm going to sue you under the Investment Company Act for violating the Investment Company Act."

CHUCK JAFFE

I have talked to some activist investors who were saying before this they felt they were seeing a decline in activism, in part because there was better governance, in part because of various things that were going on in the industry. Since this forecloses that primary avenue that Saba was using and maybe one or two others were following as well, do we wind up seeing activism dramatically reduced, in your opinion?

And does this mean, and this is the part where I know you can't give me the legal opinion, but for anybody who's an investor, who says, "Yes, I'll buy a fund with a wide discount and hope that maybe that'll happen," as an investor go back to buying it mostly because it's got a good payout, it's got whatever, the activism pile is not going to be one you get to jump in much more likely than in the past?

KEN BURDON

Yeah. I mean, it's an interesting point you make, Chuck, because I do also feel that what we saw over the course of the past five to eight years has slowed down and there's less of the proxy fights, there's less of the litigation than we've seen over the course of the past, like I said, five to eight years. So does this contribute to really taking those types of strategies off the table? I think it contributes to taking the ease of those strategies off the table when it comes to litigation as a threat.

Because how this litigation was pursued, the cost benefit analysis changes when instead of going into what, I think, was largely viewed as a friendly federal district court and federal circuit, you're going to have to go make your argument to the Maryland courts or the Delaware courts that their corporate governance framework for some reason does not work for this type of entity. And I think that's fundamentally less of a simple summary judgment legal question as opposed to more of a policy and fact finding question which, again, it's more expensive than litigation.

CHUCK JAFFE

If I take the side of the activists for a moment, one thing that activists say is they make funds function better, they make management stay on point, be tight with what they're doing, et cetera. Is there a reverse fallout to this as well if you don't have a watchdog on the alert? It's easier to get a fox in the henhouse, or whatever analogy you want to put into it, is there any chance that as an investor I should somehow be more worried that this will lead to a more relaxed, less efficient management?

KEN BURDON

I would submit that investors should look to who the SEC and Congress has given the watchdog role to, which are the independent directors of closed-end funds, and all registered investment companies. That is their role, they are super independent, they're not just NYSE-listed company independent, there's a long provision in the Investment Company Act detailing the type of independence that independent directors need to have, which includes not even holding one security issued by the advisor or its parent company, so there is a very high standard of independence.

Going back to one of the themes of the court's opinion here, the SEC and Congress have created a regulatory structure that has worked for over 80 years, and in that regulatory structure, outside the SEC, it's the independent directors who are looking out for the shareholders at large. I would submit that you don't need to have a concentrated vocal minority shareholder who is self-interested trying to act in that role.

Because even the Investment Company Act recognizes that a concentrated minority position in the Investment Company Act, so anything over 5%, makes you an "affiliated person" of the investment company, and that imposes somewhat Draconian restrictions on how you can deal with the fund. Because the judgment in the statute is that that type of affiliation and that type of self-interest makes you not suited to look out for the interests of all the shareholders.

CHUCK JAFFE

Now I want to talk about your interest. I mean, your interest in that you're a partner in the Registered Funds Group at Simpson Thacher, so you're involved in all the fund law and all the things that happen.

Is one of the impacts here, and again, this is not something that you can tell me from the court perspective, it's just yours on the business, we've seen more interest in closed-end funds, we've seen companies coming into the business thinking about it, does this make it more likely that we're going to see that pick up steam?

In other words, was the threat of activism being done the way it was done, the way it probably will not be done going forward because of this, make it that we will see more investment companies that have maybe thought about it but haven't gone through with it start issuing closed-end funds?

KEN BURDON

I hope so, Chuck. I mean, we saw one of the biggest listed closed-end funds ever launch recently, it shows that you can still sell a listed closed-end fund. And I think when managers are looking at the cost benefit of whether to do a listed closed-end fund versus do a tender-offer fund or an interval fund, or perhaps one of the retail companies that are sold more to higher net worth folks, it kind of brings the listed closed-end fund back into the conversation, and perhaps this is the first plank in getting the listed closed-end fund back in the conversation.

Because the last thing any of the managers or my clients want to do is put a lot of upfront money and investment into a listed closed-end fund, then it immediately comes under attack a year, year and a half after it's been listed, before they're even able to execute on it and show that long-term portfolio potential.

CHUCK JAFFE

Last question. The Supreme Court has ruled, there's not a reason to expect this decision, for any reason, gets overturned in any sort of short order, is there?

KEN BURDON

No, I don't think so, you had a 6 to 3 majority. The interesting part about the case, which I won't really go into that much, apart from the Investment Company aspect of it, is the dynamic about how statutory interpretation should be done by judges. There's a healthy debate about that in this case. And I think outside of our little corner of the world, that's what this case is going to be more interesting to the academics about, is how it just plainly contrasts two different approaches to how you look at what a statute means.

I don't think you're going to see this case come up and be overturned anytime soon. And it is, again, just another case in a long line of cases that stretches back 25 years dealing with this particular issue, in terms of how you interpret a statute.

CHUCK JAFFE

Ken, really interesting stuff. Not the most exciting subject, but you made it pretty exciting for us to talk about today, thanks for joining me on The NAVigator.

KEN BURDON

Thanks for having me again.

CHUCK JAFFE

The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yeah, that's me, I'd love it if you'd check out my hour-long weekday show on your favorite podcast app or you can go MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance.

Thanks to my guest Ken Burdon, he's a partner in the Registered Funds Group at Simpson Thacher & Barlett, which is online at STBlaw.com. You can go there for more details, but better yet, look at the link in the show notes for this episode of The NAVigator and you'll get directly to the firm's write up on the case we've been discussing.

The NAVigator podcast has something new for you every Friday, except for a holiday week like this one when we're out on Thursdays, so make plans to join us again next week. Make sure you don't miss an episode by following along on your favorite podcast app. Have a great holiday and we'll see you again next week. Until then, happy investing, everybody.

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