

ICI VIEWPOINTS

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## Proxy Advisory Firms—Killing Closed-End Funds Softly with Their Policies

By Kenneth Fang and James Duvall

Closed-end funds (CEFs) trying to fend off hostile hedge funds and other activist investors are facing another headwind from an unexpected corner: proxy advisory firms.

Proxy advisors, which make recommendations to institutional investors on management actions and shareholder proposals associated with their investments, are providing one-size-fits-all advice that might be appropriate for operating companies—think S&P 500 companies—and applying it to CEFs. This awkward fit has the unintended consequence of making CEFs more vulnerable to activist takeovers, costing retirees money in the process. It needs to be fixed.

### Activist Threat

CEFs have helped millions of Americans save for retirement and achieve other financial goals. They are professionally managed, subject to a robust regulatory framework, and possess several unique features that make them attractive, including the potential for steady income and outsized total returns. Yet, they are frequently the target of [hedge fund raiders](#) looking to take advantage of market dislocations.

These activist investors opportunistically acquire CEF shares that are trading at discounts to their net asset values (NAVs), usurp control of the fund's board, then generally force liquidity events—liquidating the fund, forcing it to repurchase its shares at inopportune times, or converting it to an open-end fund, thereby changing the investment. In one case, an activist gained control of a CEF, and can now use the CEF's investments as capital to cannibalize the industry by raiding and coercing opportunistic events at other CEFs.

These short-term strategies exploit the CEF structure and negatively affect long-term retail shareholders. What's worse is that the activists make no secret of their intentions, bragging about their ability to make easy money off the backs of retail shareholders. Activists have infiltrated the market and now hold shares in [nearly half of all CEFs](#).

### Compounding the Problem

CEFs have access to antitakeover defenses, recognized by state law, to protect long-term shareholders from activist-induced harm. Policies such as staggering board terms, majority vote standards, and control share provisions are effective tools, but their impact is undermined by proxy advisors and their antiquated policies.

#### Take a Closer Look

**Proxy advisory firms** provide a number of third-party services to help institutional investors carry out voting responsibilities on behalf of their funds' shareholders, such as:

- Handling administrative tasks associated with proxy voting
- Analyzing and making recommendations on the matters presented for shareholder vote
- Assisting with the formulation of and amendments to proxy voting guidelines

Proxy advisors incorrectly view these defenses as management entrenchment. They weigh CEF antitakeover measures negatively in their analysis of shareholder proposals and CEF director nominees. In some cases, proxy advisors will *automatically* recommend against or withhold votes for a director that serves on the nominating or governance committee of a board that employs such practices. These policies fail to distinguish CEFs from operating companies and ignore the facts around the structural features of CEFs.

**Antitakeover defenses:**

- *Staggered boards.* Sets of directors serve three-year terms and stand for election in different years. This promotes stability and ensures some board members who are familiar with the CEF serve at all times.
- *Majority vote standards.* Directors must receive approval from a majority of the fund's outstanding shares before taking office, as opposed to just receiving more votes than any other nominee. This ensures all shareholders have a voice.
- *Control share provisions.* Allowed under state law, funds restrict certain insiders from voting their shares that exceed a certain threshold unless other shareholders restore those rights. This protects CEFs from undue influence by any one insider.

## CEFs That Seek to Protect Their Long-Term Shareholders Are Penalized

CEF directors who choose to employ defense tactics to protect shareholders know that they will face repercussions for doing so when they stand for election. Proxy advisors' recommendations can impact final votes, as many intermediaries—such as underwriters, broker-dealers, and large registered investment advisers—have internal policies requiring them to adhere to the recommendations. These effects can be amplified by other investors that may be required to “mirror vote,” meaning they vote their shares in the same proportion as all other shares cast.

## Creating Long-Term Value for Investors

Certain proxy advisory firms refuse to consider changes to their proxy advisory policies unless the entity making the request invests in CEFs *and* subscribes to the proxy advisory firm's CEF services. This position leaves out CEF sponsors and others that would argue on behalf of everyday retail investors.

However, many retail shareholders own CEFs through intermediaries that presumably recommended or offered the CEF to them because of the fund's initial value proposition—its investment objective and strategy. We urge intermediaries that are clients of proxy advisory firms to voice their concerns about those firms' strict policies, which heavily favor activists and hurt their clients.

Proxy advisors purport to act in the best interest of shareholders but seem to ignore the fact that CEFs have provided stable income and helped retail investors save for decades. They should not penalize CEFs or their directors for employing common-sense legal defenses against the dangers of short-term activism.

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**Be sure to attend ICI's 2023 Closed-End Fund Conference on November 14 in New York City to learn more.**

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