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2 Cases Show Risks Of Fund Industry's Control Share Bylaws

By **Aaron Morris** (May 6, 2022, 5:08 PM EDT)

Aaron Morris

The fund industry recently lost its second case on investment companies' use of control share bylaws, which seek to limit the ability of large shareholders to vote their shares after their holdings exceed a defined threshold.

In Saba Capital CEF Opportunities 1 Ltd. v. Nuveen Floating Rate Income Fund, the U.S. District Court for the Southern District of New York held in a February 2022 decision that the implementation of control share bylaws by the closed-end funds at issue violated Section 18(i) of the Investment Company Act of 1940, which requires that every share of stock issued by a registered investment company "be a voting stock and have equal voting rights with every other outstanding voting stock."[1]

Last year, the Massachusetts Superior Court ruled in Eaton Vance Senior Income Trust v. Saba Capital Master Fund Ltd. that newly enacted control share bylaws by the closed end funds at issue in that case also violated Section 18(i).[2]

Neither case is over — the New York case is on appeal and the Massachusetts case is proceeding through discovery — but with two decisions in the bag, fund trustees should begin to give serious consideration to the legality of defensive bylaws under the 1940 Act as well as the rationales used by investment advisers to justify their enactment.

While the New York case challenged only the legality of the bylaws under Section 18(i) of the 1940 Act, the Massachusetts case addresses more broadly the contractual and fiduciary liability that trustees and advisers may face for causing a fund to implement an improper defensive bylaw, which may pose additional and different legal issues for the industry.

This article provides a brief background on the use of control share bylaws followed by points to consider when contemplating the use of such bylaws by an investment company.

Background

Control share bylaws can provide a tool for investment companies, primarily closed-end funds, to ward off so-called activist shareholders, who may seek to influence a fund's management, investment strategies, or trading discount.[3]

The use of defensive bylaws, however, has long rested on shaky ground. In 2010, the U.S. Securities and Exchange Commission issued guidance stating that the use of control share bylaws by an investment company to "restrict the ability of certain shareholders to vote 'control shares' ... would be inconsistent with the fundamental requirements of Section 18(i)."

In 2020, however, the staff withdrew that guidance in a nonbinding statement with "no legal force or effect," stating that it would consider compliance with Section 18(i) on a case-by-case basis 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."

The SEC's more recent move encouraged multiple closed-end funds to enact new control share bylaws in an effort to insulate management from shareholder activism, which led to legal challenges by an activist, Saba Capital Management.

The first two rulings on the legality of the bylaws under Section 18(i) have gone in favor of the activist.[4] While these cases work their way through the court system — and we await finality on the legal issue itself — trustees should consider carefully the basis for an adviser's recommendation to enact such bylaws and, if applicable, reconsider their decision to do so in the past.

A Solution Without A Problem

The industry's push in favor of control share bylaws stems from its fatigue in dealing with activist investors, which typically target underperforming and highly discounted funds with weak management. In litigation and otherwise, advisers rely on a thin veneer — the interests of so-called long-term shareholders — to cover the real purpose of such defensive maneuvers: the protection and entrenchment of current management.

The long-term shareholders, typically described so as to conjure images of innocent pensioners, are pitted against the malevolent short-term activists, which purportedly seek to milk the fund of its value and discard the shell.

This is a fictionalized dynamic. As an initial matter, fund managers have little idea what portion of a fund's shareholder base consists of "long-term holders," a term with no standardized definition in any event.

Further, even if advisers could figure that out, the 1940 Act does not permit fund managers to act only in the best interests of some shareholders, long-term or otherwise, to the exclusion of others — their duties are owed holistically to the entire shareholder base.

Moreover, even long-term holders have to sell eventually (e.g., when they want to retire, build a house or send a kid to college). Thus, it seems dubious that any rational shareholder, notwithstanding their holding period, would prefer to be invested in an underperforming fund with a wide and persistent discount to its true value.

For these reasons, criticisms of fund activism are overblown and unjustifiably discount the extent to which the goals of an activist overlap with other shareholders. For example, in Nuveen, the adviser made much of the activist's efforts to force dramatic changes to maximize its own self-interest at the expense of other shareholders "who largely invest in closed-end funds for their long-term returns."[5]

But at the time of the lawsuit, the funds at issue, all fixed-income strategies, were trading at roughly 10% (or greater) discounts to their net asset value, meaning that shareholders could exit the fund at only 90 cents on the dollar or less.

The average discount for fixed income funds is 3-4%. The conduct identified by the adviser in Nuveen as advancing only the activist's self-interest in reality had the potential to deliver value to all shareholders equally, including those holding for the long term, as shown by the table below.

Allegedly Self-Interested Conduct Identified By The Adviser In Nuveen[6]	**Why The Conduct Could Deliver Value To All Shareholders[7]**

"[E]lect to a fund board one or more directors or trustees affiliated with or favored by Saba."	New trustees could take action to improve performance, lower fees, or decrease the trading discounts.
"[D]eclassify a fund board, such that all directors or trustees stand for reelection simultaneously."	Permits shareholders to vote on multiple trustees all at once, who then would have sufficient board sway to immediately implement the changes above.
"[A]uthorize a tender offer by a fund to repurchase up to a specified percentage of the fund's outstanding shares."	Tender offers can have the effect of decreasing a fund's trading discount and unlocking value for all shareholders.
"[C]hange a fund investment adviser from the original sponsoring adviser to another entity affiliated with or favored by Saba."	Permits shareholders to consider whether a new adviser affiliated with the activist could deliver more value than the current manager (requires an affirmative shareholder vote).
"[C]onvert a fund from a closed-end structure to an open-end structure or merge into an open-end fund."	A conversion has the effect of eliminating a fund's trading discount because open-end fund shares are redeemed at NAV, unlocking value for all shareholders.
"[L]iquidate a fund."	Provides shareholders with 100% of the value of their shares in cash, which shareholders may use to make new investments.

In light of recent developments, trustees should think carefully before accommodating an adviser's efforts to protect its position through control share measures. Not only have two courts found that control share bylaws violate Section 18(i) of the 1940 Act, but it is difficult to envision circumstances under which the implementation of a control share bylaw would not be viewed as entrenchment.[8]

The squawk around fund activists' tactics is not coming from so-called long-term retail shareholders who, in many cases, support and follow the efforts of major activists like Saba, but rather the industry itself, which prefers not having to justify its own performance or a fund's persistent discount.

While shareholders have much to gain in unlocking the value of their shares diminished by trading discounts, advisers have much to lose if their control over the fund is compromised.

The latter, however, should be of little consequence to trustees, who ultimately owe fiduciary duties to the investment company and its shareholders — not the fund's adviser — and likely should be siding with investors in many activist dust-ups. Trustees who choose the side of the

fund's adviser in such circumstances risk becoming litigation targets for seemingly no benefit to shareholders or even themselves.

In corporate America, the role of activists in advancing the long-term interests of stockholders has earned greater acceptance, and high-profile campaigns have surged in recent years, including with respect to environmental, social and governance issues.

Activism within investment companies has similar potential to deliver value to shareholders, and trustees should not be the parties constructing roadblocks, save in circumstances with truly compelling evidence of a likelihood of harm to the fund.

Correction: Citations in this article have been updated to reflect that the quotations in the table are from the defendants' memo in support of the motion to dismiss.

Aaron Morris is a partner at Morris Kandinov LLP.

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[1] Saba Cap. CEF Opportunities 1, Ltd. v. Nuveen Floating Rate Income Fund , No. 21-CV-00327 (JPO), 2022 WL 493554, at *1 (S.D.N.Y. Feb. 17, 2022).

[2] Eaton Vance Senior Income Trust v. Saba Capital Master Fund, Ltd. , No. 2084CV01533-BLS2, 2021 WL 1422031 (Mass. Super. Ct. Mar. 31, 2021).

[3] It's worth noting that the two cases challenging control share measures have involved funds organized in Massachusetts, which does not have a control share statute. Thus, the funds at issue implemented control share limitations through their bylaws. Maryland, also a common jurisdiction for funds, does has a control share statute that corporations may opt in to, and thus Maryland-domiciled funds typically enact control share measures through a board resolution. Under either circumstance, the effect of Section 18(i) would appear to be the same.

[4] Saba also prevailed in a case pending in the Arizona Superior Court involving a bylaw that changed the voting standard for trustee elections to a 60% standard, but that decision did not address Section 18(i). See Saba Capital CEF Opportunities 1 Ltd v. Voya Prime Rate Trust , No. CV 2020-005293, 2020 WL 5087054, at *3 (Ariz. Super. June 26, 2020).

[5] Defendants' Joint Memorandum Of Law In Support Of Their Motion To Dismiss Plaintiffs' Complaint, No. 1:21-cv-00327, ECF 39 (filed 3/30/21) at 1.

[6] Id. at 4 (as to all quotations in the table).

[7] The commentary in the right column of the chart is my own and does not derive from the opinions discussed herein, which have not addressed the merits of fund activism directly.

[8] The Eaton Vance case, which is currently in discovery, is likely to result in a ruling regarding whether the use of control share bylaws for entrenchment purposes constitutes a breach of fiduciary duty.

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