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Comment Letter on Proposed Amendments to Fund Merger Rules, January 2002

January 18, 2002

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Investment Company Mergers
(File No. S7-21-01)

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to provide comments on the Securities and Exchange Commission's proposed amendments to Rule 17a-8 under the Investment Company Act of 1940, the rule that permits mergers and other business combinations between certain affiliated registered investment companies ("funds").[2] The Commission's proposal would (1) make the rule available to affiliated funds regardless of the source of the affiliation, (2) make the rule available for mergers between funds and certain unregistered entities, (3) add to the rule certain factors that directors must consider, if relevant, when assessing proposed mergers, and (4) require approval of the merger by shareholders of any merging fund that will not survive the merger.

In 1998, the Institute submitted to the Commission staff a proposal to amend Rule 17a-8 as part of a package of recommendations regarding affiliated transactions under Section 17 of the Investment Company Act.[3] We are pleased that the Commission has undertaken to address this issue and we encourage the Commission to consider the other proposals in the submission as soon as possible.

The Institute generally supports the Commission's proposal. As indicated in our 1998 submission, the Commission has extensive experience granting exemptive relief in this area, forming a sound basis for rulemaking that will relieve burdens on funds and the Commission's staff alike.

While we generally support the proposal, we have several comments that are intended to ensure that the proposal achieves its intended goal of reducing burdens on funds while preserving important shareholder protections. In summary, our comments are as follows:

We oppose the Commission's proposal to codify in the rule the factors that boards should consider in determining that a fund merger is in the best interests of shareholders; instead, we recommend that the factors be set forth in the adopting release.

We support the proposed shareholder approval requirement, but only in circumstances where the terms of the merger would have a material effect on shareholders' interests.

We oppose the proposed echo voting requirement as it is unnecessary given the other protections provided by the rule.

We support the Commission's proposal to expand the rule to permit mergers between funds and unregistered entities, but we oppose the proposed pricing provision (including the requirement for an independent evaluator) and recommend instead that the registered fund utilize its pricing procedures to value the assets of the unregistered entity. We also recommend expanding the proposal to permit mergers involving other unregistered entities, such as insurance company separate accounts, among others.

We oppose the Commission's proposal to add a provision to the rule prohibiting certain transactions that would be prohibited under Section 17(a) of the Investment Company Act inasmuch as it would be redundant of Section 48(a) of the Act.

Each of these comments is discussed more fully below.

A. Mergers Between Registered Funds

1. Board Determinations

Rule 17a-8 permits affiliated funds to engage in mergers and other business combinations provided that the board of each participating fund (including a majority of each fund's independent directors) determines that the merger is in the best interests of the fund and that the merger will not dilute the interests of the fund's existing shareholders. In the original proposing and adopting releases for Rule 17a-8, the Commission instructed fund directors to consider all information that would be material in determining whether a merger is in the best interests of fund shareholders.[4] According to the releases, such information could include:

(1) the compatibility of the participating funds' investment objectives, policies, restrictions and portfolios; (2) the terms and conditions of the transaction that affect the price of the shares to be exchanged; and (3) any other direct or indirect costs to be incurred by the fund as a result of the transaction, such as the effect on the investment advisory contract, significant tax consequences, and brokerage expenses arising from any portfolio adjustment necessitated by the transaction.

Under the Commission's current proposal, these factors would be modified and codified in the rule. Thus, in determining whether a merger is in fund shareholders' best interests, the board, including a majority of the independent directors, would have to consider, if relevant: (1) any direct or indirect federal income tax consequences of the merger to the merging fund's shareholders; (2) any fees or expenses that the merging company will pay (directly or indirectly) in connection with the merger; (3) any change in fees or expenses to be paid or borne by shareholders of the merging company (directly or indirectly) after the merger; (4) any change in services to be provided to shareholders of the merging company after the merger; and (5) any change in investment objectives, restrictions, and policies after the merger.

The Institute does not dispute that these are generally appropriate factors for fund boards to consider in determining whether a merger is in the best interests of a fund's shareholders (although, as the proposal recognizes, they might not all be relevant in all cases). We do not believe, however, that it is either necessary or appropriate to codify them in the rule.

The Proposing Release suggests that codifying these factors will "ensure that boards weigh these issues in their deliberations."[5] The Release does not indicate, however, that fund boards have failed to consider appropriate factors when assessing affiliated fund mergers in the past, nor does it assert that the proposed expansion of the rule makes it necessary to include specific factors for boards to consider within the rule. In our view, while it might provide the Commission's examinations staff with a convenient checklist, codifying these particular factors would do little to enhance board deliberations. Indeed, it might tend to limit the board's considerations to these specific factors, contrary to the Commission's apparent intent.

Moreover, while we agree that in many instances the factors identified in the Commission's proposal will likely be the ones considered by a fund's board, it is inappropriate for the Commission to mandate in the rule any one set of factors that fund boards should consider. Nor should the rule mandate with such specificity how a board should reach its determination whether a proposed merger is in the best interests of the fund. The Commission recently adopted rule amendments intended to enhance the independence of directors of mutual funds that rely on various exemptive rules, including Rule 17a-8. It seems incongruous now to tell the board how to do its job. Instead, these factors could be discussed in the adopting release as examples of the types of factors that directors may consider in fulfilling their specific obligations under the rule. This approach would be consistent with the Commission's current approach under Rule 17a-8. It also would provide flexibility to the Commission, as it would obviate the need for rulemaking in the event that these factors change over time.

2. Shareholder Voting

Rule 17a-8 does not currently include any shareholder voting requirements. The Proposing Release notes that state corporation statutes that govern funds typically require approval of a merger by the outstanding voting securities of any fund that will not survive the merger (i.e., the acquired fund). The Release expresses concern, however, that increasingly, funds have organized or reorganized as business trusts, which, under various states' laws, may not be required to receive shareholder approval before being acquired by another fund. In response, the Commission's proposal would require approval by shareholders of the acquired fund before consummating any merger, regardless of applicable state law. According to the Proposing Release, "[w]hile a fund's board of directors is well-equipped to assess a merger, individual shareholders are best able to gauge the impact in light of their personal circumstances."[6]

The Institute agrees that it is appropriate to seek shareholder approval of proposed mergers that could have a material impact on shareholders' interests. We therefore support the general intent of the Commission's proposed shareholder voting requirement, but recommend that it be modified to target those mergers that would materially impact the interests of shareholders. Thus, our recommended approach would eliminate the need for a vote where the proposed merger would have little, if any, impact on shareholders' interests.

The shareholder voting requirements under the Investment Company Act provide a useful starting point for determining when shareholder approval should be required under Rule 17a-8. For example, if the merger would result in a change in the acquired fund's investment adviser, or the acquired fund's shareholders paying higher management fees or 12b-1 fees (or the imposition of a 12b-1 fee), a vote should be required.[7] In addition, similar to existing Investment Company Act requirements outside of the merger context, we recommend that shareholder approval be required under Rule 17a-8 when the acquired fund's board finds that a merger would result in a material change to the acquired fund's fundamental investment objective or policies.[8] Also, we recommend requiring a shareholder vote in the unlikely event that a merger would result in a taxable gain to any taxable shareholders of the acquired fund.

By contrast, there are numerous cases in which the impact of a fund merger on the acquired fund shareholders' interests is minimal or even nonexistent. For example, mergers involving funds with similar investment objectives that merge for the sole purpose of sharing the same fiscal year end would have virtually no impact on a shareholder's investment. In these types of situations, the board's responsibilities under the rule provide adequate investor protection and the costly and time-consuming process of soliciting shareholder approval is not justified.

Accordingly, the Commission should revise the proposed shareholder approval requirement to apply only in the event of (1) a change in the fund's investment adviser, (2) an increase in management fees or 12b-1 fees (or the imposition of a 12b-1 fee), (3) a finding by the acquired fund's board that the merger would result in a material change to the fund's fundamental investment objective or policies, or (4) a merger that results in a taxable gain to any taxable shareholders of the acquired fund. To further address the Commission's concerns about shareholder protections, we recommend that in the event that shareholder approval of a fund merger is not solicited, then the acquired fund should provide its shareholders with sufficient advance notice of the merger (e.g., 45 or 60 days).

On a related issue, the Proposing Release requests comment on whether the Commission should impose a shareholder approval requirement on the outstanding voting securities of the acquiring fund. The Institute does not believe that it is necessary to impose such a requirement, inasmuch as the shareholders of an acquiring fund are far less likely to be significantly affected by a fund merger. Thus, we support the Commission's proposal to rely on the fund's directors to determine whether the merger is in the best interests of the acquiring fund's shareholders.

3. Echo Voting

In addition to requiring a vote of shareholders of the acquired fund, the Commission's proposal would impose an "echo voting" requirement in certain circumstances. Specifically, 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 would have to vote its shares in the same proportion as non-related shareholders. The Proposing Release suggests that this requirement is necessary because the rule is being expanded to now cover affiliated mergers in which fund affiliates would have both the ability and pecuniary incentive to affect the terms of the merger.[9]

The Institute opposes the imposition of an echo voting requirement. In our view, such a requirement is unnecessary given the investor protection measures already provided in the rule. In particular, as noted above, Rule 17a-8 requires (and would continue to require) fund boards to determine that participating in a merger is in the best interests of fund shareholders and that their interests will not be diluted as a result of the merger. Moreover, the Proposing Release notes that given the new independent director provisions in the rule, "independent directors will be in a position to influence the terms of a merger and to prevent abuses."[10] As a result, we question how the abuses that an echo voting requirement is intended to prevent could arise, especially given that the terms of the merger will already be in place at the time of any shareholder vote.[11]

We also note that situations can arise in which a related shareholder will be unable to echo vote. It is true that the Commission's proposal would provide two exceptions from the echo voting requirement: the first where the fund receives voting instructions from a beneficial owner of the securities; and the second, where a fund receives voting instructions from a person appointed to provide guidance on the voting securities by an ERISA plan fiduciary. Neither exception, however, addresses the situation where a related shareholder, such as a bank trustee, is obligated to vote fund shares pursuant to other laws (e.g., state or common law) or a contractual arrangement that gives the related shareholder general voting authority. As a result, a related shareholder may not be able to comply with the echo voting requirement, which, in turn, would preclude reliance on the rule.[12]

In support of the echo voting requirement, the Proposing Release cites two exemptive applications in which fund advisers represented that they would echo vote shares held in their name. However, for the reasons noted above, we believe that imposing such a standard on all fund mergers under Rule 17a-8 would be unnecessary and problematic.

B. Mergers of Registered Funds and Certain Unregistered Entities

Historically, Rule 17a-8 has been available only for mergers involving registered investment companies. The Commission's proposal would expand the rule to permit fund mergers involving funds and certain unregistered entities—namely, bank common trust funds and bank collective trust funds—provided that the surviving entity is a registered fund. The Institute generally supports this proposal. Expanding the rule in this manner would further reduce burdens on funds and the Commission by eliminating the need to seek individual relief for these transactions. We have comments on two aspects of the proposed amendments regarding mergers with unregistered entities, as discussed below.

1. Pricing Provision

As a condition for expanding the rule to permit funds to merge with bank common trust funds and bank collective trust funds, the proposed amendments would require the board of the acquiring fund to approve procedures for the valuation of the unregistered entity's assets. Those procedures would have to provide for an "independent evaluator" (as defined in proposed Rule 17a-8(b)(5)) to prepare a report setting forth the "current fair market value" (as defined in proposed Rule 17a-8(b)(6)) of each asset that will be transferred by the unregistered entity to the fund in the merger. The Proposing Release explains that this requirement is intended to protect against potential mispricing of assets of affiliated unregistered entities which, unlike funds, may not calculate net asset values ("NAVs") on a daily basis or in accordance with well-established procedures.

The Institute opposes the "independent evaluator" requirement. While we recognize the importance of properly valuing the assets of an affiliated unregistered entity, we do not believe that it is necessary to require an independent evaluator to perform that function. The Proposing Release does not point to, nor are we aware of, any abuses in this area that would give rise to such a requirement.

In lieu of the "independent evaluator" requirement, we recommend that the surviving fund value the unregistered entity's assets using the same pricing procedures it uses to value its own assets (which procedures already have been approved by the acquiring fund's board). We recommend this approach for a number of reasons. First, the Investment Company Act regulates the registered fund's pricing of its assets, which provides a safeguard against mispricing. Applying the registered fund's pricing procedures to value the assets of the unregistered entity would provide a similar safeguard, and would obviate any perceived need for an independent evaluator.[13]

Second, the Institute's approach would avoid any pricing inconsistencies that could occur as a result of using an independent evaluator. Under the Commission's proposed pricing provision, the values of assets of an unregistered entity as determined by an independent evaluator could differ from those values as determined pursuant to the pricing procedures of an acquiring fund. In particular, in determining the fair value of securities for which market quotations are not readily available, unless the evaluator uses the same pricing methodologies to value the assets pre-merger as the fund will use to value the assets post-merger, discrepancies could result. These discrepancies could prove disruptive to the acquiring fund, which will be obligated to apply its own pricing procedures upon acquiring the unregistered entity's assets. Our proposal would eliminate the potential for such differences because the same procedures and methodologies would be used in pricing the assets of both portfolios.

2. Scope of the Rule

The Institute recommends that the scope of this provision of the proposal be expanded to include additional unregistered entities. Given that the proposed amendments would require the surviving entity in a merger between a registered fund and an unregistered entity to be a registered entity, and the other safeguards that would apply, it should not matter what type of unregistered entity is involved in the merger.

If the Commission determines not to expand the rule in this manner, however, then the Institute recommends that at the very least it consider expanding the rule to include insurance company separate accounts. These accounts are pooled investment vehicles analogous to bank collective trust funds in their operation and structure. We note that the Commission has treated insurance company separate accounts and bank collective trust funds similarly for purposes of the exemption from registration under Section 3(c)(11) of the Investment Company Act. We see no valid reason for distinguishing between these types of entities for purposes of the proposed amendments to Rule 17a-8.

C. Prohibition on Evading Section 17(a)

The Commission's proposal would make Rule 17a-8 available only for mergers that are not part of a plan or scheme to evade the affiliated transactions prohibitions of Section 17(a) of the Investment Company Act. The Proposing Release explains that this condition is in response to the Commission's concern that non-merger affiliated transactions that would otherwise be prohibited under Section 17(a) could be structured as mergers under Rule 17a-8.

The Institute believes that this provision is unnecessary. As the Proposing Release points out, Section 48(a) of the Investment Company Act prohibits a person from doing indirectly through another person what the person is prohibited from doing directly. Because this catch-all provision applies to all transactions under the Investment Company Act, it is unclear what a similar provision under Rule 17a-8 would add. Furthermore, this "belt and suspenders" approach of selectively inserting this provision in one rule under the Act but not in others could be confusing and could have the unintended consequence of effectively eroding the importance of Section 48(a). If there are concerns about the use of Rule 17a-8 to circumvent Section 17(a), the Commission has ample authority under Section 48(a) to deal with those particular situations.

* * *

The Institute appreciates the opportunity to provide comment on this proposal. If you have any questions regarding our comments, or would like any additional information, please contact me at (202) 326-5824 or Barry E. Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director
Robert E. Plaze, Associate Director
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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes9,040 open-end investment companies ("mutual funds"), 484 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.906trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] SEC Release No. IC-25259 (November 8, 2001), 66 Fed. Reg. 57602 (Nov. 15, 2001) ("Proposing Release"). Rule 17a-8 currently exempts from the affiliated transaction prohibitions under Section 17(a) mergers, consolidations or purchases or sales of substantially all of the assets (collectively, "mergers") involving registered investment companies, which may be affiliated persons, or affiliated persons of affiliated persons, solely by reason of having a common investment adviser, common directors, and/or common officers, provided that certain conditions are met. Because of a growing number of mergers of financial services firms involving fund sponsors or advisers, many funds have become affiliated for reasons other than the existence of these common personnel, and, as a result, have had to pursue exemptive relief under Section 17(b) of the Investment Company Act in order to merge affiliated funds.

[3] See Letter from Craig S. Tyle, General Counsel, ICI, to Paul Roye, Director, Division of Investment Management, SEC, dated December 10, 1998. The Commission's proposal differs from the proposal we submitted in certain respects. In general, the Commission's proposal is broader in scope. In addition, it includes certain proposed conditions that were not part of the Institute's proposal.

[4] See Mergers and Consolidations Involving Registered Investment Companies, SEC Release No. 10886 (Oct. 2, 1979) (proposing release), and SEC Release No. 11053 (Feb. 19, 1980)(adopting release). In determining that a merger will not have a dilutive effect on shareholders' interests, fund boards generally have relied in large part on funds' practice of basing fund mergers on the relative net asset values of the funds involved in the merger.

[5] See Proposing Release at p. 57604.

[6] Proposing Release at p. 57605.

[7] A merger that would result in lower fees for the acquired fund, however, should not require shareholder approval, in the absence of other changes that themselves would require shareholder approval.

[8] In contrast to the shareholder voting requirements under the Investment Company Act, under our proposal the board would have discretion to determine that certain changes to fundamental policies as a result of a merger are not material and therefore would not require shareholder approval. For example, a board could reasonably determine that a shareholder vote would not be required where a fund that has a fundamental policy of investing no more than 40% of its assets in companies operating exclusively in any one foreign country merges with a fund that has a similar fundamental policy but with a 35% limit.

[9] The Proposing Release states that "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." Proposing Release at p. 57605.

[10] See Proposing Release at p. 57604.

[11] The proposed echo voting requirement also raises certain logistical issues in that it incorrectly presumes that a related shareholder would know prior to casting its vote how the other, non-related shareholders have voted. This practical problem may be exacerbated where there is more than one related shareholder.

[12] There may even be instances where a related shareholder refuses to echo vote, thus forcing the funds to go through the expensive and time-consuming process of obtaining exemptive relief from the Commission.

[13] We note that the proposed definition of “independent evaluator” would permit an interested person of the acquiring fund to serve in this capacity.