

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 270

[Release No. IC-25888; File No. S7-13-02]

RIN 3235-A128

### Transactions of Investment Companies With Portfolio and Subadviser Affiliates

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is adopting 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 adopting one new rule and several rule amendments to permit funds to engage in transactions with subadvisers of affiliated funds. The rules 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.

**EFFECTIVE DATE:** *Effective Date:* February 24, 2003. *Compliance Date:* April 23, 2003. Section II of this document contains more information on transition prior to the compliance date.

**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 adopting new rule 17a-10 (17 CFR 270.17a-10) and 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").<sup>1</sup>

<sup>1</sup> Unless otherwise noted, when we refer to rules 10f-3, 12d3-1, 17a-6, 17a-10, 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, as amended by this release: 17 CFR 270.10f-3, 17 CFR 270.12d3-1, 17 CFR 270.17a-6, 17 CFR 270.17a-10, 17 CFR 270.17d-1, or 17 CFR 270.17e-1 respectively.

## Table of Contents

### Executive Summary

- I. Discussion
    - A. Portfolio Affiliates
      1. Second-Tier Affiliates
      2. Financial Interests
      3. Time Periods
    - B. Subadviser Affiliates
      1. Principal Transactions with Subadvisers: Section 17(a)
      2. Transactions with Subadvisers as Brokers: Section 17(e)
      3. Purchases During Primary Offering Underwritten by Subadvisers: Section 10(f)
      4. Ownership of Securities Issued by Subadvisers: Section 12(d)(3)
  - II. Effective Date
  - III. Cost-Benefit Analysis
    - A. Benefits
    - B. Costs
  - IV. Consideration of Promotion of Efficiency, Competition, and Capital Formation
  - V. Paperwork Reduction Act
    - A. Portfolio Affiliates
    - B. Subadviser Affiliates
  - VI. Summary of Final Regulatory Flexibility Analysis
  - VII. Statutory Authority
- Text of Rules

### Executive Summary

The Commission is adopting one new rule and amending five current rules to permit investment companies ("funds") and certain of their affiliated persons to enter into a variety of transactions and joint arrangements without first obtaining an individual exemptive order from the Commission. Amendments to rules 17a-17d-1(d)(5) expand the circumstances in which a fund may enter into principal transactions and joint arrangements with its portfolio affiliates, and the portfolio affiliates of affiliated funds. New rule 17a-10 and the amendments to rules 10f-3, 12d3-1, and 17e-1 expand the circumstances in which a fund may engage in transactions and arrangements with persons who are affiliated persons of the fund because they provide investment advice with respect to (i) an affiliated fund, or (ii) a portion of the fund's assets that will be unaffected by the transaction.

### I. Discussion

The Investment Company Act prohibits certain transactions between investment companies and their affiliated persons ("first-tier affiliates") and affiliated persons of their affiliated persons ("second-tier affiliates").<sup>2</sup> The

<sup>2</sup> See section 17(a) [15 U.S.C. 80a-17(a)] (prohibiting first- and second-tier affiliates 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); section 17(d) [15 U.S.C. 80a-17(d)] (making it unlawful for first- and second-tier

Act's restrictions are designed to prevent these persons from managing the fund for their own benefit, rather than for the benefit of the fund's shareholders.<sup>3</sup> Affiliated persons of a fund include (i) its investment adviser and any subadvisers,<sup>4</sup> (ii) companies the fund controls or five percent (or more) of whose securities are held by the fund, (iii) persons who control the fund, and (iv) persons who are under common control with the fund.<sup>5</sup>

In April 2002, we proposed to exempt certain persons from the Act's restrictions on affiliated transactions.<sup>6</sup> Under the proposal, funds would be permitted to enter into transactions with two types of affiliated persons—

- Portfolio affiliates, which are companies that are affiliated persons of a fund because the fund controls the company, or holds five percent or more of the company's voting securities, and

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 Commission rules); rule 17d-1(a) (prohibiting 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 enterprise, arrangement or plan has been filed with the Commission and has been granted); section 10(f) [15 U.S.C. 80a-10(f)] (prohibiting a fund from purchasing securities in a primary offering if certain affiliated persons of the fund are members of the underwriting or selling syndicate); section 17(e) [15 U.S.C. 80a-17(e)] (limiting the remuneration that first- and second-tier affiliates of a fund may receive in transactions involving the fund, and companies that the fund controls); and section 12(d)(3) [15 U.S.C. 80a-12(d)(3)] and rule 12d3-1 (together prohibiting a fund from acquiring securities issued by, among others, its own investment adviser).

<sup>3</sup> 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).

<sup>4</sup> Many funds use "subadvisers" to help manage fund assets. A subadviser is an investment adviser for purposes of the 1940 Act. The 1940 Act describes an "investment adviser" as a person 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).

<sup>5</sup> See 15 U.S.C. 80a-2(a)(3) (defining "affiliated person"). Unless otherwise noted, in this release we will use the term "affiliated person" to include both first- and second-tier affiliates of a fund.

<sup>6</sup> See *Transactions of Investment Companies With Portfolio and Subadvisory Affiliates*, Investment Company Act Release No. 25557 (Apr. 30, 2002) [67 FR 31081 (May 8, 2002)] ("Proposing Release").