

because the principal adviser must be able to discharge a subadviser in order to effectively supervise the subadviser, our proposed rule includes a condition requiring that the subadvisory contracts be terminable at any time by the principal adviser, on no more than 60 days written notice, without payment of penalty.<sup>28</sup>

### 3. Arm's Length Relationship Between Principal Adviser and Subadvisers

We are proposing two related conditions designed to limit the rule to arrangements in which the principal adviser is in a position to hire and supervise (and, if necessary, discharge) subadvisers on the basis of the subadviser's performance, rather than on the basis of other business relationships the principal adviser may have with the subadviser. First, we would preclude subadvisers relying on the rule from being affiliated persons of the principal adviser with which they contract or of the fund (other than by reason of serving as investment advisers to the fund) ("affiliated subadviser").<sup>29</sup> Second, we would preclude any director or officer of the fund and the principal adviser or any director or officer of the principal adviser with which the subadviser has contracted from owning, directly or indirectly, any material interest in the subadviser other than through a pooled investment vehicle that is not controlled by such person or entity.<sup>30</sup> A principal adviser may not be in a position to discharge, for example, a parent corporation or a sister corporation, or a person that controls the principal adviser. It may have substantial economic incentives to hire and refrain from discharging a subsidiary or other types of affiliated persons. These conditions have been a key element of our exemptive orders in order to protect against the conflict of interest and potential for self-dealing

that are inherent when a principal adviser hires an affiliated subadviser.<sup>31</sup>

The Commission, however, has issued an order expanding the traditional relief to allow wholly-owned subsidiaries of the principal adviser to replace other wholly-owned subsidiaries of the principal adviser as subadvisers ("wholly-owned subadvisers") to the manager of managers fund and to allow the principal adviser to materially amend a wholly-owned subsidiary's subadvisory contract without shareholder approval.<sup>32</sup> The applicants asserted that no impermissible conflict of interest would be present when replacing one wholly-owned subadviser with another wholly-owned subadviser.<sup>33</sup>

In light of the absence of an economic incentive for the principal adviser to replace one wholly-owned subadviser with another (other than to increase the fund's return on its investments),<sup>34</sup> we are including wholly-owned subadvisers within the scope of the proposed rule.<sup>35</sup> We are, however, limiting relief to allow the principal adviser to replace only a wholly-owned subadviser and to allow the principal adviser to materially amend a wholly-owned subsidiary's subadvisory contract without shareholder approval.<sup>36</sup> The rule would not permit

a principal adviser to replace any other type of subadviser with a wholly-owned subadviser, because the principal adviser would have an economic incentive in such a situation by virtue of its total (or near total) ownership interest in the wholly-owned subadviser, as compared to no ownership or a smaller ownership interest in the subadviser being replaced.

- We request comment on whether the scope of the proposed rule should be expanded to include wholly-owned subadvisers replacing other affiliated subadvisers.

- Should the scope of the rule be expanded to include other affiliated subadvisers? Should all subadvisory contracts be exempt from the Act's shareholder voting requirement? If so, should the Commission expand the proposed rule to include all subadvisers?

### 4. Board Oversight

Under the Investment Company Act, a fund's board plays an important role in the selection and oversight of the fund's subadvisers.<sup>37</sup> Because the rule would permit a fund board to approve subadvisory contracts without the shareholder vote that the statute otherwise requires, we propose to require that the fund adopt certain governance practices that strengthen the role of the independent directors. As part of our initiative to improve fund governance practices, in 2001 we made similar amendments to a number of our exemptive rules, including rule 15a-4, which permits boards of directors to approve interim advisory contracts

shareholders. A wholly-owned subadviser that replaces the original wholly-owned subadviser (and any wholly-owned subadvisers thereafter that replace other wholly-owned subadvisers) would then be eligible for exemptive relief under the proposed rule.

<sup>37</sup> Section 15 of the Act requires that a majority of the board's independent directors approve the fund's advisory contracts (including subadvisory contracts), and that the board (or shareholders) annually approve any advisory contract that continues more than two years. 15 U.S.C. 80-15(a), 15(c). The directors also must request and evaluate information reasonably necessary for them to evaluate the terms of an advisory contract. 15 U.S.C. 80a-15(c). The board in carrying out its obligations under the Act should consider any material business arrangements between the adviser or principal underwriter and the subadviser, including the involvement of the subadviser in the distribution of the fund's shares. The board when approving a wholly-owned subadviser's contract also should consider the effect that the affiliation between the principal adviser and wholly-owned subadviser had on the decision of the principal adviser to replace a wholly-owned subadviser with another wholly-owned subadviser (as opposed to replacing with an unaffiliated subadviser).

<sup>31</sup> 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).

<sup>32</sup> See PIMCO Funds: Multi-Manager Series and PIMCO Advisors L.P., Investment Company Act Release Nos. 24558 (July 17, 2000) [65 FR 45632 (July 24, 2000)] (notice) and 24597 (Aug. 14, 2000) [73 SEC Docket 176 (Sept. 12, 2000)] (order) ("PIMCO"). A "wholly-owned subsidiary" is defined in section 2(a)(43) of the Act [15 U.S.C. 80a-2(a)(43)].

<sup>33</sup> See PIMCO, *supra* note. That order contains all of the other conditions contained in a typical manager of managers order, including the condition that prohibits a new subadvisory contract from increasing the management fees. The principal adviser would be unlikely to have a direct economic incentive to replace one wholly-owned subadviser with another, because its overall compensation would not increase by virtue of its ownership interest in both entities.

<sup>34</sup> Replacing one wholly-owned subadviser with another is no different than the principal adviser terminating a wholly-owned subadviser and directly managing the assets of the fund formerly managed by the wholly-owned subadviser. In either situation, the principal adviser's advisory fee (and the portion of the fee that it retains after paying all unaffiliated subadvisers) remains the same.

<sup>35</sup> Proposed rule 15a-5(a)(2)(ii).

<sup>36</sup> Proposed rule 15a-5(a)(2)(ii). The first wholly-owned subadviser hired by the fund would not qualify for relief under the proposed rule, and its subadvisory contract would have to be approved by

Investment Trust II and Hillview Capital Advisors, LLC, Investment Company Act Release Nos. 24853 (Feb. 6, 2001) [66 FR 10037 (Feb. 13, 2001)] (notice) and 25055 (June 29, 2001) [66 FR 35676 (July 6, 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).

<sup>28</sup> Proposed rule 15a-5(b)(4). The manager of managers exemptive orders typically do not require that the principal adviser be able to terminate a subadvisory contract. Most subadvisory contracts for manager of managers funds operating under an exemptive order, however, are terminable by the principal adviser. This termination provision often is found in the same section of the contract that provides, as required by section 15(a)(3) of the Act [15 U.S.C. 80a-15(a)(3)], that the advisory contract is terminable by the fund's board or shareholders.

<sup>29</sup> Proposed rule 15a-5(a)(2)(i).

<sup>30</sup> Proposed rule 15a-5(a)(2)(i).