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Preferred Shareholders Demand Representation

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Common shareholders are generally the vocal class when it comes to demanding action from a fund's board, and there is no lack of this type of dissident activity this year. But in addition, lack of liquidity for ARPs has given preferred shareholders a reason to speak up or to support dissidents. Closed-end fund activists have latched on to the prospect of gaining an advantage through harnessing this discontent in the form of votes. Most of the activity is based on an interesting situation that is created by the fact that two board members are elected by just the ARPs shareholders voting separately as a class. Although the ARPs elect these two board members, the directors then serve on the board as full members, with authority over issues related to both the common and preferred shares.

Denali Fund (DNY), a closed-end fund which holds 93 auction rate preferred shares of **TS&W/Claymore Tax-Advantaged Balanced Fund** (TYW) representing a par value of $2.3 million, submitted a shareholder proposal to nominate Richard I. Barr as a director to be elected by the preferred shares at TYW's upcoming annual meeting. But don't expect to see Mr. Barr's name on the company's proxy—at least not this year. The current shareholder proposal rules under Rule 14a-8 of the Securities Exchange Act of 1934, clearly allow companies to exclude proposals that relate to election to the board and TYW has received the okay from the SEC to exclude the nomination based on that rule.

The ARPs held by DNY represent only about 2% of TYW's outstanding preferred shares, and the proposed nomination of Mr. Barr may be meant only as a warning that the group is tired of waiting for the fund to finish redeeming the rest of its preferred shares. To date, TYW has redeemed about 12.5% of its ARPs. We haven't seen any other nominations submitted by DNY or its affiliates for the other 15 funds in which they hold preferred shares, but this seems like a tactic the group may use for other ARPs holdings in which it has grown impatient waiting for liquidity. (Mr. Barr is already on the board of DNY and two other funds managed by the same advisor. Those boards are themselves struggling with finding replacement leverage in order to redeem their own outstanding ARPs.)

Another way to get a shareholder's candidates on the proxy is to have them nominated by the fund's Nominating Committee. The Karpus shareholder group with an 11.5% stake in the common shares, is taking a second stab at getting its candidates endorsed by the Nominating Committee of **MFS Intermediate Income Trust** (MIN) after all its nominees were rejected last year. This year it is proposing eight names for the October, 2009, election.

But the Karpus shareholder group is also trying a similar tactic in another fund—one in which it holds a majority of the preferred shares. It is proposing candidates for the two preferred share board seats, posts for which Karpus holds more than enough votes to guarantee election. Karpus filed a Schedule 13D with the SEC showing that it holds 87.61% of the ARPs issued by **First Trust/Four Corners Senior Floating Rate Income Fund** (FCM), attaching a letter to submit its nominations as required by FCM's Nominating Committee Charter. It will now be up to FCM's Nominating Committee to determine if the Karpus candidates will be nominated and appear on the fund's proxy, or if the Committee will endorse the incumbent directors.

Shift in Balance of Power

Incidentally, although changes in FCM's By-Laws made in 2006 converted the fund's board to staggered three-year terms, the two preferred board members come up for election together in 2009, making this year's showdown immediately possible. The Karpus nominations are particularly interesting and could be a thorny issue for FCM because the fund's board consists of only five members, one affiliated director and four independent. If the Karpus group were to control two independent board posts they could

effectively block actions that require the affirmative approval of a majority of the independent directors—issues such as renewal of the advisory agreement.

Since the current shareholder proposal rules allow funds to exclude specific types of proposals from the company-issued proxy, large shareholders sometimes go to the expense of issuing their own proxy, to present their proposals and in many cases their own board nominees. An affiliate of DNY's advisor, the Horejsi shareholder group, has done so in the past, as has the Karpus group and several others. Karpus may well choose not to leave its fate to FCM's Nominating Committee and go to the expense of issuing its own proxy. With enough shares to win the preferred share vote, they could probably wage a proxy battle quite cheaply. Their goal, however, seems to be limited to redemption of their preferred shares. In a recent *Dow Jones Newswire* article on the FCM issue, Cody Bartlett, Managing Director of Karpus, is quoted as saying, "we're doing this to sort of pressure the board to do something now rather than later."

FCM may indeed be thinking about doing something now. On May 22, 2009, the fund, and sister fund **First Trust/Four Corners Senior Floating Rate Income Fund II** (FCT), filed a request for exemptive relief with the SEC to allow both funds to replace their ARPs leverage with debt and temporarily be subject to 200% rather than 300% asset coverage.

Coincidentally, on the subject of shareholder proposals, the SEC announced proposed amendments to Rule 14a-8 just this month, focusing specifically on allowing large shareholders a greater ability to nominate director candidates. The rule amendments will be subject to a 60-day comment period before final adoption. At least that is the plan. We've been down this road once before, in late 2003 (see our coverage in the December, 2003, issue*: SEC Proposes Allowing Shareholders to Nominate Directors*.) The focus of the 2003 changes was to provide large shareholders a "limited access right" to proxy materials to include their own nominees for director posts, the changes were to be applicable to closed-end as well as open-end funds. Shareholders with 5% of the outstanding shares would be able to include their own director nominees in the fund's proxy under certain conditions, provided the shareholder was not seeking to influence control over the fund. After the comment period, nothing happened. There were no changes made to the existing rule as well as no announcement as to why.

Rule 14a-8 Spells Out Current Shareholder Proposals Rules

Rule 14a-8 under the Securities and Exchange Act of 1934 provides the guidelines for shareholder proposals. The SEC's website provides an easy to read plain English description of the process of submitting a shareholder proposal at http://www.sec.gov/rules/final/34-40018.htm (a question and answer format begins about three-quarters down the page.)

Briefly, rule 14a-8 stipulates that, for a proposal to be eligible for inclusion on a proxy statement, the shareholder making it must be a record or beneficial owner of at least 1% of the company's securities entitled to be voted at the meeting, or $2,000 in market value of the fund, and must have held the position for at least one year. He must continue to own the fund through the meeting date and be prepared to show proof of his ownership. Only one proposal may be submitted for a particular meeting; and the proposal, including any supporting statement, may not exceed 500 words. The shareholder or his representative must present the proposal at the meeting. If not, the fund is not required to include any proposals submitted by that shareholder for the next two calendar years.

Even if the 14a-8 rules are conscientiously followed and the deadlines observed, there are circumstances under which a fund can omit inclusion of a proposal.* A summary of some of the topics which can not be the subject of a shareholder proposal appear in the box on page 9.

To propose actions that may conflict with these exclusions, some shareholder proposals can be worded as *recommendations* to the board rather than resolutions for definitive action.

*Any comments presented in this report are not to be considered legal advice. Please consult your legal counsel for your individual circumstances.

SUBJECTS THAT CAN NOT BE THE SUBJECT OF A SHAREHOLDER PROPOSAL UNDER 14a-8

1. The proposal is not a proper subject for action by shareholders under state law.
2. The proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject.
3. The proposal is contrary to any of the SEC's proxy rules, including containing materially false or misleading statements.
4. The proposal addresses a personal claim or grievance against a company or other person, or it furthers a personal interest, which is not shared by other shareholders at large.
5. The proposal relates to operations that account for less than 5% of the company's total assets and for less than 5% of its net earnings and gross sales and is not otherwise significantly related to the company's business.
6. The company lacks the power or authority to implement the proposal.
7. The proposal deals with a matter related to the company's ordinary business operations.
8. The proposal relates to election for membership on the board of directors.
9. The proposal conflicts with one of the company's proposals that is to be presented at the same shareholder meeting.
10. The company has already substantially implemented the proposal.
11. The proposal duplicates another shareholder proposal previously submitted for the same meeting.
12. The proposal deals with the same subject matter as a proposal in the preceding 5 calendar years and within 3 years of the last time it was included; the proposal received less than 3% of the vote if proposed once within the preceding 5 calendar years, less than 6% on the last submission if proposed twice within that time frame, or less than 10% on the last submission if proposed three times or more.
13. The proposal relates the specific amount of dividends.

Proposed Changes Would Allow Board Nominations

The SEC has proposed a new Exchange Act Rule 14a-11, which outlines when and how shareholders would be able to nominate candidates for director posts and have their nominees included in the company's proxy materials. Closed-end fund investors are notoriously apathetic and either vote in line with management's recommendations or, more commonly, they don't vote at all. A full-blown proxy battle in which both management and dissidents vie for shareholder votes can be expensive and frustrating. Getting candidates on management's ballot is not only cheaper for activists, but the endorsement of the board can usually assure success.

The new SEC-proposed rule change would apply *unless otherwise prohibited by either state law or the company's charter or bylaws*—technicalities that may greatly reduce effectiveness of the changes. Rule 14a-11 "would apply to all Exchange Act reporting companies, including investment companies, other than debt-only companies." While the full text is not yet available, the press release contains several specifics.

"Honey, I'm so confused. Should we vote the white proxy or the green?"

"I say go green."

The amount of shares a nominating shareholder must hold will vary, based on the size of the company. For instance, for registered investment companies the categories allowed to submit nominations are as follows:

- "Large accelerated filer" must own at least 1% of the voting securities of a registered investment company with net assets of $700 million or more.
- "Accelerated filer" must own at least 3% of the voting securities of a registered investment company with net assets of between $75 million and $700 million.
- "Non-Accelerated filer" must own at least 5% of the voting securities of a registered investment company with net assets of less than $75 million.

The proposed rule allows shareholders to aggregate holdings in order to meet the thresholds, but also requires the shareholders to have held the shares at least one year and to sign a statement that they intend to continue holding the shares through the annual meeting date. Shareholders must also certify that they are "not holding their stock for the purpose of changing control of the company, or to gain more than minority representation on the board of directors."

The number of directors that can be nominated will be limited to no more than one nominee or a number that represents up to 25% of the company's current board, whichever is greater.

Preliminary Reactions

The SEC's changes are designed to give shareholders a larger say in the companies they own and to make sure boards stay focused on shareholder interests. We asked several activist closed-end fund investors about their initial reaction to the proposed changes, here are some of their responses.

Cody B. Bartlett Jr., Managing Director of Investments at Karpus Investment Management indicated that he thought "it is a positive step towards allowing ownership representation on the Board of Directors." However, he stated "we are skeptical and believe that management will find ways to exclude shareholder nominees." He also pointed out that "since the shareholder has to agree not to change control, proxy contests will likely not be diminished as a result of this rule amendment, if passed." Mr. Bartlett noted that the group's attempt to nominate candidates in MIN last year were discouraging; "we believe in a system in which an owner of a certain percent of shares (say 10 percent of outstanding) would automatically be given the right to nominate directors, a right which they could decline."

Barry Olliff, Chief Executive Officer of City of London Investment Group PLC, and a vocal proponent of good corporate governance practices, told us that nominating board candidates "is something that we'll consider using." He continued, "What we are interested in is helping the closed-end fund sector survive and grow. The only way that this will occur as far as we are concerned is if directors of closed-end funds in the U.S. start to understand that these are corporations and that they need business plans that take into account that they (these corporations) are fighting for survival (in a crowded marketplace) with other competing products. The ability of shareholders to promote new directors is taken as read in just about every developed market (and many emerging markets too). Boards become cozy and club like if they become too comfortable. In our experience U.S. emerging market closed-end fund boards want to do the right thing but they are not aware of how investors in closed-end funds make money or perceive the risks associated with either investment performance or share price tracking relative to the relevant NAV. Inevitably some new blood would change this. In our opinion this [change] would generally be for the benefit of shareholders, the board and the manager."

Gregg Abella, Portfolio Manager, Investment Partners Asset Management had the following observations: "I view this proposed rule amendment as a positive development. If closed-end funds are going to be competitive with ETFs, then boards of closed-end funds need to be vigilant to address shareholder concerns. Fund boards are usually not chosen by shareholders, but rather, in many cases, have a relationship with the fund sponsor. I am amazed when I hear about funds that utilize state-law anti-takeover statutes and poison-pill provisions to dilute the voting power of ownership interests of their shareholders. To me, those tactics don't seem to square up with the very first section of the Investment

Company Act of 1940 which condemns issuance of securities containing inequitable or discriminatory provisions, failure to protect the preferences and privileges of holders, and inequitable methods of control. I think closed-end fund board members ought to demonstrate empathy for shareholders by continually asking themselves a simple question: *if their closed-end fund became an open-end fund tomorrow, would a good portion of the shareholders redeem their holdings?* If board members believe the honest answer is 'yes,' then it may be time to re-assess their fund's governance, management, and strategy. I believe it just makes common sense that the voice of shareholders be included on a fund's board as such key issues are evaluated."

Phillip Goldstein, Principal of Bulldog Investors, doubted the changes would go through. He noted, "if it is challenged, which is very likely, a federal court will almost certainly invalidate it because it exceeds the SEC's authority under Section 14a of the 1934 Act, which is merely to regulate the proxy process and insure adequate disclosure with the goal of insuring that a proxy is as close a substitute as possible to actual attendance at the stockholder meeting—not to establish the criteria for nominating directors (or other matters about corporate governance), which are subject solely to state law. In sum, the rule is likely to generate massive publicity and commentary but in the end be much ado about nothing—although a defeat in court two years from now may prompt Congress to take some action (unless it loses interest by that time)."

Incidentally, Mr. Goldstein successfully took on the SEC in a case related to the agency overstepping its authority in requiring the registration of hedge fund advisors. In his comments, he added, "the road to hell is paved with good intentions and just because there are serious problems in this country with shareholder democracy does not mean the SEC is authorized to cure all of them through rule-making."

This special report was prepared by Thomas J. Herzfeld Advisors, Inc., specialists in closed-end funds, and is a partial excerpt from the June, 2009, issue of the monthly research publication, *The Investor's Guide to Closed-End Funds*.