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Paul Cellupica
Deputy Director and Chief Counsel
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Index-Based Funds and Sections 5(b), 13(a)(1) and 34(b) of the Investment Company Act of 1940

Dear Mr. Cellupica:

We request assurances that the staff of the Division of Investment Management (the "Staff") will not recommend that the U.S. Securities and Exchange Commission (the "Commission") take enforcement action under Sections 13(a)(1) and 34(b) of the Investment Company Act of 1940, as amended (the "1940 Act"), against an index-based fund that exceeds the limits for a diversified company, as defined in Section 5(b)(1) of the 1940 Act, with respect to investments in an issuer or several issuers to the extent necessary to approximate the composition of the fund's target broad-based index,[1] updates its registration statement to reflect the fund's ability to exceed such limits and associated risks, and provides notice of the fund's updated diversification policy to shareholders, as further described below (the "Proposed Relief"). As used in this letter, an "index-based fund" means a registered open-end fund or exchange-traded fund ("ETF") that seeks to track the performance of an unaffiliated target broad-based index by investing all or substantially all of its assets in securities that comprise the index in approximately the same proportion as such securities' weighting in the index. We believe that the Proposed Relief is consistent with the expectations of investors in an index-based fund, will minimize portfolio disruption and unnecessary costs, and will provide appropriate investor protections, including disclosure.

I. Background

We represent investment managers and sponsors that serve as investment advisers to index-based funds. We have been requested to seek no-action assurances from the Staff to

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[1] *See, e.g.*, Disclosure of Mutual Fund Performance and Portfolio Managers, Investment Company Act Rel. No. 19382 (Apr. 6, 1993), at fn 21 (describing the characteristics of a broad-based index).

permit the Proposed Relief based on the facts and representations set forth herein. The Proposed Relief would address the concern that an index-based fund, solely as a result of tracking its unaffiliated target broad-based index, would cease to be a diversified company as a result of a change in relative market capitalization or index weighting of one or more constituents of the index. The Proposed Relief would enable index-based funds that operate consistent with the representations contained in this letter to continue to invest in accordance with their investment objective and strategy in the most efficient and accurate manner and avoid unnecessary portfolio management disruption and costs.

During the past year, a few constituents of certain large cap U.S. equity growth broad-based indices (each an "Affected Index" and collectively, the "Affected Indices")[2] have grown to each represent more than 5% of the Affected Index and, in the aggregate, close to or, in some cases, more than 25% of the Affected Index at certain times. Such Affected Index constituents are technology-related companies whose rise in share price and, therefore, market capitalization has outpaced the other Affected Index constituents during the current U.S. bull market (each referred to as a "Large Index Constituent" and together as the "Large Index Constituents").[3] Each Affected Index is a float-adjusted, market capitalization weighted index, meaning each Affected Index constituent position and weighting adjusts based on the capitalization of the Affected Index constituents. The Large Index Constituents carry higher percentage weightings, while the smaller constituents in the Affected Index have lower weights. In addition, each Affected Index was created by an index provider that is not an affiliated person of the corresponding Affected Fund (defined below), its investment adviser or principal underwriter, or an affiliated person of such persons, and was not created solely for the Affected Fund or its affiliated persons.

As a result of the foregoing, index-based funds that track an Affected Index and hold themselves out as diversified companies, as defined in Section 5(b)(1) of the 1940 Act (each an "Affected Fund" and together, the "Affected Funds"), may become non-diversified companies, as defined in Section 5(b)(2) of the 1940 Act. Such Affected Funds, upon transitioning to non-diversified status, would not meet the requirements of Section 13(a)(1) of the 1940 Act unless the Affected Funds obtain prior shareholder approval of the change in diversification status, as discussed further below.

II. Basis for no-action position

We believe that an Affected Fund should be permitted to invest in securities in excess of the limits defined by Section 5(b)(1) to the extent necessary to invest in accordance with the Affected Index, under the circumstances described in this letter. These circumstances include,

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2 Examples of Affected Indices include the S&P 500 Growth Index, Russell 1000 Growth Index, MSCI USA Large Cap Growth Index, MSCI Prime Market Growth Index, CRSP US Large Cap Growth Index and CRSP US Mega Cap Growth Index.

3 For example, as of March 31, 2019, Alphabet Inc., Amazon.com, Inc., and Microsoft Corporation each represented more than 5% of the S&P 500 Growth Index and more than 19% of the index in the aggregate.

among others, providing adequate notice to shareholders of the diversification policy of the Affected Fund and related risks. For the reasons discussed below, we believe that such investments will minimize portfolio disruption and unnecessary costs, and are consistent with the expectations of investors in an index-based fund.

The Proposed Relief would also be consistent with a position taken by the Staff with respect to funds reserving the right to concentrate in an industry or group of industries to the extent that the fund's target index concentrates in one or more industries.[4] In the *First Australia Fund* SEC Staff no-action letter (the "First Australia Letter"), the Staff provided no-action assurances such that a fund could implement a concentration policy that would allow the fund to exceed 25% of its assets in securities of issuers in the same industry based on the concentration status of the fund's benchmark index.[5] The relief in the First Australia Letter was based, in part, on the fund having a principal investment strategy to invest primarily in securities included in the fund's target index that was maintained by an unaffiliated third party. The Proposed Relief would follow the same principles as in the First Australia Letter in that an Affected Fund would reserve freedom to operate as a non-diversified company only to the extent that more than 25% of an Affected Index is represented by constituents each representing more than 5% of the Affected Index and Affected Fund shareholders are informed of the circumstances under which the Affected Fund could operate as a non-diversified company.[6]

III. Relevant Law

Section 34(b) of the 1940 Act provides, in relevant part, that:

> It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this subchapter....

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4 The Commission has taken the position that a fund is concentrated if it invests more than 25% of the value of its total assets in any one industry. *See* Investment Company Act Release No. 9011 (Oct. 30, 1975). *See also*, Form N-1A, Item 9, Instruction 4 (requiring a fund's principal investment strategy included in its prospectus to describe any policy to concentrate in securities of issuers in a particular industry or group of industries).

5 *See* First Australia Fund SEC Staff No-Action Letter (pub. avail. July 29, 1999) (granting relief to a fund that invested primarily in securities included in an index but that is actively managed and not an index fund).

6 We believe that the Proposed Relief would also be consistent with the SEC Staff relief provided to the SPDR S&P Dividend ETF, in which the Staff provided no-action assurances to funds that track a third-party index to invest in insurance companies and securities related businesses beyond the limitations set forth in Sections 12(d)(2) and 12(d)(3) of the 1940 Act, subject to certain conditions. *See* SPDR S&P Dividend ETF, SEC Staff No-Action Letter (pub. avail. Mar. 28, 2016). *See also*, The Victory Stock Index Fund, SEC Staff No-Action Letter (pub. avail. Feb. 7, 1995).

Section 8(b)(1) of the 1940 Act requires a fund's registration statement to include a statement indicating whether the fund proposes to operate as a diversified company, as described in Section 5(b)(1) of the 1940 Act.

Section 13(a)(1) of the 1940 Act provides that no registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities, change its subclassification from a diversified to a nondiversified company.

Section 5(b) of the 1940 Act divides management companies into "diversified companies" and "non-diversified companies," defined as follows:

> (1) "Diversified company" means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.
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> (2) "Non-diversified company" means any management company other than a diversified company.

The purpose of Section 5(b)(1) is to ensure that registered investment companies that describe themselves to investors as having a "diversified" portfolio are in fact adequately diversified.[7] Thus, Section 5(b)(1) limits the amount that a fund may invest in any one issuer to 5% of such fund's total assets and to 10% of such issuer's voting securities, with respect to 75% of the fund's total assets.

IV. Discussion

We assert that the Proposed Relief is consistent with the expectations of investors in an index-based fund, will minimize portfolio disruption and unnecessary costs, and includes appropriate investor protections. As discussed below, the Proposed Relief would permit the Affected Funds to continue to invest in a manner that is consistent with the Affected Funds' stated investment objectives, disclosures to investors and regulatory constraints while minimizing portfolio management disruption and unnecessary costs. We therefore believe that the Proposed Relief is in the best interest of shareholders of the Affected Funds.

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[7] Senate Hearings before the Subcommittee of the Committee on Banking and Currency at 188, 192 (statement of David Schenker) (Apr. 3, 1940).

Minimize Tracking Error. The Proposed Relief would enable an Affected Fund to continue to seek to own constituents of the corresponding Affected Index consistent with their weighting in the Affected Index regardless of whether the market capitalization of one or more index constituents increases such that more than 25% of an Affected Index is represented by constituents each representing more than 5% of the Affected Index. The returns of each Affected Fund would therefore adhere more closely to the returns of its corresponding Affected Index, consistent with its stated investment objective.

Consistent with Investment Strategy. The Proposed Relief would enable each Affected Fund to be managed consistent with its investment strategy and, if applicable, exemptive relief. Each Affected Fund that is an ETF currently operates pursuant to exemptive relief that requires the ETF to maintain a certain percentage of the fund's securities in the index constituents and to limit tracking error. As a result, each such Affected Fund can best stay within the parameters of its exemptive relief by investing in all or substantially all of the Affected Fund's assets in the index constituents. The Proposed Relief would preserve the ability of the Affected Funds to pursue their investment strategies in the manner in which the Affected Funds were originally designed and sold.

Avoid Expense Associated with Shareholder Vote. The Proposed Relief would ensure that the Affected Funds and their shareholders would not incur potentially recurring expenses associated with seeking shareholder approval to convert the fund to non-diversified status. Seeking shareholder approval, even for routine proposals, has become increasingly costly, primarily for funds to receive a sufficient number of votes to reach the quorum necessary to hold the shareholder meeting.[8] ETFs, because of their more transient shareholder base, often require additional solicitation efforts. Shareholder approval of a change to the fundamental diversification policy of an Affected Fund is not a routine proposal and would require approval of a majority of the outstanding voting securities, as defined in Section 2(a)(42) of the 1940 Act,[9]

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8 *See e.g.*, Claymore Advisors LLC, SEC Staff No-Action Letter (pub. avail. Apr. 27, 2010) (granting relief under Section 15(a) as a result of an ETF failing to achieve quorum for a vote on renewal of an advisory contract).

9 Section 2(a)(42) of the 1940 Act defines the vote of a majority of the outstanding voting securities of a company to mean the vote, at the annual or a special meeting of the security holders of such company duly called, (A) of 67 per centum or more of the voting securities present at such meeting, if the holders of more than 50 per centum of the outstanding voting securities of such company are present or represented by proxy; or (B) of more than 50 per centum of the outstanding voting securities of such company, whichever is the less.

of the Affected Fund, a high voting standard.[10] Shareholders of an Affected Fund would typically bear the cost of soliciting such approval.[11]

In addition, a conversion to non-diversified status is not permanent. In particular, it is our understanding that an Affected Fund will revert to diversified status if the Affected Fund remains diversified for a period of three years following shareholder approval of non-diversified status.[12] Several index-based funds have already experienced a repeating cycle of having launched as a non-diversified fund, converted to diversified status after three years pursuant to Rule 13a-1 under the 1940 Act, sought and received shareholder approval to again become non-diversified, and then again converted to diversified status after three years of the fund's target index being diversified. The Proposed Relief would allow an Affected Fund and its shareholders to avoid these costs and permanently align the Affected Fund's diversification status under Section 5(b) with its Affected Index.

Avoid Portfolio Management Disruption. The Proposed Relief would enable an Affected Fund to avoid the portfolio management disruption that would result from being unable to hold securities in its Affected Index in approximately the same proportion as such securities' weighting in the Affected Index solely as a result of the change in relative market capitalization or index weighting of one or more Affected Index constituents. Underweighting one or more Large Index Constituents to maintain compliance with Section 5(b)(1) would result in the Affected Fund experiencing increased tracking error because of the significant dispersion in performance returns of the Large Index Constituents relative to the other index constituents. As a result, an Affected Fund's ability to meet its investment objective could be adversely impacted to the detriment of the Affected Fund's shareholders. Similarly, holding non-index securities in lieu of one or more Large Index Constituents could result in the Affected Fund experiencing significant tracking error as a result of the impact that each Large Index Constituent has on the returns of Affected Index. The Proposed Relief would enable the Affected Funds to avoid increased tracking error, portfolio disruption and trading costs caused by such changes to the Affected Fund's investments.

Inability to Rely on Section 5(c) of the 1940 Act.[13] The Affected Funds are unable to rely on Section 5(c) of the 1940 Act to preserve their diversified status without significant

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10 The cost to solicit shareholders on non-routine voting items, such as seeking shareholder approval to change a fundamental policy, could exceed tens of millions of dollars depending on the size of the Affected Fund and the size and type of its shareholder accounts.

11 Although a fund sponsor may voluntarily agree to pay, or reimburse the fund, the costs associated with proxying shareholders and holding a shareholder meeting in connection with a change of fundamental policy, typically the fund, and indirectly fund shareholders, bear such costs.

12 *See, e.g.*, Allied Capital SEC Staff No-Action Letter (pub. avail. Jan. 3, 1989). *See also* Tamar Frankel, Arthur Laby & Ann Schwing, The Regulation of Money Managers § 5.08(D)(2), (updated 2018).

13 Section 5(c) of the 1940 Act addresses the loss of status as a diversified company, as follows:

disruption to the Affected Funds' operations because such reliance would require either that an Affected Fund close to new purchases, which would obviate the need to purchase additional shares of Large Index Constituents, or accept increased tracking error by not purchasing Large Index Constituents when investing the proceeds of new subscriptions. Neither approach is consistent with the intended operation of the Affected Funds or the expectations of investors in the Affected Funds. In addition, closing an Affected Fund that operates as an ETF to new purchases may be inconsistent with the exemptive order on which the ETF relies to operate.[14]

Notice to Shareholders. Each Affected Fund's prospectus would identify within its principal investment strategy disclosure that the Affected Fund may become non-diversified, as defined in the 1940 Act, solely as a result of a change in relative market capitalization or index weighting of one or more constituents of the Affected Index.[15] The prospectus of each Affected Fund would also identify as a principal risk the risks associated with the Affected Fund becoming non-diversified.[16] In addition, the fundamental investment policy regarding diversification included in the statement of additional information of each Affected Fund would be revised to reflect that the Affected Fund intends to be diversified in approximately the same proportion as the Affected Index is diversified.[17] The updated diversification policy of an Affected Fund would also be included, at a minimum, on the Affected Fund's website. To rely on the Proposed Relief, an Affected Fund would send to its shareholders a prospectus supplement or other communication on a separate document that clearly indicates the updates to the Affected Fund's principal investment strategy and risk disclosure described in this paragraph, as well as that shareholder approval will not be sought when the fund crosses from diversified to

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A registered diversified company which at the time of its qualification as such meets the requirements of paragraph (1) of subsection (b) shall not lose its status as a diversified company because of any subsequent discrepancy between the value of its various investments and the requirements of said paragraph, so long as any such discrepancy existing immediately after its acquisition of any security or other property is neither wholly nor partly the result of such acquisition.

14 To the extent that proposed exemptive rule 6c-11 under the 1940 Act or a similar rule is adopted and replaces the exemptive relief on which an Affected Fund currently relies, such Affected Fund would comply with any requirements contained in the exemptive rule regarding maintaining a certain percentage of the fund's securities in index constituents and limiting tracking error.

15 The updates to the Affected Fund's principal investment strategies and principal risks would be included in the disclosure required by Item 4 of Form N-1A.

16 Examples of risks related to non-diversification include the risk that the Affected Fund's performance could be negatively impacted if the fund became non-diversified, the high concentration of the Affected Fund's assets in a small number of issuers, and that the Affected Fund's shares may experience significant fluctuations in value. If applicable, the prospectus disclosure would also describe risks related to investments by the Affected Fund in a specific strategy or sector.

17 The update to the Affected Fund's statement of additional information would be included in the disclosure required by Item 16 of Form N-1A.

non-diversified status due solely to a change in the relative market capitalization or index weighting of one or more constituents of the Affected Index.[18]

Maintain Diversified Status under Internal Revenue Code and Exchange Listing Standards. If the Proposed Relief is granted, the Affected Funds intend to continue to comply with the diversification requirements as set forth by the Internal Revenue Service in Section 851 of the Internal Revenue Code (the "Code"). Section 851 of the Code enables a registered investment company to qualify for pass-through tax treatment, provided that the registered investment company meets the Code's two-part diversification standard.[19] Compliance with Section 851 of the Code will provide an upper limit on the amount of each Affected Fund that a specific issuer can represent.[20]

In addition, each Affected Fund that is an ETF would continue to meet the diversification requirements of the applicable listing standards of the exchange on which the Affected Fund was traded and each Affected Fund that is not an ETF would ensure that it could meet the diversification requirements of the applicable listing standards of an exchange on which the Affected Fund would be eligible to be traded if the Affected Fund were an ETF.[21] Compliance with the diversification requirements of the Code and applicable exchange listing standards will help ensure that each Affected Fund maintains a level of diversification among its portfolio of investments.

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18 The Affected Fund would subsequently incorporate the changes to its prospectus and statement of additional into its registration statement in the Affected Fund's next post-effective amendment. The Affected Fund would also comply with the requirement of Rule 498 under the Securities Act of 1933 to post the prospectus and statement of additional information updates to the website specified in the Affected Fund's prospectus, if applicable.

19 The two-part diversification standard of Section 851 of the Code includes (1) with respect to fifty percent of an investment company's assets, no more than five percent may be invested in the securities of any one issuer and the investment company may not own more than ten percent of the outstanding voting securities of any one issuer; and (2), as to 100% of the investment company's assets, no more than twenty-five percent may be invested in the securities of any one issuer.

20 Compliance with the diversification requirements of Section 851 of the Code is required at the close of each quarter. As is the case under Section 5(c) of the 1940 Act, a registered investment company will not lose its diversified status under Section 851 of the Code because of a discrepancy during a subsequent quarter between the value of its various investments and the diversification requirements of Section 851 unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.

21 The major U.S. stock exchanges generally have consistent requirements for complying with the listing standards set forth in the applicable rules under the Securities Exchange Act of 1934. For example, NYSE Arca, NASDAQ, and Cboe each require that an index-based domestic equity ETF hold at least 13 constituents. The listing requirements of these exchanges also require, among other things, minimum market values and monthly trading volumes for securities held by the ETF and that such holdings be listed on a national securities exchange.

V. Conclusion

We believe that the Proposed Relief would enable the Affected Funds to continue to seek to achieve their investment objective in the most efficient and accurate manner. We also believe that the Proposed Relief will enable the Affected Funds and their shareholders to avoid the significant costs associated with seeking shareholder approval to convert the Affected Funds to non-diversified status and minimize the portfolio management disruption and possible significant costs described herein.

Accordingly, we request that the Staff provide assurances that it will not recommend enforcement action to the Commission under Sections 13(a)(1) and 34(b) of the 1940 Act if the investments of an Affected Fund exceed the limits defined by Section 5(b)(1) of the 1940 Act under the circumstances described in this letter.

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If you have any questions regarding this letter, please contact me at (215) 564-8173.

Sincerely,

Matthew R. DiClemente