

Investment Management Alert

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Delaware Proposes Protections for Closed-End Fund Investors

On May 5, 2022, Senate Bill 284 was introduced in the Delaware General Assembly proposing amendments to the Delaware Statutory Trust Act (DSTA).¹ These amendments include the addition of new Subchapter III — Control Beneficial Interest Acquisitions (CBIA Subchapter). The CBIA Subchapter would apply to all registered closed-end funds and business development companies (BDCs) that are organized as Delaware statutory trusts and have a class of equity securities listed on a national securities exchange.² The CBIA Subchapter would implement a control share statute for registered closed-end funds and BDCs and would contain provisions comparable to existing control share statutes in other states.³

Generally, control share statutes provide a company with the right to prevent or restrict certain changes in corporate control by altering or removing voting rights of a person that acquires, directly or indirectly, the ownership of or the power to direct the vote of control shares as defined in the specific state control share statute. Control shares are shares of stock that are equal to or exceed specified percentages of the company's total voting power. Holders of control shares cannot vote their control shares unless the company's stockholders vote to approve the voting rights by an affirmative vote of a specific proportion (*e.g.*, two-thirds of the votes entitled to be cast at a special meeting called for such purposes, excluding "all interested parties").⁴ The CBIA Subchapter would differ in some respects from existing state control share statutes by virtue of its design to complement the unique regulatory and corporate governance considerations applicable to registered closed-end funds and BDCs under the Investment Company Act of 1940 (1940 Act) and would restore Delaware to a state of parity with Maryland as a jurisdiction for organizing registered closed-end funds and business development companies.

¹ See [Delaware Senate Bill 284](#).

² The CBIA Subchapter does not apply to unlisted registered closed-end funds and business development companies, and they cannot "opt-in" to the CBIA Subchapter.

³ Approximately half of U.S. states have adopted control share statutes. However, among the organizational forms most commonly utilized by registered closed-end funds and BDCs, only one, Maryland corporate law, features a control share statute. Maryland corporate law requires registered closed-end funds to affirmatively opt-in to the control share statute, while BDCs must adopt a charter or bylaw provision to eliminate application of the control share statute. See Maryland General Corporation Law (MGCL) §§ 3-702(b)-(c).

⁴ See generally "Control Share Acquisition Statutes" Staff Statement, SEC Division of Investment Management (May 27, 2020).

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Application of the CBIA Subchapter

Many closed-end investment companies registered or regulated under the 1940 Act (Covered Funds) are organized as Delaware statutory trusts and are subject to the DSTA. The CBIA Subchapter would automatically apply to all Covered Funds, without any action on the part of the Covered Fund or its board of trustees.⁵ Consistent with the general approach of the DSTA to give maximum effect to the principle of freedom of contract,⁶ the CBIA Subchapter permits a Covered Fund's board of trustees, through a provision in the Covered Fund's governing instrument or by board action alone, to eliminate the application of the CBIA Subchapter to the acquisition of beneficial interests in the Covered Fund "specifically, generally, or generally by types, as to specifically identified or unidentified existing or future beneficial owners or their affiliates or associates or as to any series or classes of beneficial interests."⁷ However, the CBIA Subchapter does not provide that a Covered Fund can generally "opt-out" of the application of the CBIA Subchapter to the Covered Fund. The CBIA Subchapter is forward-looking only, and any control beneficial interest acquisitions before August 1, 2022 (the effective date of the CBIA Subchapter if it becomes law) would not be subject to the CBIA Subchapter.

The CBIA Subchapter follows the general structure of existing state control share statutes — it defines "control beneficial interests" by reference to an increasing series of voting power ranges and provides that a holder of control beneficial interests acquired in a control beneficial interest acquisition⁸ has no voting rights under the DSTA or the governing instrument of the Covered Fund with respect to the control beneficial interests acquired in the control beneficial interest acquisition except to the extent approved by the beneficial owners of the Covered Fund by the affirmative vote of two-thirds of all the votes entitled to be cast on the matter, excluding all interested beneficial interests.⁹ This vote generally must be taken at a special meeting requested by the acquiring person pursuant to the procedures contained in proposed Section 3885 of the DSTA.

⁵ DSTA § 3883(c) (proposed). In other words, there is no need for a Covered Fund to "opt-in" to the CBIA Subchapter.

⁶ DSTA § 3828(b).

⁷ DSTA § 3883(b) (proposed).

⁸ "Control beneficial interest acquisition" means the acquisition, directly or indirectly, by any person of ownership of, or the power to direct the exercise of voting power with respect to, issued and outstanding control beneficial interests. DSTA § 3881(d)(1) (proposed).

⁹ DSTA § 3883(b) (proposed). "Interested beneficial interests" would include beneficial interests in respect of which any of the following persons is entitled to exercise or direct the exercise of the voting power of beneficial interests of the statutory trust in the election of trustees: an acquiring person (including any associate), an officer of the Covered Fund, an employee of the Covered Fund who is also a trustee of the Covered Fund and a trustee of the Covered Fund who is an "interested person" of the Covered Fund as defined in the 1940 Act. DSTA § 3881(f) (proposed).

The CBIA Subchapter provides for an increasing series of voting power ranges considered "control beneficial interests." Whether one of these ranges of voting power is met is determined by aggregating the holdings of the acquiring person as well as those of his, her or its "associates."¹⁰ These ranges are:

- 10% or more, but less than 15% of all voting power;
- 15% or more, but less than 20% of all voting power;
- 20% or more, but less than 25% of all voting power;
- 25% or more, but less than 30% of all voting power;
- 30% or more, but less than a majority of all voting power; or
- a majority or more of all voting power.

Voting power under the CBIA Subchapter is the power (whether such power is direct or indirect or through any contract, arrangement, understanding, relationship or otherwise) to directly or indirectly exercise or direct the exercise of the voting power of beneficial interests of a Covered Fund in the election of trustees (either generally or with respect to any subset, series or class of trustees, including any trustees elected solely by a particular series or class of beneficial interests).

Under the CBIA Subchapter, once a threshold is reached, an acquirer has no voting rights with respect to beneficial interests in excess of that threshold (*i.e.*, the "control beneficial interests") until approved by a vote of beneficial owners, as described above. That process is then repeated at each threshold level. For example, upon a control beneficial interest acquisition resulting in ownership of 12% of all voting power, the acquirer would only be able to exercise 9.99% of the Covered Fund's voting power until the full 12% voting power is approved by a vote of beneficial owners. Assuming that occurred and the acquirer then executed a control beneficial interest acquisition resulting in ownership of 17% of all voting power, the acquirer would only be able to exercise 14.99% of the Covered Fund's voting power until the full 17% voting power is approved by a vote of beneficial owners.

¹⁰ DSTA § 3881(e)(1) (proposed). "Associate" means: (i) any other person (other than the statutory trust or a subsidiary of the statutory trust) of which such person is an officer, director or partner or is, directly or indirectly, the holder of 10% or more of any class of equity securities; (ii) any trust, corporation or other entity in which such person has a substantial beneficial interest or as to which such person serves as a director, trustee or in a similar fiduciary capacity; (iii) any relative or spouse of such person, or any relative of such spouse, who has the same home as such person or who is a trustee or officer of the statutory trust or any of its affiliates; or (iv) any other person that (a) directly or indirectly controls, or is controlled by, or is under common control with, the person specified, which will include any investment fund or other collective investment vehicle that has the same investment adviser as the person specified; (b) is acting as an investment adviser with regard to any person specified that is an investment fund or other collective investment vehicle; or (c) is acting or intends to act jointly or in concert with the person specified. DSTA § 3881(c) (proposed).

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The CBIA Subchapter requires a holder of beneficial interests to disclose to the Covered Fund any control beneficial interest acquisition within 10 days of such acquisition, and also permits a Covered Fund to require a holder of beneficial interests or an associate of such person to disclose the number of beneficial interests owned or with respect to which such person or an associate thereof can directly or indirectly exercise voting power.¹¹ Further, the CBIA Subchapter requires a holder of beneficial interests or an associate of such person to provide to a Covered Fund within 10 days of receiving a request therefor from the Covered Fund any information that the trustees reasonably believe is necessary or desirable to determine whether a control beneficial interest acquisition has occurred.¹²

Under the CBIA Subchapter, a member of a national securities exchange shall not be deemed to be a beneficial owner of beneficial interests held directly or indirectly by it on behalf of another person solely because such member is the record holder of such securities and, pursuant to the rules of such exchange, may direct the vote of such beneficial interests, without instruction, on other than contested matters or matters that may affect substantially the rights or privileges of the holders of the beneficial interests to be voted but is otherwise precluded by the rules of such exchange from voting without instructions.¹³

Benefits for Covered Funds

The CBIA Subchapter contains several provisions designed to complement the unique regulatory and corporate governance considerations applicable to Covered Funds under the 1940 Act, and to provide benefits relative to the Maryland Control Share Acquisition Act (MCSAA)¹⁴ that can apply to registered closed-end funds and business development companies organized as Maryland corporations.

Many Covered Funds issue preferred beneficial interests that, under the 1940 Act, are entitled to vote as a separate class to elect two trustees (Preferred Trustees).¹⁵ The definition of “control beneficial interests” would apply to acquisitions of preferred beneficial interests giving a holder voting power in the election of Preferred Trustees within the above-referenced voting power ranges, and define that as a control beneficial interest acquisition under the CBIA Subchapter. This recognizes the unique corporate governance dynamics applicable to many

¹¹ DSTA § 3888(a) (proposed).

¹² DSTA § 3888(b) (proposed).

¹³ DSTA § 3881(e)(1) (proposed).

¹⁴ MGCL §§ 3-701 to 3-710.

¹⁵ 1940 Act § 18(a)(2)(C).

Covered Funds, acknowledges the manner in which those dynamics impact corporate control and provides clarity on how to apply the CBIA Subchapter in this unique context.

Additionally, the voting power ranges constituting “control beneficial interests” are more tailored to the ranges of voting power that can result in undue influence over a Covered Fund. The MCSAA contains thresholds at (i) 1/10 or more, but less than 1/3 of all voting power, (ii) 1/3 or more, but less than a majority of all voting power and (iii) a majority or more of all voting power.¹⁶ In light of the generally low overall shareholder participation in Covered Funds’ shareholder meetings and the result that a relatively small amount of voting power can influence the outcome of a matter put to a vote by Covered Funds, the increased stratification of voting power ranges in the CBIA Subchapter could provide greater protection to investors in Covered Funds. For example, the difference between an acquiring person owning 11% and 21% of a Covered Fund’s voting power may make a significant difference in the outcome of a vote. Under the CBIA Subchapter, noninterested beneficial owners will be able to evaluate the intentions and plans of an acquiring person at the 10%, 15% and 20% level, whereas under the MCSAA, an approval at the 11% level would remain sufficient until the acquiring person owned 33.33% of the voting power.

The definition of “associate” in the CBIA Subchapter serves to encompass a wide range of parties related to an acquiring person, including any investment fund or other collective investment vehicle that shares an investment adviser with the acquiring person. This is important because the 1940 Act does not otherwise prohibit affiliated private funds with the same investment adviser from acting in concert to acquire a large position in a closed-end fund and then exert undue influence on the acquired closed-end fund.¹⁷

Registered closed-end funds and BDCs are designed to pursue a stated investment objective by pursuing a stated investment strategy for the long-term benefit of beneficial owners. The CBIA Subchapter contains provisions that serve to prevent acquiring persons from disrupting and distracting Covered Funds in the execution of these long-term strategies. Accordingly, the board of trustees is not required to call a special meeting at the request of an acquiring person to present the issue of voting rights to be accorded the beneficial interests acquired in a control beneficial interest acquisition if the acquiring person making such request

¹⁶ MGCL § 3-701(e)(1).

¹⁷ See our December 1, 2020, client alert “[Proposed Legislation Would Enhance Closed-End Fund Protections by Closing the Private Funds Loophole Under Section 12\(d\)\(1\) of the Investment Company Act.](#)”

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(or an associate of such person) has in the three-year period preceding such request made a request to have the issue of the voting rights to be accorded the beneficial interests acquired in a control beneficial interest acquisition presented for consideration at a meeting of beneficial owners where the beneficial owners have not approved such acquisition.¹⁸ The board of trustees is also entitled to include a vote on the issue of such voting rights at the Covered Fund's annual meeting (rather than call a special meeting) if an acquiring person's request is received within 120 days of the anniversary date of the Covered Fund's proxy statement for the prior year's annual meeting.¹⁹ Additionally, control beneficial interests are not considered outstanding for shareholder quorum purposes until voting rights for such control beneficial interests are approved by noninterested beneficial owners.²⁰

The application of the CBIA Subchapter is also clear and unambiguous. The new legislation would automatically apply to all Covered Funds, without any action on the part of a Covered Fund or its board of trustees. As discussed previously, the MCSAA applies to a registered closed-end fund only if its board of directors affirmatively opts-in to the coverage of the MCSAA.

¹⁸DSTA § 3886(b) (proposed).

¹⁹DSTA § 3885(c) (proposed).

²⁰DSTA § 3883(a) (proposed).

As described above, the CBIA Subchapter gives the board of trustees tools to monitor concentrated ownership that may constitute a control beneficial interest acquisition and imposes duties on beneficial owners to cooperate with reasonable requests from Covered Funds in this regard.²¹

Overall, the foregoing unique benefits that the CBIA Subchapter provides are designed to complement the unique regulatory and corporate governance considerations applicable to Covered Funds under the 1940 Act and to provide enhanced protection relative to comparable provisions in the MCSAA.

Next Steps

The use of control share statutes and bylaws by registered closed-end funds and business development companies has been a rapidly evolving area in recent years. The CBIA Subchapter represents a thoughtful legislative application of the unique 1940 Act principles relevant to registered closed-end funds and BDCs in the control share context. Registered fund and BDC sponsors should follow the progress of the CBIA Subchapter legislation and take it into account, along with all applicable legal and regulatory considerations, if presently considering a new fund launch or redomestication of an existing fund.

²¹DSTA § 3888 (proposed).

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