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Gone With the Wind? Closed-End Funds Risk Extinction

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Shares of SEC-registered closed-end funds (CEFs) have long held significant potential advantages for some investors. For example, unlike shares of mutual funds (which are open-end funds), CEF shares cannot be redeemed by the shareholder at any time for their then-current net asset value, allowing a CEF to invest its assets in less liquid securities. This enables a well-managed CEF to provide potentially better returns for investors who have relatively long-term investment horizons, including many investing for retirement income. The potential for such benefits is generally greater for investors who purchase their CEF shares in a secondary market (such as a securities exchange), rather than as part of a primary offering of the CEF shares. The reason is that CEF shares generally trade in the secondary market at a price that often is less — sometimes substantially less — than the shares' net asset value. (And this article is not talking about those types of closed-end funds whose shares are not customarily traded in secondary markets.) For decades, various types of shorter-term investors also have employed strategies to profit from secondary market purchases of CEF shares at a discount from net asset value. In recent years, however, a few hedge funds and other activist investors have been especially active in pursuing strategies of this type. For example, an activist investor may purchase enough shares to install its own directors or otherwise dominate a CEF's board, including by threatened or actual proxy contests. The activist investor thus may be able to cause the CEF to liquidate, convert to open-end status, make tender offers for its shares at inopportune times, or replace the CEF's investment manager. Such transactions may enable longer-term investors — as well as the activist investor — to profit from eliminating or reducing (at least temporarily) the discount at which the CEF's shares were trading. Nevertheless, transactions initiated by an activist investor often are, at least to some degree, contrary to the interests and objectives of the longer-term investors in a CEF. CEFs typically have in place control share, staggered board, and other provisions to help resist takeovers that may be adverse to the interests of the majority of shareholders. Such provisions, however, have not reduced the success rate of activist investor assaults on CEFs very dramatically. In this connection, activist investors are aided by the fact that many CEF shares are held by institutions (for the institution's own account or for the benefit of other investors) that retain proxy voting advisory firms to advise them on how to vote such shares. The Investment Company Institute and others who think the CEF concept has considerable merit for many investors believe that proxy voting advisory firms often fail to give due consideration to the

differences between CEFs and other publicly traded companies. Thus, proxy advisory firms often wrongly view CEF anti-takeover provisions and other management efforts as inappropriate management self-entrenchment and, therefore, recommend votes that support activist investors against CEFs. CEFs have been so beset by activist investors, among other things, that CEF sponsors have almost completely stopped organizing new CEFs. Accordingly, the number of existing CEFs has fallen from over 600 in 2005 to approximately 400 last year. In part to make abusive initiatives by activist investors more difficult, the New York Stock Exchange has proposed to eliminate the annual shareholder meeting requirement for CEFs. The Investment Company Institute and others who think the CEF concept has considerable merit for many investors also have pushed for Congress to rein in the activist investors' practices. These efforts have not yet borne fruit and, for its part, the SEC has not shown any interest in taking sides in this matter. So, as matters stand, CEFs' long-term outlook remains cloudy at best.

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