

# Investment Management Alert

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## Delaware Enacts Protections for Closed-End Fund Investors

On July 27, 2022, Delaware Gov. John Carney signed into law amendments to the Delaware Statutory Trust Act (DSTA). These amendments include the addition of new Subchapter III — Control Beneficial Interest Acquisitions (Control Share Statute), which is reproduced as Appendix A to this mailing. The Control Share Statute applies 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.<sup>1</sup> The Control Share Statute contains provisions comparable to existing control share statutes in other states, although it also contains a number of enhanced protections for registered closed-end funds and BDCs.<sup>2</sup>

Generally, control share statutes provide a company with the right to prevent or restrict certain changes in corporate control by limiting 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. Under existing control share statutes, holders of control shares typically cannot vote their control shares unless the company’s stockholders vote to approve their voting rights or the acquisition is approved in advance by the company’s board.<sup>3</sup>

The Control Share Statute differs in some respects from existing state control share statutes by virtue of being tailored to 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 restores Delaware to a state of parity with Maryland as a jurisdiction for organizing registered closed-end funds and BDCs.

The following sections describe the principal features of the Control Share Statute, which remain unchanged in all material respects from the legislation originally proposed in the Delaware General Assembly on May 5, 2022, and described in our June 7, 2022,

<sup>1</sup> The Control Share Statute does not apply to unlisted registered closed-end funds and business development companies, and they cannot “opt in” to the Control Share Statute.

<sup>2</sup> Approximately half of U.S. states have adopted control share statutes. However, among the jurisdictional and organizational forms most commonly used by registered closed-end funds and BDCs, until now only one, Maryland corporate law, featured 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).

<sup>3</sup> See generally “Control Share Acquisition Statutes” Staff Statement, SEC Division of Investment Management (May 27, 2020) (2020 SEC Staff Control Share Statement).

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client alert “[Delaware Proposes Protections for Closed-End Fund Investors](#).” Following this description of the Control Share Statute, we offer some observations on the implications of this new law under the 1940 Act and for boards of trustees.

## Application of the Control Share Statute

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 Control Share Statute automatically applies to all Covered Funds, without any action required on the part of the Covered Fund or its board of trustees to “opt in” to its provisions.<sup>4</sup>

The Control Share Statute follows the general structure of other state control share statutes — it defines “control beneficial interests” (which we refer to as “control shares”) by reference to a series of voting power thresholds and provides that a holder of control shares acquired in a control share acquisition<sup>5</sup> has no voting rights under the DSTA or the governing instrument of the Covered Fund with respect to the control shares acquired in the control share 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 shares.<sup>6</sup> This vote cannot be modified by the Covered Fund’s board of trustees or governing documents and generally must occur at a special meeting requested by the acquiring person pursuant to the procedures contained in new Section 3885 of the DSTA. However, consistent with the general approach of the DSTA to give maximum effect to the principle of freedom of contract,<sup>7</sup> the Control Share Statute also 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 Control Share Statute to the acquisition of control shares 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.”<sup>8</sup> The Control Share Statute does not provide that a Covered Fund can generally “opt out” of the application of the Control Share Statute

<sup>4</sup> DSTA § 3883(c). In other words, there is no need for a Covered Fund to “opt in” to the Control Share Statute.

<sup>5</sup> “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 shares. DSTA § 3881(d)(1).

<sup>6</sup> DSTA § 3883(b). “Interested beneficial interests” include shares in respect of which any of the following persons is entitled to exercise or direct the exercise of the voting power of shares 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).

<sup>7</sup> DSTA § 3828(b).

<sup>8</sup> DSTA § 3883(b).

to the Covered Fund; rather, specific acquisitions or classes of acquisitions may be exempted by the board of trustees, either in advance or retroactively, but other aspects of the Control Share Statute, which are described herein, would continue to apply.

The result is that several different outcomes may occur in the event of a control share acquisition that does not fall into a preexisting exemption in the Covered Fund’s governing documents or adopted by the board of trustees or contained in the Control Share Statute. The board could (i) exempt the acquisition, though the board is under no obligation to do so,<sup>9</sup> (ii) take no action and wait for a request from the acquiring person to convene a special meeting of shareholders or (iii) determine to call a special meeting of shareholders on its own accord.<sup>10</sup>

The Control Share Statute provides for a series of voting power thresholds above which shares are considered control shares. Whether one of these thresholds 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.”<sup>11</sup> These thresholds 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 Control Share Statute 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

<sup>9</sup> DSTA § 3883(b) (“In the event that either [1] a request is made under subsection (a) of §3885 of this title to have the issue of the voting rights to be accorded the beneficial interests acquired in the control beneficial interest acquisition presented for consideration at a meeting of beneficial owners or [2] the trustees determine under subsection (e)(1) of §3885 of this title to present for consideration at a meeting of beneficial owners the issue of the voting rights to be accorded the beneficial interests acquired in the control beneficial interest acquisition, then, in either case, the trustees shall have no obligation to approve or exempt any such acquisition of the beneficial interests.”)

<sup>10</sup> *Id.*

<sup>11</sup> DSTA § 3881(e)(1). “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).

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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).

The Control Share Statute is forward-looking only, and any control shares acquired before August 1, 2022 (the effective date of the Control Share Statute) are not subject to the Control Share Statute.<sup>12</sup>

Under the Control Share Statute, once a threshold is reached, an acquirer has no voting rights with respect to shares in excess of that threshold (*i.e.*, the “control shares”) until approved by a vote of beneficial owners or otherwise exempted by the board of trustees, as described above. An acquirer must repeat that process at each threshold level. For example, upon a control share 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. Assuming that approval was given and the acquirer then executed a control share 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.

In a merger or consolidation, the acquisition of shares will not constitute a control share acquisition if the Covered Fund is the surviving or resulting party in the merger or consolidation; however, any shares issued to a holder of control shares in the target party will be considered a control share acquisition and remain control shares of the surviving party, assuming that company is a Delaware statutory trust.<sup>13</sup>

The Control Share Statute requires shareholders to disclose to the Covered Fund any control share acquisition within 10 days of such acquisition, and also permits a Covered Fund to require a shareholder or an associate of such person to disclose the number of shares owned or with respect to which such person or an associate thereof can directly or indirectly exercise voting power.<sup>14</sup> Further, the Control Share Statute requires a shareholder or an associate of such person to provide to a Covered Fund

<sup>12</sup> A holder of shares that owns shares within one of these control shares ranges on the effective date of the Control Share Statute (August 1, 2022) is capped at that ownership amount. Further acquisitions would be considered acquisitions of control shares that must be exempted or approved by a vote of beneficial owners. See DSTA § 3881(e)(2)(b): “Control beneficial interests’ includes: ... (b) Beneficial interests of a statutory trust acquired within any range of voting power described in paragraph (1) of this subsection, even if the initial beneficial interests acquired within the applicable range of voting power are excluded from a control beneficial interest acquisition, including due to a reduction in the beneficial interests outstanding due to the statutory trust repurchasing or redeeming beneficial interests.”

<sup>13</sup> DSTA § 3881(d)(2)(e).

<sup>14</sup> DSTA § 3888(a).

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 share acquisition has occurred.<sup>15</sup>

Under the Control Share Statute, a member of a national securities exchange (such as a broker-dealer) shall not be deemed to be a beneficial owner of shares 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 shares, without instruction, on other than contested matters or matters that may affect substantially the rights or privileges of the holders of the shares to be voted but is otherwise precluded by the rules of such exchange from voting without instructions.<sup>16</sup>

## Benefits for Covered Funds

The Control Share Statute 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)<sup>17</sup> that can apply to registered closed-end funds and BDCs organized as Maryland corporations.

Many Covered Funds issue preferred shares that, under the 1940 Act, entitle holders to vote as a separate class to elect two trustees (Preferred Trustees).<sup>18</sup> The definition of control shares also applies to preferred shares and the control share thresholds apply to preferred shares as a separate class. For example, a preferred shareholder acquiring 12% of the preferred share voting power would be treated as having made a control share acquisition and would have 9.99% voting power with respect to class voting for the Preferred Trustees, but would not be treated as having made a control share acquisition with respect to voting for other trustees where the common and preferred shares vote together as one class (assuming that 12% preferred share position, when combined with any common share position, does not result in overall voting power above one of the thresholds described above when the preferred and common shareholders are combined as one class). This provision recognizes the unique corporate governance dynamics applicable to many Covered Funds, acknowledges how those dynamics impact corporate control and provides clarity on how to apply the Control Share Statute in this unique context.

<sup>15</sup> DSTA § 3888(b).

<sup>16</sup> DSTA § 3881(e)(1).

<sup>17</sup> MGCL §§ 3-701 to 3-710.

<sup>18</sup> 1940 Act § 18(a)(2)(C).

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Additionally, the voting power thresholds for control shares 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.<sup>19</sup> 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 Control Share Statute 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 Control Share Statute, noninterested shareholders can evaluate the intentions and plans of an acquiring person at the 10%, 15% and 20% levels, whereas under the MCSAA, an approval at the 11% level would remain sufficient until the acquiring person acquired more than 33.33% of the voting power.

The definition of "associate" in the Control Share Statute encompasses 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 exerting undue influence on the acquired closed-end fund.<sup>20</sup>

Registered closed-end funds and BDCs pursue a stated investment strategy for the long-term benefit of investors. The Control Share Statute contains provisions that prevent acquiring persons from disrupting and distracting Covered Funds in the execution of these long-term strategies. 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 a control share buyer'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.<sup>21</sup> Additionally, control shares are not considered outstanding for shareholder quorum purposes until voting rights for such control shares are approved by noninterested shareholders.<sup>22</sup>

<sup>19</sup>MGCL § 3-701(e)(1).

<sup>20</sup>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.](#)"

<sup>21</sup>DSTA § 3885(c).

<sup>22</sup>DSTA § 3883(a).

The application of the Control Share Statute is unambiguous. It automatically applies 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 the fund's board of directors affirmatively opts in to the coverage of the MCSAA.

As described above, the Control Share Statute gives the board of trustees tools to monitor concentrated ownership that may constitute a control share acquisition and imposes duties on shareholders to cooperate with reasonable requests from Covered Funds in this regard.<sup>23</sup>

Overall, the unique benefits that the Control Share Statute 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.

## 1940 Act Matters

The 2020 SEC Staff Control Share Statement stated that the Staff would not recommend enforcement action against a Covered Fund under Section 18(i) of the 1940 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." Section 18(i) provides, "Except ... as otherwise required by law, every share of stock ... shall be a voting stock and have equal voting rights with every other outstanding voting stock." The Staff reminded market participants that any action taken by a Covered Fund's board, including regarding control share statutes, should be examined in light of (i) the board's fiduciary duties, (ii) applicable federal and state law and (iii) the particular facts and circumstances surrounding the board's action.<sup>24</sup>

The U.S. District Court for the Southern District of New York recently ruled that a closed-end fund organized as a Massachusetts business trust that had adopted bylaw provisions that established a control share mechanism similar to the control share statute in Maryland corporate law violated Section 18(i) of the 1940 Act.<sup>25</sup> The closed-end fund at issue in this case has appealed the district court's decision to the U.S. Court of Appeals

<sup>23</sup>DSTA § 3888.

<sup>24</sup>The 2020 SEC Staff Control Share Statement reversed the Staff's prior position on the use of control share statutes articulated in Boulder Total Return Fund, Inc. SEC Staff Correspondence (Nov. 15, 2010) (Boulder Letter), which the 2020 SEC Staff Control Share Statement withdrew.

<sup>25</sup>*Saba Capital CEF Opportunities 1, Ltd. v. Nuveen Floating Rate Income Fund*, No. 21-CV-327 (S.D.N.Y. Feb. 17, 2022).



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for the Second Circuit. The final outcome of this litigation, and the final position of certain federal courts on closed-end funds' use of control share provisions, is therefore yet to be determined. This ruling, however, did not address the application of the 1940 Act to a fund organized in a state with a control share statute and organized as a type of legal entity to which the control share statute automatically applies.<sup>26</sup>

The Control Share Statute provides an express statutory scheme for control share acquisitions under Delaware law applicable to Covered Funds organized as Delaware statutory trusts. The Control Share Statute is automatically applicable to all Covered Funds, without any action on the part of the Covered Fund's board of trustees, and Covered Funds cannot generally "opt out" of the Control Share Statute. The Control Share Statute applies to holders of shares and not to shares themselves, and therefore is designed to not implicate Section 18(i) of the 1940 Act.<sup>27</sup> In addition, the Control Share Statute facially falls within Section 18(i)'s "unless otherwise required by law" provision. The automatic application of the Control Share Statute to Covered Funds, together with the inability of Covered Funds to generally opt out of the Control Share Statute, also directly answers the Staff's principal rationale for not applying the "unless otherwise required by law" exception in its analysis of the MCSAA in the now-withdrawn Boulder Letter.<sup>28</sup>

The Control Share Statute represents an important step forward in the application of control share statutes to registered closed-end funds and BDCs and is the most thoughtful state legislation to date

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<sup>26</sup>See *Nuveen* at 6-7 (rejecting an argument to defer to the 2020 SEC Staff Control Share Statement, in part because the facts involved a control share bylaw rather than a control share statute).

<sup>27</sup>DSTA § 3883(a). Additionally, this provision expressly recognizes that the shares never lose their voting rights: "Upon transfer of the control beneficial interests acquired in a control beneficial interest acquisition, in good faith and not for the purpose of circumventing this subchapter as determined by the trustees, the holders of such beneficial interests shall have voting rights under this chapter and the governing instrument of the statutory trust with respect to the beneficial interests acquired, unless the acquisition of such beneficial interests by such holder constituted a control beneficial interest acquisition."

<sup>28</sup>See Boulder Letter at n.17 ("A CEF is not required to opt in to the statute's provisions; the MCSAA is an optional defensive device, and there is no requirement under Maryland law that a CEF avail itself of its protection. Similarly, BDCs may opt out of the MCSAA, and are not required to remain subject to its terms. The 'otherwise required by law' qualification therefore does not affect our analysis.") (internal cross-references omitted).

addressing the unique 1940 Act considerations applicable to registered closed-end funds and business development companies in the control share context.

## Additional Matters for Consideration

The Control Share Statute will require boards of trustees to consider how the statute interacts with different scenarios that Covered Funds will or may face. Of key importance will be determinations regarding whether, how and when to exempt control share acquisitions from the Control Share Statute without a shareholder vote. The possibility of such exemptions is likely to arise in a variety of scenarios, including those involving preferred share holdings, fund-of-funds arrangements entered into pursuant to Rule 12d1-4 under the 1940 Act and insider purchases. Regarding insider purchase decisions, boards will need to balance multiple factors, including an insider's holdings as of the effective date of the Control Share Statute (*i.e.*, as of August 1, 2022) relative to any other large or concentrated positions in the fund as of that date, the potential strengthening of the foregoing Section 18(i) analysis through a policy of not granting discretionary exemptions for control share acquisitions, and any particular facts and circumstances bearing on a board's duty to act in the best interests of the Covered Fund and its shareholders.

Other issues are likely to arise in the event an acquiring shareholder requests a special meeting to have noninterested shareholders approve voting rights for control shares. In particular, how proxy voting advisory firms will analyze such a proposal or how they may recommend that shareholders vote on that proposal is not clear. Also unclear is whether proxy voting advisory firms would penalize trustees with unfavorable recommendations in trustee elections if the trustees have not granted discretionary exemptions with respect to control share acquisitions.

Boards of trustees of Covered Funds and sponsors should carefully review their particular facts and circumstances and the provisions of the Control Share Statute, and consider the impacts of the Control Share Statute and whether these impacts warrant any present action.

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