June 2, 2020

SEC Staff Takes No-Action Position Regarding Closed-End Funds' Use of State Control Share Statutes

On May 27, 2020, the SEC's Division of Investment Management published a statement (the "Statement") that, effective immediately, withdraws the 2010 Boulder Total Return Fund no-action letter (the "Boulder Letter"), which concerned the interaction between Section 18(i) of the 1940 Act and a state control share acquisition statute (a "Control Share Statute"), and replaces the Boulder Letter with a new no-action position.

- Under the new no-action position, the SEC staff would not recommend enforcement action to the SEC against a closed-end fund under Section 18(i) for opting in to and triggering a Control Share Statute, provided the fund's board decision to opt in 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 solicits comments regarding whether additional SEC action in the area of Control Share Statutes and other defensive measures is warranted to, among other things, provide greater certainty to funds and other stakeholders.

BACKGROUND

Control Share Statutes. Approximately half the states have adopted Control Share Statutes, including Maryland and Massachusetts (but not Delaware). According to the Statement, Control Share Statutes "typically apply to all companies formed under the laws of a given state, but permit companies to individually opt out of the coverage of the statute in whole or in part."[1]

- In general, Control Share Statutes serve as a corporate defense against unwanted activist investors by restricting the voting power of any person who, directly or indirectly, acquires ownership of, or the power to direct the vote of, "control shares" of the company. As defined in the Control Share Statutes, control shares are shares of stock that equal or exceed specified portions of a company's total voting power (*e.g.*, one-tenth but less than one-third; one-third but less than a majority; greater than a majority).
- Once a person engages in a control share acquisition of a company's voting stock, the acquirer cannot vote the control shares unless the company's disinterested stockholders vote to restore the acquirer's voting rights. An affirmative vote of a specified percentage (*e.g.*, a majority or two-thirds of the votes of the disinterested stockholders) is typically required to restore the acquirer's voting rights.

The Boulder Letter. The Boulder Letter concerned a closed-end fund organized as a Maryland corporation that sought to opt in to the Maryland Control Share Statute. Under that statute, the fund's board of directors must adopt a resolution to opt in to the statute's coverage. The closed-end fund requested the SEC staff's concurrence that, if the fund were to opt in to the Maryland statute, the fund would be acting in a manner consistent with Section 18(i) of the 1940 Act. In pertinent part, Section 18(i) mandates that all stock issued by a registered investment company "shall be a voting stock and have equal voting rights with every other outstanding voting stock."

In the Boulder Letter, the SEC staff rejected the closed-end fund's requested interpretation based upon its analyses of Section 18(i) and the Maryland Control Share Statute. The staff noted that the Maryland statute provides that "[h]olders of control shares of the corporation acquired in a control share acquisition have no voting rights with respect to control

[1] The Statement notes that, in some cases, "a company may not be subject to the provisions of the [Control Share Statute] unless it affirmatively opts into the coverage of the statute." This was true in the Boulder Letter and remains true under the Maryland Control Share Statute.

shares except to the extent approved by the stockholders." The SEC staff reasoned that the Maryland statute would be "inconsistent with the fundamental requirements of Section 18(i) . . . that every share of stock issued by the Fund be voting stock and have equal voting rights with every other outstanding voting stock."

THE STATEMENT

Withdrawal of the Boulder Letter. The Statement (i) noted Chairman Jay Clayton's 2018 public statement that SEC staff interpretations are non-binding and (ii) reported that the SEC staff was following the instructions of Chairman Clayton to review prior SEC staff interpretations to determine whether such interpretations should be modified or rescinded in light of subsequent developments. Following these instructions, the Statement said, "the staff has reviewed the Boulder Letter, market developments since its issuance, and recent feedback from affected market participants."[2] As a result of this process, the SEC staff determined to withdraw the Boulder Letter.

Prospectively, the SEC staff will not recommend enforcement action against a closed-end fund under Section 18(i) of the 1940 Act if the fund were to opt in to and trigger a Control Share Statute, provided that the decision by the fund's board to opt in is "taken with reasonable care on a basis consistent with other applicable duties and laws and the duty to the fund and its shareholders generally." In particular, the Statement reminded participants that any actions taken by a fund's board 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 surrounding the board's action.[3]

In a footnote in the Statement, the SEC staff also noted that other anti-takeover defenses, such as shareholder rights plans (also known as "poison pills") may implicate the 1940 Act, but the "staff is not addressing whether any particular corporate defensive measure is consistent with section 18(i) or any other section of, or rule or regulation under, the Act."

Request for Information. The Statement noted that the SEC staff seeks input, backed by data where feasible, on several questions, including (as summarized):

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, and how are those impacts affected by the availability of other defensive measures?
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?
3. Apart from Section 18(i), 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 1940 Act.
4. Should the SEC staff recommend that the SEC address the ability of a closed-end fund to opt in and trigger a Control Share Statute in accordance with Section 18(i)?

[2] The Investment Company Institute submitted a report to the SEC in March 2020 recommending that the SEC withdraw the Boulder Letter and issue guidance clarifying that closed-end funds can employ Control Share Statutes and other common takeover defenses. *See* Investment Company Institute, *Recommendations Regarding the Availability of Closed-End Fund Takeover Defenses* (March 2020).

[3] As with all no-action letters issued by the SEC staff, the recent withdrawal of the Boulder Letter is not binding on courts and thus leaves open the possibility that a court may interpret a fund's opting in to a control share statute (or implementing voting provisions having a similar effect) as inconsistent with Section 18(i) of the 1940 Act.

INITIAL OBSERVATIONS

While Massachusetts has adopted a Control Share Statute,[4] it applies only to "issuing public companies," a term that does not include Massachusetts business trusts (which are not directly subject to the Massachusetts corporations statute generally). While a Massachusetts business trust therefore presumably cannot "opt in" to the Massachusetts Control Share Statute *per se*, it seems reasonable to interpret the SEC's staff's position in the Statement as also applying where closed-end funds organized as Massachusetts business trusts implement voting limitations that have a similar effect as the Massachusetts Control Share Statute. Depending on the terms of a fund's existing declaration of trust and bylaws, the amendments necessary to implement these provisions may require shareholder approval.

Maryland has adopted a Control Share Statute[5] that applies to a closed-end fund organized as a Maryland corporation, provided the fund's board of directors adopts a resolution to be covered by (*i.e.*, opting in to) the statute.[6] Depending on the terms of a fund's existing charter and bylaws, opting in to the Maryland statute also may require shareholder approval of changes to these documents.

Neither the Delaware Statutory Trust Act[7] nor the Delaware General Corporations Law[8] contains a Control Share Statute. This leaves open the question of how a closed-end fund organized as a Delaware corporation or statutory trust (or any closed-end fund organized under the laws of a state without a Control Share Statute, for that matter) could best take advantage of the withdrawal of the Boulder Letter, perhaps by adopting provisions in its charter document incorporating the substance of a Control Share Statute of another state – *e.g.*, a Delaware statutory trust adopting provisions in its charter that are akin to the Maryland or Massachusetts Control Share Statutes.

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For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney.

[4] *See* M.G.L. c. 110D, § 1 *et seq.*
[5] *See* Md. Code, Corps. & Ass'ns § 3-701 *et seq.*
[6] *Id.* at § 3-702.
[7] 12 Del. C. § 3801 *et seq.*
[8] 8 Del. C. § 101 *et seq.*