

provisions of the Act may restrict the ability of subadviser affiliates to enter into transactions or arrangements with a fund even if the subadviser affiliate lacks the ability to influence the fund.²⁰ We proposed one rule and a number of rule amendments to exempt transactions and arrangements between funds and their subadviser affiliates where there is little risk that the affiliated person is in a position to take advantage of the fund.

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

Section 17(a) of the Act prohibits a subadviser that is an affiliated person 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.²¹ We proposed new rule 17a-10 to permit (i) a subadviser of a fund to enter into transactions with funds the subadviser does not advise but which are affiliated persons of a fund that it does advise (*e.g.*, other funds in the fund complex), and (ii) a subadviser (and its affiliated persons) to enter into transactions and arrangements with funds the subadviser does advise, but only with respect to discrete portions of the subadvised fund for which the subadviser does not provide investment advice.²²

Our proposed exemption was subject to two conditions. First, the subadvisory relationship must be the sole reason why section 17(a) prohibits the transaction; and second, the participating subadviser (*i.e.*, the one who, or whose affiliated person, enters into the transaction or arrangement) and any subadviser of the participating fund or portion of a fund's portfolio (*i.e.*, the one advising the fund to enter into the transaction) must be prohibited by their

control of its adviser, officers or directors depends on all of the relevant facts and circumstances. See *Proposing Release*, *supra* note 6, at n.14. 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 the proposed exemptions.

²⁰ For example, if Funds A and B are under the common control of a principal adviser, and Subadviser A provides investment advice only with respect to Fund A, then Subadviser A is a second-tier affiliate of Fund B, and subject to all of the Act's prohibitions against transactions involving second-tier affiliates, even though Subadviser A may not have the ability to influence Fund B.

²¹ Section 17(a) also prohibits affiliated persons of the subadviser from entering into such transactions if the subadviser is a first-tier affiliate of the fund.

²² See *Proposing Release*, *supra* note 6, at nn. 42-46 and accompanying text. This second category of relief would thus be available only when a fund has one or more subadvisers, which are responsible for managing discrete portions of the fund's assets. The rule permits 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.

advisory contracts from consulting with each other concerning securities transactions of the participating fund or portion.²³

While all commenters supported the new exemption, two asserted that we should not condition the exemption in rule 17a-10 on fund subadvisers being contractually prohibited from consulting with one another concerning securities transactions of the fund.²⁴ These commenters suggested that the condition was unnecessary because subadvisers rarely, if ever, consult with one another concerning fund transactions. The rule's exemption, however, is premised on the unlikelihood that a subadviser participating in the transaction will be able to influence investment decisions made on behalf of a fund (or portion of a fund) that it does not advise. To the extent that such discussions among subadvisers do occur, they increase the likelihood of reciprocal arrangements. We are, therefore, adopting the provision as proposed, with one revision that clarifies that the prohibitions extend to transaction of the fund in any type of assets, not just securities.²⁵

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

Section 17(e)(2) of the Act generally limits the remuneration that an affiliated person of a fund, acting as broker, 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

²³ See *Proposing Release*, *supra* note 6, at nn. 44-45 and accompanying text. We note that while the rule does not contain a condition prohibiting subadvisers and principal advisers from consulting with each other, the principal adviser (like the subadvisers) remains a fiduciary of the fund and may not collaborate with fund subadvisers for purposes of overreaching the fund. See *Proposing Release*, *supra* note 6, at n. 45.

²⁴ Two commenters requested that we affirmatively state that two funds, with different principal advisers but a common subadviser, are not under common control, and therefore not affiliated persons. One commenter argued that otherwise the rule would be unnecessary, as two funds that share a principal investment adviser, but different subadvisers could not then be under common control. As we stated in the *Proposing Release*, not all advisers control the funds they advise, and the determination of whether a fund is under the control of its adviser (or subadviser), officers, or directors depends on the relevant facts and circumstances. See *Proposing Release*, *supra* note 6, at n. 14.

²⁵ Rule 17a-10(a)(2)(i). As we stated in the *Proposing Release*, we would not view changes to subadvisory contracts that are made to comply with the conditions of this rule to be material for purposes of section 15 of the Investment Company Act [15 U.S.C. 80a-15], and funds would not have to obtain shareholder approval of such changes. See *Proposing Release*, *supra* note 6, at section III.B.2.

commission."²⁶ Section 17(e)(2)'s limits apply to purchases and sales made on behalf of a fund by affiliated persons, which include the fund's subadviser (a first-tier affiliate), affiliated persons of the subadviser (second-tier affiliates), and may include 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").²⁷ In addition, the fund must maintain a record of the transactions ("recordkeeping requirement").²⁸ The review and recordkeeping requirements of rule 17e-1 were designed to permit fund directors and our examination staff to monitor the reasonableness and fairness of remuneration received by affiliated persons of the fund.²⁹

We proposed to amend rule 17e-1 to permit a fund's subadviser (or other affiliated person) to receive remuneration for service as a broker without complying with the recordkeeping and review requirements, in circumstances in which the affiliated person has very limited ability to influence decisions regarding execution of fund securities transactions, *i.e.*, when the affiliated person would be eligible to enter into principal transactions with the fund under rule 17a-10.³⁰ Commenters supported the

²⁶ Section 17(e)(2) limits the remuneration that an affiliated person of a fund, acting as broker, 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.

²⁷ 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).

²⁸ Rule 17e-1(d).

²⁹ 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.

³⁰ See *Proposing Release*, *supra* note 6, at n. 51 and accompanying text.