SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–25557, File No. S7–13–02]

RIN 3235–AI28

Transactions of Investment Companies With Portfolio and Subadvisory Affiliates

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is proposing amendments to rules under the Investment Company Act of 1940 to expand the current exemptions for investment companies (''funds'') to engage in transactions with ''portfolio affiliates''—companies that are affiliated with the fund solely as a result of the fund (or an affiliated fund) controlling them or owning more than five percent of their voting securities. The Commission is also proposing one new rule and several rule amendments to permit funds to engage in transactions with subadvisers of affiliated funds. The proposals respond to the growth of investment companies and changes in the organization of funds; they are designed to permit transactions between funds and certain affiliated persons under circumstances where it is unlikely that the affiliate would be in a position to take advantage of the fund.

DATES: Comments must be received on or before July 19, 2002.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically to the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. S7–13–02; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (*http://www.sec.gov*.) [1]

FOR FURTHER INFORMATION CONTACT: William C. Middlebrooks, Jr., Attorney, or Martha B. Peterson, Special Counsel, at (202) 942–0690, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is requesting public comment on proposed rule 17a–10 [17 CFR 270.17a–10] and proposed amendments to rules 10f–3 [17 CFR 270.10f–3], 12d3–1 [17 CFR 270.12d3–1], 17a–6 [17 CFR 270.17a–6], 17d–1 [17 CFR 270.17d–1], and 17e–1 [17 CFR 270.17e–1] under the Investment Company Act of 1940 [15 U.S.C. 80a] (''Investment Company Act'' or ''Act''). [2]

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I. Discussion

The Investment Company Act restricts a wide range of transactions and arrangements involving investment companies (''funds'') [3] and their affiliated persons. These restrictions lie at the heart of the Act, and are designed to prevent affiliated persons from managing the fund's assets for their own benefit, rather than for the benefit of the fund's shareholders.[4] Affiliated persons of a fund include (i) its investment adviser and any subadvisers, (ii) companies the fund controls or five percent (or more) of whose securities are held by the fund (''portfolio affiliates''), (iii) persons who control the fund, and (iv) persons who are under common control with the fund.[5] Many of the restrictions on transactions and arrangements with fund affiliates apply not only to affiliated persons of the fund (''first-tier'' affiliates), but also to affiliated persons of those persons (''second-tier'' affiliates).[6]

Provisions of the Act and our rules restricting transactions or arrangements with affiliated persons include:

- Section 17(a), which prohibits affiliated persons 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; [7]

[1] We do not edit personal, identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] Unless otherwise noted, when we refer to rules 10f–3, 12d3–1, 17a–6, 17d–1, or 17e–1, or any paragraph of those rules, we are referring to the following sections of the Code of Federal Regulations in which each of these rules is published: 17 CFR 270.10f–3, 17 CFR 270.12d3–1, 17 CFR 270.17a–6, 17 CFR 270.17d–1, or 17 CFR 270.17e–1 respectively.

[3] We use the term ''fund'' throughout this release to refer to registered investment companies, series of registered investment companies that are series companies, and business development companies, which are unregistered investment companies.

[4] *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency,* 76th Cong., 3d Sess. 37 (1940) (Statement of Commissioner Healy).

[5] The Act defines an ''affiliated person'' of another person as (A) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of such other person; (B) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is a fund, any investment adviser of the fund or any member of its advisory board; and (F) if such other person is an unincorporated fund, not having a board of directors, the depositor of the fund. 15 U.S.C. 80a–2(a)(3). The term ''control'' means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of a company is presumed to control such company. 15 U.S.C. 80a–2(a)(9).

[6] A fund's investment adviser is, for example, a first-tier affiliate of the fund. A company that owns five percent of the voting securities of the fund's investment adviser is a second-tier affiliate of the fund. The prohibitions of the Act extend to second-tier affiliates to make those prohibitions more difficult to circumvent. *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency,* 76th Cong., 3d Sess. 261 (1940) (Statement of David Schenker).

[7] 15 U.S.C. 80a–17(a). The prohibition in section 17(a) also extends to promoters and principal underwriters for the fund and persons affiliated with the promoters and principal underwriters. Section 17(a) was recently amended to make it

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• Section 17(d), and rule 17d–1 thereunder, which prohibit affiliated persons of a fund from participating with the fund in any joint enterprise or other joint arrangement or profit-sharing plan;[8]

• Section 10(f), which prohibits a fund from purchasing securities in a primary offering if certain affiliated persons of the fund are members of the underwriting or selling syndicate;[9]

• Section 17(e), which limits the remuneration that affiliated persons of a fund may receive in transactions involving the fund, and companies that the fund controls; and[10]

• Section 12(d)(3) and rule 12d3–1, which together prohibit a fund from acquiring securities issued by, among others, its own investment adviser.[11]

Since 1940, the number of persons who are either first-tier or second-tier affiliates of a fund has grown markedly for a number of reasons. First, as funds have grown larger, they are more likely to own positions in excess of five percent of the voting securities of an issuer, creating ''portfolio affiliates.'' [12] Second, many funds today use subadvisers to help manage fund assets, making each subadviser an affiliate of the fund and persons affiliated with each subadviser second-tier affiliates of the fund.[13] Third, most funds are today organized into complexes under the common control of an adviser (or other person), making each fund an affiliated person of all of the other funds in the complex.[14] When multiple funds with subadvisers and portfolio affiliates are under common control, the number of potential first- and second-tier affiliated persons can be quite large.[15]

The growth in the number of first-tier and second-tier affiliates of funds has resulted in an increasing number of persons with whom funds may not enter into transactions or arrangements under the Act. Many of these affiliated persons, however, have neither the ability nor the incentive to take advantage of the fund.[16] Accordingly, we have issued a number of exemptive orders permitting transactions when we have determined that the exemption is in the public interest, and consistent with the protection of investors and the purposes of the Act.[17]

We are today proposing one new rule and revisions to several current rules that would codify the terms of many of these orders.[18] The proposed rule and rule amendments are designed to permit funds to engage in transactions and arrangements with affiliated persons that are not likely to raise the concerns that the Act was intended to address.[19]

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unlawful for a first-or second-tier affiliate to lend money or other property to a fund, or a company controlled by a fund, in contravention of such rules, regulations, or orders as the Commission, after consultation with and taking into consideration the views of the Federal banking agencies (as defined in section 3 of the Federal Deposit Insurance Act [12 U.S.C. 1813]), issues consistent with the protection of investors. 15 U.S.C. 80a–17(a)(4) (effective May 12, 2001). The Commission has not yet issued any rules or orders under this section. Section 17(a) applies to transactions between, among others, a fund and its portfolio affiliates. *SEC* v. *General Time*, 407 F.2d 65, 68 (2d Cir. 1968); Talley Industries, Inc., Investment Company Act Release No. 5953 (Jan. 9, 1970).

[8] Section 17(d) of the Act makes it unlawful for first- and second-tier affiliates of a fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters, acting as principal, to effect any transaction in which the fund or a company controlled by the fund is a joint or a joint and several participant ''in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant.'' 15 U.S.C. 80a–17(d). Rule 17d–1(a) prohibits first- and second-tier affiliates of a fund, the fund's principal underwriter, and affiliated persons of the fund's principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which any such fund or company controlled by a fund is a participant ''unless an application regarding such joint enterprise, arrangement or profit-sharing plan has been filed with the Commission and has been granted.'' Section 17(d) and rule 17d–1 apply to joint transactions of funds and, among others, their portfolio affiliates. *SEC* v. *Talley Industries,* 399 F2d 396, 402 (2d Cir. 1968).

[9] 15 U.S.C. 80a–10(f).

[10] Section 17(e)(1) of the Act prohibits an affiliated person acting as agent from accepting any compensation from any source (other than a regular salary or wage from a fund) for the purchase or sale of property to or for the fund, or companies controlled by the fund, except in the course of the person's business as an underwriter or broker. Section 17(e)(2) of the Act limits the remuneration that a person may receive when acting in reliance on section 17(e)(1)'s exemption for the brokerage business. 15 U.S.C. 80a–17(e).

[11] Section 12(d)(3) of the Act generally prohibits any fund, and any company or companies controlled by a fund, from purchasing or acquiring any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under the Investment Advisers Act of 1940. 15 U.S.C. 80a–12(d)(3), referring to 15 U.S.C. 80b. Rule 12d3–1 provides an exemption from this general prohibition, but the exemption does not extend to the acquisition of a general partnership interest or a security issued by the acquiring company's investment adviser, promoter, or principal underwriter, or any affiliated person of such investment adviser, promoter, or principal underwriter. *See* rule 12d3–1(c).

[12] Average assets per fund grew from $346 million in 1990 to $852 million in 2000. Investment Company Institute, Mutual Fund Fact Book 63 (2001) (''ICI Fact Book''). Schedule 13D and 13G Reports [17 CFR 240.13d–101 and 13d–102] (reporting ownership of more than five percent of the voting stock of a security traded on an exchange) by funds grew during the same period from 510 (reporting ownership by approximately 65 funds in 450 issuers) to 1,378 (reporting ownership by 190 funds in 875 issuers).

[13] Of the approximately 9,700 portfolios of open-end and closed-end investment companies reporting information on Form N-SAR [17 CFR 274.101] during the first six months of 2001, approximately 1,900 reported using at least one subadviser, and 520 reported using two or more subadvisers.

[14] In 2000 there were 431 fund complexes. ICI Fact Book, *supra* note 12, at 63. Funds in a fund complex are under the common control of an investment adviser or other person when the adviser or other person exercises a controlling influence over the management or policies of the funds. 15 U.S.C. 80a–2(a)(9). *See supra* note 5. Not 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. *See* Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)] at n.11. Throughout this release we presume that the funds in a fund complex are under common control as funds that are *not* affiliated persons will not require and thus will not rely on most of the proposed exemptions. The exception is the exemption for transactions restricted by section 10(f) of the Act, which we describe in section I.B.3.

[15] For example, in a fund complex with five funds controlled by a single investment adviser, if each fund has one subadviser and one portfolio affiliate, then every fund would have seven first-tier affiliates (one adviser, one subadviser, one portfolio affiliate, and four affiliated funds) and eight second-tier affiliates (four subadvisers of affiliated funds and four portfolio affiliates of affiliated funds).

[16] For example, in a fund complex where multiple funds are under common control but are managed by different subadvisers, each subadviser is a first-tier affiliate of any fund that it advises, and a second-tier affiliate of all of the other funds. The restrictions on affiliate transactions apply to dealings between a fund and the subadvisers that are its second-tier affiliates even if the fund's own subadviser is a business competitor of the second-tier affiliate subadvisers.

[17] These orders have been issued pursuant to our authority under sections 6(c), 10(f), and 17(b) of the Act. 15 U.S.C. 80a–6(c), 80a–10(f), and 80a–17(b). *See, e.g.*, CDC IXIS Asset Management Advisers, L.P., Investment Company Act Release Nos. 25061 (July 12, 2001) [66 FR 37497 (July 18, 2001)] (notice) and 25103 (Aug. 8, 2001) (order); Frank Russell Investment Co., Investment Company Act Release Nos. 24820 (Jan. 3, 2001) [66 FR 2031 (Jan. 10, 2001)] (notice) and 24847 (Jan. 30, 2001) (order); SEI Investments Management Corporation, Investment Company Act Release Nos. 24430 (Apr. 28, 2000) [65 FR 26246 (May 5, 2000)] (notice) and 24463 (May 23, 2000) (order); North American Security Trust, Investment Company Act Release Nos. 18860 (Jul. 22, 1992) [57 FR 33540 (Jul. 29, 1992)] (notice) and 18899 (Aug. 18, 1992) (order); State Street Bank and Trust Co., Investment Company Act Release Nos. 19784 (Oct. 13, 1993) [58 FR 53983 (Oct. 19, 1993)] (notice) and 19844 (Nov. 9, 1993) (order).

[18] We are also taking this opportunity to redraft in plain English the rules that permit funds to enter into transactions and arrangements with their portfolio affiliates.

[19] Today's proposal responds, in part, to a rulemaking petition submitted by the Investment Company Institute to the Commission in December 1998 (''ICI Petition''). A copy of that petition is available in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC (File No. S7–13–02). In November 2000 we proposed to amend rule 10f–3 to expand the exemption provided by the rule to permit a fund to purchase government securities in a syndicated offering. *See* Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No.

A. Portfolio Affiliates

Rules 17a–6 and 17d–1(d)(5) permit a fund and its portfolio affiliates to engage in principal transactions and enter into joint arrangements that would otherwise be prohibited by section 17(a), or by section 17(d) and rule 17d–1(a). Under the rules, a fund may enter into a principal transaction or a joint arrangement with a portfolio affiliate, or an affiliated person of a portfolio affiliate, 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) (''Prohibited Participants'') are not parties to the transaction and do not have a financial interest in a party to the transaction.[20]

1. Second-Tier Affiliates

Rules 17a–6 and 17d–1(d)(5) give broad exemptions that permit transactions and arrangements involving a fund and its own portfolio affiliates, but do not extend to identical transactions or arrangements involving portfolio affiliates of funds under common control with the fund. As a result, a fund may be able to enter into a transaction or 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).[21]

Fund complexes and series companies were relatively uncommon when we amended rules 17a–6 (in 1964)[22] and 17d–1(d)(5) (in 1974)[23] to permit funds to engage in principal transactions and joint arrangements with their portfolio affiliates.[24] Transactions and arrangements between a fund and its second-tier portfolio affiliates do not appear to raise concerns that are different from those raised by transactions and arrangements between a fund and its first-tier portfolio affiliates. Therefore, we are 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 as with first-tier portfolio affiliates.[25]

We request comment on our proposal to expand the exemptive relief provided in rules 17a–6 and 17d–1(d)(5). Do arrangements and transactions with second-tier portfolio affiliates raise investor protection issues not present in arrangements and transactions with first-tier portfolio affiliates? If so, should exemptive relief for transactions and arrangements involving second-tier portfolio affiliates be subject to any additional conditions?

2. Financial Interests

As discussed above, our exemptions for transactions or arrangements with portfolio affiliates are unavailable if certain other affiliated persons have a ''financial interest'' in a party to the transaction (other than the fund).[26] Our rules do not explain what constitutes a ''financial interest'' in a party. Instead, the rules provide a list of interests that are deemed not to be ''financial interests.''[27]

We are concerned that the rules, as currently drafted, do not (and cannot) anticipate every remote or minor interest in a party to a transaction, and thus they may prohibit many transactions with portfolio affiliates even though the affiliated person's financial interest is unlikely to present an incentive for overreaching the fund. We are therefore proposing to 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'' does 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.[28]

We are also proposing to amend our rules to make them consistent with one another with regard to the time period for which a Prohibited Participant's financial interest will result in loss of the rules' exemption.[29] Under the proposed amendments, the exemptions under both rules 17a–6 and 17d–1(d)(5) 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.[30]

24775 (Nov. 29, 2000) [65 FR 76189 (Dec. 6, 2000)]. We are reproposing certain aspects of the rule 10f–3 proposal in this Release, and are adopting other aspects of that proposal in a companion release that we are issuing today. *See* Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 25560 (April 30, 2002).

[20] The rules were designed to exempt transactions and arrangements from the prohibitions of section 17 when 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 investment company. *See* Investment Company Act Release No. 10698 (May 17, 1979) [44 FR 29908 (May 23, 1979)].

[21] Thus, for example, under current rule 17a–6 a fund whose first-tier portfolio affiliate merges with another company in which the fund invests may receive shares of the acquiring company (in exchange for its shares of the acquired company) in connection with the merger. However, the rule does not permit an identical transaction in which the acquiring company is an affiliated person of another fund in the fund complex. *See* Longleaf Partners Funds Trust, SEC Staff No-Action Letter (Apr. 9, 2001).

[22] We adopted rule 17a–6 in 1961 to provide small business investment companies licensed by the United States Small Business Administration with an exemption from section 17(a)(1) and section 17(a)(3) for certain transactions with their portfolio affiliates. Investment Company Act Release No. 3361 (Nov. 17, 1961) [26 FR 11238 (Nov. 29, 1961)]. We amended the rule in 1964 to exempt from section 17(a) additional persons and transactions, including transactions involving all other types of investment companies and their portfolio affiliates that were ''non-public'' companies, and again in 1979 to extend the rule to transactions with portfolio affiliates that are public companies. Investment Company Act Release Nos. 3968 (Apr. 29, 1964) [29 FR 6152 (May 9, 1964)] and 10828 (Aug. 13, 1979) [44 FR 48657 (Aug. 20, 1979)].

[23] We amended rule 17d–1 in 1974 to permit joint transactions under conditions similar to those imposed by rule 17a–6. Adoption of Amendment to Rule 17d–1 Under the Investment Company Act of 1940 Exempting Certain Joint Transactions Involving Registered Investment Companies, Including SBIC Stock Option Plans, From the Application Requirements of the Rule, Investment Company Act Release No. 8542 (Oct. 15, 1974) [39 FR 37971 (Oct. 25, 1974)].

[24] In 1958 there were only five ''multi-fund'' open-end investment companies (series companies) and 29 ''multi-company groups'' (fund complexes). Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 6, 42 (1962). As recently as 1980 few management investment companies were organized as series companies and there were only 120 fund complexes. ICI Fund Fact Book, *supra* note 12, at 63; Securities and Exchange Commission Annual Report for 1980, 48th Annual Report. In 2000, approximately 1,400 management investment companies were organized as series companies (with 7,000 portfolios) and there were approximately 430 fund complexes. ICI Fund Fact Book, *supra* note 12, at 63; Reports on Form N–SAR [17 CFR 274.101].

[25] Proposed rules 17a–6(a) and 17d–1(d)(5).

[26] Rules 17a–6(a)(5)(ii) and 17d–1(d)(5)(i).

[27] Rules 17a–6(b)(1) and 17d–1(d)(5)(iii).

[28] Proposed rules 17a–6(b)(1)(i)(H) and 17d–1(d)(5)(ii)(A)(*8*). Our proposed amendments would also require that the directors record the basis for their finding in the minutes of the board's meeting. *Id.*

[29] Rule 17a–6 is not available if a Prohibited Participant ''has, or within six months prior to the transaction had * * * or pursuant to an arrangement will acquire'' a financial interest in a party to the transaction. Rule 17a–6(a)(ii). Rule 17d–1(d)(5) is not available if a Prohibited Participant ''is, was or proposes to be'' a participant in the joint enterprise through a financial interest in a person ''who is, was or will be'' a participant in the joint enterprise. Rule 17d–1(d)(5)(i).

[30] Proposed rules 17a–6(b)(1)(ii) and 17d–1(d)(5)(ii)(B). Rule 17d–1(d)(6) includes references to the Prohibited Participants identified in current

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We request comment on our proposed amendments regarding the financial interests of Prohibited Participants. Should Prohibited Participants be permitted to have an interest in parties to the transaction or arrangement if the interest is not material? Should the rules provide a standard against which directors should determine whether an interest is not material? [31] If so, what should the standard be?

3. Percentage Limits on Investment in Joint Enterprise

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.[32] When we amended rule 17d–1 to permit funds to engage in joint enterprises with portfolio affiliates, we were concerned that a fund that committed a significant percentage of its assets to a joint enterprise could be susceptible to disadvantage or unfair treatment.[33] As a result, we decided to continue to review those transactions by considering exemptive relief on a case-by-case basis. There is no comparable limitation for principal transactions with portfolio affiliates, however, and it is not clear that the limit continues to serve a useful purpose. We therefore are proposing to amend rule 17d–1(d)(5) to eliminate the rule's percentage limit.[34] We request comment on this amendment. Is there any specific harm that could result from elimination of the limit?

B. Subadviser Affiliates

As we discussed above, funds today are typically organized, operated, and controlled by an investment adviser that advises a number of other funds in a fund complex. That adviser may be assisted by one or more subadvisers, which may provide general advisory assistance or may manage a discrete portion of the fund's portfolio and have no responsibilities with respect to the rest of the fund.[35] Each subadviser is a first-tier affiliate of any fund it advises and a second-tier affiliate of each fund in the fund complex that it does not advise.[36] Section 17(a) of the Act prohibits the common adviser (a first-tier affiliate) and each fund's own subadviser (a first-tier affiliate), as well as *each* subadviser of the other funds (second-tier affiliates) from entering into principal transactions with the fund.[37] Section 17(e) restricts the remuneration the common adviser, each fund's own subadviser, and the subadvisers of the other funds may receive in transactions involving the fund and companies that the fund controls.[38] Section 10(f) prohibits each fund from purchasing securities in any primary offering in which the underwriting or selling syndicate includes the common adviser, the fund's own subadviser, or any person with which these advisers are affiliated.[39] Section 12(d)(3) and rule 12d3–1 prohibit each fund from acquiring securities issued by the common adviser or its own subadvisers.[40]

Ordinarily a subadviser has little power to overreach those funds, or portions of a fund, with which it is affiliated but which it does not advise. We have, therefore, issued a number of orders exempting subadvisers and funds from sections 17(a), 17(e), 10(f), and 12(d)(3) in order to permit subadvisers to engage in transactions with affiliated funds when they are not in a position to influence the fund's decision to participate in the transaction.[41] Today we are proposing to codify these orders in one new rule and three rule amendments. The new rule and amendments will permit these transactions and arrangements to go forward without the expense and delay of obtaining an exemptive order from the Commission.

1. Principal Transactions With Subadvisers: Section 17(a)

Section 17(a) of the Act prohibits a subadviser that is a first-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.[42] We are proposing a new rule 17a–10 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 (*e.g.,* other funds in the fund complex), 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.[43] The proposed exemption

rule 17d–1(d)(5)(i) and to the definition of ''financial interest'' in current rule 17d–1(d)(5)(iii). We are proposing to amend rule 17d–1(d)(6) to conform these references to rule 17d–1(d)(5) as proposed to be amended.

[31] *Compare* rule 15a–4(b)(2)(v) [17 CFR 270.15a–4(b)(2)(v)] (board of directors must find differences between interim advisory contract and previous contract to be immaterial) *with* rule 0–1(a)(6)(i)(A) [17 CFR 270.0–1(a)(6)(i)(A)] (majority of disinterested directors must reasonably determine in the exercise of their judgment that any representation of the fund's investment adviser, principal underwriter, administrator, or any of their control persons, since the beginning of the fund's last two completed fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of person providing legal representation to the disinterested directors).

[32] Rule 17d–1(d)(5)(ii) (In a joint enterprise, other than a merger of portfolio affiliates, neither a fund nor a company that a fund controls may commit in excess of five percent of its assets, except that a fund which is licensed by the Small Business Administration (SBA) under the Small Business Investment Act of 1958 may not commit more than 20 percent of its paid-in capital and surplus.)

[33] *See* Notice of Proposal to Amend Rule 17d–1 Under the Investment Company Act of 1940 to Exempt Certain Joint Transactions Involving Registered Investment Companies, Including SBIC Stock Option Plans, From the Application Requirements of the Rule, Investment Company Act Release No. 8273 (Mar. 14, 1974) [39 FR 11312 (Oct. 25, 1974)].

[34] A fund licensed by the Small Business Administration under the Small Business Investment Act of 1958 would, however, still be subject to all SBA regulations regarding the percentage of its paid-in capital and surplus it could commit to a joint enterprise. *See* 13 CFR 107.740.

[35] *See* Benjamin J. Haskin, *Hiring and Oversight of Sub-Advisers,* 5 The Investment Lawyer 8, 11 (1998) (describing subadvisory arrangements generally).

[36] A subadviser is an ''investment adviser'' for purposes of the Act, which defines a fund's ''investment adviser'' as a person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of the fund) who regularly furnishes advice to the fund with respect to the desirability of investing in, purchasing, or selling securities or other property, or is empowered to determine what securities or other property are to be purchased or sold by the fund. 15 U.S.C. 80a–2(a)(20). The investment adviser may act pursuant to a contract with a fund [15 U.S.C. 80a–2(a)(20)(A)] or pursuant to a contract with an investment adviser that has contracted with the fund. 15 U.S.C. 80a–2(a)(20)(B).

[37] The section also prohibits principal transactions between the fund and affiliates of the common adviser (second-tier affiliates) and affiliates of the fund's own subadviser (second-tier affiliates).

[38] The prohibition in section 17(e) also extends to affiliates of the common adviser and the fund's subadviser.

[39] A fund therefore is prohibited from purchasing securities in an offering in which a participant in the underwriting or selling syndicate is under common control with the fund's adviser.

[40] A fund is also prohibited from acquiring securities issued by an affiliated person of the common adviser or an affiliated person of the fund's subadviser if the affiliated person is a broker, dealer, investment adviser, or engaged in the business of underwriting.

[41] *See, e.g.,* CDC IXIS Management Advisers, L.P. *et al.,* Investment Company Act Release Nos. 25061 (July 12, 2001) [66 FR 37497 (July 18, 2001)] (notice) and 25103 (Aug. 8, 2001) (order); AMR Investment Services Trust, *et al.*, Investment Company Act Release Nos. 23773 (Apr. 7, 1999) [64 FR 18454 (Apr. 14, 1999)] (notice) and 23823 (May 4, 1999) (order); North American Security Trust, Investment Company Act Release Nos. 18860 (Jul. 22, 1992) [57 FR 33540 (July 29, 1992)] (notice) and 18899 (Aug. 18, 1992) (order); State Street Bank and Trust Co., Investment Company Act Release Nos. 19784 (Oct. 13, 1993) [58 FR 53983 (Oct. 19, 1993)] (notice) and 19844 (Nov. 9, 1993) (order).

[42] *See supra* note and accompanying text.

[43] This second category of relief would thus be available only when a fund has one or more subadvisers that are responsible for managing a discrete portion of the fund's assets. The rule would permit the adviser of one portion of the fund to direct that portion to engage in a principal transaction with the subadviser of another portion of the fund's assets. *See* discussion below.

would be subject to conditions, discussed below, designed to limit its availability to circumstances in which the subadviser is unable to influence the management of the fund, or portion of the fund, that participates in the transaction (''participating fund'' or ''participating portion'').

First, 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).[44] Second, the rule 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.[45] These conditions, which have been conditions of our exemptive orders permitting subadvisers to engage in principal transactions with funds with which they are affiliated, are 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.

We are not proposing to prohibit subadvisers and principal advisers from consulting with each other, 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. Application of such a condition could interfere with the principal adviser's duty to supervise the performance of the subadviser.[46] Nevertheless, the principal adviser, as a fiduciary to the fund, could not lawfully collaborate with subadvisers for the purpose of overreaching the fund. We request comment whether, in light of our decision not to impose a communication barrier, we should not permit subadvisers and their affiliates from entering into transactions with funds or portions of funds advised by a principal adviser.

We request comment in general on our proposal to permit funds to engage in principal transactions with subadvisers (and their affiliated persons) that are affiliated with the fund, but which are not in a position to influence the fund's conduct. Are the proposed conditions sufficient to protect the fund from overreaching or self-dealing by subadvisers? Are any of the proposed conditions unnecessary? Should the proposed exemption be subject to additional conditions, such as conditions that would prevent a subadviser from influencing the principal adviser to coordinate the actions of the other subadvisers? Is this likely?

2. Transactions With Subadvisers as Brokers: Section 17(e)

Section 17(e)(2) of the Act generally limits the remuneration that a first- or second-tier affiliate of a fund may receive for effecting purchases and sales of securities on a securities exchange on behalf of the fund, or a company the fund controls, to the ''usual and customary broker's commission.''[47] The limits of section 17(e)(2) apply to purchases and sales made on behalf of a fund by the fund's subadviser (a first-tier affiliate), affiliates of the subadviser (second-tier affiliates), and subadvisers of funds under common control with the fund (second-tier affiliates).

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.'' The rule, among other things, 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 (''review requirement'').[48] In addition, the fund must maintain a record of the transactions (''recordkeeping requirement'').[49] The review and recordkeeping requirements of rule 17e–1 were designed to permit fund directors and our examinations staff to monitor the reasonableness and fairness of remuneration received by affiliated persons of the fund.[50] We are 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 in which the subadviser has very limited ability to influence decisions regarding the purchase and sale of fund securities.[51] Under our proposal, funds would not have to comply with rule 17e–1's review and recordkeeping requirements in circumstances, and subject to conditions, identical to those in which a subadviser could engage in a principal transaction with an affiliated fund under proposed rule 17a–10.[52]

The proposed amendments would relieve funds and subadvisers from the review and recordkeeping requirements when the relationship between the subadviser and fund is sufficiently remote to make it unlikely that the subadviser could directly or indirectly cause the fund to pay an unreasonable or unfair commission.[53] We request commenters to address our proposal to exempt brokerage transactions between funds and certain affiliated subadvisers from rule 17e–1's review and recordkeeping requirements.

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.[54] The

[44] Proposed rule 17a–10(a)(1).

[45] Proposed rule 17a–10(a)(2). We are not proposing to extend this condition to the fund's principal adviser, although subadvisers and their affiliated persons would be permitted to rely on the rule to enter into transactions and arrangements with a fund or portion of a fund with respect to which the principal adviser alone provides investment advice. We are concerned that in the context of the relationship between a principal adviser and a subadviser the condition could be interpreted in a manner inconsistent with the principal adviser's duty to oversee the conduct of subadvisers. Nonetheless, the principal adviser remains a fiduciary of the fund and may not collaborate with fund subadvisers for the purpose of overreaching the fund.

[46] *See* Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Investment Advisers Act Release No. 1980 (Sept. 28, 2001).

[47] Section 17(e)(2) limits the remuneration that any affiliated broker of a fund may receive in connection with a securities transaction to (A) the usual and customary broker's commission for transactions effected on an exchange, (B) two percent of the sales price for secondary distribution, and (C) one percent of the purchase or sale price for other purchases or sales.

[48] Rule 17e–1(a) and (b). The rule also requires that a majority of the directors of the fund not be ''interested persons'' of the fund, that those directors select and nominate any other disinterested directors, and any person who acts as legal counsel for the disinterested directors be an independent legal counsel. Rule 17e–1(c). Section 2(a)(19) identifies persons who are ''interested persons'' of a fund. 15 U.S.C. 80a–2(a)(19).

[49] Rule 17e–1(d).

[50] Agency Transactions by Affiliated Persons on a Securities Exchange, Investment Company Act Release No. 10605 (Feb. 27, 1979) [44 FR 12202 (Mar. 6, 1979)] at n.10 and accompanying text.

[51] Funds are required to retain certain records of brokerage orders by or on behalf of the fund. *See* rule 31a–1(b)(5) [17 CFR 270.31a–1(b)(5)]. Our proposal is not intended to affect these or other recordkeeping requirements not included within rule 17e–1.

[52] Proposed rules 17e–1(b)(3) and (d)(2). *See supra* Section I.B.1 (discussing conditions in proposed rule 17a–10).

[53] Fund directors may, however, wish to continue to review these transactions as a matter of good business practice.

[54] Section 10(f), in relevant part, prohibits a registered investment company from knowingly

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section protects fund shareholders by preventing an affiliated underwriter from placing or ''dumping'' unmarketable securities with the fund.[55] Rule 10f–3 provides an exemption from the prohibition in section 10(f) if certain conditions are satisfied.[56] One of the key conditions is that a 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'').[57] The purpose of the percentage limit is to provide an indication that a significant portion of the offering is being purchased by persons acting independently of the adviser. The existence of these purchasers suggests that the price of the securities is based on market forces and demonstrates that the securities are not being ''dumped.''[58]

When a fund has multiple subadvisers, section 10(f) can limit significantly the fund's ability to purchase securities in a primary offering.[59] A fund is subject to the prohibition in section 10(f) if *any* of its subadvisers participate in the underwriting or selling syndicate (or are affiliated persons of participants), whether or not the subadviser that *recommends* the purchase is participating. Moreover, in order for a fund to rely on the exemption in rule 10f–3, the aggregate purchases by *all* of the funds advised by *each* of the fund's subadvisers (as well as *all* of the funds advised by the fund's principal adviser) must comply with the rule's percentage limit.

We have issued a number of exemptive orders to permit funds to purchase securities during an underwriting or selling syndicate in which one of its subadvisers is a participant,[60] when the adviser recommending the purchase is not a participant in the syndicate.[61] 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. We concluded that, in these circumstances, an exemption from section 10(f) is consistent with the protection of investors because a subadviser that participates in an underwriting or selling syndicate has little opportunity to ''dump'' securities into funds or portions of a fund's portfolio that the subadviser does not advise. Moreover, we concluded that purchases recommended by an adviser that is not a participant in the underwriting (and not influenced by participants in the underwriting) should be considered purchases independent of the adviser participating in the underwriting. Today we are proposing amendments to rule 10f–3 to codify many of the terms of these orders.

The proposed amendments to rule 10f–3 would deem each of the series of a series company and the ''managed portions'' [62] of a fund portfolio (''series'' or ''portion'') to be separate registered investment companies for purposes of section 10(f) and rule 10f–3.[63] 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.[64] The proposed amendments are designed to exempt funds from the prohibition in section 10(f) when that prohibition is triggered by the participation in an underwriting or selling syndicate of a person who is not in a position to influence the fund's investment decisions.[65]

We are proposing additional amendments to rule 10f–3 that would revise the way funds are required to aggregate purchases to determine compliance with the percentage limits of rule 10f–3. Currently, a fund is required to aggregate all of its purchases with those of any other fund advised by its investment adviser.[66] As a result, a fund that is a series must aggregate purchases by all of the other series if the fund's subadviser participates in the underwriting, but the fund need not aggregate purchases made by, for example, a hedge fund advised by the participating subadviser.

The rule appears to be both too broad (in that in 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). Therefore, we are proposing to amend rule 10f–3 to require the aggregation of purchases by funds that are advised, and accounts

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purchasing or otherwise acquiring, during the existence of any underwriting or selling syndicate, any security (except a security of which the company is the issuer) a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of the company, or any person of which any of the foregoing are affiliated persons.

[55] *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency*, 76th Cong., 3d Sess. 35 (1940) (Statement of Commissioner Healy); Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 24775, *supra* note 19, at n.4 and accompanying text; Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 22775 (July 31, 1997) [62 FR 42401 (Aug. 7, 1997)] at n.1 and accompanying text.

[56] Rule 10f–3 permits a fund to purchase securities in a transaction that otherwise would violate section 10(f) if, among other things: (i) The securities either are registered under the Securities Act of 1933 [15 U.S.C. 77a–aa], are part of an issue of government securities, are municipal securities with certain credit ratings, or are offered in certain foreign or private institutional offerings; (ii) the offering involves a ''firm commitment'' underwriting; (iii) the fund (together with other funds advised by the same investment adviser) purchases no more than 25 percent of the offering; (iv) the fund purchases the securities from a member of the syndicate other than its affiliated underwriter; (v) the fund's directors have approved procedures for purchases under the rule and regularly review the purchases to determine whether they have complied with the procedures. *See* rule 10f–3(b).

[57] Rule 10f–3(b)(7).

[58] *See* Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 24775, *supra* note 19, at n.22 and accompanying text.

[59] A fund may have multiple subadvisers because more than one subadviser has been retained to provide investment advice with respect to various portions of the fund. A fund may also have multiple subadvisers because the fund is one of several portfolios of a series company, and different subadvisers provide investment advice with respect to the assets of the different portfolios.

[60] Unless otherwise noted, we will refer to a subadviser that is a principal underwriter, or an affiliated person of a principal underwriter of a security, as a ''participant'' in the underwriting or selling syndicate.

[61] See, *e.g.*, CDC IXIS Asset Management Advisers, L.P., Investment Company Act Release Nos. 25061(July 12, 2001) [66 FR 37497 (July 18, 2001)] (notice) and 25103 (Aug. 8, 2001) (order); AB Funds Trust, et al., Investment Company Act Release Nos. 24999 (June 7, 2001) [66 FR 31953 (June 13, 2001)] (notice) and 25054 (June 29, 2001) (order).

[62] 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. Proposed rule 10f–3(a)(6).

[63] Proposed rule 10f–3(b).

[64] *Id.*

[65] The proposed amendments to rule 10f–3 would effectively permit a fund that is a series in a series company to purchase securities during an underwriting or selling syndicate in which an officer, director, member of an advisory board, investment adviser, or employee of a series other than the purchasing series is (or is an affiliated person of) a participant. The proposed amendments would also permit a fund to purchase securities during a syndicate in which an investment adviser of the fund is (or is an affiliated person of) a participant, if the investment adviser does not provide investment advice (or have the opportunity to influence investment decisions) for the portion of the fund's assets for which the securities are purchased.

[66] Rule 10f–3(b)(7).

that are controlled, by an investment adviser that is a participant in the underwriting or selling syndicate.[67] 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.[68] We request comment on our proposal to amend rule 10f–3.

As discussed above, the proposed percentage limit would encompass purchases by the *accounts* controlled by a fund's investment adviser, as well as the funds advised by the adviser. We initially proposed this amendment in 2000 because we were concerned that rule 10f–3's percentage limit may not provide reliable evidence of a market for the security if most or all of the offering is purchased by fund and non-fund clients of an adviser participating in the underwriting or selling syndicate.[69] While several commenters objected to the proposal, none addressed the policy concerns behind the proposal.[70] We are re-proposing the amendment today in light of the other changes we are proposing to the rule. We request comment on rule 10f–3's percentage limit under these circumstances. Do the other changes we are proposing to rule 10f–3 warrant further changes in the rule?

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'').[71] 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,[72] but a fund may not rely on rule 12d3–1 to acquire securities of its own investment adviser or any affiliated person of its own investment adviser.[73] Thus, a fund may not acquire securities issued by any of its subadvisers, or their affiliated persons.[74]

We have issued several orders exempting funds from the prohibition in section 12(d)(3) to permit them to use 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.[75] We are today proposing to amend rule 12d3–1 to codify these orders and 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 the other rules we are proposing that would permit transactions with subadvisers and which we discuss above.[76] 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.[77] We request comment on our proposal to amend rule 12d3–1.

II. General Request for Comment

We request comment on the proposed rules and proposed rule amendments that are the subject of this Release, suggestions for additional provisions or changes to the rules, and comments on other matters that might have an effect on the proposals contained in this Release. We encourage commenters to provide data to support their views.

III. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The Act and our rules restrict the ability of a first-or second-tier affiliate of a fund to engage in various types of transactions involving the fund, and companies that the fund controls, without first obtaining an exemptive order from the Commission. The proposed rule and amendments would expand the circumstances under which portfolio companies and subadvisers that are affiliated persons of funds may engage in otherwise prohibited transactions with those funds without first obtaining an exemptive order. We have identified certain costs and benefits, which are discussed below, which may result from the proposed rule and rule amendments. As the proposed rule and rule amendments are exemptive, rather than prescriptive, funds and their affiliated persons are not required to rely on them. Therefore, we assume that funds will only rely on the provisions of the proposed rule and rule amendments if the anticipated benefits from such actions would exceed the anticipated costs. We request comment on the costs and benefits of the proposed rule and amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

[67] Proposed rule 10f–3(c)(7).

[68] *Id.* If more than one investment adviser of a fund is a participant in the underwriting or selling syndicate then the percentage limit would apply independently with respect to each such investment adviser. Proposed rule 10f–3(c)(7)(iii). The percentage limit would not apply at all if a fund is prohibited from purchasing a security because a person other than the fund's investment adviser (e.g., an officer, director, or employee of the fund) is a participant in the underwriting or selling syndicate. Proposed rule 10f–3(c)(7)(ii).

[69] *See* Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, *supra* note.

[70] Several commenters opposed the proposed amendment on the grounds that it could limit funds' access to primary offerings.

[71] With minor exceptions, section 12(d)(3) prohibits a fund from purchasing or otherwise acquiring ''any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is [an] investment adviser.''

[72] Paragraph (a) of rule 12d3–1 permits a fund to acquire any security issued by any person that, in its most recent fiscal year, derived 15 percent or less of its gross revenues from securities-related activities unless the fund would control such person after the acquisition. Paragraph (b)(3) of rule 12d3–1 permits a fund to invest up to five percent of the value of its total assets in the securities of an issuer that derives more than 15 percent of its gross revenues from securities-related activities. Rule 12d3–1(d)(1) defines ''securities related activities'' as a person's activities as a broker, a dealer, an underwriter, an investment adviser registered under the Investment Advisers Act of 1940 [15 U.S.C. 80b], or an investment adviser to a registered investment company.

[73] Rule 12d3–1(c) provides that the rule does not exempt the acquisition of a security issued by the acquiring company's investment adviser, promoter, or principal underwriter, or any affiliated person of such investment adviser, promoter, or principal underwriter. Rule 12d3–1(d)(8) provides that any class or series of an investment company that issues two or more classes or series of preferred or special stock, each of which is preferred over all other classes or series with respect to assets specifically allocated to that class or series, shall be treated as if it is a registered investment company. Accordingly, a fund that is a series of a series company may rely on rule 12d3–1 to purchase securities issued by subadvisers (and persons affiliated with those subadvisers) of the other series of the series company.

[74] Congress adopted section 12(d)(3) for two purposes: (i) To limit the exposure of funds to the entrepreneurial risks peculiar to investing in securities-related businesses and (ii) to prevent potential conflicts of interest and certain reciprocal practices. *See Investment Trusts and Investment Companies, Hearings on S. 3580 before a Subcomm. Of the Comm. On Banking and Currency,* 76th Cong., 3d Sess. 243 (1940). In 1940 most securities-related businesses were organized as privately held general partnerships. If a securities-related business failed, the fund, as a general partner, could have been held accountable for the partnership's liabilities. Rule 12d3–1 preserves these purposes: rule 12d3–1(c) effectively precludes a fund from acquiring, regardless of the source of its revenues, a general partnership interest in a broker, dealer, investment adviser, or underwriter. Today, however, virtually all securities firms are organized as corporations and not as general partnerships.

[75] *See, e.g.*, CDC IXIS Asset Management Advisers, L.P., Investment Company Act Release Nos. 25061 (July 12, 2001) [66 FR 37497 (July 18, 2001)] (notice) and 25103 (Aug. 8, 2001) (order).

[76] Proposed rule 12d3–1(c)(3). *See* sections I.B.1. and I.B.3. of this Release (discussing proposed new rule 17a–10 and proposed amendments to rule 10f–3).

[77] Proposed rule 12d3–1(c)(3)(i) and (ii). The ownership limits in rule 12d3–1(a) and (b) would continue to apply to the fund as a whole.

A. Benefits

1. In General

We anticipate that funds, their shareholders, and their advisers and other affiliated persons would benefit from the proposed rule and amendments. As discussed earlier, the number of persons that are affiliated persons of funds has increased markedly since 1940.[78] As a result, 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. The Act authorizes us to issue orders providing exemptive relief from the restrictions on affiliate transactions, but the process for obtaining such an exemption imposes direct and indirect costs on funds. The proposed rules and amendments each will benefit funds, their shareholders, and their affiliated persons by eliminating these direct and indirect costs.

The most direct cost of the application process is the cost of filing the application itself. From 1996 to 2001, we received twenty-one applications for exemptions from sections 17(a), 17(d), 17(e), 10(f), and 12(d)(3) that involved transactions of funds with portfolio and subadvisory affiliates. Based on discussions with industry representatives, our staff estimates the average cost of filing an application to be approximately $20,000 when the application involves relatively simple issues, and up to $80,000 for applications involving complex, novel issues. Thus, we estimate the cost of filing applications for these exemptions since 1996 to be between $420,000 to $1,680,000. Funds also commonly incur the cost of filing one or more amendments after the initial application. One benefit of our proposal would be elimination of these direct costs.

The application process also produces indirect costs, as funds forego beneficial transactions rather than undertake to obtain an exemptive order. Funds may forgo transactions either because the anticipated benefit of the transaction does not exceed the cost of obtaining an exemptive order, or because the transaction is time-sensitive, and it is not feasible for a fund to obtain an exemptive order quickly enough to be able to enter into the transaction. For applications since 1996, the time between the filing of an application and the granting of an exemptive order has ranged from four months for a relatively straightforward application that added parties to an earlier exemptive order,[79] to 17 months for a more complicated application requiring several amendments.[80] Encouraging beneficial transactions by eliminating these potentially significant costs and delays would be a further benefit of our proposal.

Furthermore, eliminating direct and indirect costs of the application process may reduce factors that discriminate against smaller funds and smaller transactions. The direct cost and delay imposed by the application process may discourage smaller funds from applying for exemptions to a greater extent than larger funds, since a larger fund may be more willing to pay direct costs and wait for approval of exemptions. Funds of any size may have a disincentive to enter into smaller transactions if the cost of obtaining an exemptive order represents a greater proportion of the expected benefits of a smaller transaction than a larger one. Elimination of these factors would reduce ways in which currently there may be a disproportionate adverse effect on smaller funds and a distortion of investment decisions of funds away from smaller transactions.

2. Portfolio Affiliates

The proposed amendments to rules 17a–6 and 17d–1(d)(5) regarding transactions and joint arrangements with second-tier portfolio affiliates may expand the range of possible partners with which funds may enter into transactions and joint arrangements. Funds, second-tier portfolio affiliates, and their shareholders each may benefit from the transactions and arrangements made possible by the proposed amendments. It may not be possible to quantify this benefit, since it varies on a case-by-case basis depending on the characteristics of individual transactions and joint arrangements and on the extent to which funds involved in such transactions have second-tier portfolio affiliates. Moreover, any benefits would have to be measured against the benefits of alternative transactions or joint arrangements that may have been entered into. We request comment on the nature and potential magnitude of this benefit.

Amending rules 17a–6 and 17d–1(d)(5), to provide that the term ''financial interest'' does not include interests that the fund's board of directors finds to be not material, may expand the range of possible partners for transactions and joint arrangements with funds by making the rules' exemptions more widely available.[81] So too may the proposed removal of rule 17d–1(d)(5)'s condition limiting a fund to committing no more than five percent of its assets in any given joint enterprise.[82] These amendments may, thus, expand the scope of the exemptions for transactions or joint arrangements with both first- and second-tier portfolio affiliates, to the additional benefit of funds, their portfolio affiliates, and their shareholders. We request comment on the nature and potential magnitude of this benefit.

3. Subadvisory Affiliates

Principal Transactions

Proposed rule 17a–10 may benefit subadvisers, affiliated funds of a subadvised fund, and portions of the subadvised fund for which the subadviser does not provide investment advice by broadening investments options available to those persons. The restrictions that the Act currently places on transactions with affiliated persons limit the potential trading partners available to buyers and sellers. By allowing a subadviser of a fund to enter into principal transactions with (i) affiliated funds of the subadvised fund and (ii) those portions of the subadvised fund for which the subadviser does not provide investment advice, proposed rule 17a–10 would allow each party to enter into transactions with a wider range of funds. By broadening the markets available to both buyers and sellers, proposed rule 17a–10 may permit sellers to obtain more favorable pricing, and make a wider range of investment options available to buyers. It may not be possible to quantify this benefit, as it depends on the characteristics of individual transactions and on the extent to which funds involved in such transactions have subadvisory affiliates. We request comment on the nature and potential magnitude of this benefit.

Brokerage Transactions

Proposed rule 17e–1 would, under certain circumstances, permit subadvisers and their affiliated persons

[78] *Supra* notes 12–14.

[79] *See* Mercury Asset Management International Ltd., Investment Company Act Release Nos. 23867 (June 9, 1999) [64 FR 32073 (June 15, 1999)] (notice) (application was originally filed Mar. 3, 1999) and 23887 (July 1, 1999) (order).

[80] *See* Frank Russell Investment Company et al., Investment Company Act Release Nos. 24820 (January 3, 2001) [66 FR 2031 (Jan. 10, 2001)] (notice) (application was originally filed Aug. 21, 1999) and 24847 (Jan. 30, 2001) (order).

[81] Expansion of the exemption in this manner may also impose costs by eliminating what has been a ''bright line'' prohibition and expanding the opportunities for harmful transactions. Commenters addressing the benefits of the rule's expansion should also address the potential costs.

[82] Rule 17d–1(d)(5)(ii).

to receive remuneration when acting as broker for an affiliated fund, without complying with all of the rule's conditions. The rule requires, among other things, that fund directors review the transaction, and that funds maintain records of the transaction. Proposed rule 17e–1 would exempt funds from these requirements in circumstances identical to those in which proposed rule 17a–10 would permit a subadviser or its affiliates to engage in a principal transaction with an affiliated fund.[83] Our staff estimates that boards of directors of funds that employ affiliated brokers currently spend approximately 12.5 meeting hours per year per fund conducting the required review. Our staff further estimates that a fund that uses in-house counsel to assist fund directors in reviewing these transactions incurs a cost of $775 per year for counsel, based on an hourly cost for in-house counsel of $62 per hour. Funds incur the additional incremental cost of maintaining records of the transaction. The proposed amendments to rule 17e–1 may benefit funds and their shareholders by allowing funds to avoid these tasks and expenses.

Purchases During Primary Offerings Underwritten by Affiliated Subadvisers

The proposed amendments to rule 10f–3 may benefit funds by broadening their investment options. The Act prohibits a series of a series company from purchasing securities during an underwriting or selling syndicate of which an adviser to any of the series is a member. By providing that, for purposes of section 10(f) and rule 10f–3, a series of a series company is a separate investment company, the proposed amendments to rule 10f–3 could broaden (i) the investment opportunities available to such funds and (ii) the range of possible purchasers when a subadviser participates in an underwriting syndicate. Funds, fund shareholders, and subadvisers all may benefit from the proposed rule. As with proposed rule 17a–10, it may not be possible to quantify this benefit. We request comment on the nature and potential magnitude of this benefit.

The Act also does not distinguish between a fund with multiple subadvisers that manage discrete portions of its portfolio, and a fund whose subadvisers manage the portfolio in its entirety. The proposed amendments to rule 10f–3 that would deem separately managed portions of a fund's portfolio to be separate investment companies for purposes of section 10(f) and rule 10f–3 may increase the investment opportunities of a fund with multiple subadvisers that manage discrete portions of its portfolio. Quantifying the potential magnitude of this benefit may not be possible. We request comment on the nature and potential magnitude of this benefit.

The proposed amendments to rule 10f–3 regarding the rule's percentage limits also may broaden the investment options available to funds. The Act currently does not distinguish between purchases by funds or portions of funds that are recommended by a subadviser that is (or is an affiliated person of) a participant in the underwriting or selling syndicate and purchases by funds or portions of funds for which other subadvisers provide investment advice. By providing that the percentage limit of rule 10f–3 applies only to purchases by funds, portions of funds, and accounts for which participants provide investment advice, the proposed amendments to rule 10f–3 may increase the investment opportunities of a fund with multiple subadvisers that manage discrete portions of its portfolio. It may not be possible to quantify the potential magnitude of this benefit. We request comment on the nature and potential magnitude of this benefit.

4. Ownership of Securities Issued by Subadvisers

The proposed amendments to rule 12d3–1 may also benefit funds by broadening their investment options. The restrictions that the Act and rule 12d3–1 currently place on purchases by a fund of securities of its own investment adviser or any affiliated person of its own investment adviser may significantly limit the options available to a fund among securities issued by securities-related businesses, if the fund is advised by multiple investment advisers. Amending rule 12d3–1 to permit a fund to acquire securities issued by one of its subadvisers, or an affiliated person of one of its subadvisers, when the subadviser is not in a position to influence the decision by the fund to purchase the securities, may increase the investment opportunities of these funds. Quantifying the potential magnitude of this benefit also may not be possible. We request comment on the nature and potential magnitude of this benefit.

B. Costs

The Commission anticipates that funds, their shareholders, and their advisers and other affiliated persons may incur certain costs from the proposed new rule and amendments. These persons may incur certain direct costs of complying with the proposed new rule and amendments. The exemptions in the proposed new rule and amendments also may encourage shifts in market behavior that would create direct and indirect costs for certain entities. Furthermore, the exemptions may allow funds to proceed with disadvantageous transactions that existing restrictions would have prevented.

1. Portfolio Affiliates

The proposed amendments to rules 17a–6 and 17d–1(d)(5) would exempt currently prohibited transactions from the restrictions of sections 17(a) and 17(d) and rule 17d–1. We do not anticipate that there will be any costs associated with the rule amendments, other than a cost associated with the proposed provision that a fund's board of directors may find that an interest is not material and hence not a ''financial interest.'' As a fund may only avail itself of the benefit of this aspect of the proposal if the fund directors make certain findings, and record the basis for those findings in their minutes, the benefit of the proposal is offset to some extent by the cost to the fund of the board fulfilling its obligations. Based on discussions with industry representatives, our staff estimates that reviewing the materiality of a Prohibited Participant's interest in a party to the transaction and recording the basis for those findings would require approximately 11.2 hours and $1,140 per meeting, in addition to the discussions that occur during the board meeting. This cost may partially offset the benefits of the exemption, including the direct benefit of allowing a fund to forego the cost of applying for exemptive relief from the restrictions of section 17(a) and rule 17d–1. We assume that if the cost of holding such a meeting exceeds the benefit to the fund, the fund will either forgo the opportunity to engage in the transaction or require the Prohibited Participant to divest itself of its interest.

2. Subadvisory Affiliates

In complying with the requirements of proposed rule 17a–10 and the proposed amendments to rules 10f–3, 12d3–1, and 17e–1 and availing themselves of their benefits, a fund and its advisers and subadvisers may incur

[83] Despite the proposed removal of some aspects of board review required by rule 17e–1, it may be prudent for fund directors to continue to oversee and review the proposed exempted transactions as a matter of course. We would not, however, view any such additional oversight as a cost attributable to the proposed amendments to rule 17e–1.

direct costs that would partially offset those benefits. In order for a fund to rely on the exemptions in the proposed rule and amendments, the fund's advisory contracts must include certain provisions, which they may not currently include. Since such contracts generally are subject to renewal at regular intervals, additional administrative cost may not be required to add such provisions. If adopted, we 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. Based on discussions with industry representatives, the staff estimates that drafting and executing revised subadvisory contracts would require approximately 6 hours. Assuming that all funds that are advised by subadvisers modify their advisory contracts in order that they and their affiliated funds may rely on the proposed exemptions, the proposed rule and rule amendments would create an estimated initial one-time cost of approximately $836,000.

Proposed rule 17e–1 may result in increased costs to funds as a result of higher brokerage commissions. By exempting the commissions paid to certain affiliated subadvisers from the requirement for scrutiny by the board of directors, proposed rule 17e–1 may allow a rise in brokerage commissions, at the expense of the fund and its shareholders. Whether this increased cost would occur depends on the extent to which the scrutiny currently required of boards of directors has resulted in findings that commissions to be paid by funds are excessive. We request comment on the frequency of boards of directors making such findings, and the magnitude of the effect of such findings on brokerage commissions.

The proposed amendments to rule 10f–3 may encourage division of funds into discrete parts managed by multiple subadvisers. A fund that is advised by subadvisers that participate, or are affiliated with persons that participate, in underwriting syndicates may have an incentive to reorganize in order to take advantage of the opportunity to have a part of the fund purchase securities during the syndicate. Likewise, a fund that is advised by a subadviser that participates in underwriting syndicates may have an incentive to reorganize in order to comply with the percentage limit of rule 10f–3 and take advantage of the opportunity to purchase securities in reliance on that rule's exemption. Such a development would benefit subadvisers, but the use of additional subadvisers could also result in increased costs to funds and their shareholders.

C. Request for Comment

We request comment on the potential costs and benefits identified in the proposal and any other costs or benefits that may result from the proposed rules and amendments. We request comments on the anticipated costs and benefits of the proposed new rule 17a–10 and the proposed amendments to rules 10f–3, 17a–6, 17d–1(d)(5), 17e–1, and 12d3–1 as compared with the costs and benefits of the Act without proposed rule 17a–10 and of rules 10f–3, 17a–6, 17d–1, 17e–1, and 12d3–1 in their current forms. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, [84] the Commission also requests information regarding the proposed impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide data to support their views.

IV. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[85]

Portfolio Affiliates

The proposed amendments to rules 17a–6 and 17d–1(d)(5) would expand the circumstances under which funds, and companies they control, could enter into principal transactions and joint arrangements with portfolio affiliates without first obtaining an exemptive order from the Commission. The proposed amendments would permit funds and their controlled companies to engage in otherwise prohibited transactions with: (i) A wider array of first-tier portfolio affiliates than the rules currently permit; and (ii) certain second-tier portfolio affiliates. [86] We anticipate that the proposed amendments will promote efficiency and competition. The Act's restrictions on transactions involving funds and their affiliated persons respond to market failures that can occur when an affiliated person, in a position to influence the management of a fund, causes the fund to behave in a manner that benefits the affiliated person, rather than the shareholders of the fund. The proposed amendments to rules 17a–6 and 17d–1(d)(5) would permit market forces to operate to allocate resources in circumstances where market failure is unlikely because the affiliated person is not in a position to influence fund management. The proposed amendments to rules 17a–6 and 17d–1(d)(5) are unrelated to, and we believe will have no effect on, capital formation.

Subadvisory Affiliates

The proposed amendments to rules 17e–1, 10f–3, and 12d3–1 and proposed new rule 17a–10 would permit funds, and companies controlled by funds, to engage in transactions with subadvisers that are affiliated persons of the fund, but which are not in a position to influence the fund's decision to participate in the transaction. The proposed rule and amendments would permit, in limited circumstances, funds, and companies controlled by funds, to: (i) Engage in principal transactions with such subadvisers, (ii) purchase securities during a primary offering in which such subadvisers participate (or are affiliated with persons that participate) in the underwriting or selling syndicate, and (iii) purchase securities issued by such subadvisers. The proposed amendments to rule 17e–1 would permit, in limited circumstances, an affiliated subadviser acting as broker to receive remuneration without complying with certain conditions of the rule. As in the case of the proposed amendments to rules 17a–6 and 17d–1(d)(5), we anticipate that the proposed rules and rule amendments will promote efficiency and competition by permitting market forces to operate in circumstances where there is limited chance of market failure. We also believe that the proposed amendments to rule 10f–3 may enhance capital formation by enabling funds to purchase securities during primary offerings, when they would otherwise be prohibited from doing so without a Commission exemptive order.

The proposed rule and amendments may, however, adversely affect competition by promoting increased concentration of the market for subadvisory services. Proposed rule 17a–10 may reduce or eliminate any incentive to select subadvisers specifically because they are not affiliated with a large number of funds, which may encourage funds to shift subadvisory business toward certain

[84] Pub. L. 104–121, Title II, 110 Stat. 857 (1996).

[85] 15 U.S.C. 80a–2(c).

[86] An additional proposed change to rule 17d–1(d)(5) would remove existing limitations regarding the percentage of a fund's assets that the fund could commit to a joint enterprise. If adopted, this amendment would bring rule 17d–1(d)(5) into line with rule 17a–6, which has no such limitations. Rule 17d–1(d)(5)(ii).

particularly successful subadvisers. The proposed amendments to rule 10f–3 may remove an incentive to select subadvisers that are not either major participants or affiliated with major participants in the underwriting business. By removing disincentives against market concentration, these proposed rules may have the effect of encouraging the market for subadvisory services to concentrate in a smaller set of subadvisers.

The Commission requests comments on whether the proposed rule amendments, if adopted, would promote efficiency, competition, and capital formation. Will the proposed amendments materially affect the number of transactions involving funds, their controlled companies, and affiliated persons of funds? Will any costs that result from the proposed amendments affect efficiency, competition, or capital formation? We will consider any comments in satisfying our responsibilities under section 2(c) of the Investment Company Act. We request commenters to provide empirical data and other factual support for their views to the extent possible.

V. Paperwork Reduction Act

Certain provisions of proposed rule 17a–10 and the proposed amendments to rules 10f–3, 12d3–1, 17a–6, 17d–1, and 17e–1 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501–3520] (''PRA''). The Commission is submitting the proposed collections of information to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: (i) ''Rule 10f–3 under the Investment Company Act of 1940, Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate'; (ii) ''Rule 12d3–1 under the Investment Company Act of 1940, Exemption of acquisitions of securities issued by persons engaged in securities related businesses'; (iii) ''Rule 17a–6 under the Investment Company Act of 1940, Exemption for transactions with portfolio affiliates'; (iv) ''Rule 17a–10 under the Investment Company Act of 1940, Exemption for transactions with certain subadvisory affiliates'; (v) ''Rule 17d–1 under the Investment Company Act of 1940, Applications regarding joint enterprises or arrangements and certain profit-sharing plans'; and (vi) ''Rule 17e–1 under the Investment Company Act of 1940, Brokerage transactions on a securities exchange''. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.[87]

A. Portfolio Affiliates

Rules 17a–6 and 17d–1

Under rules 17a–6 and 17d–1, a fund or company controlled by a fund may enter into principal and joint transactions with a portfolio affiliate, or an affiliated person of a portfolio affiliate, as long as certain other Prohibited Participants are not parties to the transaction and do not have a financial interest in a party to the transaction. Rules 17a–6 and 17d–1 include a list of interests that are not ''financial interests'' for purposes of the rule.[88] We are proposing to amend that list to provide that ''financial interest'' does not include an interest that the fund's board of directors finds to be not material, provided that the directors record the basis for that finding in the minutes of their meeting.[89] This aspect of the proposed amendments would create a paperwork burden.

Based on public filings with the Commission, the Commission's staff estimates that 200 registered investment companies are affiliated persons of 900 issuers as a result of the investment company's ownership or control of the issuer's voting securities, and that there are approximately 1,400 such affiliate relationships.[90] The staff estimates that annually there will be a total of 1,400 principal transactions under rule 17a–6 [91] and 1,400 joint arrangements under rule 17d–1(d)(5),[92] and that for each rule approximately 420 transactions or arrangements will result in a paperwork burden.[93]

The Commission staff estimates that compliance with the proposed amendments would impose a burden of .2 hours for each transaction for which there is a paperwork burden.[94] Therefore we estimate 84 burden hours to be associated with the proposed amendments to rule 17a–6 annually and 84 burden hours to be associated with the proposed amendments to rule 17d–1 annually.

B. Subadviser Affiliates

The Commission staff estimates that 1,900 portfolios of approximately 800 investment companies use the services of one or more subadvisers.[95] Based on discussions with industry representatives, the Commission staff estimates that it will require approximately 6 hours to draft and execute revised subadvisory contracts (5 staff attorney hours, 1 supervisory attorney), in order for funds and subadvisers to be able to rely on the exemptions in proposed rule 17a–10 and the proposed amendments to rule 10f–3, 17e–1, and 12d3–1.[96] Assuming that all funds that are advised by subadvisers modify their advisory contracts in order that they and their affiliated funds may rely on the proposed exemptions, the proposed rule and rule amendments would create an estimated initial one-time burden of approximately 11,400 burden hours.

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[87] Rule 10f–3 (OMB Control No. 3235–0226) was adopted pursuant to authority set forth in sections 10(f), 31(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a–10(f), 80a–30(a), and 80a–37(a)]. Rule 12d3–1 was adopted pursuant to authority set forth in sections 6(c) and 38(a) of the Act. [15 U.S.C. 80a–6(c)]. Rule 17a–6 was adopted pursuant to authority set forth in sections 6(c), 17(b), 31(a), and 38(a) of the Act [15 U.S.C. 80a–17(b)]. Rule 17d–1 was adopted pursuant to authority set forth in sections 6(c), 17(d), and 38(a). Rule 17e–1 (OMB Control No. 3235–0217) was adopted pursuant to authority set forth in sections 6(c), 31(a), and 38(a) of the Act.

[88] *See supra* note 26.

[89] Proposed rules 17a–6(b)(1)(H) and 17d–1(d)(8). Collection of this information is necessary to obtain the benefit of the exemption in the proposed rule amendments.

[90] *See supra* note 12. For purposes of this analysis, the staff estimates that investment companies will enter into one principal transaction and one joint arrangement each year with each of their portfolio affiliates, and that in thirty percent of those transactions and arrangements a Prohibited Participant will have a financial interest in a party to the transaction that the board of directors of the affected investment company will consider for purposes of determining whether that financial interest is material.

[91] 1,400 affiliate relationships × 1 principal transaction per year = 1,400 transactions under rule 17a–6.

[92] 1,400 affiliate relationships × 1 joint arrangement per year = 1,400 joint arrangements under rule 17d–1(d)(5). In addition to expanding fund business opportunities by allowing funds to transact with a wider range of portfolio affiliates, we are also proposing to eliminate the limit imposed by rule 17d–1(d)(5) on the percentage of assets a fund can commit to any given joint enterprise. Rule 17d–1(d)(5)(ii). The staff does not anticipate that allowing funds to increase the size of their commitment to a joint transaction will result in an increase in the expected number of such transactions.

[93] 1,400 transactions or arrangements × .30 (percentage of transactions or arrangements in which a Prohibited Participant is assumed to have a financial interest) = 420.

[94] The staff estimates the hourly burden to comply with the board of director's obligation to make a finding as to the materiality of a prohibited person's financial interest in a transaction to be 11 hours. The staff estimates that funds will spend .2 hours complying with the requirement that the basis for the board's findings be recorded in the minutes of its meeting.

[95] *See supra* note 13.

[96] The fund's advisory contracts must include these conditions in order for the fund to obtain the benefit of the exemptions in the proposed rule and rule amendments.

The total estimated first year cost of these burden hours is $836,000.[97]

ESTIMATED ONE TIME BURDEN HOURS AND COST OF SUBADVISORY RULE AND AMENDMENTS

Number of funds modifying contracts	Staff attorney hours	Supervisory attorney hours	Total burden hours	Cost per staff attorney hour	Cost per supervisory attorney hour	Total cost of burden hours
1,900	5	1	11,400	$62	$130	$836,000

Proposed rule 17a–10 and the proposed amendments to rules 10f–3, 12d3–1, and 17e–1 would require virtually identical modifications to fund advisory contracts. The Commission staff assumes that funds will rely equally on the exemptions in all of these rules, and therefore the burden hours associated with the required contract modifications should be apportioned equally among the four rules. Therefore the estimated one-time burden hours associated with rules 17a–10, 10f–3, 12d3–1, and 17e–1 are 2,850 hours for each rule (11,400 total burden hours for all of the rules/four rules), and the estimated one-time cost of these burden hours is $209,000 for each rule ($836,000/four rules).[98]

The staff estimates that a total of 60 funds will enter into subadvisory agreements each year after the first year in which the proposed rule and rule amendments are adopted.[99] Assuming that each of these funds enters into a contract that permits it and its affiliated funds to rely on the exemptions in proposed rule 17a–10, and the proposed amendments to rules 10f–3, 12d3–1, and 17e–1, an estimated 360 burden hours (90 hours per rule) will be associated with these rules annually, with an associated cost of $26,400 ($6,600 per rule).[100]

Rule 17e–1

Based on an analysis of investment company filings, the staff estimates that approximately 293 investment companies use at least one affiliated broker and that each of these investment companies spends an estimated 12.5 hours per year (at a cost of $775 per year) complying with rule 17e–1's requirements that (i) the fund retain records of transactions entered into pursuant to the rule (''recordkeeping requirement''), and (ii) the fund's directors review those transactions quarterly (''review requirement'').[101] Based on conversations with representatives of investment companies, the staff estimates that the proposed amendments to rule 17e–1 would exempt approximately 40 percent of transactions that occur under rule 17e–1 from the rule's recordkeeping and review requirements. The Commission staff estimates, therefore, that the proposed amendments to rule 17e–1 would, in this respect, *decrease* the rule's information collection burden to 2,200 hours[102] and $136,422 per year.[103]

ESTIMATED REDUCTION IN BURDEN HOURS AND COST OF RULE 17E–1 (EFFECT OF EXEMPTION FROM REVIEW AND RECORDKEEPING REQUIREMENTS)

	Number of funds relying on rule 17e–1	Number of funds subject to recordkeeping and review requirements	Burden hours of recordkeeping and review requirements	Total burden hours of recordkeeping and review requirements	Cost per hour of recordkeeping and review requirements	Total cost of burden hours
Current Rule	293	293	12.5	3,663	$62	$227,106
As proposed to be amended	293	176	12.5	2,200	62	136,422

This reduction will be offset to some extent by the increase in estimated burden hours described above with respect to the required modifications of the funds' investment advisory contract. Therefore rule 17e–1, as proposed to be amended, would impose an estimated burden of 5,050 hours ($345,400) in the first year after the amendments are adopted, and an estimated burden of 2,290 hours ($143,000) in subsequent years.

C. Request for Comments

We request comments on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collections of information on those who are to

[97] (5 hours ×$62 = $310) + (1 hour ×$130 = $130) = $440. (5 attorney hours, 1 deputy general counsel hour). $440 ×1,900 funds=$ 836,000.

[98] The proposed amendments to rule 17e–1 will also, as discussed below, decrease the burden hours associated with that rule.

[99] Based on an analysis of investment company filings, the staff estimates that approximately 250 funds are created annually. Assuming that the number of these funds that will use the services of subadvisers is proportionate to the number of funds that currently use the services of subadvisers, then approximately 50 new funds will enter into subadvisory agreements each year. The Commission staff estimates, based on an analysis of investment company filings, that an additional 10 funds, currently in existence, will employ the services of subadvisers for the first time each year.

[100] 6 hours × 60 funds=360 total hours. $440 × 60 funds= $26,400.

[101] In calculating the total annual cost of complying with amended rule 17e–1, the Commission staff assumes that the entire burden would be attributable to professionals with an average hourly wage rate of $62 per hour.

[102] 293 transactions × 12.5 hours = 3,663 hours if adopted; 60% of the 293 transactions (or 176 transactions) would proceed under rule 17e–1. 176 transactions (60% of the 293 transactions anticipated to be impacted by rule) × 12.5 hours = 2,200 hours.

[103] 3,663 hours × $62 = $227,106; 2,200 hours × $62 = $136,422.

respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rules and rule amendments should direct them to the Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10202, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–13–02. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–13–02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

VI. Summary of Initial Regulatory Flexibility Analysis

We have prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding the proposed rule 17a-10 and the proposed amendments to rules 10f-3, 12d3–1, 17a-6, 17d-1, and 17e-1 under the Investment Company Act. The following summarizes the IRFA.

The IRFA summarizes the background of the proposed amendments. The IRFA also discusses the reasons for the proposed amendments and the objectives of, and legal basis for, the amendments. Those items are discussed above in the Release.

The IRFA discusses the effect of the proposed amendments on small entities. For purposes of the Regulatory Flexibility Act, a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of $50 million or less as of the end of its most recent fiscal year.[104] An investment adviser is a small entity if it (i) manages less than $25 million in assets, (ii) has total assets of less than $5 million on the last day of its most recent fiscal year, and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that manages $25 million or more in assets, or any person (other than a natural person) that had total assets of $5 million or more on the last day of the most recent fiscal year.[105] A portfolio company (i.e., a company in which a fund invests) is a small entity if its total assets on the last day of its most recent fiscal year were $5 million or less.[106] The staff estimates, based upon Commission filings, that there are approximately 3,650 active registered management investment companies, of which approximately 200 are small entities, and may rely on the rule if they satisfy its conditions. The staff further estimates that there are approximately 7,560 registered investment advisers, of which approximately 430 are small entities.[107]

The IRFA states that proposed amendments to rules 17a–6 and 17d–1 would impose recordkeeping requirements on funds that engage in principal transactions or joint arrangements in reliance on the rule, when a Prohibited Participant has an interest in a party to the transaction or arrangement that is not material, in that the board of directors of the fund would be required to record in the minutes of its meetings the basis for the board's finding that the Prohibited Participant's interest is not material. The IRFA further explains that the exemptions in proposed rule 17a-10 and the proposed amendments to rules 10f-3, 12d3–1, and 17e–1 would be conditioned on the funds' advisory contracts including certain provisions.

The IRFA explains that we have not identified any federal rules that duplicate or conflict with the proposed rule and rule amendments. The IRFA states that the Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant economic impact on small entities. The overall impact of the amendments would be to decrease the burdens on all entities, including small entities, because the burdens under the proposed amendments should be more than offset by the elimination of existing requirements. Therefore, the potential impact of the amendments on small entities should not be significant. For these reasons, alternatives to the proposed amendments and proposed new rule are unlikely to minimize any impact that the proposed amendments may have on small entities.[108]

We encourage comment with respect to any aspect of the IRFA. We specifically request comment on the number of small entities that would be affected by the proposed rule amendments, and the likely impact of the proposal on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of the rule amendments, and will be placed in the same public file as comments on the proposed amendments themselves. A copy of the IRFA may be obtained by contacting William C. Middlebrooks, Jr., Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

VII. Statutory Authority

The Commission is proposing amendments to rules 10f-3, 12d3–1, 17a-6, 17d-1, and 17e-1 and new rule 17a-10 under the Investment Company Act pursuant to authority set forth in sections 6(c), 10(f), 17(b), 17(d), 31(a), and 38(a) of the Investment Company Act.

List of Subjects

17 CFR Part 270

Investment companies; reporting and recordkeeping requirements; securities.

Text of Proposed Rules

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, 80a–39, unless otherwise noted;

* * * * *

2. Section 270.10f–3 is amended by:

a. Redesignating paragraph (b) as paragraph (c);

b. Adding paragraphs (a)(6), (a)(7), (a)(8), and new paragraph (b);

c. Revising the paragraph heading in newly redesignated paragraph (c); and

[104] 17 CFR 270.0–10.

[105] 17 CFR 275.0–7.

[106] 17 CFR 240.0–10.

[107] We estimate that 875 issuers are portfolio affiliates of funds. *See supra* note 12. We are unable to estimate the number of these issuers that are small entities.

[108] Alternatives in this category would include: (i) Establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating or simplifying the compliance requirements for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of all or part of the rule.

d. Revising newly redesignated paragraph (c)(7) to read as follows:

§ 270.10f–3 Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate.

(a) * * *

(6) *Managed Portion* of a portfolio of a registered investment company means a discrete portion of a portfolio of a registered investment company for which a Subadviser is responsible for providing investment advice, provided that:

(i) The Subadviser is not an affiliated person of any investment adviser, promoter, underwriter, officer, director, member of an advisory board, or employee of the registered investment company; and

(ii) The Subadviser's advisory contract:

(A) Prohibits it from consulting with any subadviser of the investment company that is a principal underwriter or an affiliated person of a principal underwriter concerning securities transactions of the investment company; and

(B) Limits its responsibility in providing advice to providing advice with respect to such portion.

(7) *Series of a Series Company* means any class or series of a registered investment company that issues two or more classes or series of preferred or special stock, each of which is preferred over all other classes or series with respect to assets specifically allocated to that class or series.

(8) *Subadviser* means an investment adviser as defined in section 2(a)(20)(B) of the Act (15 U.S.C. 80a–2(a)(20)(B)).

(b) *Exemption for purchases by Series Companies and Investment Companies with Managed Portions.* For purposes of this section and section 10(f) of the Act (15 U.S.C. 80a–10(f)), each Series of a Series Company, and each Managed Portion of a portfolio of a registered investment company, is deemed to be a separate investment company. Therefore, a purchase or acquisition of a security by a registered investment company is exempt from the prohibitions of section 10(f) of the Act if section 10(f) of the Act would not prohibit such purchase if each Series and each Managed Portion of the company were a separately registered investment company.

(c) *Exemption for other purchases.*

* * *

(7) *Percentage limit.* (i) *Generally*. The amount of securities of any class of such issue to be purchased by the investment company, aggregated with purchases by any other investment company advised by the investment company's investment adviser, and purchases by any other account over which such adviser has discretionary authority or otherwise exercises control, does not exceed the following limits:

(A) If purchased in an offering other than an Eligible Rule 144A Offering, 25 percent of the principal amount of the offering of such class; or

(B) If purchased in an Eligible Rule 144A Offering, 25 percent of the total of:

(*1*) The principal amount of the offering of such class sold by underwriters or members of the selling syndicate to qualified institutional buyers, as defined in § 230.144A(a)(1) of this chapter; plus

(*2*) The principal amount of the offering of such class in any concurrent public offering.

(ii) *Exemption from percentage limit.* The requirement in paragraph (c)(7)(i) of this section applies only if the investment adviser of the investment company is, or is an affiliated person of, a principal underwriter of the security; and

(iii) *Separate aggregation.* The requirement in paragraph (c)(7)(i) of this section applies independently with respect to each investment adviser of the investment company that is, or is an affiliated person of, a principal underwriter of the security.

* * * * *

3. Section 270.12d3–1 is amended by revising paragraph (c) and adding paragraph (d)(9) before the Note:

§ 270.12d3–1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

* * * * *

(c) Notwithstanding paragraphs (a) and (b) of this section, this section does not exempt the acquisition of:

(1) A general partnership interest; or

(2) A security issued by the acquiring company's promoter, principal underwriter, or any affiliated person of such promoter, or principal underwriter; or

(3) A security issued by the acquiring company's investment adviser, or an affiliated person of the acquiring company's investment adviser, other than a security issued by a Subadviser or an affiliated person of a Subadviser of the acquiring company provided that:

(i) *Prohibited relationships.* The Subadviser that is (or whose affiliated person is) the issuer is not, and is not an affiliated person of, an investment adviser responsible for providing advice with respect to the portion of the acquiring company that is acquiring the securities, or of any promoter, underwriter, officer, director, member of an advisory board, or employee of the acquiring company;

(ii) *Advisory contract.* The advisory contracts of the Subadviser that is (or whose affiliated person is) the issuer, and any Subadviser that is advising the portion of the acquiring company that is purchasing the securities:

(A) Prohibit them from consulting with each other concerning securities transactions for the acquiring company, other than for purposes of complying with the conditions of paragraphs (a) and (b) of this section; and

(B) Limit their responsibility in providing advice to providing advice with respect to a discrete portion of the acquiring company's portfolio.

(d) * * *

(9) *Subadviser* means an investment adviser as defined in section 2(a)(20)(B) of the Act (15 U.S.C. 80a–2(a)(20)(B)).

* * * * *

4. Section 270.17a–6 is revised to read as follows:

§ 270.17a–6 Exemption for transactions with portfolio affiliates.

(a) *Exemption for transactions with portfolio affiliates.* A transaction to which a Fund, or a company controlled by a Fund, and a Portfolio Affiliate of the Fund are parties is exempt from the provisions of section 17(a) of the Act (15 U.S.C. 80a–17(a)), provided that none of the following persons is a party to the transaction, or has a direct or indirect Financial Interest in a party to the transaction other than the Fund:

(1) An officer, director, employee, investment adviser, member of an advisory board, depositor, promoter of or principal underwriter for the Fund;

(2) A person directly or indirectly controlling the Fund;

(3) A person directly or indirectly owning, controlling or holding with power to vote five percent or more of the outstanding voting securities of the Fund;

(4) A person directly or indirectly under common control with the Fund, other than:

(i) A Portfolio Affiliate of the Fund; or

(ii) A Fund whose sole interest in the transaction is an interest in a Portfolio Affiliate of the Fund; or

(5) An affiliated person of any of the persons mentioned in paragraphs (a)(1)–(4) of this section, other than the Fund or a Portfolio Affiliate of the Fund.

(b) *Definitions.*

(1) *Financial Interest.*

(i) The term *Financial Interest* as used in this section does not include:

(A) Any interest through ownership of securities issued by the Fund;

(B) Any interest of a wholly-owned subsidiary of a Fund;

(C) Usual and ordinary fees for services as a director;

(D) An interest of a non-executive employee;

(E) An interest of an insurance company arising from a loan or policy made or issued by it in the ordinary course of business to a natural person;

(F) An interest of a bank arising from a loan or account made or maintained by it in the ordinary course of business to or with a natural person, unless it arises from a loan to a person who is an officer, director or executive of a company which is a party to the transaction, or from a loan to a person who directly or indirectly owns, controls, or holds with power to vote, five percent or more of the outstanding voting securities of a company which is a party to the transaction;

(G) An interest acquired in a transaction described in paragraph (d)(3) of § 270.17d–1; or

(H) Any other interest that the board of directors of the Fund, including a majority of the directors who are not interested persons of the Fund, finds to be not material, provided that the directors record the basis for that finding in the minutes of their meeting.

(ii) A person has a Financial Interest in any party in which it has a Financial Interest, in which it had a Financial Interest within six months prior to the transaction, or in which it will acquire a Financial Interest pursuant to an arrangement in existence at the time of the transaction.

(2) *Fund* means a registered investment company or separate series of a registered investment company.

(3) *Portfolio Affiliate of a Fund* means a person that is an affiliated person (or an affiliated person of an affiliated person) of a Fund solely because the Fund, a Fund under common control with the Fund, or both:

(i) Controls such person (or an affiliated person of such person); or

(ii) Owns, controls, or holds with power to vote five percent or more of the outstanding voting securities of such person (or an affiliated person of such person).

5. Section 270.17a–10 is added to read as follows:

§ 270.17a–10 Exemption for transactions with certain subadvisory affiliates.

(a) *Generally.* A person that is prohibited by section 17(a) of the Act (15 U.S.C. 80a–17(a)) from entering into a transaction with a Fund solely because such person is, or is an affiliated person of, a Subadviser of the Fund, or a Subadviser of a Fund that is under common control with the Fund, may nonetheless enter into such transaction, if:

(1) *Prohibited relationship.* The person is not, and is not an affiliated person of, an investment adviser responsible for providing advice with respect to the portion of the Fund for which the transaction is entered into, or of any promoter, underwriter, officer, director, member of an advisory board, or employee of the Fund.

(2) *Advisory contract.* The advisory contracts of the Subadviser that is (or whose affiliated person is) entering into the transaction, and any Subadviser that is advising the fund (or portion of the fund) entering into the transaction:

(i) Prohibit them from consulting with each other concerning securities transactions for the Fund; and

(ii) If both such Subadvisers are responsible for providing investment advice to the Fund, limit their responsibility in providing advice with respect to a discrete portion of the Fund's portfolio.

(b) *Definitions.*

(1) *Fund* means a registered investment company and includes a separate series of a registered investment company.

(2) *Subadviser* means an investment adviser as defined in section 2(a)(20)(B) of the Act (15 U.S.C. 80a–2(a)(20)(B)).

6. Section 270.17d–1 is amended by revising paragraphs (d)(5) and (d)(6) to read as follows:

§ 270.17d–1 Applications regarding joint enterprises or arrangements and certain profit-sharing plans.

* * * * *

(d) * * *

(5) Any joint enterprise or other joint arrangement or profit-sharing plan (''joint enterprise'') in which a registered investment company or a company controlled by such a company, is a participant, and in which a Portfolio Affiliate (as defined in § 270.17a–6(b)(3)) of such registered investment company is also a participant, provided that:

(i) None of the persons identified in § 270.17a–6(a) is a participant in the joint enterprise, or has a direct or indirect Financial Interest in a participant in the joint enterprise (other than the registered investment company);

(ii) *Financial Interest.*

(A) The term *Financial Interest* as used in this section does not include:

(*1*) Any interest through ownership of securities issued by the registered investment company;

(*2*) Any interest of a wholly-owned subsidiary of the registered investment company;

(*3*) Usual and ordinary fees for services as a director;

(*4*) An interest of a non-executive employee;

(*5*) An interest of an insurance company arising from a loan or policy made or issued by it in the ordinary course of business to a natural person;

(*6*) An interest of a bank arising from a loan to a person who is an officer, director, or executive of a company which is a participant in the joint transaction or from a loan to a person who directly or indirectly owns, controls, or holds with power to vote, five percent or more of the outstanding voting securities of a company which is a participant in the joint transaction;

(*7*) An interest acquired in a transaction described in paragraph (d)(3) of this section; or

(*8*) Any other interest that the board of directors of the investment company, including a majority of the directors who are not interested persons of the investment company, finds to be not material, provided that the directors record the basis for that finding in the minutes of their meeting.

(B) A person has a Financial Interest in any party in which it has a Financial Interest, in which it had a Financial Interest within six months prior to the investment company's participation in the enterprise, or in which it will acquire a Financial Interest pursuant to an arrangement in existence at the time of the investment company's participation in the enterprise.

(6) The receipt of securities and/or cash by an investment company or a controlled company thereof and an affiliated person of such investment company or an affiliated person of such person pursuant to a plan of reorganization: *Provided*, That no person identified in § 270.17a–6(a)(1) or any company in which such a person has a direct or indirect Financial Interest (as defined in paragraph (d)(5)(iii) of this section):

* * * * *

7. Section 270.17e–1 is amended by revising paragraphs (b)(3) and (d) to read as follows:

§ 270.17e–1 Brokerage transactions on a securities exchange.

* * * * *

(b) * * *

(3) Determines no less frequently than quarterly that all transactions effected pursuant to this section during the preceding quarter (other than transactions in which the person acting as broker is a person permitted to enter into a transaction with the investment company by § 270.17a–10) were effected in compliance with such procedures;

* * * * *

(d) The investment company:

(1) Shall maintain and preserve permanently in an easily accessible place a copy of the procedures (and any modification thereto) described in paragraph (b)(1) of this section; and

(2) Shall maintain and preserve for a period not less than six years from the end of the fiscal year in which any transactions occurred, the first two years in an easily accessible place, a record of each such transaction (other than any transaction in which the person acting as broker is a person permitted to enter into a transaction with the investment company by § 270.17a–10) setting forth the amount and source of the commission, fee or other remuneration received or to be received, the identity of the person acting as broker, the terms of the transaction, and the information or materials upon which the findings described in paragraph (b)(3) of this section were made.

Dated: April 30, 2002.

By the Commission.

Jill M. Peterson,

Assistant Secretary.

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