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SERVING INDIVIDUAL INVESTORS
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Appellate Court Affirms Decision that Certain Closed-End Fund Control Share Provisions are Impermissible

[35522]

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TO: ICI Members
Investment Company Directors SUBJECTS: Closed-End Funds RE: Appellate Court Affirms Decision that Certain Closed-End Fund Control Share Provisions are Impermissible

The U.S. Court of Appeals for the Second Circuit recently affirmed a lower court decision holding that certain closed-end funds' "control share" provisions are impermissible under the Investment Company Act of 1940.[1] The Second Circuit decision could impact several closed-end funds that have either opted-in to state control share statutes or adopted control share provisions in their governing documents. We provide background and summarize the decision below.

Background

In 2010, a closed-end fund requested SEC staff input as it considered opting-in to a state control share statute. In response to the request, the SEC staff issued a no-action letter, The Boulder Total Return Fund, Inc., determining that opting-in to the statute would be inconsistent with the requirement in Section 18(i) of the Investment Company Act that every share of stock issued by a fund be "voting stock" and have "equal voting rights" with every other outstanding voting stock.[2]

In 2020, the SEC staff issued a statement withdrawing the Boulder letter and reversing the SEC staff's previous position that funds opting-in to state control share statutes are acting inconsistent with the Investment Company Act.[3] The staff's actions followed ICI advocacy urging the Commission or its staff to permit funds to opt-in to state control share statutes and to issue guidance on the defenses that closed-end funds and their independent directors may use to defend against activist campaigns.[4]

Since the issuance of the staff statement, several closed-end funds have either opted-in to state control share statutes (e.g., if the fund's state of incorporation has enacted a state control share statute) or adopted control share provisions in their governing documents that mirror state control share statutes.

In 2021, an activist sued certain closed-end funds alleging, among other things, that their adoption of a control share provision violated Section 18(i) of the Investment Company Act.

Decision

The Second Circuit relied heavily on the statutory language of the Investment Company Act in its decision. It noted that Section 18(i) of the Investment Company Act requires that every share of stock issued by a closed-end fund be "voting stock" and "have equal voting rights" with every other outstanding share.[5] Although the Act does not define "voting stock," it does define "voting security" as "any security presently entitling the owner or holder thereof to vote for the election of directors of a company."[6] The court noted that the plain and unambiguous language of these sections requires that all closed-end fund stock be voting stock that "presently entitles" the owner to vote it. The court found that an owner of stock subject to the funds' control share provisions cannot "presently" vote its stock and that the provisions deprive some shares of voting power—contrary to the requirement that all shares have equal voting rights. The court, thus, affirmed the lower court's decision, concluding that the lower court construed the provisions correctly.

The Second Circuit specifically evaluated and rejected the funds' two primary arguments that: (1) there is a longstanding distinction between restrictions on shares and restrictions on shareholders and that the control share provisions in question were restrictions on shareholders; and (2) the court must interpret the Investment Company Act in accordance with its policy and purposes and that Section 18(i) must be read to protect shareholders from overreaching from activists.

The court found that there was little evidence to support a "longstanding" distinction between restrictions on shares versus restrictions on shareholders. It distinguished two cases the funds cited as support, noting that one case only covered state law issues with distinct differences from the Investment Company Act.[7] The court noted that the other case involved poison pills, which limit a controlling shareholder's ability to acquire additional shares. In that instance, the court stated that the case only impacted the shareholder's economic interests not its voting rights because the poison pill provision was not limiting the shareholder's ability to vote its shares.[8]

The court also found unconvincing the funds' arguments that courts must read the Investment Company Act in a manner most conducive to the effectuation of its goals. Although the court agreed with such principle, it noted that courts should not deviate from the statute's plain meaning and that the policy and purposes sections of the Investment Company Act did not compel the court to deviate from the plain text of Section 18(i).[9]

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Notes

[1] See Saba Capital CEF Opportunities 1, LTD v. Nuveen Floating Rate Income Fund, Docket No. 22-407 (2nd Cir. Nov. 30, 2023). A control share provision generally restricts the rights of a shareholder who owns more than a certain percentage of a company's shares

from voting those shares, unless the other non-interested shareholders restore those rights. The Second Circuit matter arose on appeal after the US District Court for the Southern District of New York held that certain closed-end funds' control share provisions impermissibly violate the Investment Company Act of 1940. See Saba Capital CEF Opportunities 1, LTD v. Nuveen Floating Rate Income Fund, No. 21-CV-327 (JPO) (SDNY Feb. 17, 2022). For a summary of the District Court opinion, please see ICI Memorandum No. 34045, available at https://www.ici.org/memo34045.

[2] See Boulder Total Return Fund, Inc. (pub. avail. Nov. 15, 2010) ("Boulder letter"), available at www.sec.gov/divisions/investment/noaction/2010/bouldertotalreturn111510.htm.

[3] See SEC Division of Investment Management, Control Share Acquisition Statues (May 27, 2020) ("staff statement"), available at www.sec.gov/investment/control-share-acquisition-statutes. For a summary of the staff statement, please see ICI Memorandum No. 32487, available at www.ici.org/my_ici/memorandum/memo32487.

[4] See, e.g., ICI, Recommendations Regarding the Availability of Closed-End Fund Takeover Defenses (Mar. 2020), available at https://www.ici.org/pdf/20_ltr_cef.pdf.

[5] See Section 18(i) of the Investment Company Act.

[6] See Section 2(a)(42) of the Investment Company Act (emphasis added).

[7] Because the funds at issue were organized as Massachusetts business trusts with no governing state control share statute under Massachusetts law, the Second Circuit solely focused on interpreting federal law. Further, the court did not analyze whether control share provisions adopted pursuant to a state control share statute would be allowable under the phrase "as otherwise required by law" in Section 18(i) of the Investment Company Act.

[8] The court also distinguished the funds' argument that the SEC imposes restrictions on shareholders by imposing conditions on shareholders' right to vote in an exemptive rule that allows those shareholders to exceed certain fund-of-fund limitations (e.g., requiring those shareholders to vote in accordance with instructions or in the same proportion as the vote of all other shareholders). It noted that the SEC imposing voting conditions on presumptively unlawful acquisitions through an exemptive rule is different than otherwise restricting shareholders in a manner that is directly at odds with the Section 18(i) language.

[9] In addition, the Second Circuit determined that the plaintiffs had sufficient standing to challenge the lower court's decision, even though the plaintiffs had not alleged, or supported with evidence, an actual or imminent injury that is concrete. On this point, the defendants alleged that the plaintiffs' challenge was speculative because the plaintiffs had not yet made any control share acquisitions and that the funds' shareholders have not been asked to decide and have not decided whether the plaintiffs could vote their future shares. Nevertheless, the court determined that the plaintiffs' injury was imminent and concrete. It determined that the harm of the plaintiffs not being able to vote any additional share as imminent because: (a) the plaintiffs established a pattern of increasing their ownership of the funds for a two-year period prior to the adoption of the control share provision; (b) the plaintiffs established an intent to purchase additional shares in the funds but for the control share provision; and (c) the control share provision would automatically be triggered to

limit the plaintiffs' voting rights. It determined that the harm also was concrete, as encumbering the voting rights of the shares was analogous to a property-based injury because the control share provisions impair the shares' condition, quality, or value.
