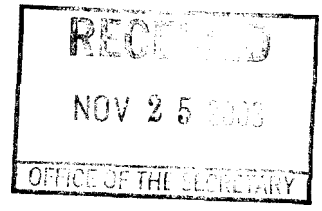
S7-14-03 149

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON. D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT



November 24,2003

Mi. Phillip Goldstein
60 Heritage Drive
Pleasantville, NY 10570
[By e-mail]

Dear Mr. Goldstein:

Thank you for your letter dated March 1,2003. We apologize for the delay in responding to you. In your letter, you request that the staff of the Division of Investment Management (the "Division") express its views on the court's decision in *Badlands Trust Co. v. First Financial Fund, Inc.,* No. 02-2088, Fed. Sec. L. Rep. (CCH) 192,274 (4th Cir. 2003) *("Badlands"),* which concerned a dispute over the procedures for electing the directors of a closed-end investment company.

Generally, the staff of the Division does not publicly comment on court decisions. When the Commission determines that its views would be in the public interest with respect to a matter under consideration by a court, the SEC's Office of General Counsel files an *amicus curiae* brief with the court on behalf of the Commission. The Commission did not file such a brief in the *Badlands* case.

As you may know, however, the Commission has been very concerned about corporate governance issues, and recently has focused particularly on the process for nominating and electing the directors of public companies, including registered investment companies such as closed-end funds. If you have not already done so, you may wish to review some of the materials that the Commission and staff recently have issued relating to these matters.[1] We

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[1] *See, e.g., Commission to Review Current Proxy Rules and Regulations to Improve Corporate Democracy*, SEC Press Release No. 2003-46 (Apr. 14, 2003); *Notice of Solicitation of Public Views Regarding Possible Changes to the Proxy Rules*, Securities Exchange Act Release No. 47778 (Apr. 14,2003); the SEC Division of Corporation Finance's *Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors* (July 15, *2003); Pro-posed Rule: Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors,* Investment Company Act Release No. 26145 **(Aug.** 8,2003); *SEC Proposes Rules to Increase Proxy Access by Shareholders,* SEC Press Release No. 2003-133 (Oct. 8, 2003); ***Proposed** Rule: Security Holder **Director** Nominations,* Investment Company Act Release No. 26206 (Oct. 14, 2003).

appreciate your sharing your views with us and will forward your letter for consideration in connection with the proposed proxy rule amendments.

Very truly yours,

Wendy Friedlander
Senior Counsel

Cc: Jonathan G. Katz, Secretary
File Nos. S7-19-03 and S7-14-03

60 Heritage Drive
Pleasantville, NY 10570
(914) 747-5262 // Fax: (914) 747-5258
March 1,2003

Douglas J. Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0506

Dear Mr. Scheidt:

I am the chairman of the board of The Mexico Equity and Income Fund, Inc. (the "Fund"). I originally intended, solely in order to solicit the views of the staff of the Division of Investment Management (the "Staff'), to request assurance from the Staff that it would not recommend any enforcement action to the Securities and Exchange Commission (the "Commission")under Section 16(a), Section 18(i) or Section 36(a) of the Investment Company Act of 1940, as mended (the "ICA") if the Fund's board of directors adopts a bylaw that would require that directors be elected by a majority of the shares eligible to vote ("MOTSETV"). However, because the board has no intention of adopting a MOTSETV bylaw, I elected to submit this letter in lieu of a formal "no action" request. There seems to be a disturbing trend among closed-end investment companies of adopting a MQTSETV bylaw' and it is likely this trend will continue in the absence of contrary guidance by the Staff. Therefore, please consider this letter a request for the Staff s views about whether a MQTSETV bylaw contravenes any of the aforementioned provisions of the ICA.

I. Background

On January 30,2003, the United States Court of Appeals for the Fourth Circuit, in *Badlands Trust Company v. First Fin. Fund, Inc.*, *2003* U.S. **App.** LEXIS 1492 (copy enclosed), found that (1) at a meeting of stockholders where the challengers received 59% of the votes cast for director of a registered closed-end investment company, no candidate received "a majority of the shares outstanding and entitled to vote thereon" as required for election under its bylaws and (2) no violation of Section 16(a) occurs if an incumbent director who was elected at an earlier meeting of stockholders (with or without opposition or under a different criterion for election) continues to serve after his or her term has expired as a result of a such a "failed election." As the court explained in *Badlands*, "This widely used, stopgap measure [of allowing holdover directors to serve after a failed election] provides for the smooth functioning of corporate governance."

[1] At least three closed-end investment companies have adopted a MOTSETV bylaw: First Financial Fund Inc., Aberdeen Australian Equity Fund Inc. and The SMALLCap Fund, Inc. Each of these funds adopted its MOTSETV bylaw in response to a potential proxy contest for election of directors by Stewart R. Horejsi, Bankgesellschaft Berlin **AG** and Ralph W. Bradshaw respectively. each of whose nominees would very likely have received more votes than the incumbent directors.

II. Relevant Provisions of the ICA

The only conceivable purpose of a MOTSETV bylaw is to delay or prevent a change of control by raising the bar for election of a challenger to a level higher than the norm in democratic societies which is a plurality of the votes cast. As a result, questions arise as to whether a MOTSETV bylaw unilaterally adopted by a board runs afoul of certain provisions of the ICA, specifically Section 16(a), Section 18(i) and Section 36(a).

Section 16(a)

As noted, in ***Badlands,*** the United States Court of Appeals for the Fourth Circuit determined that no violation of Section 16(a)[2] occurs if an incumbent director who was elected at an earlier meeting of stockholders continues to serve after his or her term has expired as a result of a failed election, i.e., one at which no directors were elected. However, the ***Badlands*** opinion does not address whether Section 16(a) requires an election for directors to be fair to all candidates and conform to democratic norms. Or, does Section 16(a) allow those directors in office unbridled discretion to determine the criteria for future elections, even if they choose to establish an uneven playing field?

Maryland law appears to leave the determination of the requirements for election to the board to the board's discretion. Section 2-401 of The Maryland General Corporation Law ("MGCL") provides: "(a) The business and affairs of a corporation shall be managed under the direction of a board of directors; (b) All powers of the corporation may be exercised by or under authority of the board of directors except as conferred on or reserved to the stockholders by law or by the charter or by-laws of the corporation." Moreover, no provision of the MGCL specifically prevents a board from establishing requirements for electing directors that has the effect of deterring or preventing a successful challenge to the incumbent directors.

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[2] Election of directors. No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting, securities of such company. at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting. In the event that at any time less than a majority of the directors of such company holding office at that time were so elected by the holders of the outstanding voting securities, the board of directors or proper officer of such company shall forthwith cause to be held as promptly as possible and in any event within sixty days a meeting of such holders for the purpose of electing directors to fill any existing vacancies in the board of directors unless the Commission shall by order extend such period. The foregoing provisions of this subsection shall not apply to members of an advisory board. (Emphasis added.)

Nothing herein shall, however, preclude a registered investment company from dividing its directors into classes if its charter, certificate of incorporation, articles of association, by-laws, trust indenture, or other instrument or the law under which it is organized, so provides and prescribes the tenure of office of the several classes: Provided, That no class shall be elected for a shorter period than one year or for **a** longer period than five years and the term of office of at least one class shall expire each year.

However, there is a substantial body of case law supporting the principle that corporate elections must be fair[3] and a board may not rely solely on its plenary authority to manage the business and affairs of the corporation "for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their right to undertake a proxy contest against management."[4] The Delaware Chancery Court, in *Aprahamian v. HBO &* Co., 531 A.2d 1204, 1206-07 (Del. Ch. 1987) stated:

> The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates. In the interests of corporate democracy, those in charge of the election machinery of a corporation must be held to the highest standards in providing for and conducting corporate elections.

A MOTSETV bylaw confers on the incumbent candidates an advantage that makes a contested election far less meaningful (democratic) than one in which the nominee receiving a plurality of the votes cast is elected. Therefore, I request that the Staff express its view as to whether a MOTSETV bylaw is inconsistent with the Section 16(a) requirement that directors be "elected to that office."

Also, *Badlands* is *an* unpublished opinion and as such, not binding precedent in the Fourth Circuit. Therefore, I ask that the Staff state whether or not it concurs with the court's position that if a MOTSETV bylaw amendment leads to a failed election, continued service by holdover directors who were originally elected without opposition is not inconsistent with Section 16(a).

Section 18(i)

Section 18(i) provides that "except as provided in subsection (a) of this section, or as otherwise required by law, every share of stock hereafter issued by a registered management company (except a common-law trust of the character described in section 16(c) [15 USCS § 80a-16(c)]) shall be a voting stock and have equal voting rights with every other outstanding voting stock." **A** MOTSETV bylaw could be construed as a *de facto* reduction in the voting rights of the stock of stockholders who, in a contested election, vote their stock for the challengers because (a) it makes a failed contested election likely and (b) such a failed election would be a *de facto* defeat for challengers receiving a plurality of the votes cast and a *defacto* victory for the incumbents – but not *vice versa.* Thus, a MOTSETV bylaw would arguably result in a diminution of the voting rights of the stock of stockholders seeking to replace the incumbents relative to the voting rights of the stock of stockholders seeking to retain them.

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[3] See, e.g.,, *Jewlecor Management, Inc. v. Thistle* ***Group*** *Holdings, Co.,* et al., March, 2002, No. 1623, First Jud. District of **PA,** Court of Common Pleas of Philadelphia County, ("Here, it is clear that a fair and honest election cannot be held and . . . therefore . . . an injunction is appropriate.")

[4] *Schell v. Chris-Craft Industries,* 285 A.2d 437 (Del. 1971)

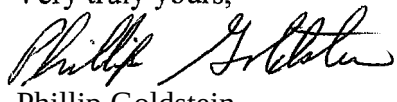
Section 36(a)

Section 36(a) authorizes the Commission to bring an action alleging that a person has engaged in "any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company." Adoption of a MOTSETV bylaw could well be construed as a breach of fiduciary duty involving personal misconduct because its primary purpose is to entrench the incumbent directors by depriving shareholders of a fair opportunity to vote to replace them.[5] In *Blasius v. Atlas Corp.*,[6] a landmark opinion that has been accepted by many federal and state courts, the Delaware Chancery Court determined that a board breaches its fiduciary duty when, absent a compelling justification, it acts for the primary purpose of interfering with the effectiveness of a shareholder vote. According to *Blasius*, such an action by a board does not enjoy any presumption of validity under the business judgment rule. As noted previously, interfering with the effectiveness of a shareholder vote appears to be the sole purpose of a MOTSETV bylaw.

III. Conclusion

Because (a) a MOTSETV bylaw raises issues with respect to Section 16(a), Section 18(i) and Section 36(a) of the ICA and (b) it appears likely that, barring a contrary view by the Staff, more closed-end funds will adopt a MOTSETV bylaw, I respectfully request that the Staff promptly consider these issues and express its views. If the Staff has any questions concerning this matter, please do not hesitate to contact me at (914) 747-5262.

Very truly yours,



Phillip Goldstein
Chairman of the Board of Directors
The Mexico Equity and Income Fund, Inc.

[5] See e.g., *Hilton Hotels Corporation v. ITT Corporation*, 978 F. Supp. 1342 (D. Nev. 1997) in which the court enjoined a plan whose primary purpose was "to impermissibly impede the exercise of the shareholder franchise." ("The right of shareholders to vote on directors at an annual meeting is a fundamental principle of corporate law.")

[6] 564 A.2d 651,659 (Del. Ch. 1988)

UNPUBLISHED

UNITED STATES COURT OF APPEALS

FOR THE FOURTH CIRCUIT

BADLANDS TRUST COMPANY, a South Dakota corporation, as Trustee for Lola Brown Trust No. 1B,

Plaintif-Appellee,

V.

FIRST FINANCIAL FUND, INCORPORATED, a Maryland corporation,

Defendant-Appellant.

NO. 02-2088

Appeal from the United States District Court
for the District of Maryland, at Baltimore.
J. Frederick Motz, District Judge.
(CA-02-2423-EM)

Argued: December 6, 2002

Decided: January **30,** 2003

Before WILKINS, MICHAEL, and KING, Circuit Judges.

Reversed by unpublished per curiam opinion.

COUNSEL

ARGUED: Jeffrey B. Maletta, KIRKPATRICK & LOCJSHART, L.L.P., Washington, D.C., for Appellant. James Harold Hulme, ARENT, FOX, KINTNER, PLOTKIN & KAHN, P.L.L.C., Washington, D.C., for Appellee. **ON BRIEF:** Donald B. Mitchell, Jr., J. Mar-

cus Meeks, ARENT, FOX, KINTNER, PLOTKIN & KAHN, P.L.L.C., Washington, D.C., for Appellee.

OPINION

PER CURIAM:

Badlands Trust Company (Badlands) sued First Financial Fund, Inc. (First Financial), seeking an injunction to require First Financial to seat two Badlands nominees as members of First Financial's board of directors. Badlands' nominees did not receive the number of votes required for election under First Financial's relevant bylaw. Badlands, however, argues that this bylaw violates Maryland corporation law and that the holdover of incumbent directors violates the federal Investment Company Act (ICA). The district court ordered First Financial to seat Badlands' nominees. Because we conclude that First Financial's bylaw is valid under Maryland law and that the practice of directors holding over does not violate the ICA, we reverse.

I.

Badlands is a large, but minority, shareholder in First Financial, holding almost forty percent of the shares. At an election for two directors at the annual meeting of shareholders in August 2002, the nominees supported by Badlands received almost sixty percent of the votes cast; the incumbents received roughly forty percent. The Badlands nominees, however, received only forty-seven percent of the outstanding shares eligible to vote. The incumbents received votes from roughly thirty-five percent of these outstanding shares. First Financial determined that under one of its bylaws, which requires that directors be elected by a majority of shares eligible to vote, no directors had been elected, resulting in a holdover of the two incumbents.

At the time of the annual meeting Badlands had a suit pending against First Financial in the United States District Court for the District of Maryland; Badlands was seeking information about First Financial shareholders. Badlands amended its complaint to claim that the bylaw for electing directors violated Maryland law and that the holdover violated federal law. Badlands also sought a preliminary injunction prohibiting the incumbent directors who stood for election in August 2000 from participating in board meetings. The district court granted Badlands' request for a preliminary injunction and enjoined First Financial from convening a meeting of its board until the court issued a final order. On September 19, 2002, the district court granted summary judgment for Badlands and enjoined First Financial to seat the Badlands nominees as directors. The district court stayed its final order temporarily, and we granted First Financial a stay pending appeal.

II.

Badlands argues first that First Financial's bylaw, requiring directors to be elected by a majority of shares eligible to vote rather than a majority of votes cast, violates Maryland corporation law. Maryland General Corporation Law (MGCL) contains two provisions relevant to this suit. First, MGCL § 2-404(d) states: "Unless the charter or bylaws of a corporation provide otherwise, a plurality of all the votes cast at a meeting at which a quorum is present is sufficient to elect a director." Md. Code *Ann.,* Corps & Ass'ns § 2-404(d) (1999). MGCL § 2-506(a) reads in relevant part: "Unless this article or the charter of a corporation provides otherwise, at a meeting of stockholders . . . [a] majority of all the votes cast at a meeting at which a quorum is present is sufficient to approve any matter which properly comes before the meeting." Md. Code *Ann.,* Corps & Ass'ns § 2-506(a) (1999).

Badlands argues that § 2-506(a) essentially caps the number of votes necessary for approval of a matter at a stockholder meeting, requiring only a majority of votes cast (assuming the presence of a quorum). Increasing vote number requirements beyond the statutory cap, Badlands says, can be achieved in only two ways — by corporate charter or by statute. Both parties agree that First Financial has not established a different voting requirement in its charter; its more strin-

gent requirement is only included in a bylaw. Badlands recognizes that § 2-404(d) allows election of directors by a plurality rather than a majority of votes cast. Section 2-404(d) also permits changes to its plurality default rule to be made in a corporation's bylaws as well as its charter. Badlands urges us, however, to adopt the view of the district court and conclude that § 2-404(d) only authorizes alternative voting requirements that are ***less*** stringent than § 2-506(a)'s standard, thus invalidating First Financial's ***more*** stringent rule.

Badlands makes two primary arguments in support **of** its claim. First, it says that § 2-404(d) does not "provide[ ] otherwise" for vote requirements in director elections, as required by § 2-506(a) to alter that provision's default rule. To "provide otherwise," the argument goes, § 2-404(d) would need to spell out a specific mechanism through which a corporation could implement a heightened voting requirement. The only standard explicitly established by § 2-404(d) is the lower, plurality requirement. The language in § 2-404(d) that allows a corporation to make changes in voting requirements in its bylaws, Badlands says, merely permits changes that are consistent with § 2-506(a) and does not "provide" an alternate voting scheme requiring ***more*** votes than specified under § 2-506(a). Changes in the bylaws, Badlands concludes, can be used to alter the voting requirement to something above (or below) the plurality of votes cast, as established by § 2-404(d), but such changes cannot be used to increase the number of votes required to a level above § 2-506(a)'s majority-of-votes-cast rule. Second, Badlands argues that the legislative history of § 2-506(a) makes clear that the Maryland legislature was attempting to cap the number of shareholder votes required for corporations to act to reduce the chances of failed elections and that § 2-404(d) was designed to make election of directors even easier. To conclude that § 2-404(d) allows corporations to raise the number of required votes (and thus increase the likelihood of a failed election) through the relatively easy mechanism of a bylaw change, Badlands says, would undercut the clear intent behind § 2-506(a) and § 2-404(d). According to Badlands, the failed election in this case resulted from the application of precisely the sort of heightened voting requirement that both provisions were designed to prohibit.

We disagree with Badlands on both accounts. First, § 2-404(d) does in fact create an exception to § 2-506(a); it does, as § 2-506(a)

is no ambiguity in the plain language of the statute, a court does not look to the legislative history. *Adamson*, 753 A.2d at 508 ("If the legislature's intentions are evident from the text of the statute, our inquiry normally will cease and the plain meaning of the statute will govern."); ***Williams,*** 753 A.2d at 49 ("Where the statutory language is plain and free from ambiguity, and expresses a definite and simple meaning, courts normally do not look beyond the words of the statute to determine legislative intent."); ***Tucker,*** 517 A.2d at 732 ("[W]here statutory provisions are clear and unambiguous, no construction or clarification is needed or permitted, it being the rule that a plainly worded statute must be construed without forced or subtle interpretations designed to extend or limit the scope of its operation."). We read these cases to mean that in Maryland, as elsewhere, when the text of the statute itself is not ambiguous, we do not look to the legislative history to create ambiguities.

We are left, then, with the clear commands of the statutes. Section 2-506(a) allows alterations in the voting requirement (from a majority of the votes cast) only **if** provided in the corporate charter or in article 2 of the MGCL. Although First Financial does not have such a provision in its charter, a provision in article 2 of the statute provides otherwise. Section 2-404(d) adopts an even lower voting requirement for the election of directors, but permits a different requirement to be established by charter or bylaw. First Financial's bylaws plainly establish a higher voting requirement for the election of new directors; they must be elected by a majority of the shares eligible to vote. Because First Financial's bylaw "provides otherwise," its bylaw is lawful and controls the outcome of this election.

Badlands' final argument also fails. Badlands notes that MGCL § 2-104(b)(4) explicitly allows corporations to include in their charters provisions raising the voting requirement above that provided by statute; § 2-110, which governs bylaws, contains no such provision. ***See*** Md. Code Ann., Corps & Ass'ns § 2-104(b)(4) & 2-110 (1999). Thus, Badlands argues, heightened voting requirements can only be included in corporate charters, not bylaws. This argument ignores the language of § 2-110, which does not provide ***a*** closed list of permissible subjects for bylaws, but instead specifically states that bylaws "may contain any provisions not inconsistent with law or the charter of the corporation." Md. Code **Ann.,** Corps & Ass'ns § 2-110 (1999).

Because a heightened voting requirement is not inconsistent with law or First Financial's charter, it can be included in the bylaws.

We conclude, therefore, that First Financial's bylaw requiring directors to be elected by a majority of eligible votes is valid under Maryland law. Because Badlands' nominees did not receive the required number of votes, its nominees cannot be seated as members of First Financial's Board of Directors.

III.

Because the district court found for Badlands on the state law question, it did not reach the issue of whether the holdover of directors violates the Investment Company Act of 1940 (ICA). Because we have concluded that the Badlands nominees were not validly elected under Maryland law, we must consider the federal law issue.

The Investment Company Act of 1940 (ICA) mandates, among other things, that "[n]o person shall serve as a director of a registered investment company unless elected to that office." 15 **U.S.C.** § 80a-16(a). It also permits corporations to divide directors into classes, but it requires that the term of at least one class expire every year. ***Id.*** Badlands asserts that it has an implied private right of action to enforce violations of this statute and that First Financial's holdover of directors violates the statute in two ways. First, it suggests that because the incumbent directors are holding over, they were not "elected to that office" as required by § 80a-16(a). Second, it argues that even if the directors were elected, some portion of the board — one class — must step down from the board every year.

Whether Badlands has an implied right of action under § 80a-16(a) is an interesting and debatable question. ***Compare*** *Lessler* ***v. Little,*** 857 F.2d 866, 871-73 (1st Cir. 1988) (allowing a private right of action under § 80a-17(a)(2) of the ICA), ***with Olmstead v.*** *Pruco* ***Life Ins.*** *Co.*, 283 F.3d 429, 436 (2d Cir. 2002) (concluding that §§ 80a-26(f) and 80a-27(i) of the ICA did not create private rights of action).

Even if § 80a-16 does provide a private right of action, Badlands would still be unable to prevail because the holdover of the incumbent