

MEMORANDUM

TO: File No. S7-27-18

FROM: Jacob Krawitz
Branch Chief, Division of Investment Management

RE: Meeting with Representatives of Advent Capital Management and Gabelli Asset Management

DATE: May 13, 2019

On May 10, 2019, Dalia Blass, Paul Cellupica, David Bartels, Naseem Nixon, Jacob Krawitz, Melissa Gainor, and Brian Johnson, all staff of the Securities and Exchange Commission met with the following representatives of Advent Capital Management and Gabelli Asset Management

- Laura Bevill, Advent Capital Management
- Tracy Maitland, Advent Capital Management
- Tony Huang, Advent Capital Management,
- Ed Delk, Advent Capital Management
- Mario Gabelli, Gabelli Asset Management,
- David Goldman, Gabelli Asset Management

The participants discussed, among other things, the Commission's Fund of Funds Arrangements proposal, set forth in Investment Company Act Release No. 33329 (December 19, 2018).

Information provided by Advent Capital Management and Gabelli Asset Management in connection with this meeting is set forth in Annex A.

Annex A

SEC Proposed Rule 12d1-4:

**Suggestions to Further Enhance Protections for
Shareholders in Closed-End Funds**

May 2019

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1. Background on Closed-End Funds

Quick Facts

- 496 Closed-End Funds with \$236 Billion in Net Assets*
- \$16.8 Billion in Distributions to Shareholders**
- 3.6 Million US Households (38% retired)***

Issuance & Trading of Shares

- IPO on Stock Exchange (NYSE / NASDAQ)
- Fixed Number of Shares
- Shares Are Not “Redeemable”
- Shares Trade Intraday at Market Prices Determined by Supply & Demand
 - *Discount:* Market Price is Less Than NAV
 - 83% of Listed CEFs Traded at Discount*
 - Median Discount = 8.53%; Maximum Discount = 30%**
 - January Effect = Seasonal Expansion & Narrowing of Discount (Q4 Tax Loss Selling)
 - *Premium:* Market Price is Greater Than NAV
 - Maximum Premium = 56%**

Annual Shareholder Meetings

- Exchange Listing Requirement

*As of 3/31/19.

**As of 12/31/19.

***As of 12/31/18.

1. Background on Closed-End Funds

Average Distributions Significantly Exceed Prevailing Interest Rates

- Provides Regular Income in Retirement

Stability of Capital Allows For Important Longer-Term Investments With Greater Return Potential

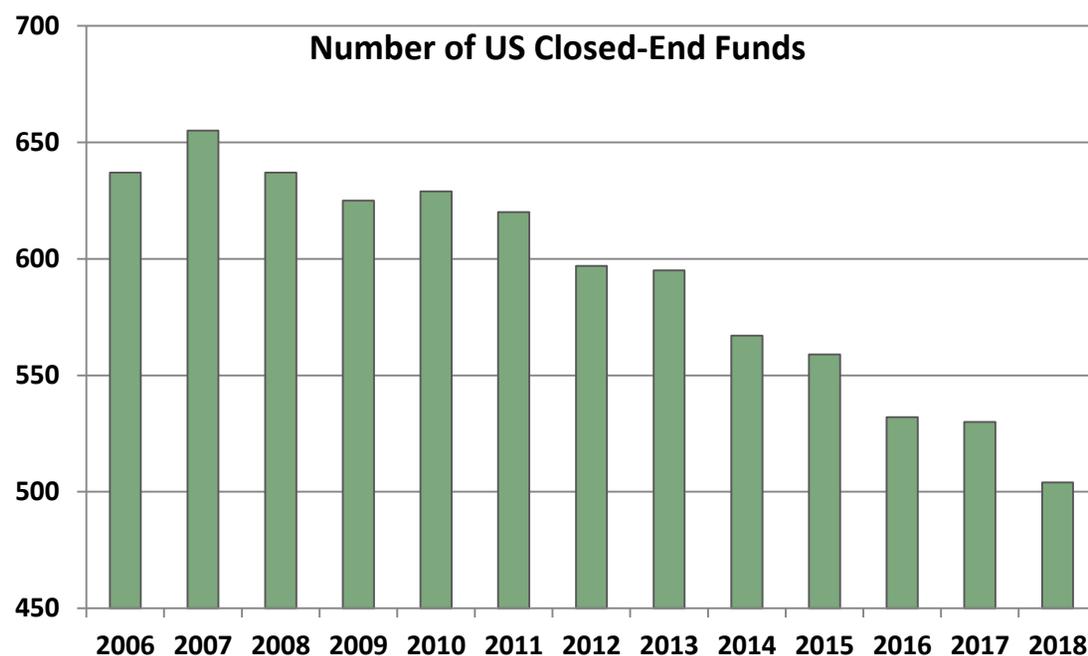
- Attractive To Businesses Raising Capital for Expansion, Hiring, Equipment Purchases & Other Activities Requiring Years To Realize Value
- Can Make Investments Where Trading Liquidity & Maturity Date Not Paramount Concerns

Provide Retail Shareholders Access to Asset Classes Traditionally Utilized by Institutions

- Bank Loans and Securities in Under-Developed Foreign Markets
- Private Equity and Venture Capital
- Rule 144A Securities

1. Background on Closed-End Funds

The Number of Closed-End Funds is Declining



- 655 in 2007 to 496 in 2019
- Decline Influenced By Effects of Activist Discount Arbitrage Strategies

2. Purpose & Protections of Section 12(d)(1) and Rule 12d1-4

Section 12(d)(1) of 1940 Act

- Designed to Protect Registered Funds From Abuse by Acquiring Funds
 - Targets undue influence, duplicative fees and complex structures
- **Prohibits “Pyramiding” of Voting Power Over Registered Funds**
 - Circumstances where investors in an acquiring fund control assets of a registered fund and use those assets to enrich themselves at the expense of registered fund shareholders

Section 12(d)(1)(A)(i) of 1940 Act

- 3% Limitation on Acquiring Voting Stock in a Registered Fund
- Private Funds Are Considered Investment Companies For Purposes of 3% Limitation
- Private Funds Must Obtain Exemptive Relief to Exceed 3% Limitation

2. Purpose & Protections of Section 12(d)(1) and Rule 12d1-4

Statutory Exemptions, Commission Rules & Exemptive Orders

- All **premised on making passive investments** in registered funds
- Facilitate asset allocation, diversification and other investment objectives
- Impose **conditions to prevent abuses** that led Congress to enact Section 12(d)(1)

Proposed Rule 12d1-4

- Provides investors with the benefits of fund of funds arrangements
- Includes certain conditions that could help protect investors from the historical abuses associated with fund of fund arrangements
- Excludes private funds from scope of rule
 - Not registered as investment companies
 - Not subject to SEC reporting or recordkeeping
- **The proposal should be revised to protect closed-end funds from abuse by controlled groups of acquiring private funds**

3. Commission Action Is Needed To Protect Closed-End Funds From Abuse By Activist Private Fund Managers

The 3% Limitation Has a Loophole

- Applies Only To Individual Investment Company and Any Companies it Controls
 - For example, 6 private funds can each acquire up to (but not more than) 3% of the voting shares of the same closed-end fund
 - In a vacuum, each private fund will have complied with Section 12(d)(1)(A)(i)
 - Differs from approach taken in Section 12(d)(1)(C)
 - Does not require aggregation of the voting positions of multiple “sister” funds controlled by a common investment adviser
- “Technical” Compliance Does Not Necessarily Achieve “Substantive” Compliance
 - Shareholder protections can be evaded if separate acquisitions by private funds are:
 - Coordinated by a common adviser that directs the 6 funds to use their collective 18% voting position to exert undue control or influence over the closed-end fund to enrich the private funds at the expense of closed-end fund shareholders
 - Technical compliance with the 3% limitation can mask an underlying sham or conduit for circumvention of Section 12(d)(1)(A)(i)
 - **Activist Discount Arbitrage is a real world investment strategy** that uses fund of funds arrangements **to enrich private funds at the expense of closed-end funds**

3. Commission Action Is Needed To Protect Closed-End Funds From Abuse By Activist Private Fund Managers

Activist Discount Arbitrage Investment Strategy

Investment Objective

Acquire shares of a listed closed-end fund at prices substantially less than NAV and use voting power to force the fund to repurchase those shares at price at or near NAV

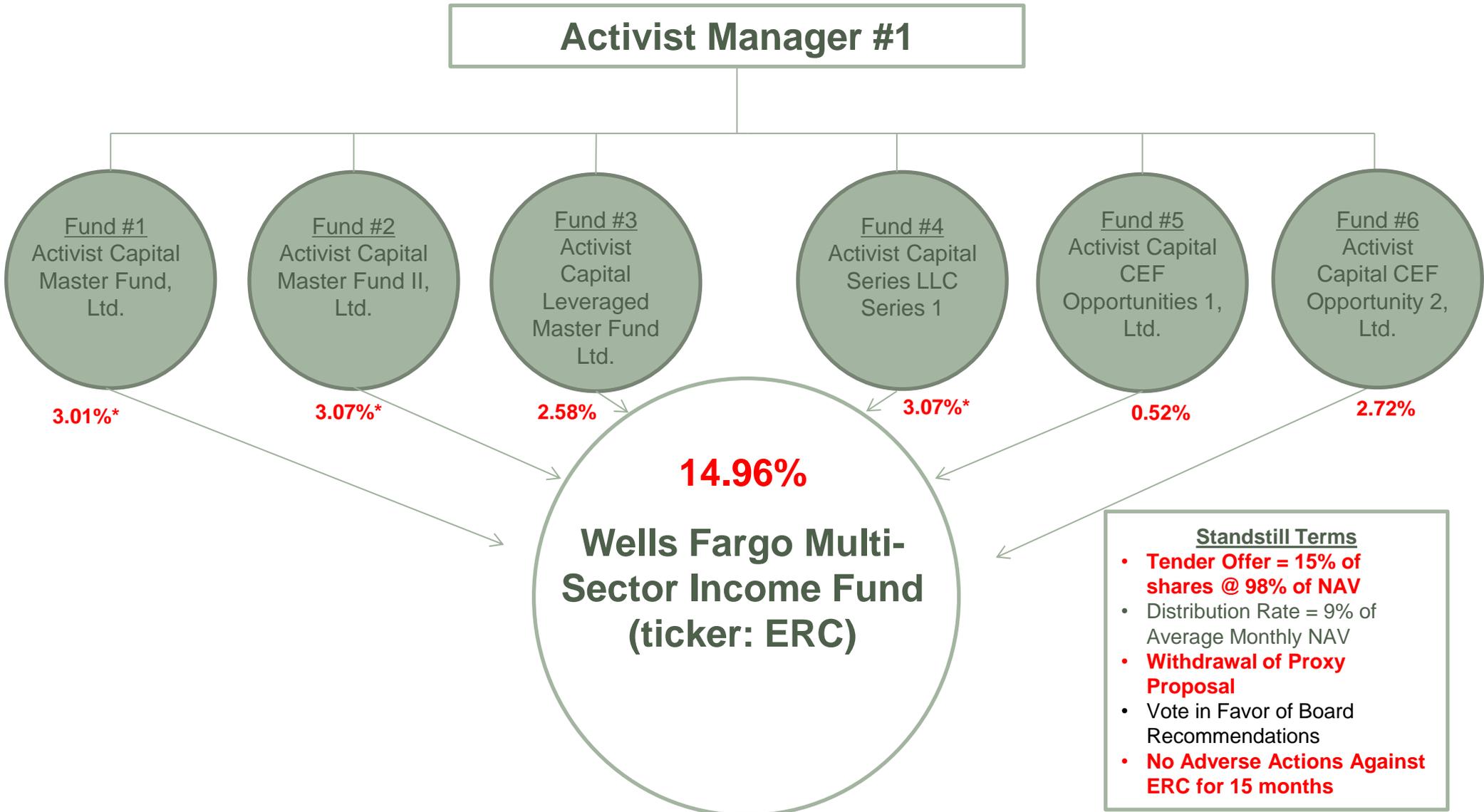
Step #1: Acquire Disproportionately Large Stake in Closed-End Fund

- Activist manager directs multiple private funds under its control to each acquire up to 3% of the voting shares of a listed closed-end fund
- Activist obtains voting power and dispositive authority over entire block of voting shares held by the captive group of private funds
- Acquisitions made when shares trade at a price representing a substantial discount to NAV

Step #2: Force Closed-End Fund to Conduct A One-Time Liquidity Event

- Use proxy contests or other measures (such as changes in the board of directors or investment adviser) to pressure fund to create a one-time liquidity event such as:
 - **Large self-tender; conversion to open-end fund; outright liquidation; or gradual liquidation via multi-year fixed distribution rate (regardless of income or gains)**
- After the closed-end fund complies, the activist will withdraw its shareholder proposals and enter into a “standstill” agreement with the closed-end fund

3. Commission Action Is Needed To Protect Closed-End Funds From Abuse By Activist Private Fund Managers



* Some acquiring funds owned more than 3% because the acquired fund repurchased shares in the open market, reducing its outstanding share count. Please see [Appendix B](#) for Clough case study.

3. Commission Action Is Needed To Protect Closed-End Funds From Abuse By Activist Private Fund Managers

Section 48(a) Prohibits Indirect Violations of Section 12(d)(1)(A)(i)

- Unlawful for Person to Do Indirectly Through Another Person What Would Be Unlawful for Person to Do Directly
 - Commission staff has **integrated separate private funds into a single fund** for purposes of determining compliance with the 100 investor limit contained in Section 3(c)(1) **when the separate offerings did not present investors with materially different investment opportunities** (Cornish & Carey Commercial, Inc., SEC Staff No-Action Letter, Jun. 21, 1996)
- Section 48(a) Applies to Activist Discount Arbitrage Investment Strategies
 - Multiple private funds acting in concert to collectively acquire shares in the same closed-end fund above the 3% limitation through the coordination and direction of a common adviser in order to enrich private funds at expense of closed-end fund
 - Multiple funds should be treated as a single fund for purposes of the 3% limitation
- **Plain Text Interpretation of Section 12(d)(1)(A)(i) Should Apply Anti-Evasion Mechanism Congress Established in Section 48(a)**
 - The Mutual Series Fund SEC No-Action Letter did not raise the investor protection concerns that are presented by activist discount arbitrage investment strategies

3. Commission Action Is Needed To Protect Closed-End Funds From Abuse By Activist Private Fund Managers

Four Ways SEC Can Address Activist Discount Arbitrage Strategy

1. Publish Interpretive Position in Adopting Release for Rule 12d1-4

- State that Commission may disregard technical compliance with the 3% limitation and “look through” to the underlying substance of holdings in situations where:
 - The collective voting security ownership of a closed-end fund by multiple investment companies – including private funds – sharing the same or affiliated investment advisers exceeds the 3% limitation; and
 - An intent to change or influence the management or control of the closed-end fund has been manifested

2. Address Potential Indirect Violations of Section 12(d)(1)(A)(i) by Using Investigative and Enforcement Authority Under Section 42

- Investigate as necessary to determine whether any person has violated the 1940 Act
- Bring an action to enjoin acts or practices constituting a violation of the 1940 Act
- Bring an action to enforce compliance with the 1940 Act

3. Commission Action Is Needed To Protect Closed-End Funds From Abuse By Activist Private Fund Managers

Four Ways SEC Can Address Activist Discount Arbitrage Strategy (Cont.)

3. Support Congressional Amendment of Section 12(d)(1)(A)(i)

- In computing 3% limit, include investment companies and managed accounts having the same investment adviser (use concept from Section 12(d)(1)(C))
- In computing 3% limit, include holdings of acquiring fund and its “advisory group” as defined in proposed Rule 12d1-4

4. Support Congressional Amendment of Sections 3(c)(1) and 3(c)(7)

- Change language so that unregistered investment companies are subject to Section 12(d)(1)(C), as well as Section 12(d)(1)(A)(i)

4. Other Comments on Proposed Rule*

- A. Aggregate ownership limit should be set to 10%
- B. Acquired funds should be permitted to enter into participation agreements as a prerequisite to allowing acquiring funds to exceed 10% ownership
- C. Proposed rule should require an acquiring fund to aggregate ownership of the acquiring fund advisory group with any acquiring fund sub-advisory group
- D. Advisory group definition should be revised to require aggregation of acquired fund's holdings with separately managed accounts advised by acquired fund's adviser, sub-adviser or their respective affiliates
- E. Rule should avoid grandfathering and require disposition of holdings exceeding 10%

* Please see [Appendix E](#) for details on these suggestions.



Questions?

Appendix A – Relevant Statutory Provisions: 3(c)(1)

Notwithstanding subsection (a), none of the following is an investment company within the meaning of this title.

- Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons (or, in the case of a qualifying venture capital fund, 250 persons) and which is not making and does not presently propose to make a public offering of its securities. ***Such issuer shall be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer.***

Appendix A – Relevant Statutory Provisions: 3(c)(7)

- Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.
- ***Any issuer that is excepted under this paragraph shall nonetheless be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 12(d)(1) relating to the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer.***

Appendix A – Relevant Statutory Provisions: Section 12(d)(1)(A)

- It shall be unlawful for any registered investment company (the “acquiring company”) and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the “acquired company”), and for any investment company (the “acquiring company”) and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the “acquired company”), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate—
 - ***(i) more than 3 per centum of the total outstanding voting stock of the acquired company;***
 - (ii) securities issued by the acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or
 - (iii) securities issued by the acquired company and all other investment companies (other than treasury stock of the acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of the acquiring company.

Appendix A – Relevant Statutory Provisions: Section 12(d)(1)(C)

- It shall be unlawful for any investment company (the "acquiring company") and any company or companies controlled by the acquiring company to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition the acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own more than 10 per centum of the total outstanding voting stock of such closed-end company.

Appendix A – Relevant Statutory Provisions: Section 48(a)

- It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this title or any rule, regulation, or order thereunder.

Appendix B – Clough Case Study

Clough Case Study – Share Discounts Attract Activists

- Clough Capital Partners L.P. serves as the investment adviser to three closed-end funds:
 - Clough Global Equity Fund (GLQ)
 - Clough Global Opportunities Fund (GLO)
 - Clough Global Dividend and Income Fund (GLV)

- In October 2016, the funds were trading at discounts of 15.8% (GLQ), 18.3% (GLO) and 15.7% (GLV)

- In February 2017, Activist #1 submitted a request for trustee appointments for GLQ, GLO and GLV for the Funds' 2017 shareholder meeting

- Activist #1 also proposed that GLO and GLV consider the declassification of their Boards

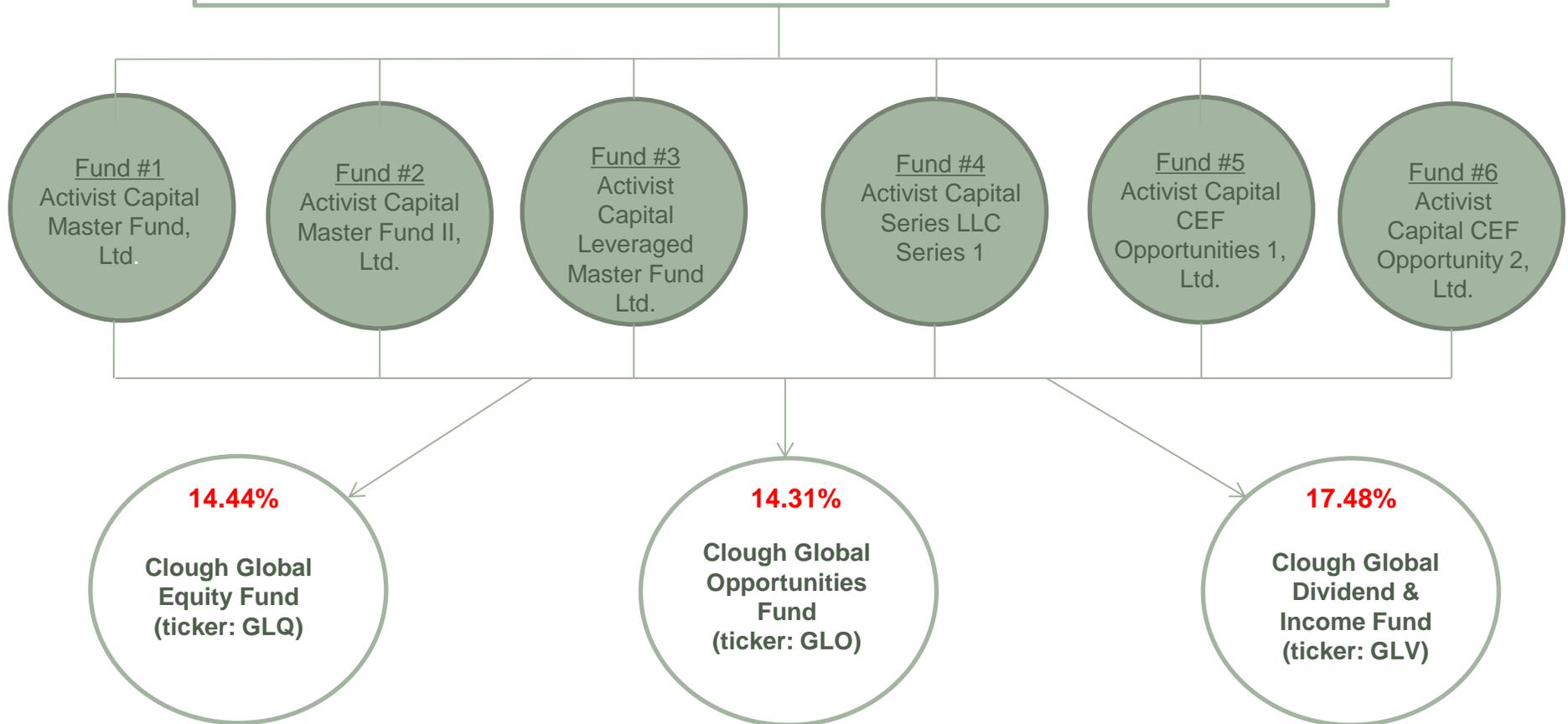
Appendix B – Clough Case Study

Clough Case Study (Cont.) – Activists Acquire Shares Using a Group of Controlled Private Funds

- A month before the shareholder meeting, Activist #1 reported shared voting power over 14.4% of GLQ, 14.3% of GLO and 17.5% of GLV
 - Details appear in Schedule 13D filings made by Activist #1 on June 10, 2017
 - Filings show capital for share purchases were derived from the subscriptions proceeds from investors in 6 private funds, the capital appreciation thereon and margin account borrowings made in the ordinary course of business
 - The 6 private funds used by Activist #1 are listed in Appendix C of this presentation
- Activist #2, although not identified as part of the Activist #1 group for purposes of Schedule 13D, also accumulated voting shares in the Clough Funds through investments by multiple private funds controlled by Activist #2
- The next page presents a diagram of how Activist #1 directed its controlled group of 6 private funds to make coordinated investments in GLQ, GLO and GLV

Appendix B – Clough Case Study

Private Fund Group Controlled by Activist Manager #1



Appendix B – Clough Case Study

Clough Case Study (Cont.) – **The Settlement**

- Prior to the shareholder meetings, Clough announced a settlement with Activist #1 and Activist #2 under which the Boards of Trustees approved:
 - **Cash tender offers** for up to 37.5% of each of GLQ's and GLO's respective outstanding common shares and up to 32.5% of GLV's outstanding common shares at a price per Share equal to 98.5% of each Fund's respective NAV
 - **A four year managed distribution program** for each Fund:
 - For the first two years, each Fund agreed to pay monthly distributions in an annualized amount of not less than 10% of the Fund's average monthly NAV
 - In the next two years, each Fund agreed to pay monthly distributions in an amount not less than the average monthly distribution rate of a peer group
 - For the fiscal year ended 2018, the Funds reported that 0% (GLQ), 21% (GLO) and 64% (GLV) of the distributions for the year (on a cumulative basis) consisted of return of capital
- Under the settlement, **Activist #1 agreed to withdraw its board nominees and proposals and sign a 4-year "Standstill Agreement"** with the Funds
- **Activist #2 also signed a Standstill Agreement** with the Funds

Appendix B – Clough Case Study

Clough Case Study (Cont.) – Clough Shareholders Were Harmed

- Following the tender offers, the **total expense ratios** (excluding interest expense) of the Funds **increased**:
 - GLQ = 2.00% to 2.21%; GLO = 2.17% to 2.27%; GLV = 1.68% to 1.99%
- The **Funds incurred meaningful legal and additional solicitation costs**:

During fiscal year 2017, legal and proxy fees were 0.14% of net assets for the three funds combined; the next year, fiscal year 2018, they dropped to 0.01%
- The Funds had a **diminished pool of assets** post-tender, which could increase trading costs, impact portfolio management, reduce potential for economies of scale and result in Fund expenses being spread over a smaller asset base

Clough Funds Had **No Legal Recourse** to Address These Abuses

- The few courts have ruled in relevant cases concluded that **no private right of action** exists to enforce the 3% limitation (see Appendix D)
- These **practices continue unchecked, leaving closed-end funds (and their shareholders) unprotected by Section 12(d)(1)(A)(i)**

Appendix C – Schedule 13D: Examples of Private Funds Being Managed as a Group

Activist #1 (Sampling of June/July 2017 13D filings)

Acquired Registered Fund	Invesco High Income Trust II	Wells Fargo Advantage Multi-Sector Income Fund	First Trust High Income Long/Short Fund
Activist #1 Investors	Activist #1 Capital Master Fund Ltd. (A1MF) Activist #1 II AIV, L.P. (A1MF II) Activist #1 Capital Leveraged Master Fund Ltd. (A1LMF) Activist #1 Capital Series LLC Series 1 (A1S), Activist #1 Capital CEF Opportunities 1, Ltd. (A1CEF1) Activist #1 Capital CEF Opportunities 2, Ltd. (A1CEF2) Activist #1 Closed-End Funds ETF (A1-CEF-ETF)	A1MF A1MF II A1LMF A1S A1CEF1 A1CEF2	A1MF A1MF II A1LMF A1S A1CEF1 A1CEF2

Activist #2 (Sampling of June/July 2017 13D filings)

Acquired Registered Fund	Korea Equity Fund	Pacholder High Yield Fund	Aberdeen Singapore Fund Inc
Activist #2 Investors	Activist #2 Opportunity Partners LP (A2OP) Activist #2 West Partners LP (A2WP) Activist #2 Value Special Situations Fund LP (A2VSS) Activist #2 Value Offshore Fund, Ltd (A2VO) Activist #2 Opportunity Income Plus (A2OIP) Activist #2 Value Partners LP (A2VP) Activist #2 Partners LP (A2P) Activist #2 Gain Partners LP (A2GP) Activist #2 Opportunity Partners (A2M)	A2OP A2WP A2VSS A2VO A2OIP A2VP A2M	A2OP A2WP A2VSS A2OIP A2VP A2M

Appendix D – Section 12(d)(1)(A)(i): No Private Right of Action

- In two instances, target closed-end funds have sued activist managers and the hedge funds they advise alleging that they violated Section 12(d)(1)(A)(i) by using multiple funds to avoid compliance
 - The litigants alleged that the activists were doing indirectly what they were not permitted to do directly (i.e., Section 48(a) concept)
- In both cases, **the courts concluded that neither the closed-end fund involved nor its investors had standing to sue for a violation of Section 12(d)(1)(A)(i) because there is no private right of action to enforce this provision**
 - See Gabelli Global Multimedia Trust, Inc. v. Western Investment LLC, Civil No. RBD 10-0557 (D. Md. 2010); meVC Draper Fisher Jurvetson Fund I, Inc. v. Millenium Partners, L.P., 260 F. Supp 2d. 616 (S.D.N.Y. 2003)
 - **Enforcement is the sole prerogative of the SEC**

Appendix E – Other Comments on Proposed Rule (Details)

Pass Through Voting Provides No Protection to Closed-End Funds

- Private fund managers have a uniquely close relationship with underlying investors arising from the one-on-one nature of the private placement process
- Those investors want to benefit from manager's abusive discount arbitrage strategy and will vote lockstep to accommodate manager's recommendations
- This dynamic guarantees that pass through voting will result in approval of proxy proposals submitted by the activist manager

Acquiring Funds in Closed-End Funds Should Use Only Mirror Voting

- Acquiring fund should "vote the [acquired fund] shares held by it in the same proportion as the vote of all other holders of such security"
- This would prevent activist managers from influencing the outcome of proxy proposals

Appendix E – Other Comments on Proposed Rule (Details)

Aggregate Ownership Limit Should Be Set To 10%

- In our experience, holdings below the 25% level result in:
 - The type of undue influence the Commission is seeking to prevent with the conditions of the proposed rule; and
 - An acquiring fund assuring success in forcing an acquired closed-end fund to take short-term actions detrimental to its retail, long-term, Main Street shareholders
- **Closed-end funds have a large majority of retail shareholders who are not required** (unlike institutional investors) **to vote shares in proxy contests**
 - The lower retail voting participation amplifies the voting power of a large acquiring fund and its lockstep advisory group, and results in undue influence with holdings below the 25% level
 - Holdings at 15%, when combined with a proxy contest, frequently result in a large holders being able to dictate various events that are usually not in the best interests of the shareholders of a closed-end fund (see [Appendix C](#))
- Section 12(d)(1)(C) appears to represent a **long-standing Congressional judgment that a 10% level of collective closed-end fund ownership is appropriate** to prevent the abusive practices targeted by Section 12(d)(1)

Appendix E – Other Comments on Proposed Rule (Details)

Acquired Funds Should Be Permitted to Enter Into **Participation Agreements As a Prerequisite** to Allowing Acquiring Funds to Exceed 10% Ownership

- An acquired fund should be free to make a judgment that no risk of undue influence exists from a particular acquiring fund
- The proposed rule should permit an acquired fund to insist on a participation agreement with the acquiring fund akin to what the Commission's fund of funds exemptive orders now typically require
- The proposed rule should require that **a participation agreement be a prerequisite to purchasing an acquired fund's voting securities in an amount exceeding 10%, but in any event not over 25%, and require the acquiring fund to maintain a "passive" investment** as defined by the standards which apply to the filing of Schedule 13G

Appendix E – Other Comments on Proposed Rule (Details)

Proposed Rule Should Require an Acquiring Fund to Aggregate Ownership of an Acquiring Fund Advisory Group with an Acquiring Fund Sub-Advisory Group

- While the proposed definition of “advisory group” is consistent with past exemptive orders, we believe that it provides insufficient protection to registered funds because different groups of activist managers often informally coordinate or synchronize their attacks on a single closed-end fund
- **Activist fund managers will likely seek to mine Rule 12d1-4 for every advantage possible, even if it means featuring registered funds more prominently in their abusive discount arbitrage strategies**
- Groups of activist managers could easily employ sub-advisory arrangements among themselves to evade a narrow definition of advisory group

Appendix E – Other Comments on Proposed Rule (Details)

Advisory Group Definition Should be Revised to Require Aggregation of Acquired Fund's Holdings With Separately Managed Accounts Advised by Acquired Fund's Adviser, Sub-Adviser or Their Respective Affiliates

- Separately managed accounts (SMAs) generally are not viewed as being “controlled” by the adviser because SMAs are not “companies”
- However, an adviser is often delegated voting discretion and dispositive power over SMA assets, and with that authority, the adviser can exert undue influence on an acquired fund
- **Activists would likely evade a narrow definition of advisory group by combining SMAs with private funds and registered funds when implementing a discount arbitrage strategy**

Appendix E – Other Comments on Proposed Rule (Details)

Rule Should Avoid Grandfathering and Require Disposition of Holdings Exceeding 10%

- Any final rule **should not include any “grandfathering” provision** for closed-end funds with a current acquiring fund and advisory group holding in excess of 25% or whatever ceiling is adopted in the final rule
- Any final rule should contain an affirmative disposition requirement to come within the confines of the final rule within a defined period of time
- At best, **allowing these positions to remain will subject unlucky closed-end funds to the risk of continuing undue influence** to the detriment of their retail, long-term, Main Street shareholders
- At worst, this **will incentivize advisory groups seeking control or influence to increase their holdings of targeted closed-end funds** above the permitted threshold prior to the effectiveness of the final rule

Appendix E – Other Comments on Proposed Rule (Details)

The 3% Redemption Limit Should Be Applied to Acquired Funds That Are Closed-End Funds

- The proposed rule would prohibit an acquiring fund that purchases more than 3% of an acquired fund's outstanding shares from redeeming or submitting for redemption, or tendering for repurchase, more than 3% of an acquired fund's total outstanding shares in any 30-day period
- We believe the 3% redemption limit should apply to acquiring fund investments in voting shares of listed closed-end funds
- **This limit would protect acquired closed-end funds from** one of the key abuses which Congress targeted through its adoption of Section 12(d)(1) – **the pyramiding of indirect control of investment companies through** coercion effected by **the threat of large-scale redemptions**