

life insurance contracts.<sup>6</sup> They represent one of the more recent innovations in managed asset arrangements.

Many sponsors of manager of managers funds have sought and obtained from us orders exempting them from section 15(a) of the Act,<sup>7</sup> which prohibits any person from serving as an investment adviser (or a subadviser) to a fund except under a written contract that the fund's shareholders have approved.<sup>8</sup> The orders permit funds and advisers to enter into and materially amend subadvisory contracts without shareholder approval. Many sponsors of these funds have asserted that without relief from the shareholder voting requirement, the costs and delays associated with obtaining a shareholder vote would prevent advisers from hiring and firing subadvisers and from achieving the funds' investment objectives. They also have asserted that the underlying purpose of section 15(a)—to give shareholders a voice in the fund's investment advisory arrangements<sup>9</sup>—would be satisfied without a shareholder vote on the subadvisory contracts because the principal adviser's contract must still be approved by fund shareholders. Moreover, the principal adviser would act in the shareholders' interests by supervising and overseeing the fund's subadvisers. Sponsors have analogized subadvisers in a manager of managers arrangement to portfolio managers employed by a fund adviser who may be hired and fired without the consent of shareholders.<sup>10</sup>

The Commission is today proposing a new rule, 15a–5, and amendments to

Form N–1A, which together would codify the orders we have issued for manager of managers funds, including many of their conditions.<sup>11</sup> The Commission believes that the proposed rule would benefit shareholders by allowing funds to terminate poorly performing subadvisers and hire new subadvisers without the need for a shareholder vote.<sup>12</sup> These amendments are designed to limit the scope of the relief to subadvisers of manager of managers funds, and to assure that investors in manager of managers funds are fully informed of the identity of the current subadviser(s) managing their portfolio, and of the fact that subadvisers could be added or replaced without shareholder approval.

## II. Discussion

Section 15(a) of the Investment Company Act was designed to protect the interests and expectations of fund shareholders by requiring that they approve advisory contracts,<sup>13</sup> including subadvisory contracts.<sup>14</sup> The Congress

<sup>11</sup> As discussed below, we also are proposing related amendments to Regulation S–X under the Act and the Securities Act and to Schedule 14A under the Securities Exchange Act. We are not, however, proposing amendments to rule 18f–2 [17 CFR 270.18f–2] even though we have provided relief, in response to requests, from rule 18f–2 in a number of our manager of managers exemptive orders. Rule 18f–2, among other things, describes how the shareholder voting requirement of section 15(a) applies in the case of a fund with multiple series or multiple classes. Because the relief we are proposing today would provide exemptive relief from the requirements of section 15(a), we believe that relief from rule 18f–2 is unnecessary.

<sup>12</sup> The inability of a fund adviser to hire a subadviser without obtaining shareholder approval can inhibit a fund manager from terminating a poorly performing subadviser and thus managing the fund in the best interests of shareholders. An investment adviser has a fiduciary duty to act in the best interests of a fund it advises. See *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971); *Brown v. Bullock*, 194 F.Supp. 207, 229, 234 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961). See also *In the Matter of Provident Management Corp.*, Securities Act Release No. 5115 (Dec. 1, 1970) at n.12 and accompanying text.

<sup>13</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. 253 (1940) (statement of David Schenker) (section 15 recognizes that a “management contract is personal, that it cannot be assigned, and that you cannot turn over the management of other people's money to someone else”).

<sup>14</sup> Section 15(a) of the Investment Company Act prohibits a person from serving as an investment adviser to a fund except under a written contract, *whether with the fund or with an investment adviser of the fund*, that has been approved by the vote of a majority of the fund's outstanding voting securities. Thus, the shareholder voting requirement applies not only to an advisory contract between a fund and an adviser, but also to a subadvisory contract between a fund's adviser and a subadviser. See 15 U.S.C. 80a–2(a)(20) (defining investment adviser). See also *Role of Independent Directors of Investment Companies*, Investment

that enacted section 15(a) anticipated subadvisory arrangements, and concluded that shareholders should have a role in the selection of subadvisers. In crafting this rule proposal (and the exemptive orders that have preceded it), we have sought to distinguish subadvisory arrangements in which the subadvisers have resembled portfolio managers from the more traditional subadvisory arrangements that Congress explicitly covered in the shareholder voting requirement of section 15(a). Our proposed rule, therefore, contains several conditions, which we discuss below, that limit the scope of relief to subadvisers of manager of managers funds and that provide other means of protecting fund investor expectations and interests.<sup>15</sup>

Today we are proposing a rule that would eliminate the need for funds to obtain exemptive orders to hire subadvisers that they supervise. We have drafted the rule to preserve, to the extent possible, the important role the Investment Company Act gives shareholders in the governance of their funds while accommodating the special needs of manager of managers funds. The other provisions of section 15 would remain applicable. Under those provisions, the manager of managers fund's principal adviser<sup>16</sup> still must have its contract approved by the fund's board and shareholders,<sup>17</sup> and the board must approve the terms of each subadvisory contract.<sup>18</sup> Thus, the rule would afford shareholders of a manager of managers fund the opportunity, both directly through their consideration of the principal advisory contract and indirectly through their representatives

Company Act Release No. 24816 (Jan 2, 2001) [66 FR 3734 (Jan. 16, 2001)] at n.53 (“The Act does not distinguish an adviser from a sub-adviser.”) (citing section 2(a)(20)). Section 15(c) also requires that a majority of the fund's independent directors approve contracts with all investment advisers, including subadvisers. 15 U.S.C. 80a–15(c).

<sup>15</sup> Section 6(c) of the Act [15 U.S.C. 80a–6(c)] permits the Commission, conditionally or unconditionally, to exempt any person, security, or transaction (or classes of persons, securities, or transactions) from any provision of the Act “if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions” of the Act.

<sup>16</sup> We use the term “principal adviser” to mean a party that contracts directly with a fund to provide investment advisory services to the fund. See *supra* note 3.

<sup>17</sup> See 15 U.S.C. 80a–15(a). Although the proposed rule does not exempt a fund's advisory contract with a principal adviser from the shareholder approval requirement of section 15(a), rule 15a–4 under the Act [17 CFR 270.15a–4] allows for the possibility that a principal adviser to the fund is temporarily serving the fund without shareholder approval of its advisory contract.

<sup>18</sup> See 15 U.S.C. 80a–15(c).

<sup>6</sup> See Gary O. Cohen, *Fitting Variable Annuity Contracts and Variable Life Insurance into the Regulatory Framework of the Investment Company Act of 1940 and Securities Act of 1933*, 813 PLI/Comm 129, 212–13 (2001).

<sup>7</sup> 15 U.S.C. 80a–15(a).

<sup>8</sup> See *supra* note 5.

<sup>9</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. 253 (1940) (statement of David Schenker).

<sup>10</sup> See, e.g., TIF Investment Program, Inc. and Foundation Advisers, Inc., Investment Company Act Release Nos. 21268 (Aug. 3, 1995) [60 FR 40875 (Aug. 10, 1995)] (notice) and 21328 (Aug. 30, 1995) [60 SEC Docket 316 (Sept. 26, 1995)] (order), in which the applicant had represented that the employment of a new subadviser was “closely analogous to the decision by a money management firm to hire another portfolio manager or analyst.” See *id.*, Investment Company Act Release No. 21268, at text following n.1. Our disclosure rules require that a change in portfolio managers be disclosed to investors through a prospectus “sticker.” See *Disclosure of Mutual Fund Performance and Portfolio Managers*, Investment Company Act Release No. 19382 (Apr. 6, 1993) [58 FR 19050 (Apr. 12, 1993)], at text accompanying nn.9–11. A fund also must disclose in its prospectus the identity of the fund's subadvisers. See Item 6(a)(1) of Form N–1A.