

("IRFA") in accordance with 5 U.S.C. 603 regarding proposed rule 15a-5 under the Investment Company Act and proposed amendments to rule 6-07 of Regulation S-X under the Investment Company Act and the Securities Act, Form N-1A under the Investment Company Act and the Securities Act, and Schedule 14A under the Exchange Act. The following summarizes the IRFA.

The IRFA summarizes the background of the proposed rule and amendments. The IRFA also discusses the reasons for the proposed rule and amendments and the objectives of, and legal basis for, the rule and amendments. Those items are discussed above in this Release.

The IRFA discusses the effect of the proposed rule and amendments on small entities. A small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act is a fund that, together with other funds in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>83</sup> Of approximately 2,200 registered open-end investment companies (consisting of about 9,000 portfolios), approximately 157 are small entities.<sup>84</sup> Approximately 2,798 portfolios (comprising portions of 631 registered open-end investment companies) currently retain one or more subadvisers. Approximately 13 of the 631 registered open-end companies (containing 35 of the 2,798 portfolios) are small entities.<sup>85</sup> Funds that are small entities, like other funds, may rely on the rule if they satisfy its conditions. The rule is an exemptive rule and therefore funds may choose not to rely on it.

The Commission staff estimates that only two of the approximately one hundred exemptive orders issued by the Commission involved small entities. The staff anticipates that the number of funds seeking exemptive relief will continue to rise, but that the proportion of small funds to total funds will remain relatively stable in the future.<sup>86</sup>

The Commission staff expects the proposed rule and amendments to have little impact on small entities. Like other funds, small entities will be affected by the proposed rule and amendments only if they enter into a subadvisory contract with an unaffiliated or wholly-owned subadviser. Because the proposed rule is voluntary in nature, only small entities that choose to rely on the rule will be subject to its conditions.<sup>87</sup> Moreover, the burdens imposed by the proposed rule and amendments should be more than offset by the fact that the proposed rule and amendments would enable funds, including small entities, to enter into subadvisory contracts without incurring the expenses associated with a shareholder vote or the filing of an application for exemption under section 6(c) of the Act.

The IRFA discusses the reporting, recordkeeping, and compliance requirements associated with the proposed rule and amendments. It notes that the proposed rule would require funds to provide an information statement to its shareholders (and file it with the Commission) within 90 days of the entry into a subadvisory contract or a material change to a wholly-owned subadviser's contract as a substitute for the proxy statement that the fund would have had to provide to each shareholder if a shareholder vote had been held.<sup>88</sup>

The IRFA also explains that the proposed rule would impose compliance requirements. For funds relying on the proposed rule, the rule would require that: (i) the subadvisory contract: (a) does not directly or indirectly increase the management and advisory fees charged to the fund or its shareholders,<sup>89</sup> and (b) provides that it may be terminated at any time, on no more than 60 days written notice, without penalty, by the principal adviser;<sup>90</sup> (ii) the subadviser is not an affiliated person of the fund or the principal adviser with which it has contracted (other than by reason of serving as an investment adviser to the

a large enough fee to justify the subadviser's time or effort. Because it is unlikely that a small fund would retain more than one subadviser, small funds rarely have reason to seek exemptive relief.

<sup>87</sup> As noted above, to date only two small funds have obtained an exemptive order allowing them to enter into subadvisory contracts without shareholder approval. The Commission does not believe that the number of small funds seeking such relief will increase in the future. See *supra* note 86 and accompanying text.

<sup>88</sup> Proposed rule 15a-5(a)(5). The exemptive orders that have been issued by the Commission require that shareholders be provided with an information statement in place of the proxy statement.

<sup>89</sup> Proposed rule 15a-5(a)(1).

<sup>90</sup> Proposed rule 15a-5(b)(4).

fund);<sup>91</sup> (iii) no director or officer of the fund, and no principal adviser or director or officer of the principal adviser with which the subadviser has contracted, directly or indirectly owns any material interest in the subadviser other than an interest through ownership of shares of a pooled investment vehicle that is not controlled by such person or entity;<sup>92</sup> (iv) shareholders of the fund have authorized a principal adviser, subject to approval by the board of directors, to enter into subadvisory contracts without shareholder approval or, if the fund's securities have not been publicly offered or sold to persons who are not promoters or affiliated persons of the fund, the directors have authorized the principal adviser to enter into such contracts;<sup>93</sup> (v) the contract between the fund and a principal adviser provides that the principal adviser must supervise and oversee the activities of its subadvisers on behalf of the fund;<sup>94</sup> (vi) if the fund identifies the subadviser as part of the fund's name or title, it also clearly identifies the principal adviser with which the subadviser has contracted, before the name of the subadviser;<sup>95</sup> (vii) a majority of the directors of the fund are not interested persons of the fund, and those directors select and nominate any other disinterested directors;<sup>96</sup> and (viii) any person who acts as legal counsel for the disinterested directors is an independent legal counsel.<sup>97</sup>

The IRFA explains that the proposed rule would benefit funds by allowing them to enter into subadvisory contracts without shareholder approval, and thereby avoid incurring the costs and delay associated with the exemptive application process or with obtaining shareholder approval. The IRFA also notes that while the proposed rule would require funds to comply with numerous conditions, many of the compliance requirements do not involve any new costs on funds and those that

<sup>91</sup> Proposed rule 15a-5(a)(2)(i).

<sup>92</sup> Proposed rule 15a-5(a)(2)(i). The proposed rule would allow a wholly-owned subadviser to qualify for relief from section 15(a) of the Act even though it is an affiliate of the principal adviser and the principal adviser has an ownership interest in the subadviser, if the wholly-owned subadviser meets all of the other conditions of the proposed rule and the wholly-owned subadviser is replacing another wholly-owned subadviser or its contract has been materially amended. Proposed rule 15a-5(a)(2)(ii).

<sup>93</sup> Proposed rule 15a-5(a)(3).

<sup>94</sup> Proposed rule 15a-5(a)(4).

<sup>95</sup> Proposed rule 15a-5(a)(6).

<sup>96</sup> Proposed rule 15a-5(a)(7)(i).

<sup>97</sup> Proposed rule 15a-5(a)(7)(ii).

<sup>83</sup> 17 CFR 270.0-10.

<sup>84</sup> Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

<sup>85</sup> These estimates are based on data reported on Form N-SAR filed with the Commission between July and December 2002.

<sup>86</sup> The Commission believes that small funds are unlikely to retain multiple subadvisers to manage fund assets because it would not be practical for subadvisers to manage a portion of a small fund's assets. A subadviser receives as a fee a percentage of the value of the assets under its management. Therefore, providing management services to a portion of a small fund's assets would not provide