

on the board of directors, to influence the terms of the advisory contracts under which their fund is managed.

A. Conditions of the Proposed Rule

1. Terms of the Subadvisory Contracts; Subadvisory Fees

The proposed amendments would largely rely on the principal adviser, negotiating with each subadviser on an arm's length basis and subject to the approval of the fund's board, to determine the terms of the subadvisory contract, including the amount of the subadviser's fee. As a condition to the rule, however, we would preclude a new or modified subadvisory contract from directly or indirectly increasing the management fees charged to the fund or its shareholders.¹⁹ As a result, the rule would preserve the statutory requirement that increases in the rate of advisory fees paid by the fund be approved by shareholders.²⁰

In most cases, subadvisers are compensated by the fund's principal adviser, which negotiates the amount of the subadvisers' compensation. Consequently, a principal adviser is free to bargain for lower subadvisory fees, which will benefit the fund to the extent that lower subadvisory fees are passed on through lower advisory fees. Sponsors of manager of managers funds have represented that they are able to negotiate lower fees with subadvisers if they do not have to disclose those fees separately, and in our orders we have provided them relief from our disclosure requirements.²¹ We are

proposing to codify this relief, which permits a manager of managers fund to disclose only the *aggregate* amount of advisory fees that it pays to subadvisers as a group.²²

We recognize that permitting aggregate disclosure of subadvisory fees will not permit investors to understand the benefits obtained by a principal adviser that negotiates lower subadvisory fees. We note, however, that the Act compels a fund board to take into consideration subadvisory fees when establishing the amount of the principal adviser's compensation,²³ and imposes significant liabilities on the principal adviser itself with respect to that compensation.²⁴ The board is in the

²² The individual fee paid to an unaffiliated subadviser of the principal adviser would not have to be disclosed, but the individual fee paid to each wholly-owned subadviser (defined below in Section II.A.3) would have to be disclosed. Under our proposal, a fund would disclose in its statement of Additional Information on Form N-1A, in lieu of the individual fee paid to each subadviser, (i) the individual fees paid to the principal adviser and to each subadviser that is an affiliated person of the principal adviser (including a wholly-owned subadviser whose contract has not been approved by shareholders on reliance on the proposed rule), (ii) the net advisory fee retained by the principal adviser after payment of fees to all subadvisers, and (iii) the aggregate fees paid to all of the fund's subadvisers that are not affiliated persons of the principal adviser. Proposed Instruction 5 to Item 15(a)(3) of Form N-1A. We also are proposing conforming amendments to rule 6-07 of Regulation S-X and the Instructions to Item 22(c) of Schedule 14A.

Under the conditions of the manager of managers orders allowing a fund to disclose the aggregate fees paid to all of the fund's unaffiliated subadvisers, the principal adviser is required to provide the board, no less frequently than quarterly, with information about its profitability for each fund that is relying on the order. In addition, the principal adviser is required to provide the board with information showing the expected impact on the principal adviser's profitability whenever a subadviser is hired or terminated. We have not included these conditions in the proposed rule. However, information must still be provided to the board pursuant to section 15(c) of the Act, which requires fund directors to request and evaluate, and an investment adviser to the fund to furnish, any information that may be necessary to evaluate the terms of any investment advisory contract with the fund.

²³ Section 15(c) of the Act requires fund directors to request and evaluate, and an investment adviser to the fund to furnish, any information that may be necessary to evaluate the terms of any investment advisory contract with the fund. Therefore, the board must request, and the principal adviser must provide, information regarding the fees paid to the principal adviser's subadvisers in order for the board to evaluate properly the terms of the principal adviser's contract with the fund.

²⁴ Section 36(b) of the Act [15 U.S.C. 80a-35(b)] imposes a fiduciary duty on an investment adviser with respect to its receipt of compensation from the fund for services, and allows an action to be brought by the Commission or a shareholder for a breach of this duty. See *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 541-42 (1984) (discussing fund shareholders' right to initiate legal proceedings against the fund's adviser for breach of the adviser's fiduciary duty with regard to its receipt of

best position to assess the overall compensation of the principal adviser when, for example, some subadvisory fees have increased and some have decreased. Moreover, the reduction of an individual subadvisory fee would be reflected in lower aggregate fees that would be disclosed under the proposed amendments.

We request comment on the proposal.

- Should the Commission permit fund directors to enter into subadvisory contracts that increase advisory fees without the consent of shareholders?

- Should the Commission limit relief to subadvisory contracts that do not increase the portion of the advisory fee retained by the principal adviser in order to assure that subadvisers are selected based on ability and performance?

- Do shareholders need information about the amount of compensation paid to each subadviser?

- We also request comment on whether any amendments are required to the fee table items of Forms N-4 and N-6, the registration forms used by insurance company separate accounts registered under the Act as unit investment trusts.²⁵

2. Obligation To Supervise

An important aspect of any manager of managers arrangement is the responsibility assumed by the principal adviser to supervise, *i.e.*, monitor and oversee, the subadvisers in the performance of their duties for the fund.²⁶ We propose to require that any principal advisory contract under the rule obligate the principal adviser to supervise the subadviser.²⁷ In addition,

compensation under section 36(b) of the Act, without first making a demand on the board to initiate such action).

²⁵ 17 CFR 239.17b-c, 274.11c-d.

²⁶ See, e.g., Pitcairn Funds and Pitcairn Trust Company, Investment Company Act Release Nos. 25106 (Aug. 9, 2001) [66 FR 42901 (Aug. 15, 2001)] (notice) and 25150 (Sept. 5, 2001) [75 SEC Docket 2214 (Oct. 2, 2001)] (order); Frank Russell Investment Company, Investment Company Act Release Nos. 21108 (June 2, 1995) [60 FR 30321 (June 8, 1995)] (notice) and 21169 (June 28, 1995) [59 SEC Docket 2105 (July 25, 1995)] (order). A typical subadvisory agreement stipulates that the subadviser, in carrying out its investment management duties under the agreement, is subject to the supervision and/or oversight of the board of directors and the principal adviser.

²⁷ Proposed rule 15a-5(a)(4). See Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (the Commission found that the principal adviser failed to adequately supervise an employee of its affiliated subadviser). Although the manager of managers orders do not require the principal advisory contract to contain a provision requiring the principal adviser to supervise all of the subadvisers it retains to provide services to the fund, the orders do require the principal adviser to supervise its subadvisers. See, e.g., Hillview

¹⁹ Proposed rule 15a-5(a)(1). It's a new subadvisory contract were to increase those fees, the subadviser entering into the contract would not qualify for relief under the rule, and the contract would need to be submitted to shareholders for their approval. A subadvisory fee could be increased under the rule, however, as long as the total amount of the advisory fees paid by the fund does not exceed the total amount provided by advisory contracts that shareholders have approved. For instance, a subadvisory contract would still be eligible for relief under the proposed rule even though it increases a fund's subadvisory fees, if the increase is deducted from the principal adviser's fee. See Republic Funds, Investment Company Act Release Nos. 24292 (Feb. 16, 2000) [65 FR 10132 (Feb. 25, 2000)] (notice) and 24338 (Mar. 14, 2000) [71 SEC Docket 2701 (Apr. 11, 2000)] (order) (granting exemption from shareholder approval for subadvisory contracts where the fund directly pays subadvisory fees and deducts the subadvisory fees from the fee paid to the principal adviser).

²⁰ See 15 U.S.C. 80a-15(a)(1) (requesting any investment advisory contract to *precisely* describe all compensation to be paid thereunder).

²¹ See, e.g., Endeavor Series Trust, Investment Company Act Release Nos. 24054 (Sept. 27, 1999) [64 FR 53428 (Oct. 1, 1999)] (notice) and 24108 (Oct. 22, 1999) [70 SEC Docket 3081 (Nov. 23, 1999)] (order); Frank Russell Investment Company, Investment Company Act Release Nos. 21108 (June 2, 1995) [60 FR 30321 (June 8, 1995)] (notice) and 21169 (June 28, 1995) [59 SEC Docket 2105 (June 25, 1995)] (order).