

B. Costs

The Commission anticipates that funds, their shareholders, and their advisers and other affiliated persons may incur certain costs, including certain direct costs from complying with the new rule and amendments. The exemptions resulting from today's rulemaking also may encourage shifts in market behavior that could 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

We do not anticipate that there will be any costs associated with the amendments to rules 17a-6 and 17d-1(d)(5), other than a cost associated with the provision that a fund's board of directors may find that an interest is not material and hence not a "financial interest." Because a fund may avail itself of the amendment only if the fund's directors make certain findings and record the basis for those findings in the minutes of their meeting, the benefit of the change is minimally offset 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.⁶⁰ 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 forego the opportunity to engage in the transaction or require the Prohibited Participant to divest itself of its interest.

2. Subadvisory Affiliates

A fund and its advisers and subadvisers may incur costs in complying with the requirements of rule 17a-10 and amended rules 10f-3, 12d3-1, and 17e-1 that partially offset the benefits of these rules. In order for a fund to rely on the exemptions in the rule and amendments, the fund's advisory contracts must include certain provisions that they may not currently include. Because such contracts generally are subject to renewal at

regular intervals, adding such provisions may not entail additional administrative costs. As discussed above, we do not view the required changes to subadvisory contracts to be material for purposes of section 15 of the Investment Company Act and, as a result, funds will not have to obtain shareholder approval of the change.⁶¹ 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 exemptions, the rule and rule amendments would create an estimated initial one-time cost of approximately \$836,000.⁶²

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, rule 17e-1 may allow a rise in brokerage commissions that the fund pays. Whether this increased cost occurs will depend 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. Although we requested comment on the frequency of boards of directors making such findings, we received no comments on this issue.

The 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.⁶³

⁶¹ See note 25 *supra*.

⁶² See notes 75-78 *infra*, and accompanying text.

⁶³ It has been estimated that expenses of subadvised funds are on average 15-20% higher than those of non-subadvised funds. See James Paton, *Outside Fund Managers Don't Bring Outside Benefits*, Reuters, Sept. 11, 2002, available in Westlaw, Reuters Eng. News Serv. File and Bridget

Investment advisers may incur costs in connection with the new requirement of rule 10f-3 that fund purchases be aggregated with purchases of certain non-funds for purposes of compliance with the rule's percentage limits. Commenters suggested that fund complexes that automate such calculations could incur significant one-time costs in connection with reconfiguring existing information collection systems to accommodate the amendments.⁶⁴ We assume that if the cost of compiling the required information would outweigh the benefits of relying on the exemption in rule 10f-3, then these advisers will forego the exemption in rule 10f-3, and comply with the prohibition in section 10(f).

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.⁶⁵

Portfolio Affiliates

The amendments to rules 17a-6 and 17d-1(d)(5) will expand the circumstances under which funds, and companies they control, may enter into principal transactions and joint arrangements with portfolio affiliates without first obtaining an exemptive order from the Commission. The amendments will permit funds and companies they control to engage in otherwise prohibited transactions with: (i) A broader array of first-tier portfolio affiliates than the rules currently permit; and (ii) certain second-tier portfolio affiliates.⁶⁶ We anticipate that the 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

O'Brian, Fund Track, *Some Fund Managers Hand Reins to 'Subadvisers'*, WALL ST. J., Aug. 31, 2001, at C1.

⁶⁴ One commenter stated that for a large fund complex with many non-fund accounts the cost of such a system reconfiguration would be \$300,000 at a minimum.

⁶⁵ 15 U.S.C. 80a-2(c).

⁶⁶ An additional 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.

⁶⁰ See notes 68-74 *infra*, and accompanying text.