

MEMO# 35396

August 11, 2023

Activist Sues Closed-End Funds and Certain Trustees Utilizing Maryland Control Share Acquisition Provisions

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TO: ICI Members

Investment Company Directors

Closed-End Investment Company Committee

Independent Directors Council SUBJECTS: Closed-End Funds RE: Activist Sues Closed-End Funds and Certain Trustees Utilizing Maryland Control Share Acquisition Provisions

On June 29, 2023, Saba Capital Management, L.P. ("Saba") filed a complaint in the United States District Court of the Southern District of New York against sixteen closed-end funds and several trustees overseeing some of the named funds. Saba contends that by opting into the Maryland Control Share Acquisition Act ("MCSAA")^[1] or having bylaws similar to the MCSAA, the closed-end funds have violated the Investment Company Act of 1940 ("1940 Act") and Saba believes such control share provisions should be rescinded.

Background

A control share statute is a state law that generally restricts the rights of a shareholder who owns more than a certain percentage of a company's shares from voting those shares in excess of the set threshold (i.e., "control shares"), unless the other non-interested shareholders restore those rights. Control share statutes function as anti-takeover devices.

Activists often acquire substantial share positions in closed-end funds to force "liquidity" events, such as a liquidation of the fund, a conversion to a mutual fund, or a tender offer.^[2] These forced "liquidity" events may hurt long-term shareholders who invested in a closed-end fund for its dividend yield, as the closed-end fund will cease to exist (in the event of a liquidation), be substantially changed (in the event of a conversion to a mutual fund), or be significantly reduced in scale and result in higher per share expenses (in the event of a tender offer).^[3] As activist activity has increased over the past several years, closed-end funds have turned to control share statutes or have adopted control share provisions in their governing documents to protect long-term investors from activists' intended results.

Section 18(i) and Recent State Shareholder Control Statute Amendments

Section 18(i) of the 1940 Act states that "Except as . . . otherwise required by law, every share of stock hereafter issued by a registered management company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock[.]" Since the SEC staff withdrew its guidance prohibiting closed-end funds from using control share provisions,[\[4\]](#) many closed-end funds have adopted control share provisions. As activist activity has grown, we have also seen some states, including both Maryland and Delaware, enact or amend control share statutes to better protect closed-end funds and their shareholders.[\[5\]](#)

Prior Saba Litigation

Saba has been successful in other litigation against closed-end fund control share provisions. Notably though, litigation where Saba has been successful at the trial level (with appeals still outstanding) have involved closed-end funds organized as Massachusetts business trusts. Massachusetts state law does not include a codified control share statute for Massachusetts business trusts that automatically applies or allows closed-end funds to opt-in, like Maryland or Delaware does. The closed-end funds at issue in these prior cases had adopted bylaws in their organizing documents that had the effect of a control share statute. Because Massachusetts did not have a codified control share statute for closed-end funds organized as Massachusetts business trusts, the courts in the prior Saba cases did not analyze the question of whether a closed-end fund may rely on a codified control share statute, like that found in Maryland and Delaware, and enact control share provisions without violating the 1940 Act.

Current Litigation

The funds Saba is suing are either closed-end funds organized as corporations under Maryland law that have opted into the MCSAA or are organized as trusts under Maryland law that have adopted bylaws similar to the MCSAA. Saba claims, as it has in the past, that the closed-end funds' control share provisions violate the 1940 Act because they do not satisfy the language of Section 18(i) that all common shares "shall be a voting stock and have equal voting rights with every other outstanding voting stock." Thus, Saba argues, the control share provisions of the closed-end funds should be rescinded. However, as noted above, Section 18(i) of the 1940 Act includes the preface "Except as . . . otherwise required by law" and under Maryland state law the control share statute is codified and legally binding upon closed-end funds organized as corporations that have opted into the statute.[\[6\]](#)

Maryland Law

Under the MCSAA, Maryland's control share statute does not apply to closed-end funds organized as corporations unless a closed-end fund's board of directors adopts a resolution to be subject to the MCSAA.[\[7\]](#) Because the MCSAA statutorily regulates the control share provisions of closed-end funds organized as corporations, and the Maryland Statutory Trust Act will do the same beginning October 1, 2023, this is a novel question not answered in the Massachusetts cases as to whether such provisions are allowable under Section 18(i) of the 1940 Act. The MCSAA is codified in statute, thus providing a stronger argument that the MCSAA restrictions are "otherwise required by law" as Section 18(i) explicitly allows for.[\[8\]](#)

Notes

[1] Md. Code Ann., Corps. & Ass'ns §§ 3-701 et seq.

[2] In some cases, an activist may seek to change the constitution of a closed-end fund's board or its investment strategy. For example, Saba recently nominated a slate of trustees for a fund and, when such trustees won election, they appointed Saba as the investment adviser of the fund. Saba then changed the strategy of the fund from investing primarily in senior loans to investing a majority of fund assets in special purpose acquisition companies ("SPACs"), other closed-end funds, private funds, and total return swaps. Compare Saba Capital Income and Opportunities Fund Semi-Annual Report (April 30, 2023), available at <https://secure.alpsinc.com/MarketingAPI/api/v1/Content/sabacef/saba-capital-income-opportunities-fund-sar-20230430.pdf> with Voya Prime Rate Trust Annual Report (February 28, 2021), available at https://www.sec.gov/Archives/edgar/data/826020/000110465921062317/tm219046d11_ncsr.htm#vprrt_003.

[3] Additionally, in each case, a closed-end fund shareholder may incur unexpected taxes.

[4] See SEC Division of Investment Management, Control Share Acquisition Statutes (May 27, 2020), available at <https://www.sec.gov/investment/control-share-acquisition-statutes>. For a summary of the staff's withdrawal letter, see ICI Memorandum No. 32487, available at <https://www.ici.org/memo32487>.

[5] Maryland recently amended the Maryland Statutory Trust Act, to be effective October 1, 2023, to automatically apply its control share statute to a Maryland statutory trust that is (i) a closed-end investment company as defined under the 1940 Act and (ii) formed on or after October 1, 2023. Further, the amendments would permit a Maryland statutory trust to apply the Maryland control share statute if the Maryland statutory trust is (i) a closed-end investment company as defined under the 1940 Act and (ii) formed before October 1, 2023. See Maryland House Bill 209 (Chapter 560 of the Laws of Maryland 2023) (Signed by Governor Moore on May 8, 2023), available at https://mgaleg.maryland.gov/2023RS/Chapters_noln/CH_560_hb0209t.pdf; also ICI Memorandum No. 35319, available at <https://www.ici.org/memo35319>. Prior to Maryland passing this bill, Delaware had amended its Delaware Statutory Trust Act, effective August 1, 2022, to adopt a control share acquisition statute that all listed closed-end funds registered under the 1940 Act and business development companies organized as Delaware statutory trusts would automatically be subject to. The newly adopted Delaware control share statute is forward-looking only and allows the fund's board of trustees to exempt specific acquisitions or classes of acquisitions from the control share statute. See Delaware Senate Bill No. 284, as Amended by House Amendment No. 1 (Chapter 38, Title 12 of the Delaware Code) (Signed by Governor John Carney on July 27, 2022), available at <https://legis.delaware.gov/json/BillDetail/GenerateHtmlDocumentEngrossment?engrossmentId=25234&docTypeId=6>; also ICI Memorandum No. 34242, available at <https://www.ici.org/memo34242>.

[6] Because the amendments to the Maryland Statutory Trust Act discussed in supra note 5 are not yet effective, they are currently not yet at issue as part of Saba's complaint. However, because litigation often is a long process, the amendments to the Maryland

Statutory Trust Act are likely to become effective during this legal process and the closed-end funds organized as Maryland trusts may be able to opt-in to the control share statutory provisions during the litigation process. Thus, to the extent closed-end funds organized as trusts under Maryland law opt-in to the control share statutory provisions of the amended Maryland Statutory Trust Act, it may make any distinguishing arguments between reliance on control share provisions by closed-end funds organized as corporations or trusts obsolete.

[7] Md. Code Ann., Corps. & Ass'ns § 3-702(c)(4). Maryland has amended the Maryland Statutory Trust Act, effective October 1, 2023, to provide a similar codified process for Maryland trusts. See *supra* note 5.

[8] Even if Saba is successful in this matter though, it will remain to be seen (and will likely play out in future litigation) whether control share statutes that automatically apply, as opposed to "opt-in" statutes like the MCSAA, provide a stronger legal defense under Section 18(i) of the 1940 Act for closed-end funds trying to protect the interests of long-term shareholders.

Further, there is existing dicta contradicting Saba's claims and favoring the legality of closed-end funds opting into the MCSAA. See *Neuberger Berman Real Estate v. Lola Brown Trust*, 485 F.Supp.2d 631 (D. Md. 2007). In *Neuberger*, while the court did not need to reach the issue of whether a closed-end fund that opts into the MCSAA is consistent with Section 18(i) of the 1940 Act, the court offered its observations on the issue. The court believed that the MCSAA control share statute was legally valid, but that the entities' "control share" voting power was capped at the percentage of shares held when the closed-end fund opted into the control share statute. Because the entities owned more than 10% of the closed-end fund prior to the enactment of any control share provision, the entities could vote those "control shares" without impugnement but any additionally acquired shares after the closed-end fund opted into the control share statute would be subject to the control share provisions.