The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 14699

May 7, 2002

SEC RULE PROPOSALS REGARDING TRANSACTIONS OF INVESTMENT COMPANIES WITH PORTFOLIO AND SUBADVISORY AFFILIATES

[14699] May 7, 2002 TO: SEC RULES COMMITTEE No. 38-02 INVESTMENT ADVISERS COMMITTEE No. 8-02 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 20-02 RE: SEC RULE PROPOSALS REGARDING TRANSACTIONS OF INVESTMENT COMPANIES WITH PORTFOLIO AND SUBADVISORY AFFILIATES The Securities and Exchange Commission has published for comment proposed amendments to Rules 10f-3, 17a-6, 17d-1 and 17e-1 and new Rule 17a-10 under the Investment Company Act of 1940 relating to transactions by investment companies with portfolio and subadvisory affiliates.1 The most significant aspects of the proposal are summarized below and a copy of the proposal is attached. Comments on the proposal must be received by the SEC no later than July 19, 2002. If you have any questions regarding the proposal or any comments you would like the Institute to include in its comment letter, please contact Ari Burstein by phone at 202-371-5408 or by e-mail at aburstein@ici.org. In addition, we have scheduled a conference call for Wednesday, May 22, at 4:00 pm Eastern to discuss the proposal and the Institute's comment letter. If you would like to participate on the call, please contact Monica Carter Johnson by phone at 202- 326-5823 or by e-mail at mcarter@ici.org by May 20. I. Portfolio Affiliates Rules 17a-6 and 17d-1(d)(5) under the Act provide exemptions from the prohibitions of Section 17(a) and 17(d) and Rule 17d-1(a) thereunder to permit a fund to enter into a principal transaction or a joint arrangement with a portfolio affiliate, or an affiliated person of a portfolio affiliate, if certain other affiliated persons of the fund (e.g., the fund's adviser, persons controlling the fund, and persons under common control with the fund) ("Prohibited Participants") are not parties to the transaction and do not have a "financial interest" in a party to the transaction. The exemptions provided by these rules, however, do not extend to the same type of transactions or arrangements involving portfolio affiliates of funds under common control with the fund. As the Release notes, a fund therefore may be able to enter into a transaction or 1 Investment Company Act Release No. 25557 (April 30, 2002) ("Release"). 2 arrangement with its own portfolio affiliate (a "first-tier" affiliate), but not with a portfolio affiliate of another fund in the same complex (a "second-tier" affiliate). The Release states that because transactions and arrangements between a fund and its second-tier portfolio affiliates do not appear to raise concerns different from those raised by transactions and arrangements between a fund and its first-tier portfolio affiliates, the SEC is proposing to amend Rules 17a-6 and 17d-1 to permit a fund to engage in principal transactions or enter into joint arrangements with its second-tier portfolio affiliates under the same conditions (discussed above) that currently

exist with first-tier portfolio affiliates. Rules 17a-6 and 17d-1(d)(5) also do not currently explain what constitutes a “financial interest” in a party for purposes of the exemption under those rules but instead provide a list of interests that are not considered to be “financial interests.” The Release states that the SEC is concerned that these rules may prohibit many transactions with portfolio affiliates even though the affiliated person’s financial interest is unlikely to raise the same concerns that these prohibitions were designed to address. The SEC is therefore proposing amendments to Rules 17a-6 and 17d-1(d)(5) to provide that, in addition to the interests currently not considered to be “financial interests,” the term “financial interest” would not include any interest that the fund’s board of directors, including a majority of the directors who are not interested persons of the fund, finds not to be material. The SEC also is proposing to amend Rules 17a-6 and 17d-1(d)(5) to make them consistent with each other with regard to the time period for which a Prohibited Participant’s financial interest will result in loss of the rules’ exemptions. Under the proposed amendments, the exemption under these rules will be available unless a Prohibited Participant (i) has a financial interest in a party at the time of the fund’s participation in the transaction or arrangement, (ii) had a financial interest in a party within the six months preceding the fund’s participation, or (iii) will obtain a financial interest in a party pursuant to an arrangement in existence at the time of the fund’s participation. Finally, under Rule 17d-1, a fund, or a company that a fund controls, may commit no more than five percent of its assets to a joint enterprise with a portfolio affiliate. The Release notes that there is no comparable limitation for principal transactions with portfolio affiliates and it is not clear that this limit continues to serve a useful purpose. The SEC therefore is proposing to amend Rule 17d-1(d)(5) to eliminate this percentage limit. II. Subadviser Affiliates 1. Principal Transactions with Subadvisers: Section 17(a) Section 17(a) of the Act prohibits a subadviser that is a first-tier or second-tier affiliate of a fund from borrowing money or other property from, or selling or buying securities or other property to or from the fund, or any company that the fund controls. The SEC is proposing new Rule 17a-10 under the Act that would permit a subadviser of a fund to enter into transactions with (i) funds the subadviser does not advise but which are affiliated persons of a fund it does advise, and (ii) funds the subadviser does advise, but with respect to portions of the subadvised fund for which the subadviser does not provide investment advice. 3 The exemption under proposed Rule 17a-10 would be subject to several conditions which, according to the Release, are designed to limit its availability to circumstances in which the subadviser is unable to influence the management of the fund, or a portion of the fund, that participates in the transaction (“participating fund” or “participating portion”). In particular, the rule would require that the subadvisory relationship be the sole reason why Section 17(a) prohibits the transaction (e.g., that the subadviser not be an affiliated person of the participating fund’s investment advisers, officers, directors, promoters, or underwriters). The rule also would require the participating subadviser and any subadviser of the participating fund or portion to be prohibited by their advisory contracts from consulting with each other concerning securities transactions of the participating fund or portion.2 2. Transactions With Subadvisers as Brokers: Section 17(e) Section 17(e)(2) of the Act generally limits the remuneration that a first-tier or second- tier affiliate of a fund may receive to the “usual and customary broker’s commission” for effecting purchases and sales of securities on a securities exchange on behalf of the fund, or a company the fund controls. Rule 17e-1 describes the circumstances in which remuneration received by an affiliated person of a fund qualifies as the “usual and customary broker’s commission.” Among other things, the rule requires that the fund’s board of directors review transactions to determine that they comply with procedures adopted by the board to ensure that the remuneration received by the affiliated person does not exceed the usual and customary broker’s commission and that the fund maintain a record of the transactions. The SEC is

proposing to amend Rule 17e-1 to permit an affiliated subadviser of a fund to receive remuneration for service as a broker without complying with these conditions, in circumstances, and subject to conditions, identical to those proposed under Rule 17a-10. 3. Purchases During Primary Offering Underwritten by Subadvisers: Section 10(f) Section 10(f) of the Act prohibits a fund from purchasing any security during an underwriting or selling syndicate if the fund has certain affiliated relationships with a principal underwriter for the security. Rule 10f-3 provides an exemption from the prohibition in Section 10(f) if certain conditions are satisfied, including that the fund relying on the rule, together with any other fund advised by the fund's adviser, purchase no more than 25 percent of the offering ("percentage limit"). The Release notes that the SEC has issued exemptive orders to permit funds to purchase securities during an underwriting or selling syndicate in which one of its subadvisers (that is a principal underwriter or an affiliated person of a principal underwriter) is a participant, when the adviser recommending the purchase is not a participant in the syndicate. These orders also permit a fund to purchase securities in reliance on Rule 10f-3 without aggregating purchases by portions of the fund advised by advisers that are not participants in the syndicate. The SEC is 2 The Release notes that although subadvisers and their affiliated persons would be able to enter into affiliated transactions and arrangements with a fund, or a portion of a fund, that the principal adviser advises, the SEC is not proposing to prohibit subadvisers and principal advisers from consulting with each other. The SEC specifically requests comment whether, in light of this decision, the SEC should not permit subadvisers and their affiliates from entering into transactions with funds, or portions of funds, advised by a principal adviser. 4 proposing amendments to Rule 10f-3 that would codify many of the terms of these exemptive orders. In particular, the proposed amendments would deem each of the series of a series company and the "managed portions"3 of a fund portfolio to be separate registered investment companies for purposes of Section 10(f) and Rule 10f-3. The amendments would exempt a purchase of securities by an investment company from the prohibition in Section 10(f) if the purchase would not be prohibited if each series or portion were separately registered. The SEC also is re-proposing amendments to Rule 10f-3 that would amend the way funds are required to aggregate purchases to determine compliance with the rule's percentage limit.4 Currently, a fund is required to aggregate all of its purchases with those of any other fund advised by its investment adviser. The Release states that the rule appears to be both too broad (in that it requires aggregation of purchases that are not influenced by participants in the underwriting) and too narrow (in that it does not require aggregation of purchases by accounts controlled by the adviser participating in the underwriting). The SEC therefore is proposing to amend Rule 10f-3 to require the aggregation of purchases by funds that are advised, and accounts that are controlled, by an investment adviser (that is a principal underwriter or an affiliated person of a principal underwriter) that is a participant in the underwriting or selling syndicate. If multiple investment advisers provide investment advice to a fund (e.g., a principal adviser and one or more subadvisers) but only one of those advisers is a participant in the underwriting or selling syndicate, Rule 10f-3's percentage limit would apply only to purchases by the funds and accounts of the participating investment adviser. 4. Ownership of Securities Issued by Subadvisers: Section 12(d)(3) Section 12(d)(3) of the Act generally prohibits funds, and companies controlled by funds, from purchasing securities issued by a registered investment adviser, broker, dealer or underwriter ("securities-related businesses"). Rule 12d3-1 permits a fund to invest up to five percent of its assets in securities of an issuer deriving more than fifteen percent of its gross revenues from securities-related businesses. A fund may not rely on the rule, however, to acquire securities of its own investment adviser or any affiliated person of its own investment adviser. The Release notes that the SEC has issued several exemptive orders to permit funds to rely on Rule 12d3-1 to purchase securities issued by fund

subadvisers when the subadviser was not in a position to influence the decision by the fund to purchase the securities. The SEC is proposing to amend Rule 12d3-1 to codify these orders and to permit a fund to acquire securities issued by one of its subadvisers (or an affiliated person of one of its subadvisers) subject to the same conditions as in Rules 17a-10 and 10f-3 that would permit transactions with 3 The Release states that a portion of a fund's portfolio would be a "managed portion" if it is a discrete portion of the portfolio for which a subadviser is responsible for providing investment advice, and the subadviser (i) does not provide investment advice with respect to any other portion of the fund's portfolio, (ii) is prohibited by its advisory contract from consulting with any other investment adviser of the investment company that is a principal underwriter or affiliated person of a principal underwriter concerning securities transactions of the fund, and (iii) is not an affiliated person of any other investment adviser, or any promoter, underwriter, officer, director, member of an advisory board, or employee of the investment company. 4 See Investment Company Act Release No. 24775 (November 29, 2000), 65 FR 76189 (December 6, 2000). 5 subadvisers. The rule would be available only to a subadviser that provides investment advice with respect to a discrete portion of the fund's portfolio, and that is not an affiliated person of the adviser causing the fund to purchase the securities. Ari Burstein Associate Counsel Attachment (in .pdf format)
