

commenters complained that the amendment could limit the ability of funds to purchase securities in principal offerings, none suggested a way to reconcile the policy underlying rule 10f-3's percentage limit with continuing to permit non-fund accounts advised by the fund's adviser to purchase unlimited amounts of the offering.<sup>44</sup> One fund commenter supporting the proposed requirement cited recent allegations of abusive practices in the market for initial public offerings as illustrative of the conflicts of interest that are inherent when underwriting participants have other business relationships with persons who purchase securities during an offering. This commenter concluded that without a limit on aggregate purchases by non-fund accounts, "there can be no assurance that the fund was participating in a bona fide offering to the public. \* \* \*" We agree, and are adopting the amendments substantially as proposed.<sup>45</sup>

At the suggestion of three commenters, we have narrowed the new aggregation requirement. Instead of requiring funds to aggregate purchases by accounts over which the fund adviser "has discretionary authority or otherwise exercises control," amended rule 10f-3 requires aggregation of purchases by other accounts with respect to which the adviser exercises "investment discretion."<sup>46</sup> The revised approach is more consistent with the current aggregation provision of rule 10f-3, which assumes that advisers to multiple funds have investment discretion with respect to fund assets.

#### 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").<sup>47</sup> 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,<sup>48</sup> but a fund could not rely on rule 12d3-1 to acquire securities of its own investment adviser or any affiliated person of its own investment adviser.<sup>49</sup> As a result, a fund could not rely on rule 12d3-1 to acquire securities issued by any of its subadvisers.

Consistent with our other proposals, we proposed to amend rule 12d3-1 to permit a fund to purchase securities issued by its subadvisers (or affiliated persons of its subadvisers) in circumstances in which the subadviser would have little ability to take advantage of the fund, because it is not in a position to direct the fund's securities purchases.<sup>50</sup> The exemption in rule 12d3-1 would be available in circumstances identical to those in which the subadviser (or affiliated person) would be permitted by rule 17a-10 to enter into a principal transaction with the fund.<sup>51</sup> Commenters supported the amendments, which we are adopting as proposed.<sup>52</sup>

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."

<sup>48</sup> 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.

<sup>49</sup> 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 investment company.

<sup>50</sup> See *Proposing Release*, *supra* note 6, at n. 77 and accompanying text.

<sup>51</sup> *Id.* The exemption in rule 12d3-1 is available if (i) the subadviser is not, and is not an affiliated person of, an investment adviser that provides advice with respect to the portion of the fund that is acquiring the securities, and (ii) the advisory contracts of the subadviser, and any subadviser that is advising the purchasing portion of the fund, prohibit them from consulting with each other concerning securities transactions of the fund, and limit their responsibility in providing advice to providing advice with respect to discrete portions of the fund's portfolio. See rule 12d3-1(c)(3)(i) and (ii).

<sup>52</sup> Rule 12d3-1(c)(3).

## II. Effective Date

The Administrative Procedure Act generally provides that a substantive rule may become effective no less than 30 days after publication in the **Federal Register**.<sup>53</sup> Accordingly, new rule 17a-10 and amendments to rules 10f-3, 12d3-1, 17a-6, 17d-1, and 17e-1 will become effective February 24, 2003.

We are, however, delaying the compliance date with respect to the amendments to rule 10f-3 until April 23, 2003. After April 23, 2003, a fund must comply with all of the conditions in rule 10f-3 as amended in order to rely on the exemption in that rule. A registered investment company that purchases securities between February 24, 2003 and April 23, 2003 may rely on either rule 10f-3 as amended, or rule 10f-3 as it existed prior to today's amendments.

## III. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits that result from its rules. As described above, the rule and amendments 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 from the Commission. We have identified certain costs and benefits that may result from today's rulemaking. Because the new 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 rely on the rule and amendments only if the anticipated benefits from such actions would exceed the anticipated costs. In the *Proposing Release*, we requested comment and specific data regarding the costs and benefits of the proposed amendments. The comments we received are discussed below; we did not receive any data.

### A. Benefits

#### 1. In General

We anticipate that funds, their shareholders, advisers and other affiliated persons will benefit from the new rule and amendments. Absent the rule and amendments, we anticipate that affiliated persons, prohibited by the Act from entering into transactions with funds, would continue to seek Commission exemptive orders. The process for obtaining such an exemption

<sup>53</sup> 5 U.S.C. 553(d).

<sup>44</sup> Commenters also argued that other protections in rule 10f-3 make it unlikely that securities could be "dumped" in the fund. These commenters, in effect, argued that there should be no quantitative limitation on the amount of purchase under the rule, an approach the Commission rejected when we amended the rule in 1997. See *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)].

<sup>45</sup> See rule 10f-3(c)(7).

<sup>46</sup> Rule 10f-3(c)(7)(i). Under the rule the purchase must be aggregated if (i) the adviser has investment discretion over the account, and (ii) the adviser has exercised such discretion in connection with the purchase.

<sup>47</sup> With minor exceptions, section 12(d)(3) prohibits a fund from purchasing or otherwise acquiring "any security issued by or any other