SEC Staff Statement Clears Way For Closed-End Funds

By **Thomas DeCapo, Kevin Hardy and Michael Hoffman** (July 1, 2020, 2:10 PM EDT)

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On May 27, the staff of the Division of Investment Management of the U.S. Securities and Exchange Commission issued a statement regarding the intersection between state control share acquisition statutes (control share statutes) and the voting requirements of Section 18(i) of the Investment Company Act of 1940.

As anticipated, the control share statute relief reverses the staff's prior position, set forth in a 2010 no-action letter issued to Boulder Total Return Fund, in which the staff concluded that a closed-end fund, by opting into a control share statute, "would be acting in a manner inconsistent with Section 18(i) of the Investment Company Act."[1]

The control share statute relief reflects only the enforcement position of the staff and is not binding on the SEC or any court. Although a court could conclude that a closed-end fund opting into a state control share statute violates the Investment Company Act, the limited judicial precedent that exists supports closed-end funds' ability to use control share statutes.

Corporate law is generally the province of state law, not federal law. However, the Investment Company Act contains several provisions that regulate the capital structure, shareholder voting rights and other corporate governance terms of registered investment companies. These preempt state law to the extent that there is a direct conflict between the Investment Company Act and state law.

Standard tools available to operating company boards for the purpose of giving their companies time to address shareholder concerns and to be able to negotiate with large hostile shareholders include shareholder rights plans (often called "poison pills") and, in a large number of states, share ownership and voting limitations contained in control share statutes. Both tools in effect prevent a single or small number of shareholders from acquiring so many shares that they are able to force changes that are not supported by the company's board.

The Boulder letter, and the staff's subsequent enforcement of the position taken in Boulder, deprived fund boards of these essential tools on the theory that the tools violated provisions of the Investment Company Act as interpreted by the staff. As a result, over the past decade closed-end funds have been targets of well-funded institutional activist investors that have acquired large stakes in a closed-end fund not as a long-term investment, but as a short-term strategy to force the fund to pay out to shareholders more than the market value of its shares. This benefited short-term investors, often at the expense of long-term investors.

Over the past 10 years many closed-end funds shrunk in size, liquidated entirely or have been unable to fully pursue their investment strategies due to the need to raise large amounts of cash quickly in

order to make large payments to shareholders forced by activists. And new closed-end fund creation fell in this hostile environment.

The control share statute relief returns to closed-end fund boards in states with applicable control share statutes this important tool and may be instrumental in revitalizing the closed-end fund industry for long-term investors and fund sponsors alike.

The withdrawal of the Boulder letter will likely have a significant impact on the closed-end fund industry. Importantly, it provides closed-end funds organized in states with applicable control share statutes with an important corporate governance tool that can be helpful to fund boards in warding off tactics to coerce funds into liquidating, converting to open-end funds or shrinking in size through liquidity events that the fund board believes are not in the fund's best interest.

Fund boards should promptly evaluate whether to avail their funds of applicable control share statutes. Where such statutes are not available, boards should consider redomesticating to a jurisdiction that has a control share statute or taking other defensive action in anticipation of funds that cannot avail themselves of the protection of a control share statute becoming more likely targets of activist campaigns.

Boulder Letter

In 2010, the staff issued a no-action letter to Boulder, interpreting Section 18(i) of the Investment Company Act[2] in connection with Boulder's consideration of whether to opt in to the provisions of the Maryland Control Share Acquisition Act. The staff concluded that the fund's use of the Maryland act "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" and would "discriminate against certain shareholders by denying important voting rights and would contribute to the entrenchment of management."

Withdrawal of Boulder Letter

On Sept. 13, 2018, SEC Chairman Jay Clayton directed each division of the SEC to review whether prior staff statements and documents should be modified, rescinded or supplemented in light of market or other developments. Following its review of the Boulder letter,[3] and due to market developments since its issuance and recent feedback from industry participants, the staff determined to withdraw the Boulder letter, effective immediately.

In the control share statute relief, the staff replaces the Boulder letter with a new no-action position, stating that the staff would not recommend enforcement action against a closed-end fund under Section 18(i) 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 staff reminds market participants that any action taken by a fund board, including regarding control share statutes, should be examined in light of (1) the board's fiduciary duties, (2) applicable federal and state law, and (3) the particular facts and circumstances surrounding the board's action.

Considerations for Funds and Fund Boards

In light of the staff's no-action relief, closed-end funds organized in states with applicable control share statutes should consider whether availing themselves of such statutes would be in the best interests of the fund and its shareholders. To rely on the relief and avoid enforcement action by the staff under the Investment Company Act, the fund board's decision to opt in to a control share statute must be taken with reasonable care consistent with other applicable duties of the board and federal and state laws and the board's duty to the fund and its shareholders generally.

For closed-end funds that do not have state control share statutes that apply to them, these funds can consider adopting share ownership and voting limitation provisions that provide similar protections to those contained in control share statutes. However, the control share statute relief does not extend to these circumstances, and it remains somewhat unclear what the staff's position

will be with respect to such action. The staff specifically noted that about half of the states have a control share statute but provided nothing further regarding their position on this issue.[4]

While we believe that the policy and legal considerations are similar and favor funds taking such action, the absence of an applicable state control share statute introduces uncertainty as to the possibility of SEC enforcement action and the validity of share ownership and voting limitations not expressly sanctioned under state law.

It is our view that going forward, professional activist investors will increasingly target funds that do not have the protections provided by a control share statute. Accordingly, closed-end funds organized in states that do not have an applicable control share statute should carefully evaluate the strength of their corporate governance profile in their governing documents to determine whether it provides the board with sufficient tools in the event that the board believes a shareholder is pursuing action that is not in the best interest of the fund and the fund's shareholders generally. This would include evaluating whether to adopt noncontrol share statute ownership and voting limitations provisions, as well as other corporate governance protections that have become more common in the closed-end fund industry.

Such boards should also consider whether it would make sense for their fund to redomesticate into a state with a control share statute, taking into account the totality of potential benefits and detriments inherent in such a change. Redomestication of a publicly listed closed-end fund typically involves the following:

- Consideration and approval by the fund board;
- Depending on the facts and circumstances, proxy statement or proxy/prospectus;
- Depending on the facts and circumstances, shareholder meeting and approval of shareholders;
- Amended governing documents;
- State filings, including formation of the new entity;
- Coordination with applicable stock exchange, including the submission of an additional listing application; and
- Amendments to Form N-8A and Form 8-A.

SEC Request for Feedback

In the control share statute relief, the staff notes that it is seeking input to determine whether additional SEC action is warranted in this area to, among other things, provide greater certainty to funds and other stakeholders.

The control share statute relief is by no means the end of closed-end fund activism, or even debate about funds' use of control share statutes. Rather it represents the introduction of a new building material in the construction of corporate governance infrastructures. The rules governing when and how to use it, how it interacts with other corporate governance construction materials, oversight responsibilities, maintenance, replacement and liability will all be worked out over time by the staff in

reviews, through enforcement, and in federal and state litigation.

We expect professional activists to work hard to curtail its use and mitigate the impact on their business models. It will be important for the closed-end industry to also work hard to continue to provide the Staff with its views on these topics. The SEC request for feedback is a direct request for that input from both the closed-end industry and professional activists. In particular, the staff is soliciting public input on the following questions:

1. What are the practical and functional impacts on closed-end funds, their management, and their shareholders when funds opt in and trigger control share statutes? How are those impacts affected by the availability of other defensive measures? Relatedly, in what circumstances would the availability of other defensive measures affect a fund's decision to opt in to and trigger a control share statute?

2. What considerations would a fund's board take into account in determining whether to opt in to and trigger a control share statute, particularly with regard to benefits to shareholders and compliance with the board's fiduciary duty? Under what specific facts and circumstances would a board decide to opt in to and trigger a control share statute (or decline to do so)?

3. Apart from Section 18(i), which turns on the meaning of "equal voting rights," please explain whether the ability to opt in to and trigger a control share statute would have a practical or functional impact on a fund's compliance with other provisions of the federal securities laws, such as section 12(d)(1)(E) of the Investment Company Act, which requires pass-through or mirror voting for certain fund of funds arrangements, or Rule 13d-1 under the Securities Exchange Act of 1934, which limits the ability of certain shareholders to vote based on the size of their holding. If relevant, please provide an analysis of any practical or functional differences between how the principle of equal voting rights may apply in those different regulatory contexts.

4. Should the staff recommend that the commission address the ability of a closed-end fund to opt in and trigger a control share statute in accordance with Section 18(i)?

We strongly encourage closed-end funds and their stakeholders to provide input to the staff on this topic and on the questions posed by the staff.

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[1] Boulder Total Return Fund, Inc., SEC Staff No-Action Letter, 2010 WL 4630835 (Nov. 15, 2010). While the specifics of control share statutes vary from state to state, control share statutes generally prohibit a person who acquires more than a specified percentage of the shares of the company (i.e., "control shares") from voting those shares. Typically, once holders of control shares lose their voting rights, such holders cannot vote their control shares unless these voting rights are restored by a vote of the company's disinterested shareholders.

[2] Section 18(i) of the 1940 Act provides that "[e]xcept as provided in subsection (a) of this section, or as otherwise required by law, every share of stock hereafter issued by a registered management company ... shall be a voting stock and have equal voting rights with every other outstanding voting stock."

[3] In the Control Share Statute Relief, the Staff acknowledged that "the number of listed closed-end funds has declined considerably since the issuance of the Boulder Letter, although it is unclear to what extent the unavailability of control share statutes under the Boulder Letter may have contributed to this trend."

[4] The Staff noted that the following states have control share statutes in effect: Arizona, Florida, Hawaii, Idaho, Indiana, Kansas, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Virginia, Wisconsin and Wyoming. The Staff notes that the vast majority of listed closed-end funds appear to be organized under Delaware, Maryland or Massachusetts law. Delaware has not adopted a control share statute. In addition, the Massachusetts Control Share Acquisition Act generally applies to corporations and is not available to most business trusts.