WORkIng Group On MarKeT EfficiEnCy And InVeStor Protection In Closed-End FUnDs

Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
Washington, D.C. 20549
VIA ELECTRONIC DELIVERY

Dear Ms. Countryman:

The Working Group on Market Efficiency and Investor Protection in Closed-End Funds (the “Working Group”) respectfully submits this comment letter regarding the New York Stock Exchange’s (“NYSE”) proposed rule change to exempt closed-end funds (“CEFs”) from the requirement to hold annual shareholder meetings (File No. SR-NYSE-2024-35, the “Proposal”).1 We have carefully analyzed the Proposal from an economic perspective and submit this comment letter to provide the SEC with a summary of our findings.2

The Working Group is composed of academic economists and former SEC officials who have studied, researched, and taught the economics of markets for decades:

- **Daniel Taylor,** Arthur Andersen Professor at The Wharton School of the University of Pennsylvania (Co-Chair of the Working Group);
- **Edwin Hu,** Associate Professor, University of Virginia School of Law, and former Staff in the SEC’s Division of Economics, Risk and Analysis (Co-Chair of the Working Group);
- **Robert Bishop,** Associate Professor, Duke School of Law, co-founder of the International Institute of Law and Finance, and former Senior Advisor at the U.S. Treasury;
- **Bradford Levy,** Assistant Professor, The Chicago Booth School of Business;
- **Shiva Rajgopal,** Roy Bernard Kester and T.W. Byrnes Professor, Columbia Business School; and
- **Jonathon Zytnick,** Associate Professor at the Georgetown University Law Center and former SEC Commissioner Counsel.

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1 A substantively similar proposal has also been submitted by CBOE BZX Exchange, see File No. SR-CboeBZX-2024-055. We respectfully request that our comments also be included in that file.

2 To our knowledge, neither NYSE, CBOE BZX Exchange, nor the Securities and Exchange Commission (“SEC”) have published any economic analysis related to the Proposal.
We write in our individual capacities and our institutional affiliations are provided for identification purposes only.

Based on four decades of research on CEFs, we conclude that the Proposal—as currently drafted—would have significant negative consequences for the CEF market and CEF investors. The SEC has a three-part mission: to protect investors, maintain and promote efficient markets, and foster capital formation. Our economic analysis leads us to conclude that the Proposal would harm all three elements of the SEC’s mission. By disenfranchising shareholders of their right to an annual vote on the business and governance of a CEF, the Proposal would make it more difficult for shareholders to hold CEF management accountable for poor performance or self-interested decisions. In turn, the Proposal would make it more difficult for the CEF market to function—impeding market efficiency, reducing capital formation, and harming investors.

The remainder of this letter provides a more detailed summary of our analysis and conclusions. While the Proposal would help preserve NYSE’s fee revenue, it would do so at the expense of investor protection and market integrity. We urge the SEC to reject the Proposal in its current form, and instead to require any such proposal to be supported by rigorous independent economic analysis. We stand ready to assist the SEC in any way possible.

Please do not hesitate to contact Daniel Taylor, co-chair of the Working Group, with any questions.

Sincerely,

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(Co-Chair, the Working Group)

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I. The Economics of Closed-End Funds

CEF s provide shareholders with exposure to a basket of assets. The value of these assets is commonly referred to as the fund’s net asset value (“NAV”). One of the most studied aspects of the CEF market is the fact that the CEF s are commonly traded at a discount to their NAV. Indeed, a recent report by the Investment Company Institute found that by the end of 2023, more than 80% of CEF s traded at a discount to NAV, and that the average discount was around 10%. Importantly, however, the discount can vary widely across CEF s and can be substantial. For example, it is not unusual to find discounts in excess of 20% even on very liquid, billion-dollar CEF s. In such circumstances, investors are effectively willing to pay just $0.80 (market price) for assets worth $1 (NAV).

The pervasiveness of the CEF discount is inconsistent with a frictionless, efficient market. For this reason, it has been the topic of study by over four decades of academic research. One of the key reasons for the persistence of this discount is that unlike exchange-traded funds and open-ended mutual funds, CEF s do not have a redemption mechanism that allow investors to transact at the fund’s NAV. Because there is no redemption mechanism for CEF s, for the invisible hand of the market to function, and the discount to be arbitraged away, shareholders have to be able to compel CEF management to either liquidate the CEF, i.e., paying out the NAV to shareholders, or convert the CEF to an open-ended fund that trades at NAV. Thus, in CEF s, the invisible hand of the market—which ensures that the market price of a basket of assets is approximately equal to the basket’s NAV—is limited by the extent of the agency problem between CEF management and CEF shareholders.

Indeed, the overwhelming consensus of over four decades of academic research is that the CEF discount represents a market inefficiency, the persistence of which is attributable to agency conflicts that prevent shareholders from liquidating or converting CEF s that trade at a substantial discount. The harder it is for shareholders to replace the management team of a CEF that trades
at a substantial discount, the more difficult it will be for market forces to function, and the greater the discount to the NAV. Indeed, the consensus of decades of academic research on CEFs shows that CEF shareholders benefit when CEFs that trade at a substantial discount either liquidate or convert to an open-ended fund.10

II. Economic Analysis of the Proposed Rule Change

Accordingly, one of the core requirements for CEFs to trade in an efficient market is that shareholders be able to “open” closed-end funds and capture the discount—either by liquidating the CEF and paying out the NAV to shareholders or converting the CEF to an open-ended fund that trades at NAV (e.g., a mutual fund). Doing so requires a robust market for control, where shareholders can hold management and the board of poorly performing CEFs (i.e., those that trade at a substantial discount) accountable, and “open” the CEF.

The management and board of poorly performing CEFs will naturally oppose such initiatives as they can result in the loss of assets under management, fees, or even their jobs. Thus, underperforming CEF managers and self-interested CEF boards have incentives to prevent the market from functioning efficiently. Consistent with the possibility of CEF managers’ pursuit of self-interest, advocates for the CEF industry have made the paradoxical claim that the functioning of an efficient market harms investors. For example, one CEF-industry advocate argued:

Activists target exchange-traded closed-end funds with share prices trading at a discount to NAV, and the arbitrage opportunity they seek to exploit is straightforward: they purchase a large number of fund shares at prices below NAV, and then use their concentrated voting power to try to force the fund to take actions that will allow [shareholders] to sell their shares at prices at or near NAV.11

[Such] activist investors, often hedge funds, are . . . extract[ing] short-term profits from closed-end funds, causing significant harm to funds and their long-term investors.12

What is puzzling about this argument is the claim that elimination of the CEF discount—allowing investors to sell shares at prices near NAV—causes investors significant harm. As described above, that claim is at odds with the broad consensus of more than forty years of financial

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economics research: that investors benefit when CEFs that trade at a steep discount to their NAV are either liquidated or converted. The argument ignores the benefits of an equilibrium where discounts are smaller, and all investors can exit at or near NAV.

The Proposal eliminates the requirement that CEFs hold annual shareholder meetings. In doing so, it disenfranchises shareholders of their right to voice their opinions annually on the business and governance of a CEF. The principal effect would be to make it more difficult for shareholders to hold CEF management accountable for poor performance or self-interested decisions and would make it more difficult to liquidate or convert a CEF that trades at a steep discount.

As the Proposal notes, in the absence of annual meetings, shareholders would have to call special meetings to vote on shareholder proposals to hold CEF management and the board accountable. However, CEF charters and by-laws can impose onerous minimum ownership levels in order to call special meetings. For example, many CEFs are incorporated in Maryland, and Maryland General Corporation Law specifies a minimum ownership requirement of at least 25% in order to call a special meeting—but permits CEFs to increase the minimum ownership requirement to 50% (i.e., a majority of shares) as long as the threshold is specified in the CEF’s charter or bylaws. Indeed, one law firm that advises many CEFs notes that:

“The bylaws of most of our closed-end fund clients permit a special meeting of stockholders to be called [only] by [1] the board of directors, or [2] specified officers, or [3] upon the request of holders of shares entitled to cast at least a majority of all the votes . . . ”

Thus, under the Proposal, CEFs with very high minimum ownership thresholds could all but ensure that shareholders would be unable to call special meetings for the purposes of holding CEF directors accountable to investors. Nor is this prospect merely theoretical. Recent research shows that a near majority of CEFs indeed require that shareholders have a majority of voting shares in order to call a special meeting. The same study shows that many CEFs combine those arrangements with additional anti-takeover features like the so-called “poison pill,” which effectively preclude shareholders from acquiring enough shares to call a special meeting in the first place.

As a result, the Proposal would further entrench management, making it costlier for shareholders to hold CEF management and CEF directors accountable for poor performance and/or self-interested decisions. In this regard, the Proposal can be viewed as akin to a request by NYSE to grant all listed CEFs a takeover defense, the economics of which are well-documented and straightforwardly harmful to investors.

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14 Ibid. (emphasis added).
15 Souther, supra note 9.
16 Ibid.
Moreover, as CEF board entrenchment increases, the ability to arbitrage away the
difference between the market price of the CEF and its NAV will diminish, impeding the
functioning of an efficient market. This would harm capital formation, as investors would demand
a greater discount to NAV to compensate for the fact that the market can no longer discipline
poorly performing CEF management. It would also harm existing CEF shareholders whose claims
on fund assets are diminished in value as a result of the increase in managerial entrenchment.

III. The Proposal is in NYSE’s Economic Self-Interest

“Show me the incentive and I will show you the outcome.”
–Charlie Munger

The Proposal, on its face, is difficult to rationalize on efficiency grounds. It is however,
entirely consistent with NYSE acting as a self-interested, profit-maximizing entity. Ironically, in
the CEF market, NYSE has incentives to impede rather than promote market efficiency. Indeed, if
market forces were allowed to operate more freely, and the CEF market was frictionless and
efficient, NYSE would lose fee revenue.

As discussed above, most CEFs trade at a discount to their NAV. For many CEFs, this
discount is substantial. Consider a CEF that trades on NYSE at a 25% discount (i.e., investors are
willing to pay $0.75 for $1 of asset value). In a frictionless, efficient market, shareholders would
be able to capture the NAV and arbitrage away the 25% discount either by liquidating the fund’s
assets and paying out the proceeds, or converting the CEF to an open-ended mutual fund that trades
at NAV. Because mutual funds are not exchange traded, in either case—liquidation or conversion–
the CEF would no longer be traded on NYSE. Thus, for CEFs that trade at a steep discount to
their NAV, the efficient market outcome would result in the loss of fee revenue to NYSE.17

Viewed through this lens, the Proposal is entirely consistent with a goal of maintaining
NYSE’s own fee revenue, rather than with the Commission’s three-part mission: to protect
investors, maintain and promote efficient markets, and foster capital formation. As discussed
above, in the CEF market, NYSE has incentives to impede market forces in order to prolong the
listing of CEFs that trade at a steep discount and maximize fee revenue. The Proposal would do
just that. It will disenfranchise shareholders, making it more difficult for investors to hold
management of poorly performing CEFs accountable, blocking the invisible hand of the market,
and exacerbating the CEF discount.

This lens also allows us to understand CEF-industry advocates’ complaint that CEFs have
grown so unpopular that “no new traditional CEFs opened” during 2023, attributing this fact to
CEF activism.18 Financial economists have long explained that CEFs are unpopular because

17 Conversion to an ETF is also a possibility, and ETFs are exchanged traded, so there is some possibility that NYSE
would retain the listing at issue. However, our point about listing fees still holds, as NYSE’s annual fees for ETFs are
generally cheaper than the annual fees charged to CEFs. See NYSE fee schedule as of Jan 1, 2024, available at
https://www.nyse.com/publicdocs/nyse/markets/nyse-arca/NYSE_Arca_Listing_Fee_Schedule.pdf (compare Items 6
and 9 for ETFs to Item 8 for CEFs).
18 Investment Company Institute, May 14, 2024, “Closed-End Fund Activism Surges, Shows Need for Congressional
investors cannot redeem at NAV. As economists, we prefer that markets—rather than advocates, regulators, or Congress—dictate the need for an investment vehicle. Economics does not support the claim that having more CEFs would be beneficial. Instead, that claim reflects the CEF industry’s self-interest.

The fact that another exchange, CBOE BZX, has now filed a similar proposal with the SEC only heightens our concern. We worry that the Proposal reflects a race to the bottom among exchanges seeking to attract and retain CEF listings—putting CEF investors at risk by making it more difficult for shareholders to hold incumbent CEF directors accountable.

The Proposal, and others like it, should be recognized for what it is: a proposal that would preserve the fee revenue of NYSE, even as it disenfranchises shareholders and harms market efficiency. The Proposal is fundamentally inconsistent with market efficiency, capital formation, and investor protection, and we urge the SEC to reject it.

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