SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–25259, File No. S7–21–01]

RIN 3235–AH81

Investment Company Mergers

AGENCY: Securities and Exchange Commission (''Commission'').

ACTION: Proposed rule.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Company Act of 1940 that permits mergers and other business combinations between certain affiliated investment companies. The proposed amendments would expand the types of business combinations exempted by the rule, codifying the relief provided in Commission exemptive orders. The amendments also would make the rule, for the first time, available for mergers between registered investment companies and certain unregistered entities. The proposed amendments are designed to reduce burdens on investment companies by eliminating the need to obtain Commission approval while protecting investors in these companies.

DATES: Comments must be received on or before January 18, 2002.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically to the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–21–01; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (*http://www.sec.gov*).[1]

FOR FURTHER INFORMATION CONTACT: Hester M. Peirce, Senior Counsel, or Martha B. Peterson, Special Counsel, at (202) 942–0690, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed amendments to rule 17a–8 [17 CFR 270.17a–8] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the ''Investment Company Act'' or the ''Act'').

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Executive Summary

The Commission is proposing amendments to rule 17a–8 under the Investment Company Act, the rule that permits affiliated registered investment companies and series or portfolios of registered investment companies (''funds'') to merge without first obtaining an exemptive order from the Commission. Currently, rule 17a–8 permits such a merger only when the participating funds are affiliated solely because they have a common investment adviser, common directors, and/or common officers.[2] The amendments that we propose today would expand the availability of the rule to include the merger of funds that are affiliated for other reasons, such as when the funds have common large shareholders. The amendments also would permit a fund and an affiliated bank common trust fund or collective trust fund to merge under the rule. Under the proposed amendments, funds would have to comply with certain new conditions for relief.

I. Introduction

Section 17(a) of the Investment Company Act prohibits an affiliated person[3] of a fund[4] from selling any security or other property (''assets'') to or buying assets from the fund (''affiliated transactions''). This prohibition was intended to prevent self-dealing and other forms of overreaching of a fund by its affiliates.[5] Section 17(a) protects investors by prohibiting a purchase or sale transaction when a party to the transaction has both the ability and the pecuniary incentive to influence the actions of the fund.[6]

[1] We do not edit personal, identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] Unless otherwise noted, all references to ''rule 17a–8'' or any paragraph of the rule will be to 17 CFR 270.17a–8.

[3] The Act defines an ''affiliated person'' of another person as:

(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

15 U.S.C. 80a–2(a)(3). Unless otherwise noted, in this release, we will use the term ''affiliate'' to include both affiliated persons of the fund (sometimes referred to as ''first-tier affiliates'') and affiliated persons of those affiliated persons (sometimes referred to as ''second-tier affiliates''). Section 17(a) also reaches transactions with a promoter of or a principal underwriter for a fund and affiliated persons of a fund's promoter or principal underwriter. In this release, we will use the term ''affiliates'' to encompass these persons also.

[4] Unless otherwise noted, we use the term ''fund'' in this release to refer to both registered investment companies and series or portfolios of registered investment companies.

[5] 15 U.S.C. 80a–17(a). This purpose is clear from section 17(b), which directs the Commission to grant an application for an exemption from section 17(a) if, along with other factors, the terms of the transaction at issue ''are reasonable and fair, and do not involve overreaching on the part of any person concerned.'' *See also* Adoption of Rules and a Related Form Applicable to Small Business Investment Companies Licensed by the Small Business Administration to Provide Exemption From Certain Requirements of Sections 17(a), 17(d) and 18(c) of the Investment Company Act of 1940, Investment Company Act Release No. 3361 (Nov. 17, 1961) [26 FR 11238 (Nov. 29, 1961)] (''One of the basic purposes of Section 17(a) is to protect investment companies against overreaching by affiliated persons.''); In the Matter of Union Securities Corporation, Investment Company Act Release No. 136 (May 28, 1941) [6 FR 2638 (May 29, 1941)] (''The general purpose of Section 17(a) . . . is of course to eliminate dealings by ''insiders'' and intercompany transactions of the type which have too often, in the past served to facilitate 'unloading', 'bail-outs', 'milking', and similar abuses.'').

[6] *See* Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 10886 at text accompanying n.8 (Oct. 2, 1979) [44 FR 58521 (Oct. 10, 1979)] (''1979 Proposing Release'') (citing Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., at 256–59 (1940) (testimony by

Mergers[7] of affiliated funds[8] involve the purchase or sale of fund assets from or to an affiliated person and thus are prohibited by section 17(a).[9] Section 17(b) of the Investment Company Act authorizes the Commission to issue orders permitting affiliated transactions, including affiliated mergers, if (i) The terms of the proposed transaction are reasonable and fair and do not involve overreaching on the part of any person concerned, (ii) the proposed transaction is consistent with the policy of each fund, and (iii) the proposed transaction is consistent with the general purposes of the Act.[10]

After issuing numerous exemptive orders under the statute, we adopted rule 17a–8 in 1980 to permit mergers between funds if they are affiliated solely because they have common investment advisers, officers, and/or directors.[11] We concluded that investors in affiliated funds merging under the rule would be protected because affiliates of the merging funds whose interests were limited to serving as adviser, director or officer of the merging funds would not have both the ability and the pecuniary incentive to affect the terms of the merger, and because compliance with the rule's conditions would preclude the types of abuses that occurred in connection with fund mergers before 1940.[12]

The relief afforded by rule 17a–8, however, was conditioned upon the directors of each merging fund, including a majority of the independent directors,[13] concluding that the merger is in the best interests of the fund, and that the merger does not dilute the interests of existing fund shareholders.[14] In connection with our recent fund governance initiative, we further conditioned the rule's relief on a majority of the board of directors of each fund relying on the rule being independent directors and these directors selecting and nominating any other independent directors.[15] In addition, any legal counsel for the independent directors of a fund relying on the rule must be an independent legal counsel.[16]

Since we adopted rule 17a–8, fund mergers have been occurring with increasing frequency.[17] These mergers can benefit funds and their shareholders by, for example, lowering expenses and improving performance.[18] Although many mergers of affiliated funds qualify for relief under the rule, a growing number do not, and therefore require exemptive relief to proceed. Based on our experience in evaluating these requests for exemptive relief, we are proposing to amend the rule to make it available for an expanded range of affiliated mergers, and to incorporate conditions designed to protect investors of merging funds under the expanded rule. The proposed amendments, which we discuss in more detail below, would (i) make the rule available to affiliated funds regardless of the source of affiliation, (ii) make the rule available for mergers involving certain types of unregistered entities, (iii) include in the rule certain factors that fund directors must consider, if relevant, in assessing mergers, and (iv) require that the merger be approved by the shareholders of each merging fund that will not survive the merger.

II. Discussion

A. Mergers Between Registered Investment Companies

Since the adoption of rule 17a–8, and particularly in recent years, we have

David Schenker, Chief Counsel of the Commission's Investment Trust Study, which served as the basis for the Investment Company Act)).

[7] We use the term ''merger'' in the proposed amendments to rule 17a–8 and this release to include a merger, consolidation, or purchase or sale of substantially all of an entity's assets. Proposed rule 17a–8(b)(1). A fund merger typically occurs in one of three ways, each of which involves the purchase or sale of fund assets: (i) One fund purchases the portfolio assets of the other; (ii) one fund purchases all securities issued by the other; or (iii) securities issued by one fund are exchanged for all or substantially all of the portfolio assets of the other fund.

[8] Funds may be affiliated with one another in a number of different ways, including through: (i) A common investment adviser that controls both funds; (ii) a shareholder that owns five percent or more of both funds; (iii) ownership by one fund of more than five percent of the other, for example, in the master-feeder context; or (iv) the funds' status as series or portfolios of the same registered investment company that are controlled by the same investment adviser and officers and directors. *See* Marco Adelfio and Melissa Ivers, *Consolidations of Bank Proprietary Funds—Dealing with Additional Affiliations,* The Investment Lawyer, Nov. 1999, at 13–14; Philip H. Newman and Edward T. O'Dell, *Master-Feeder Funds,* ALI–ABA Course of Study, June 11, 1998, 37 at 41; Philip H. Newman and Edward T. O'Dell, *Series Companies,* ALI–ABA Course of Study, June 11, 1998, 51 at 55. *See also infra* note 20.

[9] Congress intended the Act to cover mergers. *See* 15 U.S.C. 80a–1(b)(6) (''the national public interest and the interest of investors are adversely affected— * * * when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders'').

[10] 15 U.S.C. 80a–17(b).

[11] *See* Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 11053 (Feb. 19, 1980) [45 FR 12408 (Feb. 26, 1980)] (''1980 Adopting Release''). Funds with the same investment advisers, officers, and/or directors do not fit explicitly within one of the categories of affiliation set forth in section 2(a)(3) of the Act, 15 U.S.C. 80a–2(a)(3). *See supra* note 3. Such funds, however, may be affiliated under section 2(a)(3)(C), because they are under common control. The determination of whether these funds are under common control turns on whether the adviser, officers, or directors control the funds, which depends on the relevant facts and circumstances. *See, e.g.,* 1980 Adopting Release, *supra,* at n.2 (rule 17a–8 ''does not represent a Commission finding that investment companies having common officers, directors or investment advisers are always affiliated persons or affiliated persons of an affiliated person. They may or may not be, depending on the facts.''); 1979 Proposing Release, *supra* note 6, at n.5 (''An investment company is usually 'controlled' by its investment adviser. 'Only in the very rare case where the adviser's role is simply that of advising others who may or may not elect to be guided by his advice . . . can the adviser realistically be deemed not in control.' '') (quoting Steadman Security Corp., Investment Company Act Release No. 9830 (June 29, 1977) [12 SEC Docket 1041 (July 12, 1977)] at n.81).

[12] *See* 1979 Proposing Release, *supra* note 6, at text accompanying nn.8–9 (in a merger between two funds affiliated by reason of sharing an investment adviser, directors and/or officers, ''no person who is responsible for evaluating and approving the terms of the transaction . . . would have a significant personal financial interest in improperly influencing these terms''). The Commission, in its 1939 report to Congress, identified numerous instances in which fund assets had been diverted to fund affiliates as a result of mergers. *See* Securities and Exchange Commission, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess., at 1414–15 (1939) (''Investment Trust Study''). In addition, mergers often effected changes in the nature of the funds' assets, the rights associated with certain shares, management contracts, and the corporate structure of the funds involved. *See id.* at 1024–28.

[13] We use the term independent director in this release to mean a director who is not an ''interested person'' of the fund, as that term is defined in section 2(a)(19) of the Act [15 U.S.C. 80a–2(a)(19)].

[14] Rule 17a–8(a).

[15] Rule 17a–8(c)(1). Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)] (''Fund Governance Release''). The compliance date for the new conditions is July 1, 2002.

[16] Rule 17a–8(c)(2). *See* 17 CFR 270.0–1(a)(6)(i) (defining ''independent legal counsel'').

[17] The staff estimates, based on an analysis of data from Morningstar, Inc., that the annual number of mergers increased from less than 50 in 1994 to 119 in 1995, and approximately 180 in both 1998 and 1999. In calendar year 2000, there were 252 mergers. Industry observers have remarked on the increasing pace of mergers. *See, e.g., Business in Brief,* Boston Herald, June 21, 2001 (''Mutual fund companies, faced with falling asset levels, are killing ailing funds at almost double the rate of last year.''); Tamiko Toland, *How Many Fund Mergers in 2000,* MutualFundWire.com, Apr. 11, 2001 (citing data from Wiesenberger Financial suggesting that in 2001 the number of mergers could be 40% higher than it was in calendar year 2000); Lisa Singhania, *Companies Consolidate Funds to Get Rid of Laggards,* Milwaukee Journal Sentinel, Feb. 11, 2001, at 4D (''Mutual fund consolidations and liquidations are becoming more frequent because of the industry's rapid growth in the 1990s.''); Lori Pizzani, *Marketing: Scudder Kemper Merges, Eliminates Funds,* Mutual Fund Market News, Feb. 14, 2000, at 2,10 (observing trend towards consolidation in fund offerings by advisers).

[18] *See, e.g.,* Narayanan Jayaraman, *et al., An Analysis of the Determinants and Shareholder Wealth Effects of Mutual Fund Mergers,* J.Fin. (*forthcoming*) (manuscript at 23, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=279971#Paper_Download) (finding that target shareholders benefit from improved performance and lower expense ratios).

issued many exemptive orders permitting affiliated fund mergers that were unable to take advantage of the rule because the funds were affiliated for reasons other than having a common adviser, director or officer.[19] In many of these cases, an affiliate of the merging funds (often an investment adviser) held more than five percent of one or both merging funds, giving the affiliated party what we have presumed to be both the incentive (a substantial economic interest in the terms of the merger) and the means (influence that comes with being a large shareholder) to affect the terms of the merger for its own benefit.[20] In each case, after reviewing the exemptive application, we (or our staff acting under delegated authority) determined that the merger was fair and did not involve overreaching.

Today, we are proposing to extend the rule to permit mergers between registered funds regardless of the nature of the affiliation. As discussed in more detail below, in extending relief in this manner, we would rely on the fund board (including independent directors) to scrutinize the merger, and would require the merger to be approved by the shareholders of any fund not surviving the merger. Finally, we would add a provision to rule 17a–8 designed to prevent the use of the rule to circumvent the prohibitions against affiliated transactions.

We request comment on the proposed expansion of rule 17a–8 to permit mergers between affiliated funds regardless of the nature of their affiliation. We also request comment on whether the proposed conditions of the relief under the expanded rule are sufficient to protect investors, or whether any of the conditions are unnecessary to protect investors.

1. Board Determinations

Mergers of funds are governed not only by federal law, but also by state corporate or other law under which funds are organized. Those laws place substantial duties on fund directors considering a merger to act in the best interests of the fund and its shareholders.[21] Rule 17a–8 similarly relies on fund boards to review mergers of affiliated registered funds. The rule prescribes a special role for independent directors, a majority of whom must make the findings and thus consent to the merger and its terms.[22] As noted above, we recently amended rule 17a–8, along with a number of other exemptive rules, to strengthen the role that independent directors play. Under these exemptive rules, independent directors must constitute a majority of the board; they must be selected and nominated by other independent directors; and if they hire legal counsel, that counsel must be an independent legal counsel.[23] These amendments give us greater confidence, in proposing the amendments in this release, that independent directors will be in a position to influence the terms of the merger and to prevent abuses.

Relief under rule 17a–8 is conditioned on a determination by the board (including a majority of independent directors) of each participating fund that the merger is in the best interests of the fund.[24] In addition, a fund board must determine that the merger will not dilute the interests of the merging fund's shareholders.[25] In order to satisfy this latter provision, most mergers are effected on the basis of each merging fund's net asset value (''NAV''), as determined for the purpose of daily pricing under our rules.[26] The transparency of share value at which mergers occur reduces considerably the opportunity for affiliated persons to take advantage of the fund by mispricing the transaction.

Mispricing is not the only problem that can arise in connection with fund mergers. A merger could result in an increase in fees and expenses borne by shareholders (despite the greater economies of scale that a merger typically will achieve),[27] and could have negative tax consequences for shareholders. The merger also could result in a combination of funds with different investment objectives, thereby substantially changing the character of the surviving fund,[28] or the costs of the merger could be unfairly allocated to or among the merging funds. We have taken these issues into account in considering applications for exemptive relief under section 17(b).[29] In order to ensure that boards weigh these issues in their deliberations, we are proposing to include in the rule a number of factors that directors must consider, if relevant, in determining whether the merger is in the best interests of the fund: [30]

[19] From the beginning of 1989 through the end of 2000, we received 130 applications for exemption from section 17(a) for affiliated fund mergers. In calendar year 2000 alone the staff issued 22 orders for exemptive relief covering 165 fund mergers that did not qualify for relief under rule 17a–8. (Typically, one exemptive order gives relief to mergers between multiple series or portfolios of the participating investment companies.)

[20] Ownership by an affiliate of one fund of five percent or more of the other fund gives rise to an affiliation that precludes funds from relying on current rule 17a–8. The affiliate of the first fund, by virtue of its five percent ownership, would be affiliated with the second fund also. Each fund, therefore, would be a second-tier affiliate of the other. *See supra* note 3, which sets forth the Act's definition of ''affiliated person.'' *See, e.g.,* Boston 1784 Funds, Investment Company Act Release Nos. 24379 (Apr. 6, 2000) [65 FR 19941 (Apr. 13, 2000)] (notice) and 24435 (May 2, 2000) [72 SEC Docket 1058] (order); Touchstone Advisors, Inc., Investment Company Act Release Nos. 24371 (Mar. 31, 2000) [65 FR 18393 (Apr. 7, 2000)] (notice) and 24405 (Apr. 26, 2000) [72 SEC Docket 874] (order); HT Insight Funds, Inc., Investment Company Act Release Nos. 24270 (Jan. 28, 2000) [65 FR 5709 (Feb. 4, 2000)] (notice) and 24313 (Feb. 23, 2000) [71 SEC Docket 2214] (order). *See generally* Adelfio and Ivers, *supra* note , at 14.

[21] ''Directors of investment companies, like all directors, are subject to state law duties of care and loyalty.'' Edward Brodsky and M. Patricia Adamski, Law of Corporate Officers and Directors: Rights, Duties, and Liabilities § 17.02 (Supp. 2000). In the context of a merger, directors ''must be diligent and vigilant in examining critically the proposal and any alternatives, must act in good faith, must act with due care in considering all material information reasonably available, including information necessary to compare an offer to alternative courses of action, and, in certain contexts, negotiate actively to obtain the best available transaction for stockholders.'' Diane Holt Frankle, *Fiduciary Duties of Directors Considering a Business Combination,* PLI/Corp. 525, 531 (June 2000).

[22] Rule 17a–8(a).

[23] Rule 17a–8(c). *See also* 17 CFR 270.10f–3; 17 CFR 270.12b–1; 17 CFR 270.15a–4; 17 CFR 270.17a-7; 17 CFR 270.17d–1(d)(7); 17 CFR 270.17e–1; 17 CFR 270.17g–1(j); 17 CFR 270.18f–3; and 17 CFR 270.23c–3.

[24] Rule 17a–8(a)(1).

[25] Rule 17a–8(a)(2). sp;

[26] *See* rule 2a–4 [17 CFR 270.2a–4] (defining ''current net asset value''). Adjustments to NAV may be necessary for tax reasons. *See, e.g.,* Travelers Equities Fund, Inc., Investment Company Act Release Nos. 13840 (Mar. 22, 1984) [49 FR 12349–02 (Mar. 24, 1984)] (notice) and 13893 (Apr. 17, 1984) [30 SEC Docket 474] (order) (adjusting price at which merger would take place to compensate shareholders of acquired fund for capital gains taxes that might be incurred as a result of unrealized appreciation on pre-merger assets of the acquiring fund). p;

[27] *See e.g.,* Charles Gasparino, *Do Fund Mergers Hurt Small Investors?,* Wall Street Journal, July 8, 1997, at C1 (questioning whether economies of scale result in lower fees for shareholders). *But see Jayaraman, supra* note 18, at 23 (study of fund mergers showing that ''target fund shareholders also benefit from a reduction in their fund's expense ratio after the merger'').

[28] *See, e.g.,* Sandra Block, *Mergers Put More Funds on Extinction List,* USA Today, Mar. 22, 1999, at 1B (''We're seeing a lot of mergers where the new fund doesn't have the same objectives''') (quoting Christine Benz of Morningstar Inc.); Carole Gould, *Poof! For More and More Mutual Funds, A Quick Disappearing Act,* New York Times, Aug. 16, 1998, at 11 (''While mergers can sweep poor track records under the rug, they can pose a danger: Companies don't necessarily merge funds with similar objectives, so shareholders may end up with a different investment than they started with.''); Charles Jaffe, *Which Fund's Next to be Vaporized?* Could be Yours, Seattle Times, Oct. 16, 2000, at E2 (''Some mergers move money from one lackluster fund to the next while changing the kinds of assets your money is buying.'').

[29] As discussed above, one of the standards for exemptive relief for affiliated transactions under section 17(b) is that the terms of the transaction, including consideration paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned.

[30] Proposed rule 17a–8(a)(2)(ii).

• Direct or indirect federal income tax consequences of the merger to fund shareholders;[31]

• Fees or expenses that will be borne directly or indirectly by the fund in connection with the merger;[32]

• Effects of the merger on annual fund operating expenses and shareholder fees and services;[33] and

• Changes in the investment objectives, restrictions, and policies after the merger.[34]

This list of factors is not intended to be exhaustive and none of the factors would necessarily be determinative.[35] Nor would the addition of specific factors for consideration relieve a fund's board of directors or adviser of any obligation, under federal or state law, to consider other relevant factors.

We anticipate that our examinations staff, in the course of its periodic and other reviews of fund compliance, would review the board's analysis of the specific factors that we are proposing to include in rule 17a–8. In order to facilitate this review, the amended rule would continue to require that the board document its determinations and the factors underlying them in the minute books of the fund and retain the minute books as part of the record of the merger.[36]

The Commission requests comment whether the rule should include a list of factors for consideration by a fund's board in making its determination under the rule. Alternatively, should the factors be discussed in the adopting release rather than in the rule? Should any factors be omitted or modified? Should there be additional factors?

2. Shareholder Voting

a. Shareholder Approval

When we adopted rule 17a–8, we assumed that shareholders of acquired funds in an affiliated merger would have an opportunity to vote on the merger. State corporation statutes that govern funds typically impose such a requirement.[37] Congress recognized the importance of shareholder consent when it adopted section 1(b)(6) of the Act, which states that ''the national public interest and the interest of investors are adversely affected * * * when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders.''[38] When funds have sought exemptive orders for affiliated mergers, they have typically represented in their applications to us that shareholder approval would be obtained by the acquired fund before consummation of the merger.[39] Increasingly, however, funds have organized or reorganized as business trusts, which may not be required to receive shareholder approval before being acquired by another fund.[40] In light of this trend, we are proposing to amend the rule to require that shareholders of acquired funds have an opportunity to vote on affiliated mergers.[41] While a fund's board of directors is well-equipped to assess a merger, individual shareholders are best able to gauge the impact of the merger in light of their personal circumstances.

We request comment on the requirement that the merger be approved by the outstanding voting securities of any fund that will not survive the merger. Are there instances in which such a vote should not be required? We request comment on whether this provision would be inconsistent with the state laws under which some funds are organized. Would it be more appropriate to defer to state law? Do these state laws anticipate issues raised by mergers of affiliated funds? Would approval by independent directors be sufficient to protect investors in these funds? In the absence of a shareholder vote, would shareholders receive sufficient advance notice of the change in their investment through a merger? Should the outstanding voting securities of the fund that will survive the merger also be required to approve the merger?

b. Echo Voting

As discussed above, when we adopted rule 17a–8 in 1980, we designed the rule to be limited to affiliated mergers in which fund affiliates would not have both the ability and pecuniary incentive to affect the terms of the merger. An affiliate of one fund could have the ability to affect the terms of the merger if, for example, it held a large position in a second fund that is merging into the first fund. To prevent this, we propose to require that if an owner of more than five percent of the shares (''owner affiliate'') of the fund holding the vote is another merging fund, or an investment adviser, principal underwriter, or owner affiliate of another merging fund (''related shareholder''), the related shareholder must vote its shares in the same proportion as non-related shareholders (''echo voting'').[42]

We propose two exceptions to the echo voting requirement.[43] First, a related shareholder's securities could be voted in accordance with instructions received from the beneficial owner of the securities, provided that the beneficial owner is not also a related shareholder.[44] Second, a related shareholder's securities could be voted in accordance with instructions received from a person appointed to

[31] Proposed rule 17a–8(a)(2)(ii)(A).

[32] Proposed rule 17a–8(a)(2)(ii)(B).

[33] Proposed rule 17a–8(a)(2)(ii)(C) and (D).

[34] Proposed rule 17a–8(a)(2)(ii)(E).

[35] We set forth some of these factors when we proposed rule 17a–8 in 1979. *See* 1979 Proposing Release, *supra* note 6, at text accompanying nn.17–19.

[36] Proposed rule 17a–8(a)(2)(iv) and 17a–8(a)(6). Rule 31a–1(b)(4) [17 CFR 270.31a–1(b)(4)] requires funds to ''maintain and keep current'' minute books of directors' meetings, among other things. The Commission would not expect funds to maintain duplicate copies of the minute books (or relevant portions thereof) in the same place as other merger records.

[37] *See, e.g.*, Del. Code Ann. tit. 8, § 251(c) (2000); Md. Code Ann., Corps. & Ass'ns § 3–105(e) (2000); Mass. Gen. Laws Ann. ch. 156B, § 78(c)(1)(i), 79(c) (2000).

[38] 15 U.S.C. 80a–1(b)(6).

[39] *See, e.g.*, Barr Rosenberg Series Trust, Investment Company Act Release Nos. 24884 (Mar. 2, 2001) [66 FR 13983 (Mar. 8, 2001)] (notice) and 24914 (Mar. 26, 2001) [74 SEC Docket 1770] (order); Nationwide Mutual Funds, Investment Company Act Release Nos. 24855 (Feb. 7, 2001) [66 FR 10041 (Feb. 13, 2001)] (notice) and 24880 (Feb. 28, 2001) [74 SEC Docket 1257] (order); Strategist Growth Fund, Inc., Investment Company Act Release Nos. 24487 (June 1, 2000) [65 FR 36177 (June 7, 2000)] (notice) and 24546 (June 27, 2000) [72 SEC Docket 2345] (order).

[40] *See, e.g.*, Del. Code Ann. tit. 12, § 3806(a) (2000); Md. Code Ann., Corps. and Ass'ns § 12–207(b)(3) (2000) (the governing instrument for a business trust ''[m]ay provide for the taking of any action, including * * * the accomplishment of a merger or consolidation * * * without the vote or approval of any particular trustee or beneficial owner, or class, group, or series of trustees or beneficial owners''). *See also* Sheldon A. Jones, *et al.*, *The Massachusetts Business Trust and Registered Investment Companies*, 13 Del. J. Corp. L. 421, 458 (1988) (''[T]he business trust continues to offer a flexibility that corporations may not enjoy * * * The declaration of trust may provide that * * * the shareholder vote required to approve an action such as a consolidation, the sale of assets or an amendment to the declaration of trust can be less than required by state corporate law or can be eliminated * * *'').

[41] Proposed rule 17a–8(a)(3). The proposed rule requires that the outstanding voting securities of any fund that will not survive the merger approve the fund's participation in the merger, but defers to state law and the fund's governing documents to determine the percentage required for approval.

[42] Proposed rule 17a–8(a)(4)(i). Some fund advisers have represented in applications for exemptive relief in connection with fund mergers that they will echo vote shares held in their name. *See, e.g.*, John Hancock Variable Series Trust I, Investment Company Act Release Nos. 24776 (Nov. 30, 2000) [65 FR 76313 (Dec. 6, 2000)] and 24797 (Dec. 22, 2000) [73 SEC Docket 4190]; Prudential Series Fund, Investment Company Act Release Nos. 15190 (July 2, 1986) [51 FR 24959 (July 9, 1986)] and 15229 (July 29, 1986) [36 SEC Docket 347].

[43] Proposed rule 17a–8(a)(4)(ii).

[44] Often an investment adviser holds shares in a fiduciary capacity for the beneficial owners of the shares. In such a case, the fiduciary would be permitted to seek voting instructions from the beneficial owners. The proposed rule would not prevent a fiduciary or other related shareholder from advising the beneficial owners how the shares should be voted, after disclosing the nature of its affiliation with the other merging fund.

provide guidance on the voting of securities by a fiduciary of a plan under the Employee Retirement Income Security Act (ERISA).[45] Under these circumstances affiliates of merging funds would not seem to be able to influence the shareholder vote, and echo voting therefore would be unnecessary to protect the interests of shareholders.[46]

We request comment on our echo voting proposal. Does this provision raise any issues under state law? Are protections in addition to the proposed method of echo voting needed to ensure that shareholders and their affiliates do not improperly influence the merger process? Are the two exceptions to echo voting appropriate? Should we include in the rule any other exceptions to echo voting? Should shareholders other than those specified in the proposed rule be required to echo vote?

3. Recordkeeping

We propose to require, as a condition of rule 17a–8, that the fund surviving the merger preserve written records that document the merger and its terms.[47] The records would include, among other things, the minute books setting forth the board's determinations and the bases for those determinations, any supporting documents provided to the directors in connection with the merger, the independent evaluator's report in the case of a merger with an unregistered entity, and documentation of the prices at which securities were transferred in the merger. The recordkeeping requirement is intended to ensure that we have adequate information upon which to base an assessment of the merging funds' compliance with the rule's conditions.

B. Mergers of Registered Investment Companies and Certain Unregistered Entities

We are proposing to amend rule 17a–8 to also exempt mergers of funds with bank common trust funds[48] or bank collective trust funds[49] as long as the survivor of the merger is a registered investment company.[50] Currently, rule 17a–8 is available only for mergers of *registered* investment companies. When we proposed rule 17a–8 in 1979, we deferred consideration of whether transactions involving unregistered entities should be eligible for relief under the rule.[51] Today, there are a growing number of these transactions, particularly mergers involving bank common trust funds and bank collective trust funds.[52] These mergers may be effected pursuant to a Commission exemptive order under section 17(b).[53] Alternatively, these mergers may proceed under rule 17a–7, which generally permits purchase and sale transactions of readily marketable securities between a fund and certain of its affiliates if a number of conditions are met.[54]

Funds merging with affiliated common and collective trust funds under the proposed amendments to rule 17a–8 would also have to comply with a special pricing condition.[55] As noted above, when two funds merge, each board, as part of its determination that the interests of existing shareholders will not be diluted, generally has concluded that the merger is occurring on the basis of the relative NAVs of the merging funds.[56] Funds' practice of daily calculating their NAVs according to well-established procedures diminishes the likelihood that assets will be mispriced for purposes of a merger.[57] No such safeguard against mispricing of assets exists for mergers with affiliated unregistered entities, which may not calculate NAV on a daily basis or in accordance with well-established procedures as funds do. Therefore, the proposed rule would require that the board of directors of any fund that is merging with an affiliated unregistered entity approve procedures for the valuation of the unregistered

[45] 29 U.S.C. 1001–1461.

[46] For purposes of echo voting, the votes of securities that are voted pursuant to either of these exceptions would be treated as votes of securities held by shareholders who are not related in calculating the proportional voting of securities. Proposed rule 17a–8(a)(4)(iii).

[47] Proposed rule 17a–8(a)(6) (requiring the company to keep these records for six years after the merger and, for the first two years, in an easily accessible place). Thus, the Commission anticipates that the merger records of the acquired fund would be retained together with those of the surviving fund.

[48] Generally, common trust funds and similar funds—for convenience, this release refers to all of these funds as ''common trust funds''—are eligible to be exempt from registration under section 3(c)(3) of the Act [15 U.S.C. 80a–3(c)(3)], which provides for the exemption of ''any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian, if—(A) such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose; (B) except in connection with the ordinary advertising of the bank's fiduciary services, interests in such fund are not—(i) advertised; or (ii) offered for sale to the general public; and (C) fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable Federal or State law.''

[49] Collective trust funds, which are also known as ''collective investment funds,'' are exempt from registration under section 3(c)(11) of the Act [15 U.S.C. 80a–3(c)(11)], which provides for the exemption of ''any collective trust fund maintained by a bank consisting solely of assets of [any employee's stock bonus, pension or profit-sharing trust which meets requirements for qualification under section 401 of the Internal Revenue Code of 1986 or any governmental plan described in section 3(a)(2)(C) of the Securities Act of 1933] or both.''

[50] *See* proposed rule 17a–8(a)(1).

[51] *See* 1979 Proposing Release, *supra* note 6, at n.14 (''The proposed rule * * * would not apply, for example, to a transaction involving a company which is not registered under the Act * * * However, should such transactions begin to occur frequently the Commission then will consider whether those transactions would merit consideration as a separate subject for rulemaking.'').

[52] *See generally* Kathy Anderson and Peter Cappacio, *The Issue of Converting Common Trust Funds to Mutual Funds*, Trusts and Estates, Sept. 1994, at 18 (discussing reasons for converting common trust funds into proprietary mutual funds).

[53] Generally, exemptive applications involving the transfer of substantially all of the assets of bank common trust funds or collective trust funds to affiliated registered open-end investment companies represent that these transfers will satisfy the conditions in rules 17a–7 [17 CFR 270.17a–7] and 17a–8 with the exception of the requirement in rule 17a–7(a) that cash be the only consideration. *See, e.g.*, Nations Fund Trust, Investment Company Act Release Nos. 24335 (Mar. 9, 2000) [65 FR 14000 (Mar. 15, 2000)] (notice) and 24373 (Mar. 31, 2000) [72 SEC Docket 378] (order) (common trust fund); Wilmington Trust Company, Investment Company Act Release Nos. 23238 (June 2, 1998) [63 FR 31252 (June 8, 1998)] (notice) and 23285 (June 25, 1998) [67 SEC Docket 1248] (order) (collective investment fund).

[54] *See* rule 17a–7 [17 CFR 270.17a–7]. Affiliated mergers generally are not able to satisfy all of the conditions in rule 17a–7, particularly the requirement in rule 17a–7(a) [17 CFR 270.17a–7(a)] that the only consideration paid be cash. Typically, assets of the unregistered entity are exchanged for shares of the acquiring fund rather than for cash. The staff has issued no-action letters under section 17(a) and rule 17a–7 to funds seeking to merge with unregistered entities despite noncompliance with the cash consideration condition. *See, e.g.*, DFA Investment Trust Company, SEC No-Action Letter (Oct. 17, 1995); Federated Investors, SEC No-Action Letter (Apr. 21, 1994); First National Bank of Chicago, SEC No-Action Letter (Sept. 22, 1992). In the event that we adopt the proposed amendments to rule 17a–8, it is our intention that all mergers of funds with other funds, bank common trust funds, and bank collective trust funds, or any other affiliated entities will occur either (i) in compliance with rule 17a–8 or (ii) pursuant to an exemptive order under section 17(b).

[55] Proposed rule 17a–8(a)(2)(iii). The trustees of a common trust fund or collective trust fund participating in a merger would not be required to make the determinations and underlying findings set forth in rule 17a–8(a)(2) because those entities are not investment companies under the Act.

[56] *See* 1979 Proposing Release, *supra* note 6, at text accompanying n.3 (''The number of shares exchanged for shares of the liquidating investment company typically is determined on the basis of the relative net asset values of the participating investment companies so that the interests of existing shareholders of either investment company are not diluted.''). Each merging fund generally calculates its NAV in accordance with the valuation procedures set forth in the fund's prospectus and statement of additional information. The fund's board may determine that adjustments to NAV should be made for assets subject to large capital gains taxes or for assets that carry with them capital losses.

[57] Rule 22c–1(b) [17 CFR 270.22c–1(b)] requires, subject to certain exceptions, that funds compute NAV at least daily.

entity's assets.[58] These procedures, among other things, must provide for the preparation of a report by an independent evaluator[59] that sets forth the current fair market value[60] (as of the date of the merger) of each asset that will be transferred by the unregistered entity to the fund in the merger.[61]

We request comment on the expansion of rule 17a–8 to include mergers with common and collective trust funds. We also request comment on the proposal to require directors of a fund merging with an unregistered entity to approve procedures for the valuation of the assets of the unregistered entity and on the use of an independent evaluator to value the assets of unregistered entities. We request comment on whether the rule should include any additional guidelines for the selection of an independent evaluator. Should the availability of exemptive relief for mergers involving these unregistered entities be subject to any other special conditions? Should mergers with other types of unregistered entities be permitted under the rule?

C. Prohibition of Reliance on Rule 17a–8 for Certain Transactions

Rule 17a–8 is designed to facilitate mergers between affiliated funds that will generate benefits for each participating fund and its shareholders. We are concerned, however, that non-merger affiliated transactions that would otherwise be prohibited under the Act could be structured as mergers under rule 17a–8.[62] Accordingly, we propose to make the rule's exemptive relief available only for mergers that are not part of a plan or scheme to evade the affiliated transaction prohibitions of section 17(a) of the Act.[63]

We request comment on this proposed amendment to rule 17a–8. Is the proposed amendment necessary in light of section 48(a) of the Act, which prohibits a person from doing indirectly through another person what the person is prohibited from doing directly?[64] Would this provision serve to bring attention to such issues, or create uncertainty concerning the availability of the exception? Alternatively, should the rule prohibit specific improper transactions that are structured as mergers?

III. General Request for Comment

The Commission requests comment on the proposed rule amendments that are the subject of this release, suggestions for additional provisions or changes to the rule, and comments on other matters that might have an effect on the proposals contained in this release. The Commission encourages commenters to provide data to support their views.

IV. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. The proposed amendments to rule 17a–8 are designed to reduce costs incurred by funds and advisers by eliminating the need for Commission approval of mergers. The amendments also would supplement existing conditions of the rule, in order to ensure continued protection of fund shareholders in connection with affiliated fund mergers. The Commission has identified certain costs, which are discussed below, that may result from the proposed rule amendments. We request comment on the costs and benefits of the proposed rule amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

A. Benefits

We anticipate that funds, their shareholders, and their advisers and other affiliates would benefit from the proposed expansion of the scope of the rule to include mergers of affiliated funds, regardless of the nature of the affiliation, and mergers with common or collective trust funds. More merging funds would be able to rely on the rule and therefore would not have to obtain exemptive relief, which can be costly to merging funds, their shareholders, and their affiliates.[65] Thus, the proposed amendments would remove an obstacle to mergers of affiliated funds and could thereby reduce the costs of affiliated mergers.[66] Mergers give shareholders of small or poorly performing funds an opportunity to shift their assets to a better performing fund without negative tax consequences.[67] Liquidations are taxable events for fund shareholders, whereas fund mergers can be structured to be non-taxable. Investment advisers also could benefit from the greater ease with which mergers could be effected under the proposed amended rule because they often bear all or a portion of the costs of obtaining exemptive relief. In addition, investment advisers could realize enhanced economies of scale through fund mergers, which spread the costs of management, some of which are fixed, across a larger pool of assets.[68] Shareholders may benefit from these economies of scale in the form of lower fees and expenses.[69]

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58 Proposed rule 17a–8(a)(2)(iii).

59 We propose to define an ''independent evaluator'' as ''a person having expertise in the valuation of securities and other financial assets who is not an interested person, as defined in section 2(a)(19) of the Act, of the Common or Collective Trust Fund or any affiliate thereof except the Merging Company.'' Proposed rule 17a–8(b)(5).

60 We propose to define ''current fair market value'' as the ''current market price of securities or similar investments determined in accordance with rule 17a–7(b) under the Act * * * or, if market quotations are not readily available, the fair value of such investments.'' Proposed rule 17a–8(b)(6).

61 The independent evaluator's report would be included in the records of the merger that the surviving fund would be required to maintain under proposed rule 17a–8(a)(6).

62 For example, an adviser could structure a sale of assets to an affiliated fund by transferring the assets to an unregistered entity and then merging that entity with the affiliated fund.

63 Proposed rule 17a–8(a)(7).

64 15 U.S.C. 80a–47(a).

65 In calendar year 2000, exemptive orders were necessary for over 30% of affiliated fund mergers. We believe that these mergers would have been able to proceed under proposed rule 17a–8. As set forth below, we anticipate that there will be approximately 400 mergers annually. Thus, assuming that 30% of these would have had to proceed under an exemptive order, annually, approximately 120 mergers for which individualized exemptive relief would have been necessary will instead be able to proceed under the rule. The staff estimates, based on conversations with persons who have prepared exemptive applications for merger-related relief under section 17(b), that it costs an average of $36,000 to obtain an exemptive order permitting mergers of multiple portfolios of one or more affiliated registered investment companies. As discussed below, some funds may incur costs in complying with the rule's conditions that they otherwise would not have incurred. *See infra* Section IV.B.

66 The Commission staff anticipates that eliminating the need for merging funds to obtain individualized exemptive relief would not cause a significant increase in the number of mergers.

67 *See, e.g.,* Jayaraman, *supra* note 18, at 24 (finding that smaller funds are more likely to merge and that ''poor past performance increases the probability of a fund merger''); Michael L. Sapir and James A. Bernstein, *Reorganizations of Investment Companies,* 50 Bus. Law. 817, 823 (1995) (explaining that the elimination of a ''stunted fund'' is a common reason for a fund merger and can benefit the shareholders of that fund).

68 *See* Sapir and Bernstein, *supra* note, at 822 (mergers can ''increase the larger resulting fund's operating efficiencies,'' ''enhance the ability of the investment adviser to this larger fund to effect portfolio transactions on more favorable terms,'' and ''give the investment adviser greater flexibility and the ability to select a larger number of portfolio securities for the resulting fund, with the attendant ability to spread investment risks among a larger number of portfolio securities'').

69 *See* Jayaraman, *supra* note, at 23 (after a merger, ''target fund shareholders also benefit from a reduction in their fund's expense ratio after the merger''). *See also* Division of Investment Management, Securities and Exchange Commission, Report on Mutual Fund Fees and Expenses 56 (2000) (finding an inverse relationship between a fund's asset size and its expense ratio); Sapir and Bernstein, *supra* note, at n.22 (citations omitted) (''When one investment adviser acquires another investment adviser that provides substantially the same investment management and other services to another company that has a similar investment objective and policies as an investment company advised by the acquiring adviser, a reorganization of the two separate investment companies would benefit shareholders.'').

We believe that the proposed amendments, in addition to reducing costs faced by funds in connection with mergers, also may enhance the protections afforded by the rule to fund shareholders. We believe that the enumeration of certain factors for consideration by the board, if relevant, would assist a fund board, and particularly its independent directors, in scrutinizing a fund merger to ensure that it is in the best interests of the fund.[70] We believe that director scrutiny could serve as an effective tool for preventing the types of problems, discussed above, that can arise in connection with fund mergers.[71] The proposal to condition the rule's relief on approval of the merger by a majority of the outstanding voting securities of any acquired fund could benefit fund shareholders by giving them an opportunity to assess the merger in light of their own financial circumstances. Shareholders could benefit from the proposed restrictions on voting by related shareholders whose interests in the merger are defined primarily by an affiliation with another merger participant and may run counter to the interests of the fund holding the vote. These related shareholders would not be able to determine the outcome of a shareholder vote. Finally, we believe that the proposed rule's recordkeeping requirements would ensure that the Commission could assess merging funds' compliance with the rule and, therefore would encourage fund boards to carefully assess mergers. Shareholders could benefit from the resulting incentive on fund boards, because the directors are charged with representing shareholders' interests. We request comment on the nature and magnitude of the benefits afforded by the rule to funds, their investment advisers, and their shareholders.

B. Costs

Merging funds that choose to rely on proposed rule 17a–8, and their advisers, would incur certain costs in complying with the rule's conditions.[72] The supplemental conditions included in the proposed amendments, together with the increased numbers of merging funds likely to rely on the rule, could result in an increase in the aggregate annual cost of compliance with rule 17a–8.

The proposed amendments would eliminate the expenses of filing an exemptive application for certain merging funds.[73] Some of these expenses, however, are shared by a number of merging funds, and there may be certain increased compliance costs under the proposed rules for these merged funds.[74] In addition, some merging funds that would have been able to comply with current rule 17a–8, may face higher costs under the proposed amendments.[75] Finally, funds merging with bank common or collective trust funds will be able to avoid the expense of filing an exemptive application, but some funds may incur greater costs under the rule than they would have incurred otherwise, such as higher valuation costs because of the required independent evaluator's report. We believe, however, that even for these mergers the rule's costs would be justified by the combination of quantifiable benefits and intangible benefits afforded by the rule, such as enhanced shareholder protection and the elimination of the delay associated with obtaining an exemptive order.

The proposed rule is intended to ensure that boards thoroughly review merger transactions and their terms. Even in the absence of the amended rule, fund boards would meet to consider the merger.[76] Because the proposed rule would simply add factors for the board to consider during this meeting, the incremental costs attributable to consideration of these factors are likely to be minimal. We request comment on the nature and magnitude of these costs.

In conjunction with the expansion of the rule to unregistered entities, we are proposing to require that fund boards establish procedures for valuing the assets held by any common or collective trust funds participating in the merger. A mandatory part of the valuation procedures would be the preparation of a report by an independent evaluator, which the staff estimates would impose an aggregate annual cost of approximately $150,000.[77] We request comment on the cost of complying with the proposed provision governing the valuation of the assets of common or collective trust funds participating in a merger.

We anticipate that the condition in the rule requiring non-surviving funds to obtain shareholder approval would result in shareholder votes by only a few funds each year that otherwise would not have conducted shareholder votes.[78] The staff estimates that the cost of obtaining shareholder approval for a fund merger is approximately $75,000.[79] We request comment on the cost of complying with the proposed shareholder approval provision.

The echo voting requirement is likely to cause a merging fund that conducts a shareholder vote to incur some incremental administrative costs.[80] The fund holding a vote will have to provide a list of related shareholders to the entity charged with tabulating the votes and directions for implementing the voting method set forth in proposed rule 17a–8. The staff estimates, based on discussions with representatives of funds and service providers, that each acquired fund will incur a cost of $5,000 in complying with this provision.[81] We request comment on the nature and magnitude of these administrative costs.

We believe that the incremental costs associated with the recordkeeping

[70] *See supra* Section II.A.1 for a discussion of these factors.

[71] *See id.*

[72] The costs of a fund merger may be borne totally or in part by the investment adviser to one or both of the merging funds or may be borne by one or both of the merging funds. The allocation of costs of the merger is a product of negotiation between the boards of the merging funds and their investment adviser(s).

[73] *See supra* note 65 and accompanying text.

[74] Except in rare circumstances, it is unlikely that funds will experience significantly higher costs in conducting a merger under the amended rule. *See infra* notes 78–79 and accompanying text (discussing costs associated with conducting a shareholder vote).

[75] These increased costs may be attributable to the proposed rule's factors for board review, shareholder voting provisions, or recordkeeping requirements.

[76] For a discussion of factors that a board may consider during these meetings, *see* Sapir and Bernstein, *supra* note 67, at 825.

[77] The staff estimates, based on a review of fund filings, that there will be approximately 10 mergers each year involving common or collective trust funds. It is further estimated, based on discussions with professionals who have prepared similar valuation reports, that the preparation of an independent evaluator's report in each of these instances would cost approximately $15,000. We request comment on these estimates.

[78] For purposes of our Paperwork Reduction Act analysis, it is assumed that twenty funds each year will be affected. *See infra* Section VI. This estimate is based on the fact that the staff rarely sees fund mergers in which a shareholder vote is not held. Many funds are constrained by state law to conduct a shareholder vote in the event of a merger. Even funds that are not required by state law to obtain shareholder approval may do so in order to maintain good relations with their shareholders. We request comment on this estimate.

[79] This estimate, which is based on conversations with representatives of funds and service providers, includes the legal, mailing, printing, solicitation, and tabulation costs associated with a shareholder vote. For the estimated twenty affected funds, the annual aggregate cost of holding a shareholder vote (at a cost of $75,000 per fund) would be approximately $1,500,000. We request comment on these estimates.

[80] As described above, the fund's securities must be voted through echo voting or according to instructions by the beneficial owners of the securities (or according to the guidance provided by a person appointed by a named fiduciary acting on behalf of an ERISA plan).

[81] Although some acquiring funds may solicit shareholder approval, in a typical merger, only the shareholders of the acquired fund vote on the merger.

requirements in proposed rule 17a–8 would not be significant. We believe that most funds already retain the types of records that would be required by the proposed rule as a matter of good business practice. The current rule requires that the directors' findings and their bases be recorded in the minute books of the fund. The amended rule would retain this requirement at what we anticipate would continue to be a minimal cost even though the proposed amendments set forth a number of factors that the board must consider along with other relevant factors.[82] The amended rule would require the retention of written records describing the merger and its terms. Although the proposed six-year retention period for merger records may exceed the period for which funds would otherwise keep these types of records, it is consistent with the retention period applicable to many other records.[83] We believe, therefore, that the proposed recordkeeping requirement is unlikely to impose significant additional costs on funds. We request comment on the nature and magnitude of the costs of this requirement.

C. Request for Comment

The Commission requests comment on the potential costs and benefits identified in the proposal and any other costs or benefits that may result from the proposal. We request comment on the anticipated costs and benefits of the proposed amendments to rule 17a–8 compared to the costs and benefits of the rule in its current form. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[84] the Commission also requests information regarding the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide data to support their views.

V. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[85] The proposed rule amendments are intended to make rule 17a–8 available to a greater percentage of affiliated merging funds, thereby eliminating the need for most merging funds to obtain specific exemptive relief, which can be costly and time consuming.[86] The Commission anticipates that the modest amount of cost savings associated with the proposed rule amendments would not significantly affect the number of mergers, and therefore the amendments would not significantly affect efficiency, competition, or capital formation.[87] The proposed amendments also could eliminate disparities in costs incurred by affiliated funds that would have merged under the existing rule, versus those that would have merged through an exemptive order. This might create a positive, secondary competitive effect. As discussed above, however, a small number of funds could incur higher costs under the amended rule, and those costs might have some secondary effects on efficiency.

The Commission requests comments on whether the proposed rule amendments, if adopted, would promote efficiency, competition, and capital formation. Will the proposed amendments materially affect the number of fund mergers? Will any costs that result from the proposed amendments affect efficiency, competition, or capital formation? Comments will be considered by the Commission in satisfying its responsibilities under section 2(c) of the Investment Company Act. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VI. Paperwork Reduction Act

Rule 17a–8 enables affiliated investment companies to engage in mergers and similar business combinations without first obtaining from the Commission exemptive relief from section 17(a). The proposed amendments would both expand the rule's scope and include in the rule new conditions, some of which constitute new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520). The Commission is submitting these proposals to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

The title for the current collection of information is ''Rule 17a–8 under the Investment Company Act of 1940 [17 CFR 270.17a–8], 'Mergers of Certain Affiliated Investment Companies.' '' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The approved collection of information, which would be revised by the proposed amendments, displays control number 3235–0235. The staff believes that the proposed amendments will increase the annual hour burden associated with the rule, which is currently estimated to be 120 hours, and introduce an annual cost burden associated with the rule. The provision of information in accordance with amended rule 17a–8 would be voluntary, because rule 17a–8 is an exemptive rule and, therefore, funds may choose whether or not to rely on it. Because the proposed amendments do not require the provision of information to the Commission, this release does not address the confidentiality of responses under the proposed amendments to rule 17a–8.

The Commission staff anticipates that substantially all funds that engage in mergers with affiliated funds would rely on proposed rule 17a–8. Assuming that there will be approximately 400 mergers between affiliated funds or fund portfolios annually, we estimate that approximately 800 registered investment companies, or, in many cases, portfolios or series thereof, would be subject to the rule's information collection requirements annually.[88] The Commission staff estimates that merging funds would spend annually an aggregate of 600 hours—200 hours of professional time and 400 hours of clerical time—recording the relevant determinations of the boards of directors and preserving written records of the mergers and their terms.[89] The proposed amendments would require that written

[82] For purposes of the Paperwork Reduction Act analysis, the staff estimates that personnel of each fund will spend approximately .75 hours (.25 hours of professional time and .5 hours of clerical time) to satisfy the proposed rule's recordkeeping requirements in connection with a merger. *See infra* Section VI. We request comment on this estimate.

[83] *See* rule 31a–2 [17 CFR 270.31a–2].

[84] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996).

[85] 15 U.S.C. 80a–2(c).

[86] *See supra* Section IV.B.

[87] *See supra* Section IV.A. for a discussion of the cost savings.

[88] The staff estimate of approximately 400 mergers annually is higher than the approximately 279 mergers predicted for calendar year 2002 by a simple linear projection of merger data from 1993 through 2000. The staff believes, based on an evaluation of the number of mergers in recent years and current industry conditions, that 279 is an underestimate of the number of mergers that are likely to occur annually.

[89] The staff estimates, based on estimates made by the staff in 1999 in connection with the application for an extension of OMB's approval for the rule 17a–8 paperwork collection burden, that the proposed amendments would cause each of the approximately 800 participating portfolios or series of registered investment companies to incur an annual burden of .75 hours (.25 hours of professional time and .5 hours of clerical time) to record board resolutions documenting the board's findings and to preserve records of the merger transaction.

records describing the merger transaction and terms be maintained for six years after the merger, the first two in an easily accessible place.

The amended rule would require that directors of funds merging with unregistered entities [90] approve procedures for the valuation of the assets held by each unregistered entity. The approved procedures must provide for the preparation of a report by an independent evaluator to be used to value assets acquired in connection with the merger that sets forth the current fair market value (as of the date of the merger) of each security to be conveyed. Because a limited number of fund mergers involve a common or collective trust fund, the staff estimates that approximately ten merging funds would be covered by this provision in the first year following the adoption of this rule.[91] The Commission staff estimates, based on discussions with professionals who have prepared similar valuation reports, that an independent evaluator's report would cost approximately $15,000 and that, in the aggregate, the annual burden associated with this aspect of the rule will be approximately $150,000.[92]

The Commission staff believes that funds will incur a cost in connection with the echo voting provision in the proposed rule. A fund that conducts a vote will have to compile a list of each owner affiliate of the fund holding the vote that is another merging fund, or an investment adviser, principal underwriter, or owner affiliate of another merging fund (''related shareholder''). The fund will then have to ensure that the securities of related shareholders are echo voted unless they are voted according to instructions from the beneficial owners or a person appointed by a named fiduciary acting on behalf of an ERISA plan. The staff estimates, based on conversations with representatives of funds and service providers, that each acquired fund will incur a cost of $5,000 in complying with this provision.[93] The staff estimates, therefore, that the total annual cost associated with this provision will be approximately $2,000,000.[94]

There is a cost associated with obtaining the approval of the acquired fund's outstanding voting securities. The staff estimates that shareholder approval will be sought by approximately twenty funds each year that would not otherwise have conducted a shareholder vote.[95] The funds or their advisers incur legal, mailing, printing, solicitation, and tabulation costs in connection with a shareholder vote. We estimate, based on discussions with representatives of funds and service providers, that the total cost to an acquired fund of obtaining shareholder approval for a fund merger is approximately $75,000. Thus, we anticipate that the total annual cost associated with this provision will be approximately $1,500,000.

The Commission staff estimates that the paperwork burden arising from the proposed amendments reflects an increase in the paperwork burden associated with rule 17a–8 of 480 hours and an increase in the annual cost burden of approximately $3,650,000.[96] Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rule should direct them to the Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549–0609, with reference to File No. S7–21–01. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–21–01, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services.

VII. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding the proposed amendments to rule 17a–8 under the Investment Company Act. The following summarizes the IRFA.

The IRFA summarizes the background of the proposed amendments. The IRFA also discusses the reasons for the proposed amendments and the objectives of, and legal basis for, the amendments. Those items are discussed above in this release.

The IRFA discusses the effect of the proposed amendments on small entities. A small business or small organization (collectively, ''small entity'') for purposes of the Regulatory Flexibility Act is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[97] Of approximately 3,650 active funds, approximately 200 are small entities. Funds that are small entities, like other funds, will be affected by the proposed amendments only if they seek to merge with an affiliated fund or bank common trust fund or bank collective trust fund.

The IRFA states that the proposed rule amendments should not have a substantial impact on small entities. Like other funds, small entities will be affected by rule 17a–8 only if they enter into a merger with an affiliate and choose to rely on the rule.

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[90] As discussed above, the proposed amendments would extend rule 17a–8 to mergers with only certain types of unregistered entities, namely common and collective trust funds. *See supra* Section II.B.

[91] This estimate is based on a review of fund filings.

[92] *See supra* note 77, which sets forth the basis for this estimate.

[93] Although some acquiring funds may solicit shareholder approval, in a typical merger, only the shareholders of the acquired fund vote on the merger.

[94] In each of the estimated 400 mergers each year, we assume that there will be one acquired fund.

[95] This estimate is based on the fact that many funds are constrained by state law to conduct a shareholder vote in the event of a merger. Moreover, even funds that are not required by state law to obtain shareholder approval may do so in order to maintain good relations with their shareholders. We request comment on whether the estimate of twenty funds is reasonable.

[96] This figure is the total of the estimated $150,000 annual cost associated with valuing the securities of common and collective trust funds, the $1,500,000 annual cost associated with obtaining shareholder approval, and the approximately $2,000,000 annual cost associated with the echo voting provision.

[97] Rule 0–10 [17 CFR 270.0–10].

The IRFA states that Commission staff believes that the proposed rule amendments would not impose any reporting requirements on any person and would not materially increase other compliance requirements. As amended, the rule would continue to require that the board's findings and bases for those findings be recorded in the minute books of each registered company. The proposed rule would specify certain factors that the board must consider, if relevant, in connection with the finding that the merger is in the best interests of the fund. As a basis for the non-dilution finding, the board of directors of a merging fund would be required to establish procedures for valuing securities to be transferred to the fund by an unregistered entity participating in the merger. These procedures would include the preparation of a report by an ''independent evaluator'' setting forth the ''current fair market value'' of any securities to be received from an unregistered entity.[98] The IRFA describes the two provisions in the proposed rule related to shareholder voting.[99] Finally, the IRFA describes the requirement that any surviving fund maintain records relating to the merger transaction for six years, the first two in an easily accessible place, following the merger.

The IRFA explains that the proposed amendments could benefit funds, including small entities, by making the rule available to a greater number of merging funds. Funds that currently would have to file applications for exemptive relief could rely on the proposed rule.

The IRFA explains that the Commission has not identified any federal rules that duplicate or conflict with the proposed rule and rule amendments. The written records describing the merger and its terms that are required by the proposed rule may sometimes include some of the same records required by rules 31a–1 and 31a–2 under the Investment Company Act, but the IRFA explains that any overlap with these rules is expected to be insignificant.[100] The proposed rule would not require the maintenance of duplicate copies of any overlapping records.

The IRFA explains that the Commission has considered significant alternatives to the proposed amendments that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. The Commission believes that no alternative could carry out these objectives as effectively as the proposed amendments.

The Commission encourages the submission of comments on matters discussed in the IRFA. Specifically, comment is requested on the effects the proposed rule would have on small entities and the number of small entities that would be affected. Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect. These comments will be placed in the same public file as comments on the proposed rule amendments. A copy of the IRFA may be obtained by contacting Hester M. Peirce, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0506.

VIII. Statutory Authority

The Commission is proposing amendments to rule 17a–8 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), 80a–37(a)].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, 80a–39, unless otherwise noted;

* * * * *

2. Section 270.17a–8 is revised to read as follows:

§ 270.17a–8 Mergers of affiliated companies.

(a) *Exemption of affiliated Mergers.* A Merger of a registered investment company (or a series thereof) and one or more other registered investment companies (or series thereof), Common Trust Funds, or Collective Trust Funds is exempt from sections 17(a)(1) and (2) of the Act if:

(1) *Surviving Company.* The Surviving Company is a registered investment company (or a series thereof).

(2) *Board determinations.* As to any registered investment company (or series thereof) participating in the Merger (''Merging Company''):

(i) The board of directors, including a majority of the directors who are not interested persons of the Merging Company or of any other company or series participating in the Merger, determines that:

(A) Participation in the Merger is in the best interests of the Merging Company; and

(B) The interests of the Merging Company's existing shareholders will not be diluted as a result of the Merger.

(ii) The directors, in making the determination in paragraph (a)(2)(i)(A) of this section, consider at least the following factors, if relevant:

(A) Any direct or indirect federal income tax consequences of the Merger to the shareholders of the Merging Company;

(B) Any fees or expenses that the Merging Company will pay (directly or indirectly) in connection with the merger;

(C) Any change in fees or expenses to be paid or borne by shareholders of the Merging Company (directly or indirectly) after the Merger;

(D) Any change in services to be provided to shareholders of the Merging Company after the Merger; and

(E) Any change in investment objectives, restrictions, and policies after the Merger.

(iii) The directors, in making the determination in paragraph (a)(2)(i)(B) of this section, have approved procedures for the valuation of assets held by each Common or Collective Trust Fund participating in the merger. The approved procedures provide for the preparation of a report by an Independent Evaluator to be used to value assets acquired in connection with the Merger that sets forth the Current Fair Market Value as of the date of the Merger of each security and similar investment to be conveyed by each Common or Collective Trust Fund.

(iv) The determinations of the directors required in paragraph (a)(2)(i) of this section and the bases thereof are recorded fully in the minute books of the Merging Company.

(3) *Shareholder approval.* The outstanding voting securities of any Merging Company that is not a

[98] An ''independent evaluator'' would be defined as ''a person having expertise in the valuation of securities and other financial assets who is not an interested person, as defined in section 2(a)(19) of the Act, of the Common or Collective Trust Fund or any affiliate thereof except the Merging Company.'' Proposed rule 17a–8(b)(5). ''Current fair market value'' would be defined as ''the current market price of securities or similar investments determined in accordance with rule 17a–7(b) * * * or, if market quotations are not readily available, the fair value of such investments.'' Proposed rule 17a–8(b)(6).

[99] Proposed rule 17a–8(a)(3) and 17a–8(a)(4). These provisions are discussed above. *See supra* Section II.A.2.

[100] 17 CFR 270.31a–1 and 270.31a–2.

Surviving Company approve its participation in the Merger.

(4) *Echo voting.* (i) *General.* If a shareholder vote of a Merging Company is required to approve the Merger, any person who owns, controls, or holds with the power to vote more than five percent of the voting securities (''owner affiliate'') of the Merging Company and who is another Merging Company, or an investment adviser, principal underwriter, or owner affiliate of another Merging Company (collectively, ''related shareholders''), must vote those securities in the same proportion as the securities voted by shareholders who are not related shareholders (''echo voting'').

(ii) *Exceptions.* Echo voting of securities is not required if the related shareholder votes the securities in accordance with the instructions of the beneficial owner of the securities (if the beneficial owner is not a related shareholder), or in accordance with the instructions of a person who is not a related shareholder and who was appointed, for the purpose of providing guidance on the voting of securities of the Merging Company, by a fiduciary of a plan established under the Employee Retirement Income Security Act, 29 U.S.C. 1001–1461, that holds securities of the Merging Company.

(iii) *Calculating the vote.* In determining how to vote securities according to paragraph (a)(4)(i) of this section, securities voted pursuant to the exceptions of paragraph (a)(4)(ii) of this section must be treated as the votes of securities of shareholders that are not related shareholders.

(5) *Board composition; independent directors.* (i) A majority of the directors are not interested persons of the Merging Company and those directors select and nominate any other disinterested directors.

(ii) Any person who acts as legal counsel for the disinterested directors is an independent legal counsel.

(6) *Merger records.* Any Surviving Company that is a registered investment company preserves written records that describe the Merger and its terms for six years after the Merger (and for the first two years in an easily accessible place).

(7) *Prohibition against evasion.* The Merger is not part of a plan or scheme to evade the affiliated transaction prohibitions of section 17(a) of the Act.

(b) *Definitions.* For purposes of this section:

(1) *Merger* means the merger, consolidation, or purchase or sale of substantially all of the assets between a registered investment company (or a series thereof) and another company;

(2) *Collective Trust Fund* means a collective trust fund, as described in section 3(c)(11) of the Act;

(3) *Common Trust Fund* means a common trust fund or similar fund, as described in section 3(c)(3) of the Act;

(4) *Surviving Company* means a company in which shareholders of a Merging Company will obtain an interest as a result of a Merger;

(5) *Independent Evaluator* means a person having expertise in the valuation of securities and other financial assets who is not an interested person, as defined in section 2(a)(19) of the Act, of the Common or Collective Trust Fund or any affiliate thereof except the Merging Company; and

(6) *Current Fair Market Value* means the current market price of securities or similar investments determined in accordance with rule 17a–7(b) (§ 270.17a–7(b)) under the Act or, if market quotations are not readily available, the fair value of such investments.

By the Commission.

Dated: November 8, 2001.

Margaret H. McFarland,

Deputy Secretary.

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