

**MEMO# 14137**

November 13, 2001

## **SEC PROPOSED AMENDMENTS TO RULE 17A-8 UNDER THE INVESTMENT COMPANY ACT**

[14137] November 13, 2001 TO: SEC RULES COMMITTEE No. 90-01 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 20-01 RE: SEC PROPOSED AMENDMENTS TO RULE 17A-8 UNDER THE INVESTMENT COMPANY ACT The Securities and Exchange Commission has proposed amendments to Rule 17a-8 under the Investment Company Act of 1940, the rule that permits mergers and other business combinations between affiliated investment companies.<sup>1</sup> The proposed amendments would expand the types of business combinations exempted by the rule, largely codifying the relief provided in prior Commission exemptive orders. The proposed amendments also would make the rule available for mergers between registered investment companies and certain unregistered entities. Under the Commission's proposal, reliance on Rule 17a-8 would be subject to various conditions that relate to: (1) board determinations; (2) shareholder voting; (3) echo voting; and (4) recordkeeping. The Commission's release is available from the SEC's website at <http://www.sec.gov/rules/proposed/ic-25259.htm>, and it is summarized below. Comments on the proposed amendments to Rule 17a-8 are due to the Commission by January 18, 2002. We will hold a conference call to discuss issues to be addressed in the Institute's comment letter on Monday, December 3rd at 2:00 p.m. Eastern time. If you would like to participate on this call, please notify Stephanie Holly by sending an email to [sholly@ici.org](mailto:sholly@ici.org) that includes your name, firm, telephone number, and email address. Otherwise, please provide any comments you may have to Barry Simmons at 202/326-5823 (phone), 202/326-5827 (fax), or [bsimmons@ici.org](mailto:bsimmons@ici.org) (email), no later than Friday, November 30th. A.

**MERGERS OF REGISTERED FUNDS**

1. Board Determinations Currently, Rule 17a-8 permits affiliated funds to engage in mergers and other business combinations provided that the board (including a majority of independent directors) of each participating fund determines that the merger is in the best interests of the fund and that it will not dilute the interests of the merging fund's shareholders. Under the Commission's proposal, 1 SEC Release No. IC-25259 (November 8, 2001). 2 this condition would be modified to require fund boards to consider several factors, if relevant, in making this determination. Such factors include: 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. As is presently the case, the amended rule would continue to require documentation of the board's determination in the fund's books and records. Comment is

requested on whether the rule should include a list of factors for consideration, or whether instead of listing them in the rule, they should be discussed in the adopting release. Also, the Commission seeks comment on whether any of the above factors should be omitted or modified, or whether any other factors should be added.

2. Shareholder Voting Rule 17a-8 does not presently impose a shareholder voting requirement. The Release explains that historically, the Commission has assumed that in an affiliated merger the acquired fund's shareholders would have an opportunity to vote on the merger.<sup>2</sup> This is based in part on state corporation statutes, which typically impose such a requirement. The Release points out, however, that increasingly, funds have organized or reorganized as business trusts, which may not require shareholder approval for merger transactions. In light of this trend, the Commission is proposing to require that the shareholders of a fund that will not survive the merger to approve its participation in the merger. Comment is requested on this proposal and whether there are instances in which such a vote should not be required. Comment is also requested on whether this provision would be inconsistent with certain state laws, and whether it would be more appropriate to defer to state law. In addition, the Commission seeks comment on whether approval by independent directors would be sufficient to protect merging fund shareholders, and whether, in the absence of such a vote, shareholders would receive sufficient advance notice of the change in their investment. Finally, comment is sought on whether shareholders of the surviving fund should be required to approve the merger.

2 The Commission explains that when funds have sought exemptive orders for affiliated mergers, they have typically represented in their applications that shareholder approval would be obtained by the target fund before the merger was consummated.

3. Echo Voting The proposed amendments impose an "echo voting" requirement. Specifically, the amendments would require that if an owner of more than five percent of the shares of the fund ("owner affiliate") holding the vote is another merging fund, or an investment adviser, principal underwriter, or owner affiliate of another merging fund ("related shareholder"), then the related shareholder must vote its shares in the same proportion as non-related shareholders. The Release explains that this requirement is intended to provide protection in a situation where a fund affiliate otherwise would have both the ability and pecuniary incentive to affect the terms of the merger. The Commission has proposed two exceptions to the echo voting requirement. 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. Second, a related shareholder's securities could be voted in accordance with instructions received from a person appointed to provide guidance on the voting securities by a fiduciary of a plan under the Employee Retirement Income Security Act ("ERISA"). Comment is requested on whether the echo voting proposal raises any issues under state law. Comment is also requested on whether any protections in addition to the echo voting proposal are needed to ensure that shareholders and their affiliates do not improperly influence the merger process. Also, the Commission seeks comment on whether the two exceptions to the proposal are appropriate, and whether any other exceptions are needed.

4. Recordkeeping The Release provides that as a condition of Rule 17a-8, the surviving fund must preserve written records that document the merger and its terms. Such records would include, among other things, the minute books setting forth the board's determinations and the bases for those determinations, and 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 (see below), and documentation of the prices at which securities were transferred in the merger.

**B. MERGERS OF REGISTERED FUNDS AND CERTAIN UNREGISTERED ENTITIES** Currently, Rule 17a-8 is available only for registered funds. The Commission is proposing to amend the rule to exempt mergers of registered funds with bank common trust funds or bank collective trust funds, as long as the survivor

of the merger is a registered fund. In order to rely on this exemption, however, funds merging with affiliated common and collective trust funds would be subject to a special pricing condition. Specifically, the board of a registered fund that is merging with an affiliated unregistered entity would have to approve procedures for the valuation of that entity's assets. Those procedures would have to provide for an "independent evaluator" (as defined in the proposed amendments) to prepare a report setting forth the current fair market value of each asset to be transferred to the registered fund in the merger. The Release notes that this condition will protect against potential mispricing of assets of affiliated unregistered entities which, unlike registered funds, may not calculate NAV on a daily basis or in accordance with well-established procedures. Comment is requested on the proposal to expand the rule to include mergers with common and collective trust funds. Comment is also requested on the proposal to require directors of a registered 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. The Commission also seeks comment on whether such mergers should be subject to any other special conditions, and whether the rule should permit mergers with other types of unregistered entities.

C. SCOPE OF THE RULE

1. Proposed Expansion of Rule 17a-8 Rule 17a-8 currently is limited to mergers of funds that are affiliated solely because they share a common investment adviser, officer or director. The proposed amendments would expand the rule to cover mergers of affiliated funds regardless of the nature of their affiliation. Comment is requested on this change and on whether the proposed conditions for relief under the expanded rule are sufficient to protect investors, or whether any of them are unnecessary.

2. Prohibition on Evading Section 17(a) The Release notes the Commission's concern that non-merger affiliated transactions that otherwise would be prohibited under Section 17(a) of the Investment Company Act could be structured as mergers under Rule 17a-8. Accordingly, the Commission proposes to add as a condition for relief that a merger cannot be part of a plan or scheme to evade the affiliated transactions prohibitions of Section 17(a). Comment is requested on whether this provision is necessary in light of Section 48(a) of the Investment Company Act, which prohibits a person from doing indirectly through another person what the person is prohibited from doing directly. The Commission also seeks comment on whether the provision would create uncertainty and whether, as an alternative, the rule should prohibit specific improper transactions that are structured as mergers.

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