

MEMO# 16705

October 27, 2003

SEC PROPOSES MANAGER OF MANAGERS RULE UNDER THE INVESTMENT COMPANY ACT OF 1940

[16705] October 27, 2003 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 56-03 SEC RULES COMMITTEE No. 86-03 RE: SEC PROPOSES MANAGER OF MANAGERS RULE UNDER THE INVESTMENT COMPANY ACT OF 1940 The Securities and Exchange Commission has proposed new Rule 15a-5 under the Investment Company Act of 1940, which would permit an investment adviser to serve as a subadviser to an investment company without approval by the fund's shareholders.¹ The proposed rule would largely codify a number of exemptive orders the SEC has issued that facilitate funds' ability to enter into "manager of managers" arrangements.² As discussed below, reliance on the proposed rule is subject to several conditions. Comments on the proposal are due to the SEC on or before January 8, 2004. We have scheduled a conference call for Thursday, November 13, at 4:00 p.m., Eastern Time, to discuss members' comments on the proposal. The dial-in number for the call is 888-889-1956 and the passcode is Manager of Managers/Simmons. If you, or someone else from your organization, would like to participate on the call, please contact Stephanie Holly by phone at (202) 326- 5814 or by e-mail at sholly@ici.org. If you will be unable to participate on the call but would like to provide comments, please provide them to me prior to the scheduled call. I may be reached by phone at (202) 326-5923, by fax at (202) 326-5827, or by email at bsimmons@ici.org. 1 Exemption from Shareholder Approval for Certain Subadvisory Contracts, SEC Release Nos. 33-8312, 34-48683, IC-26230, dated October 23, 2003 ("Proposing Release"). The SEC's proposal also would amend: (1) Form N-1A under the Investment Company Act and the Securities Act of 1933; (2) Schedule 14A under the Securities Exchange Act of 1934; and (3) Rule 6-07 under the Investment Company Act and the Securities Act. The Proposing Release is available from the SEC's website at <http://www.sec.gov/rules/proposed/33-8312.htm>. 2 The Proposing Release makes clear, however, that the proposed rule would benefit funds with single subadvisers as well as funds with multiple subadvisers inasmuch as it would not require a fund or portfolio to engage a certain minimum number of subadvisers. See Proposing Release at 19. The Proposing Release also notes the Commission's intention to rescind its previously issued exemptive orders once the new rule is adopted. The Release explains that because those orders contain conditions that may vary slightly from fund to fund, permitting funds to operate under those orders could adversely impact competition. 2 1. Terms of the Subadvisory Contract; Subadvisory Fees Proposed Rule 15a-5 provides that a subadvisory contract would not require shareholder approval if it does not directly or indirectly increase the management and advisory fees charged to the fund or its shareholders. (Thus, any contract that increases these fees would require shareholder approval.) The proposed amendments to Form N-1A would provide additional relief to sponsors of manager of

managers funds. In particular, Item 15 would be amended to permit those funds to disclose only the aggregate amount of advisory fees that it pays to its unaffiliated subadvisers as a group, rather than requiring them to disclose each of the fees separately. The Proposing Release notes, however, that while the individual fee paid to the principal adviser's unaffiliated subadviser would not have to be disclosed, the individual fee paid to each wholly-owned subadviser (as defined in the rule) would have to be disclosed.

2. Obligation to Supervise Subadvisers Proposed Rule 15a-5(a)(4) would require any contract between a fund and its principal adviser to obligate the principal adviser to supervise the subadviser. To more effectively carry out this responsibility, Proposed Rule 15a-5(b)(4) includes a condition that requires the subadvisory contract to be terminable at any time by the principal adviser, on no more than 60 days written notice, without payment of penalty.

3. Arm's Length Relationship Between Principal Adviser and Subadvisers Proposed Rule 15a-5(a)(2) contains two conditions that prohibit conflicting relationships. First, the provision precludes a subadviser relying on the rule from being an affiliated person of the principal adviser with which it has contracted or of the fund (other than by reason of serving as the fund's investment adviser). Second, no director or officer of the fund, and no principal adviser or director or officer of the principal adviser with which the subadviser has contracted, may directly or indirectly own any material interest in the subadviser other than an interest through ownership of shares of a pooled investment vehicle that is not controlled by such person or entity. The proposed provision would, however, permit the principal adviser, without shareholder approval, to materially amend the contract of its wholly-owned subadviser, or terminate such contract and replace the wholly-owned subadviser with another wholly-owned subadviser. The Proposing Release explains that expanding the scope of the rule to include wholly-owned subadvisers is appropriate inasmuch as the relationship would not provide the principal adviser with any economic incentive to replace one wholly-owned subadviser with another wholly-owned subadviser (other than to increase the fund's return on its investments).

4. Board Oversight Consistent with the SEC's rules on fund governance, Proposed Rule 15a-5(a)(7) would require a manager of managers fund relying on the rule to have a board of directors whose independent directors (i) constitute a majority of the directors, (ii) are selected and nominated by other independent directors, and (iii) if represented by legal counsel, are represented by "independent legal counsel."

3 5. Investor Expectations The SEC's proposal contains four requirements designed to assure that investors understand that they are investing in a manager of managers fund, and that they receive information about the subadvisers, including that they could be changed at any time without shareholder approval. First, proposed Rule 15a-5(a)(3) would require that, except in the case of a newly offered fund, shareholders approve the fund's operation as a manager of managers fund, by authorizing the adviser (with the approval of the fund's board) to enter into subadvisory contracts without shareholder approval. Second, the proposed amendments to Form N-1A would require a fund to disclose in its prospectus the principal adviser's ability, subject to board approval, to retain and discharge subadvisers without shareholder approval. Third, to prevent confusion about the relative roles of the principal adviser and the subadviser, Proposed Rule 15a-5(a)(6) would prohibit a fund from having a name that contains the subadviser's name unless the subadviser's name is preceded by the principal adviser's name. Finally, Proposed Rule 15a-5(a)(5) would require a fund, within 90 days after entering into a subadvisory contract or materially amending a wholly-owned subadviser's existing contract, to furnish shareholders with (and file with the Commission) an information statement that describes the subadvisory agreement, and contains other information that would have been provided in a proxy statement had a shareholder vote been held.

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