SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–25666; File No. S7–21–01]

RIN 3235–AH81

Investment Company Mergers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting amendments to the rule under the Investment Company Act of 1940 that permits mergers and other business combinations between certain affiliated investment companies. The amendments expand the types of business combinations permitted by the rule and make the rule available for mergers between registered investment companies and certain unregistered entities. The amendments are designed to reduce burdens on investment companies by eliminating the need to obtain Commission approval for mergers that present little risk of overreaching.

DATES: *Effective Date:* July 26, 2002.

Compliance Date: October 25, 2002. Section II of this document contains more information on transition prior to the compliance date.

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

Table of Contents

Executive Summary
I. Discussion
A. Mergers between Registered Investment Companies
B. Mergers of Registered Investment Companies and Certain Unregistered Entities
II. Effective Date
III. Cost-Benefit Analysis
A. Benefits
B. Costs
IV. Effects on Efficiency, Competition, and Capital Formation
V. Paperwork Reduction Act
VI. Summary of Final Regulatory Flexibility Analysis
VII. Statutory Authority
Text of Rule

Executive Summary

The Commission is adopting amendments to rule 17a–8 under the Investment Company Act, the rule that permits mergers of registered investment companies (''funds'') with certain of their affiliated persons.[1] The amendments expand the availability of the rule in two ways: first, the rule permits funds to merge with other affiliated funds without regard to the reason for their affiliation; and second, the rule permits funds to merge with unregistered bank common trust funds, bank collective trust funds, and unregistered insurance company separate accounts. The amendments subject the exemption to certain additional conditions designed to protect investors.

I. Discussion

Section 17 of the Investment Company Act prohibits certain transactions between funds [2] and their affiliated persons [3] unless the Commission issues an order after finding that (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.[4] This section operates to prohibit mergers [5] of investment companies that are affiliated persons of each other, which typically include funds that are in the same fund complex.[6] Since 1980, our rule 17a–8 has permitted mergers of funds that are affiliated solely because they have common investment advisers, officers and/or directors.[7] We have considered other fund mergers on a case-by-case basis, and since 1980 we have issued more than 150 orders granting exemptions for fund mergers that did not qualify for relief under rule 17a-8.[8]

In November 2001, we proposed to codify the terms of our exemptive orders and expand the availability of rule 17a–8 to permit affiliated mergers regardless of the reasons for the funds' affiliation, and to permit funds to merge with unregistered bank common and collective trust funds.[9] We received eight comments on the proposed amendments to rule 17a–8.[10] Commenters supported the proposed broadening of the rule, but suggested changes. Today we are adopting the amendments to rule 17a–8, with several changes that respond to issues raised by commenters. The amended rule, which we describe below, will permit most mergers of registered investment

[1] Unless otherwise noted, when we refer to rule 17a–8 or any paragraph of that rule, we are referring to 17 CFR 270.17a–8, the section of the Code of Federal Regulations in which the rule is published, as amended by this release.

[2] We use the term ''fund'' throughout this release to refer to registered investment companies and series of registered investment companies that are series companies.

[3] The Act describes an ''affiliated person'' of another person as (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting securities of such other person; (B) any person 5 percent 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 affiliated persons of the fund and affiliated persons of those affiliated persons. Section 17(a) also reaches transactions with a promoter of or a principal underwriter for a fund and affiliated persons of such promoter or principal underwriter. For purposes of this release, the term ''affiliates'' includes these persons as well.

[4] 15 U.S.C. 80a–17(a)–(b).

[5] We use the term ''merger'' in rule 17a–8 and this release to refer to a merger, consolidation, or purchase or sale of substantially all of an entity's assets. 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.

[6] Funds in a fund complex are under the common control of an investment adviser or other person when the adviser or other person exercises a controlling influence over the management or policies of the funds. 15 U.S.C. 80a–2(a)(9). Not all advisers control the funds they advise. The determination of whether a fund is under the control of its adviser, officers, or directors depends on the relevant facts and circumstances. Throughout this release we presume that the funds in a fund complex are under common control, because funds that are *not* affiliated would not need relief under rule 17a–8.

[7] *See* Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 11053 (Feb. 19, 1980) [45 FR 12408 (Feb. 26, 1980)].

[8] Typically a single order provides an exemption for multiple funds. The 16 orders we issued in 2001 provided exemptions for 120 mergers involving approximately 220 funds.

[9] Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)] (''Proposing Release'').

[10] The comment letters and a summary of comments prepared by our staff are available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC (File No. S7–21–01). The comment summary is also available on the Commission's Internet Web site *(http://www.sec.gov/rules/extra/s72101commsumm.htm).*

companies to proceed without the need for exemptive relief.

A. Mergers Between Registered Investment Companies

The Commission is adopting, as proposed, an amendment to rule 17a-8 to permit affiliated fund mergers regardless of the reasons for the funds' affiliation.[11] The rule will continue to require that each fund's board (including a majority of disinterested directors) determine that the merger is in the best interests of the fund and will not dilute the interests of shareholders.[12] These are critical determinations boards must carefully consider, particularly when the merger involves significant conflicts of interest.[13] Directors must request and evaluate any information reasonably necessary to their determinations, and consider and give appropriate weight to all pertinent factors in making their findings under the rule, and in fulfilling the overall duty of care they owe to the fund's shareholders.[14] In making their determinations, boards should consider, if relevant, the following factors, among others [15]—

- Any fees or expenses that will be borne directly or indirectly by the fund in connection with the merger;[16]
- Any effect of the merger on annual fund operating expenses and shareholder fees and services;
- Any change in the fund's investment objectives, restrictions, and policies that will result from the merger; and
- Any direct or indirect federal income tax consequences of the merger to fund shareholders.

We do not intend the list of factors to be exhaustive, and none of the factors would necessarily be determinative. Consideration of these specific factors does not relieve a board of the obligation to consider other relevant factors.[17]

We are also adopting an amendment that requires the acquired fund, in a merger relying on rule 17a-8, to have the merger approved by its shareholders in certain circumstances.[18] In the Proposing Release we expressed concern that funds were increasingly organized (or reorganized) under state laws that did not require shareholder approval of mergers, which could deny shareholders a voice in an important change in their investment.[19] Most commenters supported requiring acquired companies to obtain shareholder approval, but in light of the costs of proxy solicitations, urged us to limit the requirement. One commenter recommended that we require shareholder approval only when the merger would result in a change that, in a context other than a merger, would require a shareholder vote under the Investment Company Act. We believe such an approach has merit because it would preserve important values embodied in the Investment Company Act while reducing the need for a fund to incur the expense of soliciting proxies when the merger may not raise significant issues for shareholders.

Under rule 17a-8, as we are today amending it, reliance on the rule requires the acquired fund to obtain the approval of a majority of its shareholders [20] in circumstances that we have derived from various provisions of the Act and our rules that specify when a fund must obtain the approval of its shareholders.[21] Under the rule as amended a majority of the shareholders of the acquired fund must approve the merger if—

- Any policy of the acquired fund that under section 13 of the Act could not be changed without a vote of a majority of its outstanding voting securities is materially different from a policy of the acquiring fund;[22]
- The acquiring fund's advisory contract is materially different from that of the acquired fund, except for the identity of the funds as parties to the contract;[23]

[11] Rule 17a-8(a).

[12] Rule 17a-8(a)(2)(i). We are not adopting a proposal to prohibit funds from relying on rule 17a-8 to effect mergers that are part of a plan or scheme to evade the prohibitions of section 17(a) of the Act; section 48(a) of the Act already makes such activity unlawful. 15 U.S.C. 80a-47(a).

[13] In January 2001, we amended rule 17a-8 to include conditions related to independent directors of a merging fund. Under those amendments, relief is conditioned on (i) a majority of the board of directors of each fund relying on the rule being independent directors, (ii) the independent directors of any fund relying on the rule selecting and nominating any other independent directors, and (iii) any legal counsel for the independent directors of the fund relying on the rule being an independent legal counsel. *See* rule 17a-8(a)(4). *See also* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)].

[14] Rule 17a-8(a)(2)(ii).

[15] In the proposal, we identified these factors in the text of the rule itself. *See* proposed rule 17a-8(a)(2)(ii). Consistent with our judgment to continue to rely on the exercise of judgment by the directors (including the disinterested directors), and because these factors only represent examples of factors that may be relevant, we have decided not to include the factors in the rule text. Instead, we have included a note in the rule to refer readers to this release. As such, the factors do not represent legal requirements. While it is true that the directors may not have to consider all of these factors, it is equally true that consideration of these factors may not suffice if the directors have not considered other relevant factors. In all cases, the directors must make their own determination as to what factors are relevant to making their findings under the rule.

[16] Directors should consider in particular whether the fund's payment of fees and expenses that would otherwise be paid by the fund's investment adviser raises questions under section 15(a)(1) [15 U.S.C. 80a-15(a)(1)] (advisory contract must precisely describe all compensation to be paid under the contract) and section 36(b) [15 U.S.C. 80a-35(b)] (investment adviser has fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by the fund or its shareholders). In addition, if the fund merger follows a merger of the fund's investment adviser, then the fund's payment of fees and expenses might constitute compensation to the investment adviser and raise questions regarding the availability of section 15(f) [15 U.S.C. 80a-15(f)] (creating a safe harbor under which investment advisers may receive a benefit in connection with a sale of securities of, or a sale of any other interest in, an investment adviser that results in an assignment of an investment advisory contract, if certain conditions are met).

[17] *See supra* note 15.

[18] In some cases rule 17a-8 may permit a merger to occur without shareholder approval, but state law or the fund's organizational documents may require shareholder approval. Nothing in rule 17a-8 relieves a fund of its obligations in this regard under state law or its organizational documents. We also proposed, but are not adopting, an amendment that would have required certain shareholders to ''echo vote'' their securities. Commenters pointed out that echo voting would be costly and complex, and that seeking instructions from beneficial owners could be contrary to the terms of underlying legal arrangements. Advisers (and their affiliated persons) that are also fund shareholders should carefully consider their fiduciary responsibilities to the fund when deciding how to cast their votes. We understand that it is a common practice for advisers with conflicting obligations to vote their shares in a manner similar to that which we proposed.

[19] Proposing Release, *supra* note 9, at text accompanying nn.37–41.

[20] The amended rule requires a ''vote of a majority of the outstanding voting securities,'' as described in section 2(a)(42) of the Act. Rule 17a-8(a)(3). We have added this provision in response to a comment that shareholder votes required under rule 17a-8 be subject to the Act's requirements for majority approval. *Cf.* Proposing Release, *supra* note 9, at n.41.

[21] We have not included the identical requirements because the application of such requirements in the context of a merger would not work, or might require a shareholder vote in all circumstances.

[22] Rule 17a–8(a)(3)(i). Under section 13 of the Act no fund may, unless authorized by the vote of a majority of its outstanding voting securities: (1) change between being an open- and closed-end investment company or from being a diversified to a nondiversified company; (2) borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities, or make loans to other persons, except in accordance with the recitals of policies contained in the fund's registration statement; (3) deviate from any investment policy that is changeable only by shareholder vote or any policy that is ''fundamental'' under section 8(b)(3) of the Act; or (4) change the nature of its business so as to cease to be an investment company. 15 U.S.C. 80a–13(a)(3).

[23] :Rule 17a–8(a)(3)(ii). *See* 15 U.S.C. 80a–15 (requiring shareholder approval of advisory contracts). We interpret section 15(a) to require shareholder approval of only material changes to an advisory contract, and thus have drafted the rule in a manner that reflects that interpretation. If, after the merger, the advisory fees payable by the acquiring fund will be greater than the advisory fees of the acquired fund, we would consider the

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• After the merger, directors of the acquired fund who are not interested persons of the acquired fund and who were elected by its shareholders will not comprise a majority of the directors of the acquiring fund who are not interested persons of the acquiring fund;[24] or

• After the merger, the acquiring fund will be authorized to pay charges under a plan that provides for use of fund assets for distribution (''rule 12b–1 plan'') that are greater than charges authorized to be paid by the acquired fund under such a plan.[25]

We are also adopting, as proposed, a requirement that each investment company that survives the merger preserve written records that document the merger and its terms.[26] The records must include, among other things, the minute books setting forth the determinations of the funds' boards and the bases for those determinations, any supporting documents provided to the directors in connection with the merger, and documentation of the prices at which securities were transferred in the merger.[27] The recordkeeping requirement ensures that we have adequate information to assess the merging funds' compliance with the rule's conditions.

B. Mergers of Registered Investment Companies and Certain Unregistered Entities

We are expanding the exemption provided by rule 17a–8 to permit funds to merge with affiliated persons that are bank common trust funds,[28] bank collective trust funds,[29] and unregistered insurance company separate accounts,[30] provided that the survivor is a registered investment company.[31] We did not propose to permit mergers with unregistered insurance company separate accounts. One commenter pointed out, and we agree, that the issues raised by mergers with that type of account are similar to the issues raised by mergers with bank common and collective trust funds.

We are also adopting a requirement that the board of directors of a fund that merges with an unregistered trust fund or account, in making its determination that the interests of the fund's shareholders will not be diluted as a result of the merger, approve procedures for the valuation of the securities (or other assets) that the unregistered entity will convey to the fund.[32] These procedures must provide for the preparation of a report by an independent evaluator[33] that sets forth the fair market value of any such assets for which market quotations are not readily available.[34] The independent evaluator's report must be included in the records of the merger.[35]

II. Effective Date

The amendments to rule 17a-8 will be effective on July 26, 2002. The Administrative Procedure Act generally provides that a substantive rule may become effective no less than 30 days after publication in the **Federal Register**.[36] Nevertheless, we may establish an effective date that is less than 30 days after publication for rule amendments that grant or recognize an exemption or relieve a restriction.[37] Today's amendments meet these criteria, because the amendments exempt certain fund mergers from the prohibition in section 17(a).

Persons entering into mergers that occur on or after October 25, 2002 (''compliance date'') must comply with the conditions in rule 17a-8 as amended in order to rely on the exemption in the rule. Persons entering into mergers that occur between July 26, 2002 and the compliance date may rely on either rule 17a-8 as amended, or rule 17a-8 as it existed prior to today's amendments.

III. Cost-Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules. The amendments to rule 17a-8 are designed to reduce costs incurred by funds and advisers by eliminating the need for Commission approval of certain fund mergers. The amendments also supplement existing conditions of the rule, in order to ensure continued protection of fund shareholders in connection with mergers of funds and their affiliates. The Commission has identified certain costs, which are discussed below, that may result from the rule amendments. The rule amendments are exemptive, rather than prescriptive, and funds are not required to rely on them. Therefore, we assume that funds will rely on the rule amendments only if the anticipated benefit from doing so exceeds the anticipated cost. We did not receive any data regarding the costs and benefits of the rule amendments from commenters.

increase in the advisory fee to be a material change requiring shareholder approval.

[24] Rule 17a–8(a)(3)(iii). In other words, a shareholder vote is *not* required if, after the merger, a majority of the disinterested directors of the acquiring company will be comprised of persons who were elected disinterested directors of the acquired company.

[25] Rule 17a-8(a)(3)(iv). *See* rule 12b–1 under the Investment Company Act [17 CFR 270.12b–1] (describing circumstances in which an open-end management investment company may bear expenses associated with the distribution of its shares).

[26] :Rule 17a–8(a)(5) (requiring the company to keep these records for six years after the merger and, for the first two years, in an easily accessible place).

[27] Rule 17a–8(a)(2)(iv). The merger records also must include any report of an independent evaluator necessary for compliance with rule 17a–8(a)(2)(iii). *See infra* Section I.B.

[28] Generally, common trust funds and similar funds are exempt from registration under section 3(c)(3) of the Act [15 U.S.C. 80a–3(c)(3)]. *See* Proposing Release, *supra* note 9, at n.48.

[29] Collective trust funds are exempt from registration under section 3(c)(11) of the Act [15 U.S.C. 80a–3(c)(11)]. *See* Proposing Release, *supra* note 9, at n.49.

[30] Separate accounts are described in section 2(a)(37) of the Act [15 U.S.C. 80a–2(a)(37)].

[31] Rule 17a–8(a)(1). As we discussed in the Proposing Release, the staff has written no-action letters in the past under section 17(a) and rule 17a–7 to funds seeking to merge with unregistered entities. Proposing Release, *supra* note 9, at n.54. Parties to mergers that occur on or after the compliance date of the amendments to rule 17a–8 should not rely on the guidance in those letters. Parties to such mergers must either (i) comply with rule 17a–8 or another applicable rule or (ii) obtain an exemptive order from the Commission under section 17(b). A merger that is conducted in reliance on rule 17a–7 must comply with all of the conditions of that rule, including the requirement that the transaction be for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available. *See* 17 CFR 270.17a–7(a).

[32] Rule 17a-8(a)(2)(iii).

[33] An ''independent evaluator'' is a person having expertise in the valuation of securities and other financial assets who is not an interested person of the unregistered entity or any of its affiliated persons, other than the fund. Rule 17a-8(b)(3).

[34] Rule 17a-8(a)(2)(iii). This provision requires the directors to obtain a report from an independent evaluator valuing those securities for which the directors will have to determine fair value for purposes of computing the net asset value of the fund's shares subsequent to the merger. *See* 17 CFR 270.2a–4(a). A number of commenters incorrectly assumed that our proposal would require the fund to accept the opinion of the independent evaluator and expressed a concern that the rule might require the fund to accept valuations for the purpose of the merger that it would not subsequently use, which would require a readjustment of values. The rule amendment essentially requires the board to receive a ''second opinion'' from an independent evaluator, which the board can use when considering the asset valuations that may have been prepared by a person that has an interest in the transaction. Although a board is free under the rule to reject the opinion, it should use caution in accepting a valuation by a person that has an interest in the merger when that person's valuation is materially different from that of the independent evaluator. The proposed amendments would have required that the independent evaluator's report include valuations for all securities to be conveyed to the acquiring fund. The rule amendments that we are adopting limit this requirement to securities for which market quotations are not readily available. Commenters expressed concern about the cost to funds of obtaining reports from independent evaluators, and we do not believe that it is necessary to require reports that value securities for which market quotations are readily available.

[35] Rule 17a-8(a)(5).

[36] 5 U.S.C. 553(d).

[37] 5 U.S.C. 553(d)(1).

A. Benefits

We anticipate that funds, their shareholders, and their advisers and other affiliates will benefit from the expansion of the rule to include mergers of affiliated funds, regardless of the nature of the affiliation, and mergers with common or collective trust funds and unregistered insurance company separate accounts. More merging funds will be able to rely on the rule and therefore will not have to obtain exemptive relief, which can be costly to merging funds, their shareholders, and their affiliates.[38] Thus, the amendments will remove an obstacle to mergers of affiliated funds and can thereby reduce the costs of affiliated mergers. Investment advisers also can benefit from the greater ease with which mergers can be effected under the amended rule because they often bear all or a portion of the costs of obtaining exemptive relief.[39]

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. However, to the extent that the number of mergers increases, mergers give shareholders of small or poorly performing funds an opportunity to shift their assets to a better performing fund without negative tax consequences.[40] In addition, investment advisers can realize economies of scale through fund mergers, which spread the costs of management, some of which are fixed, across a larger pool of assets. Shareholders may benefit from these economies of scale in the form of lower fees and expenses.[41]

We believe that the 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 provision conditioning relief on the directors requesting and evaluating such information as may reasonably be necessary to determine whether the merger is in the best interests of the fund and will not dilute the interests of the fund's existing shareholders will encourage director scrutiny of fund mergers. Conditioning the rule's relief in certain circumstances on approval of the merger by a majority of the outstanding voting securities of an acquired fund can benefit fund shareholders by giving them an opportunity to assess the merger in light of their own financial circumstances. Submitting the merger to a vote, we believe, may improve its terms since the fund managers must persuade investors to approve them. Finally, we believe that the amended rule's recordkeeping requirements will ensure that our examinations staff will be able to assess merging funds' compliance with the rule.

B. Costs

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

The amendments would eliminate the expenses of filing an exemptive application for certain merging funds.[42] Unlike the expense of complying with rule 17a-8, however, the cost of an exemptive application may be shared by a number of merging funds. Therefore, there may be certain increased compliance costs under the amended rule for these merging funds.[43] In addition, some merging funds that would have been able to comply with rule 17a-8 prior to the amendments may face higher costs under the amendments.[44] Finally, funds merging with eligible unregistered 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.

The 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; as a result, the incremental costs attributable to the board determination requirements of rule 17a-8 are likely to be minimal.

In conjunction with the expansion of the rule to unregistered entities, the amendments require that fund boards establish procedures for valuing the assets held by any eligible unregistered funds participating in the merger. If the unregistered entity will convey assets to the fund for which market quotations are not readily available, then the valuation procedures must include the preparation of a report by an independent evaluator. The staff estimates that this requirement will impose an aggregate annual cost of approximately $195,000.[45]

We believe that there will be few additional shareholder votes annually as a result of the requirement in rule 17a-8 that shareholders of the acquired fund approve certain fund mergers.[46] Currently, in most (if not all) cases acquired funds obtain approval of their shareholders before engaging in mergers that materially alter the investment held by fund shareholders. The staff estimates that the cost of obtaining

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[38] In calendar year 2000, exemptive orders were issued for over 30% of affiliated fund mergers. We believe that these mergers would have been able to proceed under amended rule 17a-8. As set forth in Section V below, we anticipate that there will be approximately 400 affiliated fund 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 now be able to proceed under the rule. The Commission 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 III.B.

[39] 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).

[40] Liquidations are generally taxable events for fund shareholders, whereas fund mergers can be structured to be non-taxable.

[41] *See* Narayanan Jayaraman, *et al., An Analysis of the Determinants and Shareholder Wealth Effects of Mutual Fund Mergers,* 57 J.Fin. 1521 (2002) (finding that target shareholders benefit from improved performance and lower expense ratios).

[42] *See supra* note and accompanying text.

[43] 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 46–47 and accompanying text (discussing costs associated with conducting a shareholder vote).

[44] These increased costs may be attributable to the amended rule's requirements regarding board determinations, shareholder voting provisions, and/or recordkeeping requirements.

[45] The staff estimates, based on a review of fund filings, that there will be approximately 13 mergers each year involving common or collective trust funds or unregistered separate accounts. The staff also estimates, based on discussions with professionals who have prepared similar valuation reports, that the preparation of an independent evaluator's report in these instances would cost approximately $15,000. This cost could, however, be considerably higher depending on the number and characteristics of the securities that are being valued.

[46] For purposes of our Paperwork Reduction Act analysis, we assumed that twenty funds each year will be affected. *See infra* Section V. Our staff rarely sees fund mergers in which there is no shareholder vote. Many funds are required by state law or the fund's organizational documents to conduct a shareholder vote in the event of a merger. Even funds that are not required to obtain shareholder approval may do so in order to maintain good relations with their shareholders.

shareholder approval for a fund merger is approximately $75,000.[47]

We believe that the incremental costs associated with the recordkeeping requirements in amended rule 17a-8 will not be significant. We believe that most funds already retain the types of records that are required by the amended rule as a matter of good business practice. Prior to the amendments, the rule required that the directors' findings and their bases be recorded in the minute books of the fund. The amended rule retains this requirement at what we anticipate will continue to be a minimal cost.[48] The amended rule also requires the acquiring fund to retain written records describing the merger and its terms. The six-year retention period is consistent with the retention period applicable to similar fund records.[49] We believe, therefore, that the recordkeeping requirement is unlikely to impose significant additional costs on funds.

IV. Effects on 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 consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[50] None of the commenters addressed these issues.

Today's amendments to rule 17a–8 are intended to make the rule available for more affiliated fund mergers, thereby eliminating the need for specific exemptive relief in most cases.[51]

The rule amendments will expedite many mergers that, prior to the amendments, could proceed only if we issued an exemptive order. These mergers will now be less costly to the merging funds, their shareholders, and their affiliates. It is possible that reducing the cost of mergers will induce more funds to combine, thereby increasing industry concentration. We do not, however, believe that the cost of obtaining a Commission exemptive order is a significant factor in funds' decisions to enter into mergers, and we do not anticipate that the rule amendments will significantly increase or decrease the number of mergers that occur annually; therefore, the amendments will not have a significant direct effect on efficiency, competition, or capital formation.[52]

The amendments may have certain secondary effects on efficiency and competition. By eliminating disparities in the costs incurred by affiliated funds that would have been able to merge under the rule prior to the amendments, versus those that would have merged through an exemptive order, the amendments may have a positive effect on competition. On the other hand, because (as discussed above) a small number of funds that would have been able to merge under the rule prior to the amendments may incur higher costs under the amended rule, the amendments may have a negative effect on efficiency. However, we do not anticipate that either effect will be significant.

V. Paperwork Reduction Act

As explained in the Proposing Release, the amendments to rule 17a-8 expand the rule's scope and add new conditions to the rule, 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). We submitted 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 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 OMB control number for amended rule 17a–8 is 3235–0235.

As discussed above, today we are adopting amendments to rule 17a–8 that are substantially similar to amendments that we proposed in November 2001. None of the commenters addressed the Paperwork Reduction Act burden associated with these amendments.

The staff believes that the 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 for purposes of the Paperwork Reduction Act. Because rule 17a–8 is an exemptive rule, funds may choose whether to rely on it. Therefore, any information provided under rule 17a–8 would be provided voluntarily. The amendments do not require that information be provided to the Commission, and thus this release does not address the confidentiality of responses under the amendments to rule 17a–8.

We anticipate that most if not all funds that engage in mergers with affiliated funds will rely on 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.[53] 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.[54] The

[47] 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. However, the cost of holding a shareholder vote would be offset by an affected fund avoiding the cost of sending shareholders an information statement. *See* 15 U.S.C. 78n(c) (providing that prior to any meeting of its shareholders with respect to which proxies are not solicited, an investment company must, in accordance with Commission rules, file with the Commission and transmit to all shareholders of record information substantially equivalent to the information which would be required to be transmitted if a solicitation were made). Our staff estimates, based on discussions with industry participants, that the cost of preparing and delivering an information statement is $30,000. Thus, we estimate that there will be an aggregate cost savings of $600,000 resulting in a net annual aggregate cost of holding a shareholder vote of approximately $900,000.

[48] 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 amended rule's recordkeeping requirements in connection with a merger. *See infra* Section V.

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

[50] 15 U.S.C. 80a–2(c). We are adopting the amendments to rule 17a–8 pursuant to the authority in section 6(c) and 38(a) of the Act. As rules that we adopt under section 6(c) must be ''necessary or appropriate in the public interest,'' the requirements of section 2(c) apply to the rule amendments.

[51] *See supra* Section III.

[52] *See supra* Section III.A. for a discussion of the cost savings.

[53] 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.

[54] 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

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

We also anticipate that most if not all funds that engage in mergers with eligible unregistered funds will rely on rule 17a–8. Our staff estimates that approximately 13 merging funds would be covered by this provision in the first year following the adoption of this rule.[55] Our staff further 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 $195,000.[56]

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.[57] 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. However, since a fund conducting a shareholder vote will not be required to send an information statement, the cost of the shareholder vote provision will be offset by the avoided cost of sending information statements. We estimate, based on discussions with fund representatives, that each information statement would cost $30,000 to prepare and deliver. Thus, we anticipate that a total of approximately $600,000 of costs will be avoided annually, and the net cost of the shareholder vote provision will be approximately $900,000.[58]

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 $1,095,000.[59]

VI. Summary of Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis (''FRFA'') in accordance with 5 U.S.C. 604 regarding the amendments to rule 17a–8 under the Investment Company Act. A summary of the Initial Regulatory Flexibility Analysis (''IRFA''), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release. The following is a summary of the FRFA.

A. Need for and Objectives of the Rule Amendments

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

B. Significant Issues Raised by Public Comment

The Commission received no comments on the IRFA.

C. Small Entities Subject to the Rule

The FRFA discusses the effect of the 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.[60] Of approximately 3,650 active funds, approximately 190 are small entities. A fund that is a small entity, like other funds, will be affected by the amendments only if it seeks to merge with an affiliated fund, bank common trust fund, bank collective trust fund, or unregistered insurance company separate account.

The FRFA states that the rule amendments should not have a substantial impact on small entities. Like other funds, a small entity will be affected by rule 17a–8 only if it enters into a merger with an affiliated person in reliance on the rule.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

As amended, the rule conditions relief on the board making the best interests and non-dilution determinations and on those determinations and the bases therefor being recorded in the minute books of each registered company. The rule requires that fund directors request and evaluate such information as may reasonably be necessary to their determinations, considering and giving appropriate weight to all pertinent factors. As a basis for the non-dilution finding, the board of directors of a fund that merges with an unregistered entity must approve procedures for the valuation of the securities (or other assets) that the unregistered entity will convey to the fund. These procedures must provide for the preparation of a report by an independent evaluator that sets forth the fair market value of any such assets for which market quotations are not readily available. The FRFA describes the provision in the rule related to shareholder voting. Finally, the FRFA 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 FRFA explains that the amendments could benefit funds, including small entities, by expanding the availability of the rule to include mergers that are currently outside the scope of the rule. Funds that currently would have to incur the expense associated with filing applications for exemptive relief could rely on the rule.

E. Agency Action To Minimize Effect on Small Entities

The FRFA explains that the Commission has considered significant alternatives to the amendments that would accomplish the stated objective, while minimizing any significant

record board resolutions documenting the board's findings and to preserve records of the merger transaction.

[55] This estimate is based on a review of fund filings. It is greater than the estimate in the Proposing Release because the amendments to rule 17a–8 in the Proposing Release did not include unregistered insurance company separate accounts as eligible unregistered funds. *See supra* Section I.B.

[56] *See supra* note 45, which sets forth the basis for this estimate. This estimate is greater than the estimate in the Proposing Release because of the increase in the estimate of the number of merging funds that will rely on rule 17a–8. *See supra* note 55.

[57] Many funds are required by state law or their organizational documents to conduct a shareholder vote in the event of a merger. Moreover, even funds that are not required to obtain shareholder approval may do so in order to maintain good relations with their shareholders.

[58] This figure is less than the estimate in the Proposing Release because the figure in the Proposing Release did not take into account the avoided cost of sending information statements. *See* Proposing Release, *supra* note , at text accompanying n.95.

[59] This figure is the total of the estimated $195,000 annual cost associated with valuing the securities of eligible unregistered funds and the $900,000 annual net cost associated with obtaining shareholder approval. It differs from the figure of $3,650,000 in the Proposing Release because of (i) an increase of $45,000 in the estimated annual cost associated with valuing the securities of eligible unregistered funds, (ii) a decrease of $600,000 in the estimated annual cost associated with obtaining shareholder approval, and (iii) the elimination of the proposed echo voting provision and its accompanying cost, estimated at $2,000,000. *See supra* note 18 for a discussion of the proposed echo voting requirement.

[60] Rule 0–10 [17 CFR 270.0–10].

adverse impact on small entities. The Commission believes that no alternative could carry out these objectives as effectively as the amendments.

VII. Statutory Authority

The Commission is adopting 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 Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is 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) or Eligible Unregistered Funds is exempt from sections 17(a)(1) and (2) of the Act (15 U.S.C. 80a–17(a)(1)–(2)) 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.

Note to paragraph (a)(2)(i): For a discussion of factors that may be relevant to the determinations in paragraph (a)(2)(i) of this section, see Investment Company Act Release No. 25666, July 18, 2002.

(ii) The directors have requested and evaluated such information as may reasonably be necessary to their determinations in paragraph (a)(2)(i) of this section, and have considered and given appropriate weight to all pertinent factors.

(iii) The directors, in making the determination in paragraph (a)(2)(i)(B) of this section, have approved procedures for the valuation of assets to be conveyed by each Eligible Unregistered Fund participating in the Merger. The approved procedures provide for the preparation of a report by an Independent Evaluator, to be considered in assessing the value of any securities (or other assets) for which market quotations are not readily available, that sets forth the fair value of each such asset as of the date of the Merger.

(iv) The determinations required in paragraph (a)(2)(i) of this section and the bases thereof, including the factors considered by the directors pursuant to paragraph (a)(2)(ii) of this section, are recorded fully in the minute books of the Merging Company.

(3) *Shareholder approval.* Participation in the Merger is approved by the vote of a majority of the outstanding voting securities (as provided in section 2(a)(42) of the Act (15 U.S.C. 80a-2(a)(42))) of any Merging Company that is not a Surviving Company, unless—

(i) No policy of the Merging Company that under section 13 of the Act (15 U.S.C. 80a-13) could not be changed without a vote of a majority of its outstanding voting securities, is materially different from a policy of the Surviving Company;

(ii) No advisory contract between the Merging Company and any investment adviser thereof is materially different from an advisory contract between the Surviving Company and any investment adviser thereof, except for the identity of the investment companies as a party to the contract;

(iii)Directors of the Merging Company who are not interested persons of the Merging Company and who were elected by its shareholders, will comprise a majority of the directors of the Surviving Company who are not interested persons of the Surviving Company; and

(iv) Any distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the Surviving Company pursuant to a plan adopted in accordance with § 270.12b-1 are no greater than the distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the Merging Company pursuant to such a plan.

(4) *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.

(5) *Merger records.* Any Surviving 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).

(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) *Eligible Unregistered Fund* means:

(i) A collective trust fund, as described in section 3(c)(11) of the Act (15 U.S.C. 80a–3(c)(11));

(ii) A common trust fund or similar fund, as described in section 3(c)(3) of the Act (15 U.S.C. 80a–3(c)(3)); or

(iii) A separate account, as described in section 2(a)(37) of the Act (15 U.S.C. 80a–2(a)(37)), that is neither registered under section 8 of the Act, nor required to be so registered;

(3) *Independent Evaluator* means a person who has expertise in the valuation of securities and other financial assets and who is not an interested person, as defined in section 2(a)(19) of the Act (15 U.S.C. 80a–2(a)(19)), of the Eligible Unregistered Fund or any affiliate thereof except the Merging Company; and

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

Dated: July 18, 2002.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–18699 Filed 7–23–02; 8:45 am]

BILLING CODE 8010–01–P