

### SEC Adopts Rules Relaxing Affiliated Transaction Restrictions for Multi-Manager Funds

The Securities and Exchange Commission (“SEC”) recently adopted new Rule 17a-10 under the Investment Company Act of 1940 (“1940 Act”) and amendments to Rules 17e-1, 10f-3 and 12d3-1 under the 1940 Act that relax the restrictions on affiliated transactions as they apply to “multi-manager funds”—for these purposes, funds that have a manager who, in turn, selects two or more subadvisers to actually perform portfolio management for the funds. Where a subadviser or any of its affiliates is a broker, dealer or otherwise in the securities industry, the 1940 Act would otherwise restrict their transactions with the fund even if the subadviser had no role or influence over the proposed transaction.

The new rule and rule amendments generally codify individual SEC exemptive orders and now permit a subadviser to a multi-manager fund or an affiliated person of that subadviser to engage in certain principal or agency transactions with a portion of the fund that the subadviser does not advise, subject to certain conditions. The new provisions are discussed below. Their effective date is February 24, 2003 (Release No. IC-25888 (Jan. 14, 2003)).

#### **NEW RULE 17a-10**

Under Section 17(a) of the 1940 Act, a subadviser to a fund (a “first-tier affiliate” of the fund) or an affiliated person of that subadviser (a “second-tier affiliate” of the fund) generally is prohibited from selling or purchasing any securities or other property to or from the fund. New Rule 17a-10 permits a subadviser to a fund and its affiliated persons to enter

into principal transactions—that is, act as a dealer—with funds advised by the subadviser where the principal transaction is with those portions of the fund that the subadviser does not advise.

This relief is subject to two conditions, as is the relief in each of the rule amendments. First, the exemption is available only if the subadvisory relationship is the exclusive source of affiliation between the fund and the subadviser and/or its affiliated persons. Thus, the new rule would not permit an affiliated person of a fund’s primary investment adviser to enter into principal transactions with the fund, even with respect to portions of the fund advised by an unaffiliated subadviser. Second, the rule requires that the advisory contracts of the participating subadviser and of the subadviser to the participating fund prohibit them from consulting with each other concerning securities transactions of the participating fund. In addition, the subadvisory contract must limit the subadviser’s responsibility in providing investment advice only with respect to a discrete portion of the fund’s assets. The SEC indicated that existing funds could incorporate these provisions into their subadvisory contracts without shareholder approval because it did not view the changes as material.

#### **AMENDED RULE 17e-1**

Section 17(e)(2) of the 1940 Act limits the compensation that a first- or second-tier affiliate of a fund acting as a broker may receive in connection with the purchase or sale of securities on behalf of the fund. Rule 17e-1 under the 1940 Act provides a

safe harbor as to when compensation received by an affiliated person of a fund qualifies as the “usual and customary broker’s commission.” The rule, among other things, requires a fund’s board to review transactions effected pursuant to the rule to determine whether the transactions comply with the rule. The rule also requires funds to maintain certain records of such transactions and of the board’s review.

Amended Rule 17e-1 permits an affiliated subadviser (or an affiliated person of that subadviser) of a fund to receive compensation for service as a broker without complying with the board review and record keeping requirements of the rule. Nevertheless, the affiliated broker itself is still required to charge no more than its usual and customary brokerage commissions on such transactions. This relief is subject to the same conditions described above with respect to new Rule 17a-10.

#### **AMENDED RULE 10f-3**

Section 10(f) of the 1940 Act prohibits a fund from acquiring any security during the existence of an underwriting syndicate where a principal underwriter of that security is, among other persons, an investment adviser of the fund or an affiliated person of an investment adviser of the fund. Prior to the adoption of amended Rule 10f-3, a fund was subject to Section 10(f)’s prohibition when any of its advisers or subadvisers or their affiliated persons participated in the underwriting syndicate regardless of whether the adviser or subadviser recommending or directing the purchase was a participant or an affiliate of a participant in the underwriting syndicate. Amended Rule 10f-3 limits the scope of Section 10(f) so that the subadviser of one portion of a fund can purchase securities in an offering where the subadviser to a second portion of the fund is a member, or affiliated with a member, of the underwriting syndicate, provided that the purchasing subadviser’s advisory contract contains the provisions required by new Rule 17a-10.

Section 10(f) and Rule 10f-3 would continue to apply to purchases by a portion of a fund in an offering that is underwritten by the subadviser (or an affiliate thereof) to the portion of the fund making the

purchase. However, the SEC relaxed the 25% limit on aggregate purchases made pursuant to the rule by permitting a portion of a fund to exclude purchases by other portions of the same fund that are advised by different subadvisers for purposes of determining compliance with the rule’s limit on aggregate purchases.

#### **AMENDED RULE 12d3-1**

Section 12(d)(3) of the 1940 Act generally prohibits funds from purchasing securities issued by a registered investment adviser, broker, dealer or underwriter (“securities-related businesses”). Rule 12d3-1 provides an exemption from Section 12(d)(3) and permits a fund to invest up to 5% of its assets in equity securities of an issuer deriving more than 15% of its gross revenues from securities-related businesses. However, a fund may not rely on the rule to purchase securities of any of its own investment advisers or their affiliated persons.

Amended Rule 12d3-1 permits a portion of a multi-manager fund to purchase securities issued by a subadviser to another portion of the same fund or an affiliated person of that subadviser. These purchases are subject to the same conditions that apply under new Rule 17a-10. In addition, the percentage ownership limits in Rule 12d3-1 continue to apply to the fund as a whole. Accordingly, multi-manager funds must monitor compliance with these limits on a fund-wide basis.

#### **SERIES FUNDS ADVISED BY SUBADVISERS**

The relief described above also would be available to a subadviser that is itself a broker-dealer seeking to enter into transactions with a fund that is affiliated with the fund that the subadviser advises (*e.g.*, other funds in the same fund complex). In particular, the rules would permit the subadviser to enter into principal and agency transactions with other funds in the same fund complex, subject to the same conditions that apply under new Rule 17a-10. In addition, the rules also would codify SEC staff no-action positions providing that Section 10(f) does not apply to a fund’s purchase of securities in an underwriting in which a subadviser (or an affiliate thereof) to another series of the same investment company is a participant.

## Additional Note: SEC Adopts Amendment to Rule 10f-3 Applicable to All Funds

Separately, the SEC adopted an additional amendment to Rule 10f-3 to tighten the rule's restriction on aggregate purchases made pursuant to the rule. The amended rule will require all funds to include both purchases by registered funds that are advised by the same adviser that is a participant (or whose affiliate is a participant) in the underwriting or selling syndicate *and* all private accounts over which the adviser has investment discretion when determining compliance with the rule's limit on aggregate purchases.

The SEC delayed the compliance date for the amendments to Rule 10f-3 until April 23, 2003. After that date, a fund must comply with all of the conditions of the rule. A fund that purchases securities between February 24, 2003 and April 23, 2003 may rely on either Rule 10f-3 as amended or Rule 10f-3 as it existed prior to these amendments.

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