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Memorandum

SEC Staff Withdraws Prior Guidance and Provides New No-Action Position Allowing Closed-End Funds to Opt in to State Control Share Statutes

June 5, 2020

The staff (the "Staff") of the Division of Investment Management (the "Division") at the U.S. Securities and Exchange Commission (the "Commission") has issued a long-awaited statement (the "Statement") addressing the interaction between state control share acquisition statutes (each, a "control share statute") and Section 18(i) of the Investment Company Act of 1940 (the "1940 Act"), which requires that every share of closed-end fund stock be a voting stock and have equal voting rights with every other share of outstanding voting stock.[1] In the Statement, the Staff withdrew a prior interpretive letter (the "Boulder Letter")[2] that expressed a view that use of a control share statute by a closed-end fund would be inconsistent with Section 18(i). Most significantly, the Staff also established a new no-action position that closed-end funds can rely upon to opt in to and trigger a control share statute notwithstanding Section 18(i).

The Staff also requested public input as to whether the Commission should take further action in this area. In this memorandum, we provide a summary of the Statement and discuss related background and the key implications of the Staff's position in the Statement.

The Statement and Withdrawal of the Boulder Letter

As SEC Chairman Jay Clayton has noted, statements from the Staff are not binding and are distinct from the Commission's rules and regulations. In September of 2018, Chairman Clayton instructed the Staff to review its prior statements to determine whether they should be modified, rescinded or supplemented in light of current conditions.[3] In accordance with Chairman Clayton's request, the Staff reviewed the Boulder Letter, the market

[1] *See* Staff Statement, Control Share Acquisition Statements, Division of Investment Management (May 27, 2020), available at https://www.sec.gov/investment/control-share-acquisition-statutes.

[2] *Boulder Total Return Fund*, SEC No-Action Letter (Nov. 15, 2010), available at https://www.sec.gov/divisions/investment/noaction/2010/bouldertotalreturn111510.htm. While the Boulder Letter only addressed Maryland's control share statute, the Staff stated that its analysis may be applicable to other states' control share statutes (about half of the states have adopted control share statutes).

[3] *See* Statement regarding SEC Staff Views, Chairman Jay Clayton (Sept. 13, 2018), available at https://www.sec.gov/news/public-statement/statement-clayton-091318.

developments since its issuance (including the considerable decline in the number of listed closed-end funds) and feedback from market participants.

Effective as of the date of the Statement, the Staff withdrew the Boulder Letter and, in its place, provided a new no-action position. Specifically, the Staff provided assurance that it would not recommend an enforcement action if a closed-end fund opted in to and triggered a control share statute, so long as the fund board's decision to do so was taken with reasonable care on a basis consistent with its applicable duties, including its fiduciary duty to the fund and shareholders generally, and federal and state law provisions. In other words, the decision to adopt certain corporate defensive measures should be within a fund board's business judgment. The Staff also suggested that any decision to opt in to a control share statute should take into account the particular facts and circumstances. This expectation aligns with the Commission's long-standing view that a rigid interpretation of Section 18(i) is inconsistent with Congressional intent and, therefore, each case must be decided upon the particular factors involved.[4] Although the Staff expressed its current view on control share statutes in the Statement, it did not address whether other corporate defensives measures, such as poison pills, may implicate Section 18(i) or any other section, rule or regulation under the 1940 Act.

Background

Generally, control share statutes provide a company with the right to divest a holder of "control shares" of voting rights when such a "control shareholder" acquires, directly or indirectly, the ownership of, or the power to direct the vote of, control shares.[5] These concepts are defined in each applicable state statute. For example, Maryland's control share statute, the MCSAA, divests any holder's voting rights when the holder's aggregated ownership exceeds any one of three thresholds of voting power—10%, 33% and 50%—until two-thirds of the disinterested shareholders vote to return voting power to such control shareholder.[6] The provisions of the MCSAA apply equally to all shares of a fund's voting stock. In other words, any holder of a fund's voting stock that exceeds these thresholds of voting power will become a control shareholder under the MCSAA.

Prior to the Statement, the ability of a closed-end fund to opt in to the provisions of a control share statute was called into question when the Staff interpreted the relevant provisions of Section 18(i) in the Boulder Letter. Section 18(i) provides, in relevant part, that "[e]xcept as . . . otherwise required by law, every share of stock

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[4] *In the Matter of the Solvay Am. Corp.*, 27 S.E.C. 971, at 974 (Apr. 12, 1948).

[5] The constitutionality of state control share statutes has been upheld by the U.S. Supreme Court. *See CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987) (holding that the Indiana control share statute was not preempted by the Williams Act and did not violate the commerce clause of the U.S. Constitution). In upholding the constitutionality of the Indiana control share statute—which is substantially similar to the Maryland Control Share Acquisition Act (the "MCSAA")—the Supreme Court stated that "[n]o principle of corporation law and practice is more firmly established that a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."

[6] *See Maryland Corporation Law* by James J. Hanks, Jr. at Ch. 14 (2019). Under Maryland corporate law, the voting standard is the affirmative vote of two-thirds of all the votes entitled to be cast on the matter, excluding all interested shares. *See* Md. Code Ann. Corps. & Ass'ns § 3-702(a)(1). For this purpose, "interested shares" means shares of a corporation in respect of which any of the following persons is entitled to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors: (1) a person who makes or proposes to make a control share acquisition, (2) an officer of the corporation or (3) an employee of the corporation who is also a director of the corporation. *See* Md. Code Ann. Corps. & Ass'ns § 3-701(g).

hereafter issued by a registered management company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock . . . ."[7]

Before the Boulder Letter, federal case law in Maryland suggested that Section 18(i) does not pre-empt a closed-end fund from opting-in to a control share statute. In 2007, the U.S. District Court for the District of Maryland held that a control shareholder of a closed-end fund was not exempt from the limitations in the MCSAA, even though it had become a control shareholder before the fund opted in to MCSAA.[8] The *Neuberger* case involved a registered closed-end fund advised by Neuberger Berman and certain trusts that were control shareholders of the Neuberger fund and were advised by a person who was also a portfolio manager for Boulder Investment Advisers ("BIA"). The *Neuberger* court's MCSAA holding implicitly rejected the control shareholder's argument that Section 18(i) precludes a closed-end fund from opting in to the MCSAA because the court divested the control shareholder's voting ability for the shares it acquired after the fund opted in to the MCSAA. If such divestiture violated Section 18(i), the court could not have reached that conclusion.

Following the *Neuberger* decision, the then-director of the Division publicly questioned the *Neuberger* court's implicit rejection of the argument that opting in to the MCSAA violates Section 18(i).[9] Shortly thereafter, the Boulder Total Return Fund, a registered closed-end fund advised by BIA, requested interpretive guidance from the Staff as to whether opting in to the MCSAA would be consistent with Section 18(i). Even though the incoming letter was ostensibly seeking interpretive guidance that would allow the board of the closed-end fund to opt in to the MCSAA, the incoming letter argued the opposite position. In effect, BIA sought to achieve through Staff interpretive guidance what it could not achieve in federal court. In response to BIA's request, the Staff issued the Boulder Letter taking the view that the use of the MCSAA control share provisions by a closed-end fund to restrict the ability of certain shareholders to vote their "control shares" would be inconsistent with Section 18(i).[10]

Implications of the Statement

As discussed above, the Statement withdraws the Boulder Letter and provides a no-action position that a closed-end fund may rely upon when opting in to state control share statutes, such as the MCSAA, or otherwise adopting control share provisions into their organizational documents. As the Staff explains in the Statement, any action by a board to opt in to a control share statute should be examined in light of (i) the board's fiduciary obligations to the fund, (ii) applicable federal and state law provisions and (iii) the particular facts and circumstances

[7] 15 U.S.C. § 80a-18(i) (2020).

[8] *Neuberger Berman Real Estate Income Fund, Inc. v. Lola Brown Trust No. 1B et al.*, 485 F. Supp. 2d 631 (D. Md. 2007) ("*Neuberger*").

[9] *See* Andrew J. Donohue, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Keynote Address at the Independent Directors Council, Investment Company Directors Conference (Nov. 12, 2009), available at https://www.sec.gov/news/speech/2009/spch111209ajd.htm.

[10] The Staff also dismissed the *Neuberger* decision by stating that the *Neuberger* court did not reach the issue of whether a closed-end fund would violate Section 18(i) by opting into the MCSAA. This line of reasoning is perplexing, however, because the *Neuberger* court would have had to reach the issue if it thought opting in to the MCSAA violated Section 18(i).

surrounding the board's action.[11] In making these determinations, we expect boards will consider whether opting in to a control share statute is protective of the fund's long-term shareholders, many of whom may be retail investors seeking income from consistent fund distributions. The considerations may vary based on the state of organization of a fund.

Given the Staff's request for additional feedback from market participants in the Statement, we expect this area to be subject to further developments and we will be closely monitoring these developments.

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[11] *See also* Statement regarding SEC Staff Views, Chairman Jay Clayton (May 27, 2020), available at https://www.sec.gov/news/public-statement/clayton-control-share-statutes-2020-05-27.