

MEMO# 14839

June 27, 2002

INSTITUTE DRAFT COMMENT LETTER ON SEC RULE PROPOSALS REGARDING TRANSACTIONS WITH PORTFOLIO AND SUBADVISORY AFFILIATES

[14839] June 27, 2002 TO: SEC RULES COMMITTEE No. 50-02 INVESTMENT ADVISERS COMMITTEE No. 10-02 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 25-02 RE: INSTITUTE DRAFT COMMENT LETTER ON SEC RULE PROPOSALS REGARDING TRANSACTIONS WITH PORTFOLIO AND SUBADVISORY AFFILIATES As we previously informed you,¹ the Securities and Exchange Commission has published for comment proposed amendments to Rules 10f-3, 17a-6, 17d-1 and 17e-1 under the Investment Company Act of 1940, as well as a new rule (Rule 17a-10) under the Act relating to transactions by investment companies with portfolio and subadvisory affiliates.² The Institute has prepared a draft comment letter on the proposal. The most significant aspects of the draft letter are summarized below and a copy of the draft letter is attached. Comments on the proposal must be received by the SEC no later than July 19, 2002. We have scheduled a conference call for Tuesday, July 9, at 2:00 pm Eastern to discuss the Institute's draft 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 July 8. Detailed information regarding the conference call will be sent shortly. If you have any comments on the draft letter and you are unable to participate on the call, please contact Ari Burstein by phone at 202-371-5408 or by e-mail at aburstein@ici.org, or Barry Simmons by phone at 202-326-5923 or by e-mail at bsimmons@ici.org no later than July 9.

A. Portfolio Affiliates The proposal would amend Rules 17a-6 and 17d-1(d)(5) to provide that, in addition to the interests currently deemed not to be "financial interests," the term "financial interest" would not include any interest that the fund's board of directors finds to be not material. The draft letter supports this proposal but, in response to a request for comment in the Proposing Release on whether the rules should provide a standard against which directors should determine whether an interest is not material, states that the Institute supports leaving this determination to the board's discretion. 1 Memorandum to SEC Rules Committee, No. 38-02, Investment Advisers Committee No. 8-02 and Closed-End Investment Company Committee No. 20-02, dated May 7, 2002. 2 Investment Company Act Release No. 25557 (April 30, 2002) ("Release"). 2 The proposal also would amend the rules to make them consistent with one another regarding the time period for which a past financial interest in a party to the transaction would result in disqualification from the rules' exemption. The draft letter recommends that these "lookback" provisions in the rules be deleted, so that the only determination that would be required is whether a "Prohibited Participant" currently has or will obtain a financial interest in a party to the transaction. Finally, the draft letter

recommends a technical change to the scope of the portfolio affiliates proposal to clarify that the rule will cover certain transactions involving second-tier portfolio affiliates that would be consistent with the Commission's intent to exempt transactions where neither the parties to the transaction nor any person with a financial interest in a party to the transaction has the potential to overreach the fund.

B. Subadviser Affiliates

1. Principal Transactions with Subadvisers

The exemption for principal transactions with subadvisers in proposed Rule 17a-10 would be subject to two conditions, including that the participating subadviser and any subadviser of the participating fund or portion of the fund must be prohibited by their advisory contracts from consulting with each other concerning securities transactions of the participating fund or portion ("consultation prohibition"). The draft letter opposes the imposition of a prohibition on consultation between subadvisers and states that such a prohibition is unnecessary and should be eliminated.³ The draft letter states that if the Commission determines that the consultation prohibition is necessary, the Institute recommends that this prohibition be narrowed to prohibit any consultation among subadvisers for the purpose of creating an understanding or agreement to engage in transactions that would evade the provisions of the rule, or, at the very least, that it be narrowed so as to be consistent with the conditions that have been included in exemptive orders the Commission has issued in this area, i.e., that an affiliated subadviser will not directly or indirectly consult with any unaffiliated subadviser concerning the allocation of principal or brokerage transactions. Finally, the draft letter seeks clarification on an issue relating to the scope of proposed Rule 17a-10. In particular, proposed Rule 17a-10 would cover certain transactions between a subadviser and other funds in the same complex as the subadvised fund. As currently drafted, however, it may not cover certain transactions between a fund and a second-tier affiliated person of a subadviser, if a subadviser is considered to "control" a fund that it subadvises. The draft letter therefore seeks clarification that a subadviser would not be considered to control a fund that it subadvises. The letter further states that if this is not the Commission's position, the Institute recommends that the language of proposed Rule 17a-10 be revised to cover transactions between a fund and a second-tier affiliate of a subadviser.

³ The consultation prohibition also is included in the proposals to amend Rules 10f-3, 12d3-1 and 17e-1. The draft letter notes that our comments on the consultation prohibition in proposed Rule 17a-10 also apply to the corresponding amendments to these rules.

3 2. Transactions with Subadvisers as Brokers

The Commission has proposed to exempt funds from the board review and recordkeeping requirements of Rule 17e-1 when an affiliated subadviser of the fund receives remuneration for service as a broker, subject to certain conditions. The draft letter supports this proposal and suggests that the Commission revise the wording of the proposed amendments to Rule 17e-1 to make clear that a series or portion of a fund would be covered by the rule amendments.

3. Purchases During Primary Offering Underwritten by Subadvisers

The Commission's proposed amendments to Rule 10f-3 would permit a fund to purchase securities during an underwriting or selling syndicate in which one of its subadvisers is a participant. The proposal also would permit a fund, or series of a fund, to purchase securities in reliance on Rule 10f-3 without having to aggregate purchases by portions of the fund or any other series of the fund advised by an adviser that is not a participant in the syndicate. The Institute's draft letter supports these proposals. The Commission's proposal also would amend the condition of the rule that generally limits the amount of securities that a fund, together with any other fund advised by the same adviser, may purchase in an offering to 25 percent of the principal amount of the offering. Specifically, the proposed amendments would require the adviser, in applying the percentage limit, to aggregate not only purchases by any other fund it advises, but also purchases by any other account over which it has discretionary authority or exercises control. The draft letter opposes this proposal. The letter recommends, however, that if the

Commission nonetheless decides to adopt the aggregation requirement, then it should reconsider the appropriateness of the rule's 25 percent limit. Moreover, any aggregation requirement should not include accounts over which an adviser does not exercise investment discretion. Ari Burstein Associate Counsel Attachment (in .pdf format)

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.