

- Subadviser affiliates, which are persons that are affiliated persons of a fund because they are the fund's subadvisers (first-tier affiliates), affiliated persons of the fund's subadvisers (second-tier affiliates), or subadvisers of other affiliated funds (second-tier affiliates).

We published the proposals in response to the growth of funds and changes in their organization, which have resulted in a growing number of persons with whom a fund may *not* enter into transactions.⁷ The amendments were designed to permit transactions between funds and these affiliated persons in circumstances in which it is unlikely that the affiliate would be in a position to take advantage of the fund. We received nine comments on the proposal.⁸ The commenters supported the proposed rule and amendments, but suggested changes. Today we are adopting rule 17a-10 and amendments to rules 10f-3, 12d3-1, 17a-6, 17d-1, and 17e-1 substantially as proposed, with changes that respond to issues raised by commenters.

A. Portfolio Affiliates

1. Second-Tier 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). We proposed to amend rules 17a-6 and 17d-1(d)(5) to permit a fund to enter into principal transactions and joint arrangements not only with its own portfolio affiliates, but also with portfolio affiliates of funds that are under common control with the fund. Commenters supported the amendments, and we are adopting them substantially as proposed.⁹ The amendments permit funds to enter into transactions with portfolio affiliates of other funds in the same fund complex, subject to the same conditions under which a fund may enter into transactions and arrangements with its own portfolio affiliates.¹⁰

2. Financial Interests

A fund may not rely on the exemptions in rules 17a-6 and 17d-1(d)(5) to enter into principal transactions or joint arrangements with portfolio affiliates if certain persons (such as the fund's adviser, officers, and principal underwriter, which we will refer to as "Prohibited Participants"), have a financial interest in a party to the transaction or arrangement (other than the fund itself).¹¹ We proposed to amend the rules to permit a portfolio affiliate to enter into a transaction or arrangement with the fund if a Prohibited Participant has a financial interest that the fund's board determines is not "material."¹² Commenters supported the amendment, and we are adopting it substantially as proposed.¹³ In determining whether a financial interest is "material," the board should consider whether the nature and extent of the interest in the transaction is sufficiently small that a reasonable person would not believe that the interest affected the determination of whether to enter into the transaction or

arrangement or the terms of the transaction or arrangement.

3. Time Periods

Currently, rule 17a-6 prohibits transactions with portfolio affiliates when 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.¹⁴ Rule 17d-1(d)(5) prohibits joint transactions with portfolio affiliates if the Prohibited Participant "is, was, or proposes to be a participant" in the joint arrangement.¹⁵ The Commission proposed to reconcile these time periods, using the more limited approach of rule 17a-6.¹⁶ Under the proposed amendments, the rule would be available unless a Prohibited Participant had a financial interest in a party to the transaction within the previous six months (as opposed to a financial interest at *any* time in the past).¹⁷ We are adopting the amendment as proposed.¹⁸

B. Subadviser Affiliates

Most funds are today organized by an investment adviser that advises and provides administrative services to a number of other funds in the same fund complex. As a result, advisers and subadvisers to a fund are not only first-tier affiliates of any funds they advise; they may also be second-tier affiliates of the other funds in the complex.¹⁹

¹⁴ See prior rule 17a-6(a)(5)(ii).

¹⁵ See prior rule 17d-1(d)(5)(i).

¹⁶ See Proposing Release, *supra* note 6, at nn. 29-30 and accompanying text.

¹⁷ As discussed above, the fund's board of directors could also determine that a financial interest held within the 6 months preceding the transaction is not material.

¹⁸ See rules 17a-6(b)(1)(ii) and 17d-1(d)(5)(ii)(B). One commenter argued that the rules' exemptions should be available without regard to the past financial interests of the fund's affiliated persons. The commenter asserted that the past financial interest of an affiliated person would probably not raise the investor protection concerns that the rules are intended to address. We disagree. The rules protect funds in circumstances where the actions of an affiliated person may continue to be influenced by the person's prior financial interests. The rules are, in this respect, analogous to regulations that in other contexts prohibit an employee from working on matters that involve former employers or clients. See, e.g., 17 CFR 210.2-01(c)(2)(iii) and (iv) (describing circumstances in which an accountant is not independent as a result of employment by the accountant of a former employee of the audit client, or employment by the audit client of a former employee of the accountant).

¹⁹ 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). Not all advisers control the funds they advise. The determination of whether a fund is under the

¹¹ See rules 17a-6(a) and 17d-1(d)(5)(i) (prohibiting the following persons from participating in, or having a financial interest in a participant in the transaction or arrangement: (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; and (5) affiliated persons of the foregoing).

¹² See Proposing Release, *supra* note 6, at n. 28 and accompanying text. We also proposed to eliminate a condition in rule 17d-1(d)(5) that limited a fund to committing no more than five percent of its assets to a joint enterprise with a portfolio affiliate. *Id.* at nn.32-34 and accompanying text. We received no comment on this proposal and are adopting the amendment as proposed.

¹³ One commenter pointed out that a fund might be unable to rely on the proposed rules if an affiliated fund has a financial interest in, but is not affiliated with, the portfolio affiliate. For example, assume that Fund A and Fund B, which have the same principal adviser, own six percent and three percent, respectively, of the outstanding voting securities of Company X. Fund A wants to enter into a transaction to purchase commercial paper issued by Company X. Under the proposed amendments to rule 17a-6, Fund A might have been unable to do so. This is because Fund B, a Prohibited Participant, might be deemed to have a disqualifying "financial interest" in a party to the transaction (Company X). A second commenter made a similar observation. We have revised the rules to make clear that this type of transaction is permissible. See rule 17a-6(a)(4)(ii) (providing that a fund under common control with the participating fund is not a Prohibited Participant if the fund's "sole interest in the transaction or a party to the transaction is an interest in [the portfolio affiliate]").

⁷ *Id.* at nn. 12-16 and accompanying text.

⁸ The comment letters and a summary of comments prepared by our staff are available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC (File No. S7-21-01). The comment summary is also available on the Commission's Internet Web site.

⁹ One technical change we have made is discussed in note 13 *infra*.

¹⁰ See note 19, *infra*, discussing when funds in a fund complex are affiliated persons because they are under common control.