**COMMENT LETTER**

July 19, 2002

# Comment Letter on SEC Proposal Regarding Fund Transactions with Certain Affiliates, July 2002

July 19, 2002

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Transactions of Investment Companies With Portfolio and Subadvisory Affiliates (File No. S7-13-02)

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to provide comments on the Securities and Exchange Commission's proposals to expand the current exemptions for investment companies under the Investment Company Act of 1940 to engage in transactions with portfolio and subadvisory affiliates.[2] In particular, the Commission is proposing new Rule 17a-10 under the Act as well as several amendments to Rules 10f-3, 12d3-1, 17a-6, 17d-1, and 17e-1 under the Act.

The Institute strongly supports the Commission's proposals. In 1998, the Institute submitted to the Commission staff several recommendations for new and amended rules concerning affiliated transactions.[3] The Institute recently resubmitted many of these recommendations to the Commission staff as part of a broader package of recommendations to improve investment company regulation.[4] We are pleased that the Commission's current proposals would address the subject matter of two of the Institute's recommendations.[5] As we stated in our submissions, while the restrictions of the Act relating to affiliated transactions remain fundamentally sound, there is an increasing number of instances in which they impede transactions that would benefit fund shareholders and that do not raise the concerns that the restrictions were intended to address. In addition, as the Proposing Release notes, as the number of persons that are affiliated persons of funds has increased, there is an increasing number of persons with which funds may not enter into transactions under the Act but which have neither the ability nor an incentive to take advantage of the funds. Given these reasons, and the Commission's extensive experience granting exemptive relief in this area, we believe the time is ripe for rulemaking to relieve these burdens on funds, as

well as the burdens on Commission staff in processing exemptive applications.

While we strongly support the goals of the proposals, we have several comments that are intended to ensure that they achieve these goals while preserving important investor protections and eliminating unnecessary burdens. In summary, our comments are as follows:

We support the Commission's proposal to expand the list of interests that are deemed not to be "financial interests" under Rules 17a-6 and 17d-1(d)(5) to include any interest that the fund's board of directors finds to be not material; in this regard, we support leaving to the board's discretion the determination of whether an interest is not material, rather than incorporating a standard for materiality in the rules.

We oppose the "lookback" provisions in Rules 17a-6 and 17d-1(d)(5) under which a participant's past financial interest would result in disqualification from the rules' exemptions.

We recommend a technical revision to clarify that the proposed amendments to Rule 17a-6 will cover certain transactions involving second-tier portfolio affiliates.

We oppose the proposed prohibition on subadvisers consulting with one another that would apply under proposed Rule 17a-10 and Rules 10f-3, 12d3-1 and 17e-1.

We seek clarification that, in the context of proposed Rule 17a-10, a subadviser would not be considered to control a fund that it subadvises. Absent such a clarification, we recommend that the language of proposed Rule 17a-10 be revised to cover transactions between a fund and a second-tier affiliate of a subadviser.

We recommend revising the wording of the amendment to Rule 17e-1 to clarify that a series or portion of a fund would be covered.

We support the Commission's proposal to amend Rule 10f-3 to permit funds to purchase securities during an underwriting or selling syndicate in which one of its subadvisers is a participant; however, we oppose the Commission's proposal to require aggregation of purchases by an adviser's fund accounts and non-fund accounts for purposes of applying the rule's 25 percent quantity limitation.

Each of these comments is discussed more fully below.

# A. Portfolio Affiliates

Rules 17a-6 and 17d-1(d)(5) currently permit a fund and its portfolio affiliates to engage in principal transactions and to enter into joint arrangements that would otherwise be prohibited, as long as 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 [6]) ("Prohibited Participants") are not parties to the transaction and do not have a "financial interest" in a party to the transaction.

## 1. Financial Interests

**a. Board Determination**

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, including a majority of the directors who are not interested persons of the fund, finds to be not material. The Institute supports this proposal because it would provide additional flexibility to allow funds to rely on the exemptions in circumstances that are unlikely to involve potential overreaching of the fund.

The Proposing Release requests comment on whether the rules should provide a standard against which directors should determine whether an interest is not material. Consistent with the Commission's proposal as drafted, the Institute supports leaving this determination to the board's discretion. The large number of variables and potentially remote interests that could exist would make it extremely difficult to construct a standard that would be appropriate under all circumstances. We also do not believe that it would be appropriate for the Commission to mandate how a board should reach its determination as to whether a financial interest is material.

**b. "Lookback" Provision**

According to the Proposing Release, the proposal would amend Rules 17a-6 and 17d-1(d)(5) to make them consistent with one another regarding the time period prior to the transaction for which a Prohibited Participant's financial interest or participation would result in disqualification from the rules' exemption. Currently, Rule 17a-6 "looks back" six months prior to the transaction to determine whether a Prohibited Participant had a financial interest in a party to the transaction. Rule 17d-1(d)(5) is less specific, but by its terms requires a determination whether a Prohibited Participant "was" a participant in a joint enterprise through a financial interest in a person "who is, was or will be" a participant in a joint enterprise. The proposal would establish six months as the lookback period for both rules.

The Institute recommends that the 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 (pursuant to an arrangement in existence at the time of the transaction) a financial interest in a party to the transaction. It is improbable that a past financial interest would raise the investor protection concerns that the rules are intended to address. Indeed, when the Commission adopted the lookback provisions in Rules 17a-6 and 17d-1(d)(5), no explanation of the purpose or need for these provisions was provided in the adopting releases, and the scant discussion in those releases only identified concerns with current and future financial interests.[7] Moreover, the lookback provisions impose unnecessary compliance burdens on funds in obtaining information about Prohibited Participants' past financial interests.[8] Therefore, absent any clear policy basis for a lookback provision, the Institute recommends that the Commission eliminate this provision from Rules 17a-6 and 17d-1(d)(5).

## 2. Technical Comment on Scope of Proposal

The proposal would amend Rules 17a-6 and 17d-1(d)(5) to permit a fund to engage in principal transactions or to enter into joint arrangements with its second-tier affiliates under the same conditions, noted above, that currently exist for first-tier affiliates. The Institute strongly supports the expansion of the rules to include second-tier affiliates (i.e., funds that share a common investment adviser). We recommend minor revisions to the proposed

amendments to Rule 17a-6, however, to clarify that the rule will cover certain transactions involving second-tier affiliates that we believe the Commission intended to include in its expansion of the rule.

For example, assume that Fund A and Fund B, which have the same principal adviser, own six percent and three percent, respectively, of the outstanding voting securities of Company X. Fund A wants to enter into a transaction to purchase commercial paper issued by Company X. Under the proposed amendments to Rule 17a-6, as currently drafted, Fund A may be unable to do so. This is because Fund B, a Prohibited Participant, might be deemed to have a disqualifying "financial interest" in a party to the transaction (Company X).9

We believe that the Commission intended such a transaction to be permitted under amended Rule 17a-6, pursuant to the exception in proposed subparagraph (a)(4)(ii) of the rule. That provision would allow Fund A to engage in the transaction if Fund B's "sole interest in the transaction is an interest in a Portfolio Affiliate of the Fund." Because Fund B does not have an interest in the transaction itself but an interest in a party to the transaction, it is unclear whether Fund A can rely on this exception.10

To address this ambiguity in the proposal, we recommend that Rule 17a-6(a)(4)(ii) be revised to read: "A Fund whose sole interest in the transaction or a party to the transaction is an interest in the Portfolio Affiliate." We believe this would permit a transaction such as that described above and 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 Commission has proposed new Rule 17a-10, which would permit a subadviser of a fund (or its affiliates) to enter into principal transactions with (1) funds the subadviser does not advise but which are affiliated persons of a fund it does advise, and (2) funds the subadviser does advise, but with respect to portions of the subadvised fund for which the subadviser does not provide investment advice. The proposed exemption would be subject to two conditions: (1) the subadvisory relationship must be the sole reason why Section 17(a) prohibits the transaction, and (2) 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").

### a. Consultation Prohibition

The Proposing Release indicates that the consultation prohibition is designed to limit the rule's exemption to those transactions in which the subadviser has no incentive or ability to influence the investment decisions made on behalf of the fund or portion of the fund that participates in the transaction. For the reasons discussed below, we believe the consultation prohibition should be eliminated.11

First, we note that the Commission proposed not to extend this prohibition to the fund's principal adviser because it would be highly impractical, if not impossible, to do so. We agree with the Commission's conclusion on this matter. We further note, however, that the Commission found comfort in the fact that "the principal adviser remains a fiduciary of the

fund and may not collaborate with fund subadvisers for the purpose of overreaching the fund."[12] Fund subadvisers have the same fiduciary responsibility to the fund as the fund's principal adviser.[13] Under the Commission's own reasoning, therefore, subadvisers already are prohibited from collaborating for the purpose of overreaching a fund. Second, certain practical realities indicate that there is little need for the prohibition. Each subadviser's contract assigns the subadviser responsibility to manage the fund or a discrete portion of the fund and, thus, each subadviser is responsible for making investment and brokerage allocation decisions independent of the other subadvisers. Moreover, as the Commission recognizes, the fund's own subadviser and the second-tier affiliated subadvisers are business competitors of one another.[14] For these reasons, subadvisers do not, as a rule, consult with each other on investment decisions. Third, the prohibition would impose unnecessary burdens on funds and their subadvisers. In addition to requiring amendments to numerous advisory contracts, the proposal would prohibit communications between subadvisers that do not raise any concerns, including communications that would be beneficial to fund shareholders (e.g., communications on compliance matters). Finally, it seems that the purpose of the prohibition is to ensure that two or more subadvisers do not collaborate with one another to engage in transactions that would otherwise be prohibited (e.g., by agreeing that Adviser X will engage in principal transactions with a fund managed by Adviser Y if Adviser Y engages in principal transactions with a fund managed by Adviser X). The Institute believes that such a practice would be prohibited under Section 48(a) of the Investment Company Act and, consequently, that there is no need to add conditions to the rules to address it.

If, however, the Commission disagrees, it would be better to have the rules address the Commission's specific concerns more directly; thus, in lieu of prohibiting all consultations among subadvisers, the rules should 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. At the very least, we recommend that the consultation prohibition be narrowed so as to be consistent with the conditions that have been included in exemptive orders the Commission has issued in this area.[15] In particular, the orders have relied upon applicants' representations that an affiliated subadviser will not directly or indirectly consult with any unaffiliated subadviser concerning the allocation of principal or brokerage transactions.[16]

Finally, if some form of consultation prohibition is retained, we recommend that it be included in the text of the rules themselves rather than in a subadviser's advisory contract. This would avoid the burdens of advisers having to amend their advisory contracts for a matter that we believe is more appropriate to address through a regulatory requirement.[17]

**b. Scope of Proposed Rule**

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, to the extent a subadviser is considered to "control" a fund that it subadvises.

For example, assume that Adviser Y is the principal adviser (and is therefore an affiliated person of) Fund A and Fund B. Adviser X subadvises (and therefore also is an affiliated person of) Fund A. Adviser X also acts as the investment adviser to funds within its own complex.

If Adviser X, as subadviser to Fund A, is considered to control Fund A, as well as the funds in

its own complex, as a commonly controlled fund, Fund A may be considered an affiliated person of the other funds in Adviser X's complex. In turn, this makes Adviser Y a second-tier affiliated person of the funds in Adviser X's complex. Because proposed Rule 17a-10 only extends to first-tier affiliated persons of Adviser X (the subadviser), Rule 17a-10 would not exempt transactions between Adviser Y and the funds in Adviser X's complex.

The Institute believes that a subadviser generally should not be deemed to control a fund that it subadvises. It is unclear, however, whether the Commission, at least for purposes of Section 17, agrees with this position.[18] We therefore seek clarification that a subadviser would not be considered to control a fund that it subadvises. If the Commission is unwilling to provide such clarification, then the Institute would recommend that Rule 17a-10 be revised to extend to transactions between a fund and any second-tier affiliate of the subadviser (Adviser X in the above example). We believe this would be entirely consistent with the rule's intended scope.[19] In these situations, any affiliation that exists is purely a "technical" affiliation, similar to those addressed in the proposal. In the example discussed above, the principal adviser has no influence or control over the investment decisions of the funds in the subadviser's complex. Thus, we see no reason why these transactions would raise any conflict of interest or self-dealing concerns. In addition, we cannot think of a situation where, under the proposed conditions in the rule, it would be appropriate for a first-tier affiliate of a subadviser to engage in principal transactions with a fund but inappropriate for a second-tier affiliate of a subadviser to do so.[20]

## 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, so long as the conditions in Rule 17a-10, discussed above, are satisfied.

The Institute strongly supports the proposed amendments to Rule 17e-1, with the changes discussed above. We have one technical comment on the proposed amendment. We request that the Commission revise Rule 17e-1 to make clear that a series or portion of a fund would be covered by the rule amendments. As proposed, Rule 17e-1 states that a fund would have to comply with the board review and recordkeeping requirements for all transactions "other than transactions in which the person acting as a broker is a person permitted to enter into a transaction with the investment company by [Rule 17a-10]" (emphasis added). The term "investment company," however, is not defined in Rule 17e-1 nor is it used in Rule 17a-10. [21] The scope of Rule 17a-10 clearly includes a series or portion of a fund. Rule 17e-1 should be revised to make clear that it is coterminous with Rule 17a-10 in this respect.

## 3. Purchases During Primary Offerings Underwritten by Subadvisers

### a. Application of Section 10(f) to Subadvisory Relationships

The Commission has proposed amendments to Rule 10f-3 to address the regulatory impact that Section 10(f) has on fund purchases of securities during primary offerings underwritten by subadvisers.[22] The proposal would deem each of the series of a series company and the "managed portions" of a fund portfolio (as defined in the rule) to be separate registered investment companies for purposes of Section 10(f) and Rule 10f-3.[23] Thus, 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 managed portion were separately registered. The proposal also would permit a fund, or

series of a fund, to purchase securities in reliance on Rule 10f-3 without aggregating 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 strongly supports this proposal. We agree that the abuses Section 10(f) was designed to prevent are not present in the circumstances covered by the Commission's proposal. A subadviser has no direct or indirect power or authority to furnish advice to, make investment decisions for, or otherwise influence series or managed portions of a fund that it does not advise. Thus, the subadviser would have no opportunity to "dump" securities into a fund or portions of a fund's portfolio that it does not advise.

**b. Aggregation of Non-Fund Accounts**

The Commission's proposal would amend the condition of the rule that generally limits the amount of securities that an affiliated fund, together with any other fund advised by the affiliated fund's 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 otherwise exercises control."[24]

The Commission first proposed this change to Rule 10f-3 in its 2000 Proposal. At that time, the Institute expressed strong opposition to requiring aggregation of an adviser's non-fund accounts.[25] For the reasons stated then, and reiterated below, we continue to oppose any such requirement.

First, the Commission has not adequately demonstrated a need for aggregating purchases by an adviser's non-fund accounts with those of funds it advises. In the 2000 Proposal, the Commission explained that requiring an adviser to include its non-fund accounts in determining compliance with the 25 percent limit was intended to close a possible "loophole" in the rule that could permit an investment adviser to circumvent the percentage limit and compromise the effectiveness of the rule by purchasing most or all of an offering for its non-fund clients while complying with the limit for its fund clients.[26] However, neither the 2000 Proposal nor the current proposal has provided any examples where the conduct that this proposal seeks to address has occurred, much less where fund shareholders have been harmed as a result. This is particularly noteworthy given that an adviser's purchase of securities through an affiliated underwriting for both fund and non-fund accounts has been an ongoing practice for many years.

Second, the Institute remains concerned that requiring an adviser to include purchases by non-fund accounts when applying the percentage limit could potentially harm fund shareholders by unduly restricting their investment opportunities (e.g., by limiting fund purchases of securities subject to Rule 10f-3 to a much smaller amount than would be permitted but for purchases by the adviser's non-fund clients). We are concerned that this proposal, when combined with an adviser's affirmative duty to allocate securities purchases on a fair and equitable basis, would effectively reduce the overall percentage available to fund shareholders. As a result, an adviser may not be able to realize the full benefit available under the rule and, as such, may choose to forego investing in the securities altogether, because the amount that each fund or account could purchase might be too small to have any significant effect on any individual fund or non-fund account.[27]

Moreover, the Commission's cost-benefit analysis fails to reflect the costs of monitoring

compliance with the proposed aggregation requirement—a cost that in many cases would be substantial. In today's marketplace, advisers to investment companies often are part of large, diversified financial services firms that have many different types of accounts. Such organizations typically have well-established procedures, including extensive information barriers, to protect against potential conflicts of interest. Requiring aggregation of securities purchases by non-fund accounts under Rule 10f-3 in these circumstances would entail costly and burdensome adjustments to the compliance monitoring function.[28]

In view of the longstanding history of industry reliance on Rule 10f-3, the lack of any demonstrated abuses in this area, the possible disadvantage to fund shareholders, and the costs of monitoring compliance, we see no reason to expand the aggregation requirement to include an adviser's non-fund accounts.

If the Commission decides, however, to adopt the aggregation requirement despite the concerns expressed above, then there are several issues that should be addressed. First, adopting an aggregation requirement would call into question the appropriateness of the rule's quantitative limitation. In the 2001 ICI Letter, we expressed concern that the current 25 percent limit is more restrictive than necessary for the protection of investors and does not provide sufficient flexibility to enable funds to achieve their investment objectives given the growth of the fund industry. As noted in our letter, a 50 percent threshold would address the Commission's concerns with ensuring the existence of a bona fide market for the securities being offered. Any expansion of the aggregation requirement would make the need for an increase in the percentage limit even more acute.

Second, we are concerned that the standard for determining which non-fund accounts would be covered by the proposed aggregation requirement, i.e., accounts over which an adviser "has discretionary authority or otherwise exercises control," is vague and could be interpreted in a manner broader than intended. For example, it is unclear under the proposal whether sponsors of certain types of advisory programs, such as wrap fee programs, would be considered to "exercise control" over such programs and therefore be required to aggregate purchases made on behalf of the accounts in the program. These programs generally involve execution of securities transactions by a sponsor that is typically dually registered as a broker-dealer and an investment adviser. Such sponsors may execute transactions directed to them by the portfolio manager, who has full discretion to manage the client accounts in the program. Since, in that situation, the sponsor has no involvement in the recommendation or selection of securities for the program, and is not in a position to otherwise influence the investment decisions made on behalf of the program's clients, we see no reason to require it to aggregate the purchases made on behalf of the program's clients with purchases made on behalf of the funds and/or accounts advised by the sponsor. We note that this conclusion is consistent with the staff's position in the Morgan, Lewis & Bockius no-action letter in which it agreed that in certain circumstances a sponsor of a wrap fee program that exercises no investment discretion and is not in a position to influence the investment decisions made by the program's investment adviser/portfolio manager would not need to comply with certain requirements under the Investment Advisers Act of 1940.[29]

To address our concerns noted above about the vagueness of the proposed standard, we have two recommendations. First, the term "discretionary authority," which is not defined in the proposal or in the Investment Company Act, should be replaced with, or defined by reference to, the term "investment discretion" as set forth in Section 3(a)(35) of the Securities Exchange Act of 1934.[30] This definition generally encompasses any person authorized to determine what securities or other property to buy or sell for an account. It

appears to be consistent with the Commission's intent and would provide further clarity as to the types of accounts that are subject to the aggregation requirement.31

Second, we strongly recommend deleting the phrase "or otherwise exercises control" from the proposal. We believe that applying the aggregation requirement to accounts over which an investment adviser exercises investment discretion, as discussed above, would capture the types of accounts the proposal is designed to address and that including a "control" component would not provide any additional benefits. In fact, as noted above, its inclusion would raise interpretive issues and could result in extension of the aggregation requirement beyond the intended scope of the proposed amendment (e.g., to accounts such as those in the wrap fee programs described above). We do not believe that the amendment is intended to, or should, cover these types of accounts.

* * *

The Institute appreciates the opportunity to provide comments on this proposal. If you have any questions regarding our comments, or would like any additional information, please contact me at (202) 326-5824, Ari Burstein at (202) 371-5408 or Barry Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director
Robert E. Plaze, Associate Director
C. Hunter Jones, Assistant Director
Martha B. Peterson, Special Counsel
Division of Investment Management

**ENDNOTES**

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,928 open-end investment companies ("mutual funds"), 499 closed-end investment companies and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.898trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

2 Investment Company Act Release No. 25557 (April 30, 2002), 67 FR 31081 (May 8, 2002) ("Proposing Release").

3 See Letter from Craig S. Tyle, General Counsel, ICI, to Paul F. Roye, Director, Division of Investment Management, SEC, dated December 10, 1998 (enclosing Recommendations for New and Amended Rules Concerning Affiliated Transactions) ("1998 ICI Submission").

4 See Letter from Craig S. Tyle, General Counsel, ICI, to Paul F. Roye, Director, Division of Investment Management, SEC, dated May 1, 2002 (enclosing Proposals to Improve Investment Company Regulation).

5 We continue to strongly urge the Commission to take expedited action on our other recommendations.

6 The Proposing Release presumes that funds in a fund complex are under common control. For purposes of our comments, we also make this presumption although we do not necessarily agree that it is always the case. We are pleased that the Commission has recognized that "[n]ot 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." Proposing Release, note 14.

7 See, e.g., Investment Company Act Release No. 8542 (October 15, 1974) ("In adopting new subparagraph (5) of Rule 17d-1, the Commission believes that when the persons designated ... do not have a financial interest in a joint transaction, there is little likelihood that participation by registered investment companies, or controlled companies thereof, ... will result in unfair or disadvantageous treatment to the investment companies or their controlled companies."); Investment Company Act Release No. 3968 (April 29, 1964) (interests of the fund may be adversely affected "if any of the affiliated persons of the investment company referred to in sub-paragraphs (a)(1) through (a)(5) has a financial interest in any party to the transaction ...").

We note that the period covered by the current lookback provision in Rule 17d-1(d)(5) is ambiguous. Although it possibly could be read to require a fund to look back in perpetuity to determine whether a Prohibited Participant was a participant in a joint enterprise, it is unclear whether that is how the Commission interprets this provision (and we are not aware of any staff positions or interpretive guidance on this point).

8 Determining whether any Prohibited Participant held a financial interest in a party to a transaction covered by Rule 17a-6 or Rule 17d-1(d)(5) at any point within six months prior to the transaction would be very difficult because Prohibited Participants include a broad range of individuals and entities and the definition of "financial interest" is open-ended.

9 This assumes that a 3 percent interest in the outstanding voting securities of an issuer is a "financial interest" for purposes of the rule. We note that under the proposal, a fund's board may determine that such an interest is not material and therefore not a financial interest for purposes of the rule.

10 Similarly, it is unclear whether the proposal would permit Fund B (rather than Fund A) to purchase the commercial paper or both Fund A and Fund B to purchase the commercial paper.

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

12 Proposing Release, note 45.

13 A subadviser is an "investment adviser" for purposes of the Investment Company Act. See Section 2(a)(20) of the Act and Proposing Release, note 36.

14 Proposing Release, note 16.

15 See, e.g., The Vantagepoint Funds and Vantagepoint Investment Advisers, LLC, Investment Company Act Release Nos. 25446 (February 26, 2002) (notice) and 25496 (March 22, 2002) (order); John Hancock Equity Trust and John Hancock Advisers, Inc. Investment Company Act Release Nos. 25414 (February 11, 2002) (notice) and 25455 (March 8, 2002); AXA Premier Funds Trust, et al., Investment Company Act Release Nos.

25323 (December 20, 2001) (notice) and 25369 (January 16, 2002) (order); CDC IXIS Asset Management Advisers, L.P., et al., Investment Company Act Release Nos. 25061 (July 12, 2001) (notice) and 25103 (August 8, 2001) (order); AB Funds Trust, et al., Investment Company Act Release Nos. 24999 (June 7, 2001) (notice) and 25054 (June 29, 2001) (order); SEI Investments Management Corporation, et al., Investment Company Act Release Nos. 24430 (April 28, 2000) (notice) and 24463 (May 23, 2000) (order); Liberty All-Star Equity Fund, et al., Investment Company Act Release Nos. 24255 (January 19, 2000) (notice) and 24288 (February 15, 2000) (order). The Proposing Release states that the proposed conditions have been conditions in the exemptive orders issued by the Commission. We have been unable to identify, however, any exemptive orders that have prohibited all consultation between subadvisers and/or required a consultation prohibition to be contained in an advisory contract.

6 The Institute also recommends a technical change to limit the consultation prohibition to "advisory personnel" of the subadviser. This would address a situation where a subadviser is dually registered as a broker-dealer and an investment adviser and, in the ordinary course of business (e.g., execution of trades), broker-dealer personnel of the subadviser communicate with another subadviser regarding securities transactions. Because the subadviser would have "Chinese walls" in place to prohibit consultation between personnel of its broker-dealer and investment adviser, we see no policy reason to prevent communication by the subadviser's broker-dealer personnel with other subadvisers.

17 If the Commission requires the consultation prohibition to be included in a subadviser's advisory contract despite our recommendations, the Institute requests clarification that changes to an advisory contract to accommodate this requirement would not require shareholder approval. The proposal's cost-benefit analysis states that the Commission would not view the required changes to subadviser contracts to be material and, as a result, funds would not have to obtain shareholder approval of the change. However, there is no mention of this issue in the section of the Proposing Release discussing the proposal itself.

18 See supra, note 6.

19 To implement this recommendation, paragraph (a) of proposed Rule 17a-10 should be revised to read: "A person that is prohibited by section 17(a) of the Act from entering into a transaction with a Fund solely because such person is, or is an affiliated person of, (i) a Subadviser of the Fund, (ii) an affiliated person of a Subadviser of the Fund, or (iii) a Subadviser of a Fund that is under common control with the Fund, may nonetheless enter into such transaction ...."

20 If the Commission determines not to expand the rule in this manner, the Institute recommends that, at the very least, the Commission amend the rule to cover transactions between an investment adviser and a fund of which the investment adviser is a second-tier affiliated person solely because an investment adviser or subadviser of the fund acts as subadviser to another fund of which the investment adviser is a first-tier affiliated person. In particular, paragraph (a) of proposed Rule 17a-10 should be revised to read: "A person that is prohibited by section 17(a) of the Act from entering into a transaction with a Fund solely because such person is, or is an affiliated person of, (i) a Subadviser of the Fund, (ii) a Subadviser of a Fund that is under common control with the Fund, or (iii) an investment adviser of another Fund advised by a Subadviser, that does not control and is not otherwise an affiliated person of the Fund, may nonetheless enter into such transaction ...."

21 Rather, Rule 17a-10 uses the term “Fund,” which is defined to include a registered investment company or separate series of a registered investment company. In addition, only the text of Rule 17a-10 itself (and not the definitional section of the rule) addresses portions of a fund.

22 For ease of reference, we refer to a subadviser that is a principal underwriter, or an affiliated person thereof, as a “participant” in the underwriting or selling syndicate.

23 We note that this proposal stems in part from the 1998 ICI Submission. In addition, this issue was raised in response to the Commission’s 2000 proposal to amend Rule 10f-3. Investment Company Act Release No. 24775 (November 29, 2000), 65 FR 76189 (December 6, 2000) (the “2000 Proposal”). Although the 2000 Proposal focused primarily on extending Rule 10f-3 to government securities sold in syndicated offerings, and modifying the rule’s aggregation requirement, industry commenters (including the Institute) raised the issue of the application of the rule on transactions involving subadvisory relationships. See Letter from Barry E. Simmons, Associate Counsel, ICI, to Jonathan G. Katz, Secretary, SEC, dated February 14, 2001 (“2001 ICI Letter”).

The 2001 ICI letter also recommended that the Commission amend Rule 10f-3 to permit funds to purchase municipal securities in group sales. Increasing demand for municipal securities has shown that the need for rulemaking relief still exists. We urge the Commission to consider amending the rule so as to provide funds wider access to municipal securities offerings than is presently the case.

24 Proposed Rule 10f-3(c)(7)(i).

25 See 2001 ICI Letter.

26 See 2000 Proposal at 76191.

27 We note that the Commission’s cost-benefit analysis in the Proposing Release does not reflect this opportunity cost.

28 For example, a member that manages over 200 mutual funds and over 25,000 non-fund accounts estimates that the start-up costs to comply with the proposal would be, at a minimum, $300,000. Although the funds and non-fund accounts are managed by the same adviser entity, they are maintained on separate systems that would have to be linked. In addition to start-up costs, there would be considerable ongoing compliance and oversight costs.

29 See Morgan, Lewis & Bockius LLP (pub. avail. April 16, 1997). In that letter, the staff agreed that a dual-registrant sponsor of a wrap-fee program could effect principal and agency cross transactions for program clients without complying with the consent and disclosure requirements of Section 206(3) of the Investment Advisers Act if (1) it has no affiliation with the program’s portfolio manager, and (2) it does not recommend, select, or play any role in the portfolio manager’s selection of particular securities to be purchased for, or sold on behalf of, program clients.

30 Section 3(a)(35) provides that a person exercises investment discretion with respect to an account if, directly or indirectly, such person: “(A) is authorized to determine what securities or other property shall be purchased or sold by or for the account; (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even thought some other person may have responsibility for such investment

decisions; or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder."

31 We further recommend an exclusion for non-discretionary transactions. There are situations in which an adviser may have clearly delineated contractual constraints on its ability to exercise investment discretion for certain transactions in an otherwise discretionary account. For example, although an adviser may have investment discretion generally over an account, it may be contractually prohibited from exercising that discretion when purchasing securities in an underwriting in which its affiliated broker-dealer is a participant. In such an instance, the adviser may be required to seek direction from the client before engaging in the transaction. These "non-discretionary" transactions are typically identified in the advisory agreement. In view of the fact that the adviser would have no investment discretion with respect to these transactions, there would be no rationale for requiring them to be aggregated for purposes of complying with the percentage limit under Rule 10f-3.

---

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.