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Only Activist Raiders Would Miss Annual Meetings

Closed-end funds' shareholder gatherings invite abuse; the NYSE is finally doing something about it.

by Paul Cellupica

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Powerful activist investors have been abusing the New York Stock Exchange's annual shareholder meeting requirement for listed closed-end funds, a requirement that provides little benefit to long-term shareholders and costs them millions of dollars.

The NYSE's proposal to change its rules and eliminate this burden is the right move, and we urge the Securities and Exchange Commission to permit this rule change to protect long-term shareholders.

The annual meeting requirement for closed-end funds has created an end run around the investor protections of the Investment Company Act of 1940. Knowing that retail investors participate in shareholder meetings at lower rates, the architects of the '40 Act worried that a powerful, rogue shareholder — not dissimilar from the activists who prey on closed-end funds today — could elect directors under its control to change a fund's core provisions in its favor. Thus, rather than annual meetings, Congress built in other governance protections for funds' retail investors, including oversight by a board with a required percentage of independent trustees and a requirement that a majority of outstanding voting securities (as defined in '40 Act) approve changes in a fund's fundamental investment policies.

Nevertheless, closed-end funds must hold annual shareholder meetings only because of an antiquated NYSE rule that predates the '40 Act. It is critical for the SEC to recognize that Congress chose not to mandate annual meetings for closed-end funds and other registered funds. This antiquated NYSE listing rule applies to no other type of registered fund.

Furthermore, given the fundamentally different nature of investment companies compared with normal operating companies, the annual meeting requirement for closed-end funds neither makes sense nor operates for the benefit of funds' long-term shareholders.

Data on contested proxies shows that, over the past five years, retail investors directing their own vote held 59% of outstanding closed-end fund shares but accounted for just 37% of the votes cast. And when these shareholders did vote, they leaned heavily toward supporting management against the activist investors, with 84% of voting accounts — representing a majority of directed retail shares — voting in favor of management.

What's more, annual meetings are expensive. Cost estimates across 145 proxy campaigns between 2012 and 2019 totaled a whopping $373 million. Funds and their shareholders ultimately bear these costs.

But these annual meetings aren't just a cost with little benefit. They are a vehicle for harmful maneuvers by predatory activist investors to take control of funds under the misleading cloak of shareholder governance.

Activist investors like to claim that the "discount" that often exists between a closed-end fund's market price and underlying net asset value is a sign of poor management. However, such discounts reflect the potential financial impact of certain unaccrued expenses, such as liquidating the portfolio, unwinding a leveraged position or perceived tax liabilities, in addition to investor sentiment.

Although the presence of a discount can represent a buying opportunity to boost the dividend yield and allow for the potential of enhanced total returns, activist investors are exploiting the NYSE's annual meeting rules to take over listed closed-end funds, typically with the primary goal of arbitraging their way to short-term profits.

This was clearly seen in the case of the Voya Prime Rate Trust.

In April 2020, an activist in that fund used its control of 24.6% of the fund's outstanding shares to institute a proxy battle that changed all eight of the fund's directors. Of approximately 147 million shares outstanding, 39% voted for the activist's board slate, 25% voted for the existing board directors, and 34% — presumably retail investors — didn't vote, meaning the activist was able to replace directors with just 14% of outstanding shares that it didn't otherwise control.

The new board, controlled by the activist, terminated the existing investment advisor and sought to appoint the activist as the new advisor. Under the activist's influence, the fund engaged in two tender offers. Although the activist secured a nice profit for itself, the tenders resulted in a significant reduction in assets and loss in economies of scale for remaining shareholders.

Further, several of the fund's investment restrictions and portfolio allocations were ultimately changed. The portfolio, 96% of which had been composed of senior loans, slashed its senior loan exposure to 10% by last October, as it reallocated toward other closed-end funds, crypto trusts and private funds while incurring new expenses related to costly short-sale exposure. These quantified harms can be visualized here.

The SEC should do everything it can to prevent these harmful activist tactics, because they prevent retail investors from using closed-end funds for long-term investing purposes. At a time when the unlisted closed-end fund market is booming and demand for ETFs shows little sign of slowing, there were no listed closed-end fund launches last year and few thus far in 2024.

This is to the detriment of retail shareholders who use listed closed-end funds to gain exposure to a wide array of income-producing assets that may be difficult to access in an open-end fund because of their less-liquid nature or for other reasons. How can this be in the interests of the U.S. capital markets and serve the goal of enhancing American investors' long-term investing opportunities?

Activists claim they are unlocking value and are aligned with retail investors. But radically altering the investment strategies that long-term shareholders signed up for when they purchased the fund doesn't fit the bill. We are glad the NYSE is proposing to eliminate the unnecessary annual meeting requirement, lowering costs for retail shareholders and making it that much harder for activists to commandeer closed-end funds.

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