PUBLICATION

SEC Staff Withdraws No-Action Letter that Prohibited Closed-End Funds from Opting In to the Maryland Control Share Acquisition Act

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On May 27, 2020, the Staff of the Securities and Exchange Commission's ("SEC") Division of Investment Management (the "Division") published a Statement entitled "Control Share Acquisition Statutes" (the "Statement") in which it withdrew its Boulder Total Return Fund, Inc. No-Action Letter (the "Boulder Letter") (publicly available November 15, 2010) and replaced it with a no-action position providing that it "would not recommend enforcement action … against a closed-end fund under section 18(i) of the [Investment Company] Act for opting in to and triggering a control share statute if the decision to do so by the board of the fund was taken with reasonable care on a basis consistent with other applicable duties and laws and the duty to the fund and its shareholders generally." The Statement also asked for feedback on several issues pertaining to the opting in to and use of control share statutes by registered closed-end funds. The Statement is available here.

During the aughts, we regularly worked with registered closed-end investment companies (closed-end funds) to implement defensive measures against attempts by activists to "open-end" or dissolve the fund, including opting in to the Maryland Control Share Acquisition Act ("Control Share Act")[1] and adopting shareholder rights plans (poison pills). Most closed-end funds organized as corporations are incorporated in Maryland.[2]

The Control Share Act eliminates the voting rights of holders of "control shares" acquired in a "control share acquisition," with respect to the control shares, unless the voting rights are granted by the affirmative vote of two-thirds of all the votes entitled to be cast on the matter, excluding all interested shares, at a meeting of the Maryland corporation's stockholders held in accordance with the Control Share Act. While the Control Share Act applies automatically to most Maryland corporations, which have the option to opt out of its application, the Control Share Act only applies to registered closed-end funds that affirmatively opt in to it.

In general, "control shares" are shares of stock of a corporation, including a closed-end fund that opts in to the Control Share Act, that, when aggregated with all other shares owned or controlled by the acquiring person, would entitle the acquiring person, but for the Control Share Act, to vote (or to direct the voting of shares) (other than solely by virtue of a revocable proxy) in the election of directors within any of the following three ranges:

- One-tenth or more, but less than one-third of all voting power;
- One-third or more, but less than a majority of all voting power; or
- A majority or more of all voting power.

A "control share acquisition" is the acquisition by a person of the direct or indirect ownership of or the right to exercise voting power over issued and outstanding "control shares" of a corporation.

In November 2009, Andrew J. Donohue, at the time the Director of the Division, gave the keynote address at the Independent Directors Council Investment Company Directors Conference, in which he opined that certain tactics being employed by some registered closed-end funds to "thwart takeover attempts," including the adoption of poison pills and opting in to state control share act provisions including the Control Share Act, were

likely inconsistent with certain provisions of the Investment Company Act of 1940 (the "Investment Company Act").[3]

Director Donohue's speech was followed by the Division's Office of Chief Counsel's issuance of the Boulder Letter, which involved a Maryland corporation named Boulder Total Return Fund, Inc. ("Boulder"). In the Boulder Letter, the Chief Counsel's Office officially took the position that Boulder's proposed "use of the [Control Share Act] … to restrict the ability of certain shareholders to vote 'control shares' … would be inconsistent with the fundamental requirements of Section 18(i) of the Investment Company Act that every share of stock issued by the Fund be voting stock and have equal voting rights with every other outstanding voting stock." As one would assume, following Director Donohue's speech and the issuance of the Boulder Letter, closed-end funds generally ceased opting in to the Control Share Act or adopting poison pills. With the issuance of the Statement, we expect that closed-end funds will once again opt in to the Control Share Act.

We will not attempt to analyze whether opting in to the Control Share Act is in fact inconsistent with Section 18(i) of the Investment Company Act. However, any closed-end fund board that opts in to the Control Share Act will likely be acting in a manner consistent with its duties under Maryland law.

In general, under Maryland corporation law, directors' acts are presumed to satisfy the directors' statutory standard of conduct set forth in Section 2-405.1(c) of the MGCL. See §2-405.1(g). Further, the act of a director of a Maryland corporation is not subject to a higher duty or greater scrutiny just because the act relates to defensive measures on behalf of the corporation. See §2-405.1(h). These provisions make any challenge to a Maryland corporation's board's decision to opt in to the Control Share Act virtually unwinnable.[4]

Unlike in the Boulder Letter, in the Statement the Staff did not provide any reasoning for its new position that a fund's opting in to a control share statute does not violate Section 18(i) of the Investment Company Act, making only vague references to "market developments" since the issuance of the Boulder Letter and "recent feedback from affected market participants" as to why the Staff determined to withdraw it. As we strongly believe that the SEC should not be in the business of picking winners and losers, we hope that the success of activists such as Phil Goldstein's Bulldog Investors in forcing closed-end funds to open-end or dissolve, and thereby put an end to the management companies making fees from these funds, is not the "market developments" or "recent feedback" the Staff was alluding to.

Perhaps we are left to conclude that the prior Division regime felt that application of a control share statute to a closed-end fund was inconsistent with Section 18(i) and the current one does not. In that regard, perhaps current Division management believes that as control share statutes arguably only impact the voting rights of certain *holders* of a fund's shares, as opposed to having any effect on the voting rights inherent in the shares themselves, there is no inconsistency with Section 18(i) of the Investment Company Act, which simply provides that each share of a registered investment company's stock be "voting stock and have equal voting rights." This argument existed, however, prior to the issuance of the Boulder Letter. James J. Hanks of Venable LLP published at least two articles between the date of Director Donohue's speech and the publication of the Boulder Letter that discussed this line of reasoning.[5] Further, the Boulder Letter specifically cites to one of these articles and addresses this line of reasoning, indicating that the purported distinction between shares and shareholders is an argument "without merit" and that

"[t]he plain wording of Section 18(i) … clearly prohibits discrimination between or among both shares and shareholders. Any interpretation of Section 18(i) that envisages personal discrimination against an investment company shareholder would be flatly inconsistent with the purposes of Sections 18(i) and 1(b) and the special protection that Congress mandated for investment company shareholders. ... Although discrimination between and among shareholders may be permitted for operating companies that use the [Control Share Act], such discrimination is not permitted for a [closed-end fund] under Section 18(i)."

Given these clear and pointed statements in Boulder regarding the interplay between the Control Share Act and Section 18(i), the change in position set forth in the Statement, without explanation, is curious at best.

As a refresher, there are a number of defensive measures that Maryland closed-end funds have at their disposal to defend against potential hostile takeovers besides opting in to the Control Share Act, including:

- a classified board structure
- advance notice provisions for stockholder proposals
- director nominations
- other stockholder meeting-related bylaw provisions
- opting in to provisions of the Maryland General Corporation Law that provide additional protections with respect to directors, including that a director on a classified board may only be removed for cause.

Depending on the circumstances, there does still remain ways for an activist to attack these defensive measures.

If you would like to discuss these developments, please feel free to contact Ken Abel.

[1] The Control Share Act is codified at §§3-701 to -710 of the Maryland General Corporation Law ("MGCL").

[2] Closed-end funds that operate as trusts are typically organized in Massachusetts or Delaware. "A review of registration statements filed by closed-end funds on Form N-2 suggests that the vast majority of listed closed-end funds are organized under Delaware, Maryland or Massachusetts law." See Statement (defined below) at endnote 5.

[3] Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission, Keynote Address at the Independent Directors Council, Investment Company Directors Conference, Amelia Island, Florida (Nov. 12, 2009) (transcript available at: http://www.sec.gov/news/speech/2009/spch111209ajd.htm#P23_6532)

[4] Other than the directors' statutory standard of conduct set forth in §2-405.1(c) of the MGCL, we are unfamiliar with any other duties the Staff may have been referencing regarding "other applicable duties and laws and the duty to the fund and its shareholders generally."

[5] See, e.g., https://s3.amazonaws.com/documents.lexology.com/56c7b756-12d3-469a-9ade-80aa13e29a21.pdf.