PUBLICATION

Analyzing Whether Section 18(I) of the Investment Company Act Really Permits Closed-End Funds to Opt In to the Maryland Control Share Acquisition Act

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March 03, 2022

Section 18(i) of the Investment Company Act of 1940 (the Act) requires, except as set forth in therein and "as otherwise required by law," that each share of stock issued by a registered closed-end fund "shall be a voting stock and have equal voting rights with every other outstanding voting stock." We discussed in a June 2020 Client Alert a then-recent Statement (the Statement) published by the Staff of the Securities and Exchange Commission's Division of Investment Management in which the Staff withdrew its Boulder Total Return Fund, Inc. No-Action Letter (the Boulder Letter) (publicly available November 15, 2010), and replaced it with a no-action position that a closed-end fund could opt into a state control share statute, such as the Maryland Control Share Acquisition Act (MCSAA),[1] without violating Section 18(i) so long as "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." When a closed-end fund opts into the MCSAA, the voting rights of its investors who acquire "control shares" – i.e. shares that result in the shareholder owning more than a certain percentage of the fund's voting power (starting at one-tenth of the outstanding shares), are limited unless restored by a vote of the fund's stockholders.

In our June 2020 Client Alert, we noted that in the Statement, unlike in the Boulder Letter, the Staff did not provide any reasoning for its new position that a fund's opting into a control share statute does not violate Section 18(i) of the Act. In the Statement, the Staff made only vague references to "market developments" since the issuance of the Boulder Letter and "recent feedback from affected market participants." In our June 2020 Client Alert, we said "the change in position set forth in the Statement, without explanation, is curious at best."

In mid-February 2022, the U.S. District Court for the Southern District of New York, consistent with the Staff's position in the Boulder Letter and contrary to the Staff's more recent position as set forth in the Statement, held on a motion for summary judgment that a control share bylaw adopted by several closed-end Massachusetts business trusts (the Trusts) did in fact violate Section 18(i) of the Act, in particular, "section 18(i)'s requirement that every stock be 'voting stock and have equal voting rights with every other outstanding voting stock.'"[2] Similar to the MCSAA, the bylaw in question provided that "a shareholder's acquisition of shares after the date of the Bylaws' enactment which, taken together with shares already owned by that shareholder before the Bylaws' enactment, would lead to that shareholder's owning 10% or more of the total shares of a trust … [could] not vote her stock acquired after the Bylaws' enactment unless authorized by an 'affirmative vote of the holders of a majority of all of the Shares entitled to vote ... excluding [any shares owned by a control shareholder].'"[3]

The Court, in finding the Statement, which the Trusts relied on as persuasive authority for their position that the control share bylaw in question did not violate Section 18(i) of the Act, noted, among other things, that the Statement, in contrast with the Boulder Letter, did not "contain any legal analysis of Section 18(i). … This contrasts with the Boulder Letter, which examined the Investment Company Act in detail and explained why closed-end funds opting into control share statutes violated the plain language of both Section 18(i)'s 'voting stock' and 'equal voting rights' requirements."[4]

The Trusts argued, among other things, that "the control share [bylaw] is consistent with Section 18(i) because it strips voting rights from *shareholders* but not from *shares*."[5] We discussed this as a possibility for the Staff's new position in the Statement in our 2020 Client Alert, even though this argument had existed prior to the issuance of the Boulder Letter. The *Saba Capital* Court, however, roundly demolished this argument, calling it a "meaningless distinction. What makes a stock 'voting' hinges on the ability of its holder to *presently* vote the stock, instead of a quality or status of the stock separate from its holder. Depriving a control shareholder of her ability to vote her stock, even temporarily, necessarily means that her stock cannot be considered a 'voting security' as the [Act] defines the term."[6]

In discussing why the Statement did not provide persuasive authority for the Trusts' position, the Court noted that "this case involves a company's control share by-law, not a statute."[7] We believe, however, that a court presented with the issue would have difficulty differentiating between the control share bylaw at issue in *Saba Capital* and a statutory provision like the MCSAA. First, a Maryland closed-end fund must opt in to the MCSAA, as opposed to a statute that would apply to a closed-end fund automatically; in each case, the fund makes an affirmative decision to limit the voting rights of certain "control shares." Second, the Court's analysis and conclusion that the application of the bylaw in question violated Section 18(i)'s requirement that every share of stock be voting and have equal voting rights, including providing its holder the *present* ability to vote, would apply equally to a fund's voluntarily opting-in to the MCSAA as it does to the bylaw voluntarily adopted by the Trusts. Finally, the Court noted that *Saba Capital* involved a control share bylaw and not a statute in the context of distinguishing the applicability of the Statement to the circumstances in question; it did not analyze why this distinction was relevant or imply that it would impact the analysis set forth in the opinion or the outcome.

The holding in the *Saba Capital* case is consistent with the holding in a similar case decided in Massachusetts last year.[8] In that case, similar to *Saba Capital*, the plaintiffs were challenging, among other things, a bylaw amendment adopted by three closed-end investment funds providing that any shareholder controlling more than 10% of the voting power of one of the funds could not exercise their voting rights unless a majority of the other shareholders agreed. Ruling on the defendants' motion to dismiss, the Court, citing to Section 18(i)'s equal voting rights requirement, found that "[t]he complaint plausibly suggests that the [amendment] violates the [Act]."[9] And like the Court in the *Saba Capital* case, the Court stated that "[i]f a share cannot be voted by its present owner, then the voting right attached to that share is no longer equal to that attached to shares owned by investors that control a small share of the [fund's] total beneficial interest."[10]

Given the outcome in these recent cases, we believe that, despite the Statement, a Maryland closed-end fund considering opting in to the MCSAA should be cautious in making a decision to do so, and that closed-end funds that have opted in to the MCSAA should be aware that any challenge to such opt-in now likely has a better chance of succeeding in light of the analysis presented, and outcome of, these cases.

If you would like to discuss these developments, please feel free to contact Ken Abel.

[1] The Control Share Act is codified at §§3-701 to -710 of the Maryland General Corporation Law ("MGCL").

[2] *Saba Cap. CEF Opportunities 1, Ltd., et al., v. Nuveen Floating Rate Income Fund, et al.*, WL 493554, at *6 (S.D.N.Y. Feb. 17, 2022) ("*Saba Capital*").

[3] *Saba Capital* at *1. We note that the voting standard for restoration of voting rights of control shares under the MCSAA is two-thirds of all the votes entitled to be cast on the matter (excluding all interested shares).

[4] *Saba Capital* at *3.

[5] *Id*.

[6] *Id*. at *4. In this regard, the Court notes that Section 2(a)(42) of the Act "defines 'voting security' as 'any security *presently* entitling the owner or holder thereof to vote for the election of directors of a company.'" *Saba Capital* at 2. (emphasis in opinion but not in original)

[7] *Id*. at *3.

[8] *Eaton Vance Senior Income Trust v. Saba Cap. Master Fund, Ltd.*, 2021 WL 2222812 (Mass. Super. Mar. 31, 2021).

[9] *Id*. at *5.

[10] *Id*.