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To: The Staff of the Division of Investment Management

From: Phillip Goldstein, Managing Member (pgoldstein@bulldoginvestors.com)

Re: Control Share Statutes

Date: July 28, 2020

"You're supposed to **stand** for somethin'! You're supposed to protect people!"[1]

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Once upon a time, investment companies ("funds") were only subject to the laws of the state in which they were registered. In a report to Congress, the SEC identified a number of abuses and evils, including funds taking advantage of lax state laws to issue securities with inequitable or discriminatory provisions.

After extensive hearings, Congress concluded that the individual states had failed to protect investors from the sort of abuses the SEC had documented.[2] Consequently, Congress adopted the Investment Company Act of 1940 (the "ICA"). Unlike other federal securities laws that focused on disclosure and fraud, the ICA required funds to adopt certain governance practices and prohibited others. Commissioner Robert E. Healy and Chief Counsel David Schenker[3] were the primary architects of what was to become the ICA. In a prepared statement to the Senate Subcommittee on Banking and Currency on April 2, 1940, Commissioner Healy said this:

> IT IS PERHAPS NOT TOO MUCH TO SAY THAT THE DISREGARD OF FIDUCIARY STANDARDS LIES AT THE ROOT OF MANY INVESTMENT COMPANY PROBLEMS. THE FIDUCIARY OBLIGATION OF THE MANAGEMENT TO STOCKHOLDERS IS TOO OFTEN VIOLATED OR DISREGARDED. The Bill undertakes to impose specific conditions which will insure the observance of this fundamental obligation.[4]

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[1] Al Pacino as defense attorney, Arthur Kirkland in "And Justice For All." (1979)

[2] See Section 1(a)(5) of the Investment Company Act of 1940. ("[T]he activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.")

[3] Schenker later became the first head of DIM.

[4] Available at http://www.sechistorical.org/museum/galleries/icr/icr02_rules_of_new_game.php.

The ICA sought to codify and elevate the prevailing fiduciary standards for fund insiders by imposing such specific conditions. As the Second Circuit Court of Appeals noted in *Brown v. Bullock*,[5] "It is…unreasonable to suppose that Congress would have wished to permit its purpose to protect investors in all investment companies…to be frustrated if a particular state of incorporation should be satisfied with lower standards of fiduciary responsibility for directors than those prevailing generally."

To that end, Section 36(a) authorizes the SEC to bring an action alleging "a breach of fiduciary duty involving personal misconduct in respect of any registered investment company." Section 36(b) compels the investment adviser of a registered investment company to "have a fiduciary duty with respect to the receipt of compensation for services" even in the absence of "personal misconduct." And Section 17(h) prohibits "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of [one's] office" – each of which constitutes a breach of fiduciary duty. These sections of the ICA would be meaningless if the definition of "fiduciary duty," "personal misconduct," "willful misfeasance," bad faith," "gross negligence," and "reckless disregard of the duties involved in the conduct of [one's] office" differed based upon the state in which a fund is registered. As the *Bullock* panel observed, the ICA presupposes a standard of fiduciary duty that supersedes any state law that falls below that standard.

Section 18(i) of the ICA establishes a fiduciary duty floor regarding the voting rights of fund shareholders by making unlawful the issuance of "securities containing inequitable or discriminatory provisions," and requiring funds "to protect the preferences and privileges of the holders of their outstanding securities."[6] It requires that "every share of stock hereafter issued by a [fund] shall be a voting stock and have equal voting rights with every other outstanding voting stock…." That prohibition has not prevented some states from trying to lure funds to such states by authorizing boards to take actions that impair the voting rights of shareholders. Maryland is the leader in this "race to the bottom," a race that Congress was well aware of when it adopted the ICA.[7] To entice sponsors to register their funds in Maryland, the legislature, among other things, adopted a control share statute ("CSS").[8] If a fund opts into Maryland's CSS, a shareholder that

[5] 294 F.2d 415 (2d Cir. 1961).

[6] Section 1(b)(3) of the ICA.

[7] See *Liggett v. Lee*, 288 U.S. 517, 557-60 (1932) ("Lesser States, eager for revenue derived from that traffic in charters[,] had removed safeguards from their own incorporation laws…. The race was not one of diligence but of laxity…. [T]he great industrial States yielded in order not to lose wholly the prospect of the revenue and control incident to domestic incorporation.")

[8] Delaware, the premier state for operating corporations, does not have a CSS.

acquires more than 10% of its outstanding shares is prohibited from voting any of its so called "control shares," i.e., any shares above that amount.

Congress knew that fund insiders might try to find loopholes in the ICA. Consequently, it included the following statement as a directive to the SEC and courts:

> It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.[9]

Supporters of Maryland's CSS claim that it does not affect the voting rights of control shares themselves; it merely restricts the voting rights of the owner of those shares. But shares do not vote themselves. Voting rights can only be exercised by human beings and the ICA was intended to protect investors, not inanimate objects. Section 1(b)'s interpretive mandate is clearly intended to protect the voting rights of the human beings that own and vote shares of registered funds.

In 2010, the staff of the Division of Investment Management ("DIM") addressed the tension between Section 18(i) and a state CSS. In a well-reasoned letter (the "Boulder Letter") signed by Kyle R. Ahlgren, Senior Counsel of DIM, the staff analyzed the legislative history and Congressional intent underlying Section 18(i) and applied Section 1(b)'s interpretive command to conclude that a fund would violate Section 18(i) if it opted into a CSS like Maryland's. In other words, regardless of each state's power to dilute the standard of fiduciary duty for insiders of other corporations, the minimum fiduciary standard demanded by the Section 18(i) of the ICA prohibits a registered fund's board of directors from causing it to opt into a state CSS.

The standard of fiduciary duty applicable to a board's consideration of whether a fund should opt into a CSS is set forth in *Blasius Industries, Inc. v. Atlas Corp.*[10] In *Blasius*, Chancellor Allen ruled that a board of directors may take an action "for the sole or primary purpose of thwarting a shareholder vote" only if the board has a "compelling justification" for the action.[11] To our knowledge, no court has ever found a "compelling justification" for an action taken for the primary purpose of thwarting, impeding or interfering with a shareholder vote.

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[9] Section 1(b) of the ICA.

[10] 564 A.2d 651 (Del. Ch. 1988).

[11] *Id.* at 661-63.

Opting into a CSS impairs the market for control of CEFs. With a vibrant market for control, if a CEF is poorly managed and investors do not receive an acceptable return on their money, its shares often trade at a wide discount from net asset value ("NAV"). Activist investors can buy up the shares, gain control of the poorly managed CEF and then improve the management or governance, and/or create a liquidity event to allow shareholders that were previously reluctant to sell shares at a large discount to do so at a price close to NAV.[12]

Some sponsors of closed-end funds ("CEFs") saw the Boulder Letter as a threat to their control over their funds and the income they derived from them. Consequently, those sponsors began to lobby DIM and the Commission to rescind the Boulder Letter. On May 27, 2020, their efforts bore fruit when DIM issued a bombshell statement (the "May 27th Statement") in which it announced that it was withdrawing the Boulder Letter, and that from now on a CEF could opt into a state CSS subject to some nebulous generic conditions.[13] Tellingly, the May 27th Statement offered no examples of the sort of factors a board should consider before determining to opt into a CSS or when doing so might be a breach of its fiduciary duty. And the reason provided in the May 27th Statement for withdrawing the Boulder Letter was unconvincing:

> On September 13, 2018, Chairman Jay Clayton, after noting that staff statements are non-binding and are distinct from Commission rules and regulations, instructed the Division to review prior staff statements and staff documents to ascertain whether such statements or documents should be modified, rescinded, or supplemented in light of market or other developments. Following this instruction, and recognizing the distinctions between staff guidance and Commission action, the staff has reviewed the Boulder Letter, market developments since its issuance, and recent feedback from affected market participants. As a result, the staff has determined to withdraw the Boulder Letter, effective today. (Footnotes omitted.)

Every staff member of DIM knows "that staff statements are non-binding and are distinct from Commission rules and regulations." So that is nothing new. And, while it

[12] Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685 (2009).

[13] The conditions would apply to virtually any action taken by a board. They are as follows:

> The staff would not recommend enforcement action to the Commission against a closed-end fund under section 18(i) of the Act for opting in to and triggering a control share statute if 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. We would expect any inquiry into the application of section 18(i) to be based on the facts and circumstances. In particular, the staff reminds market participants that any actions taken by a board of a fund, including with regard to control share statutes, should be examined in light of (1) the board's fiduciary obligations to the fund, (2) applicable federal and state law provisions, and (3) the particular facts and circumstances surrounding the board's action. (Footnotes omitted.)

may be appropriate to review certain staff positions from time to time, in the case of the well-reasoned Boulder Letter, "market or other developments" are irrelevant. A fund that opts into a CSS either violates Section 18(i) or it doesn't. It has nothing to do with "market or other developments"[14] or any conceivable "facts and circumstances."

The May 27th Statement did not disavow the reasoning in the Boulder Letter nor its conclusion, i.e., that a CEF would violate Section 18(i) by opting into a CSS. Nor did it assert that withdrawing the Boulder Letter was in the best interest of investors. In effect, the May 27th Statement effectively told boards, "If you choose to violate Section 18(i) of the ICA by opting into a CSS without an exemptive order, we will look the other way. Just make sure to paper the file." <u>This is the only instance we know of the SEC or the staff agreeing to turn a blind eye to a violation of the securities laws.</u>

So, what was the real reason DIM issued the May 27th Statement? Notably it was unsigned, which suggests that no staff member wanted to take responsibility for it. Another clue is that Chairman Clayton played more than a passing role in the matter. In his announcement that same day, he "thank[ed] the staff for continuing their retrospective review of prior staff statements and documents to ascertain whether they should be modified, rescinded, or supplemented in light of market or other developments."[15] (There is that suspicious "other developments" phrase again.)

The next day brought a more revealing clue in the form of a press release[16] issued by the Investment Company Institute, an industry trade organization, applauding the withdrawal of the Boulder Letter: "ICI is truly grateful the SEC staff took this important step to further protect closed-end fund shareholders from growing attacks by activist private funds." Under a heading in the ICI's press release entitled "Additional Information on ICI's Advocacy to Withdraw the Boulder Letter," the ICI gleefully boasted about its lobbying efforts:

> ICI submitted a report[17] to the SEC in March 2020 recommending the Commission or its staff withdraw the Boulder letter and issue guidance clarifying that closed-end funds can employ common takeover defenses. The submission

[14] The only "development" cited in the May 27th Statement is that "the number of listed closed-end funds has declined considerably since the issuance of the Boulder Letter, although it is unclear to what extent the unavailability of control share statutes under the Boulder Letter may have contributed to this trend." A more likely cause is competition from low cost alternative investment vehicles like index funds and ETFs. In any event, that "development" has no bearing on the legal conclusion reached in the Boulder Letter.

[15] Available at https://www.sec.gov/news/public-statement/clayton-control-share-statutes-2020-05-27.

[16] Available at https://www.ici.org/pressroom/news/20_news_secboulder.

[17] Available at https://www.ici.org/pdf/20_ltr_cef.pdf.

provides extensive legal analysis explaining why the conclusions in the Boulder letter are incorrect.

The May 27th statement did not mention the ICI report, let alone indicate that DIM agreed with its legal analysis. Indeed, the Boulder Letter had rejected its arguments as being "without merit."

A reasonable inference to be drawn from these facts is that the ICI successfully lobbied Chairman Clayton who directly or indirectly pressured DIM to issue a statement that it would not have issued absent such pressure. It is inconceivable that Mr. Algren, for one, is happy about that. There are probably other staff members who take seriously their mission to protect investors from the sort of abuses that led Congress to adopt the ICA and who are troubled about giving fund boards a license to violate Section 18(i).

To repeat, Congress' rationale for adopting the ICA was its finding that the states had failed to protect the interests of investors. DIM, by withdrawing the Boulder Letter, has perversely thrown investors back into the clutches of states like Maryland that have demonstrated a willingness to weaken investor protections and fiduciary duty standards to entice fund sponsors to register their funds there. What do you think Messrs. Healy and Schenker would say about allowing a fund to opt into a CSS like Maryland's?

If a film is ever made about the real story behind the May 27th Statement, it might be entitled "Regulatory Capture."[18] Consider the following familiar dialogue:

> SENATOR KANE: Mr. Pentangeli, you are contradicting your confessions to our investigators; I ask you again, were you a member of a crime organization headed by Michael Corleone?
>
> FRANK PENTANGELI: No. I never heard of it. I never heard of nothing like that. I was in the olive oil business with his father a long time ago. That's all.
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> SENATOR KANE: Mr. Hagen, would you kindly identify to this committee that gentleman sitting on your right hand?
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> TOM HAGEN: (coolly) Yes, sir. His name is Vincenzo Pentangeli.
>
> SENATOR KANE: Is he related to the witness?
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> TOM HAGEN: He is, I believe, a brother.

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[18] Regulatory capture occurs when a regulatory agency becomes more concerned with promoting the interest of the very industry it is charged with regulating than the public it is charged to protect.

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KAY: Tell me, Michael. What really happened with Pentangeli?

MICHAEL CORLEONE: His brother came to help him.

KAY: I didn't even know he had a brother. And where is he now?

MICHAEL: On a plane back to Sicily.

KAY: And that's all he had to do. Just show his face.[19]

In this updated version of "The Godfather II," the roles of Senator Kane and Kay are played by Healy, Schenker, Algren and fund investors; Frank Pentangeli by DIM, and Vincenzo Pentangeli by Chairman Clayton. Of course, the Investment Company Institute is a proxy for the Godfather, Michael Corleone.

The staff asserts that its May 27th statement is "the staff's view." That is hard to swallow. Are investors to believe that that the staff now disagrees the following statement by Professor Tamar Frankel?

> Congress determined that the freedom traditionally afforded corporate management under state law to determine and change corporate strategies and business policies is inappropriate for investment companies, and thus determined to regulate investment companies differently. To ensure accountability and transparency, Congress created a comprehensive regulatory structure for investment companies that enhanced fiduciary obligations, enacted reporting requirements, and prohibited the advisers and the companies' directors from discriminating against shareholders. These goals are in direct conflict with state anti-takeover statutes (or judicial decisions) that permit discrimination and entrenchment tactics in ordinary operating companies. Indeed, the self-dealing and discrimination inherent in state anti-takeover statutes (or state court decisions permitting anti-takeover measures) are precisely what the Investment Company Act was designed to prevent, not enable. . . The SEC, in general, has interpreted the explicit provisions of the [Investment Company Act] as preempting state law provisions that vitiate the [Investment Company Act], especially in the case of shareholders' voting rights.[20]

To conclude, the SEC has a duty to protect investors, not the fund industry. As explained above, circumstantial evidence suggests that the withdrawal of the Boulder

[19] *The Godfather II* (Portions of Senate Hearing Scene and Subsequent Scene With Michael and Kay).

[20] The Boulder Letter, fn. 45

Letter is the result of regulatory capture and is not in the interest of investors. Therefore, the Boulder Letter should be reissued.

Very truly yours,

Phillip Goldstein
Managing Member