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Litigation Expected as SEC's Ruling on Boulder No-Action Letter Limits Activism

By Jennifer Banzaca

The SEC's decision on May to rescind the Boulder No-Action letter, allowing a closed-end fund to opt into a state control share statute without risking an enforcement action, could have a chilling effect on activism, and could face litigation for violating the Investment Company Act.

During the Corporate Governance & Activism in CEFs panel at the Active Investment Company Alliance's (AICAlliance.org)'s Summer Summit on August 13th, Phil Goldstein, co-founder and principal of Bulldog Investors, said the reversal of the SEC's position on closed-end funds opting into state control share statutes limits the ability of activist firms to vote shares above 10%.

"We don't really have a lot of options, if you're looking at the potential anti-takeover measures," Goldstein noted.

He added, "I think allowing funds to opt in to the control share statute violates the investment company act. There still could be activism, even if you can't go over 10%, but it puts a damper on what you can do if you're limited."

Thomas DeCapo, a Partner at Skadden, Arps, Slate, Meagher & Flom, said in light of the SEC's decision, the board of a closed-end fund should look at the defensive measures that it has in place to respond to and/or defend against an activist or activists and consider whether it wants to opt in to a control share statute or adopt similar org doc provisions..

DeCapo explained that control share statutes provide a company with the ability to prevent changes in corporate control by removing voting rights when a person acquires shares in excess of a certain percentage of a company's voting power.

"Once holders of control shares lose their voting rights, such holders cannot vote the excess shares unless the company's stockholders vote to approve the restoration of voting rights" DeCapo said.

Whether a particular CEF or BDC should subject itself to control share provisions is a question for the fund's board to consider under the particular circumstances of the fund and in the exercise of their fiduciary obligations.

The steps for adding control share restrictions depend on the state law and fund documents involved.

While an activist's options may be limited in light of the SEC's recent decision, funds cannot simply ignore an activist investor, which Brian Schaffer, a Managing Director at Prosek Partners, said is a mistake.

"Regardless of their investment approach, they are likely your largest shareholder or near the top, and they should be afforded a level of access commensurate with their size and on par with the fund's other shareholders," Schaffer said.

In responding to activists, Peter Kimball, Head of Advisory Solutions at ISS Corporate Solutions, also advised CEFs to get an advisory team in place earlier on in order to conduct more research on the shareholder and, if applicable, on the nominees that are being contemplated to be nominated by the shareholder.

"You want as much time as you can get to also asses your own governance provisions and your own readiness to engage, whether it's amicably or defensively.," Kimball added.

DeCapo also advised managers to act in the best interests of their shareholders, and said boards generally do not have an obligation to take action to address secondary market trading discounts, particularly where actions may interfere with the Fund's long-term investment objectives or increase fund expenses.

As an example, DeCapo said "In the event that the fund's mandate is to pursue investments in fixed-income securities and not to monitor discounts, the board might very well decide that what's in the best interest of shareholders is to simply stay the course, keep doing what its mandate tells it to do."

Funds also need not wait to hear from the activist when a 13D is filed but may reach out as soon as the activist shows up on the register to understand a known activist's intentions.

When responding to an activist, funds should not be overly defensive or hostile and instead listen to what the activist wants, then stick to the facts in making their argument to shareholders and clearly articulate the fund's investment objective and any discount mitigation initiatives already in place," Schaffer advised.

Finally, Schaffer cautioned funds not to assume that the remaining shareholders will support the fund and its directors.

"Understanding the composition of the shareholder base, their cost of capital, and their voting tendencies is requirement, not an option. This also extends to understanding the impact of mirror voting, which can be extremely valuable in determining how to prepare messaging and who to specifically target, allowing the fund the ability to wage an effective defense," Schaffer explained.

Goldstein noted that the composition of shareholders factors into the activist action his firm will take.

"We look at the investors to try to determine if we will become active. We want to know if we will have support in our campaign or if investors are happy with the status quo. Before taking any action we may talk to some of the other large institutional investors because they may have different investment objectives. They may not want a fund to liquidate but they might support a modest tender offer or a share repurchase program. So we have to get a sense of what the shareholders want and factor that into our decision of whether to become activist and what course of action we may take," Goldstein said.

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