S7-20-03

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January 8, 2004

BY HAND

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Proposed Rule: Exemption from Shareholder Approval for Certain Subadvisory Contracts
File No. S7-20-03
(Release Nos. 33-8312, 34-48683, IC-26230)

Dear Mr. Katz:

On behalf of CitiStreet Funds Management LLC ("CitiStreet Management"), we appreciate the opportunity to comment on proposed rule 15a-5 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), which would provide a general exemption to permit an investment adviser to serve as a subadviser to an investment company (a "fund") without approval of the fund's shareholders provided certain conditions were complied with.

About CitiStreet Management and the CitiStreet Funds

CitiStreet Funds Management LLC (formerly American Odyssey Funds Management, Inc.) serves as principal investment adviser to CitiStreet Funds, Inc. (formerly American Odyssey Funds, Inc.). Shares of CitiStreet Funds, Inc. are available exclusively as the underlying fund investment for certain variable annuity contracts and through certain qualified retirement plans. CitiStreet Management and CitiStreet Funds, Inc. have used a "manager-of-manager" structure since 1998. CitiStreet Management and CitiStreet Funds, Inc. were among the first variable insurance product-related funds to obtain an exemption from Section 15(a) of the 1940 Act in order to put the manager-of-manager structure in place. See American Odyssey Funds, Inc., et al., Rel. Nos. IC-23017, 66 SEC Dkt. 951 (Feb. 2, 1998) (notice), and IC-23060, 66 SEC Dkt. 1463 (March 5, 1998) (order).

CitiStreet Funds, Inc. currently has four separate portfolios (each, a "CitiStreet Fund" or a "Fund"). Each Fund currently has subadvisory contracts with three separate subadvisers, in addition to its advisory agreement with CitiStreet Management. CitiStreet Management supervises and oversees the activities of the subadvisers of each Fund. CitiStreet Management also determines how to allocate each Fund's assets among the Fund's three subadvisers.

Each CitiStreet Fund pay CitiStreet Management an investment advisory fee equal on an annual basis to 0.25% of average daily net assets. In addition, each Fund pays advisory fees to each subadviser. Three facts about the CitiStreet Funds are especially relevant in connection with the Proposed Rule.

- First, each CitiStreet Fund pays each subadviser directly – CitiStreet Management (the principal adviser) does *not* pay the subadvisory fee out of its own advisory fee. This means that a lower subadvisory fee results in lower aggregate advisory fees for a Fund and its shareholders, and a higher subadvisory fee results in higher aggregate fees for a Fund and its shareholders. A lower or higher subadvisory fee has no effect on the advisory fee retained by CitiStreet Management.

- Second, each subadviser's advisory fee as specified in its investment advisory agreement is independent of other subadvisers' fees. In other words, each Fund generally compensates each of its subadvisers at a different rate from its other subadvisers. This means that when CitiStreet Management reallocates a Fund's assets among a Fund's subadvisers, that reallocation may result in a change in the amount of advisory fees the Fund pays. This is explained in greater detail below.

- Third, pursuant to its exemptive order and shareholder approval, a CitiStreet Fund may enter into an advisory agreement with a new subadviser at a fee rate slightly higher than the rate the Fund currently pays. The maximum rates have been approved by shareholders and are specified in the advisory agreement with CitiStreet Management. The maximum advisory fee rates are disclosed in the prospectus, along with the current rates.

Comments on the Proposed Rule

CitiStreet Management supports the purpose underlying the Proposed Rule: to provide a general exemption from Section 15(a) of the 1940 Act to permit funds to use a manager-of-manager structure, while ensuring that shareholders' interests are protected in a manner consistent with the 1940 Act and its underlying goals.

Paragraph (a)(1) of the Proposed Rule causes us concern, however. That paragraph provides, as one of the conditions for a fund seeking to qualify under the Proposed Rule:

> "No increase in fees. The subadvisory contract does not directly or indirectly increase the management and advisory fees charged to the fund or its shareholders."

The Commission requests comment on whether to "permit fund directors to enter into subadvisory contracts that increase advisory fees without the consent of shareholders."

CitiStreet Management respectfully suggests that the Proposed Rule is too restrictive in this regard. Although giving fund boards unfettered discretion to enter into new subadvisory contracts that increased fees without limit would obviously be contrary to Section 15 of the 1940 Act and its underlying purposes, we suggest that providing limited discretion for a fund's board to enter into new subadvisory contracts that increase advisory fees would benefit shareholders while continuing to protect them, provided two important conditions are met:

- Shareholders must have previously approved the amount of the new advisory fees, even if the current subadvisory contract specifies a lower fee, and the prospectus must have disclosed this higher approved advisory fee.

- Only subadvisers unaffiliated with the principal adviser or the fund (other than by reason of serving as an investment adviser to the fund) may have their advisory fees increased. No principal adviser nor any of its affiliates should receive higher advisory fees as a result of a new subadvisory contract unapproved by shareholders. This prevents a potential conflict of interest between the principal adviser and the fund.

With this change, funds that pay their subadvisers directly could enter into subadvisory agreements specifying lower fees without compromising their flexibility to later enter into subadvisory agreements specifying the higher fees already approved by shareholders if doing so benefited the fund.

In prohibiting any increase in advisory fees without exception, the Proposed Rule appears to make certain assumptions about the fee structure of manager-of-manager funds. Because those assumptions are not true of all funds that currently use a manager-of-manager approach, the Proposed Rule, if adopted in its proposed form, would inhibit competition and product innovation, and would result in subjecting funds – such as the

CitiStreet Funds – that use a different fee structure to a perverse set of incentives probably not contemplated by the Commission when it promulgated the Proposed Rule.

1. The Proposed Rule's Structural Assumptions.

Specifically, the Proposed Rule's categorical prohibition on increasing advisory fees appears to presuppose that in a manager-of-manager arrangement a fund pays its entire advisory fee to the principal adviser, which then pays the subadvisers some portion of that advisory fee. In other words, the Proposed Rule contemplates that subadvisers receive their fee *indirectly* from the fund, and that the principal adviser's "net" fee then consists of whatever portion remains after paying the subadvisers. Thus, the proposing release states (in the text accompanying n.21) that "[i]n most cases, subadvisers are compensated by the fund's principal adviser, which negotiates the amount of the subadvisers' compensation." The proposing release implies that lowering a subadvisory fee will typically result in a larger net fee for the principal adviser and that raising a subadvisory fee will typically result in a smaller net fee for the principal adviser.

As noted above, however, some funds – including the CitiStreet Funds – do not use this structure. The CitiStreet Funds pay their subadvisers directly. When CitiStreet Management negotiates a lower fee with a new subadviser, the Fund and its shareholders – rather than CitiStreet Management – receives the benefit of that lower fee. At the same time, CitiStreet Management has no financial incentive to negotiate higher subadvisory fees. The sole reason CitiStreet Management would recommend to the Fund's board of directors that a Fund enter into a subadvisory agreement specifying higher fees (that is, higher than a current subadvisory agreement, but no higher than the maximum approved by shareholders) would be to obtain better subadvisory services.

The Proposed Rule, if adopted as proposed, would subject funds such as the CitiStreet Funds that pay their subadvisers directly to a perverse set of incentives. For example, assume that a fund has a manager-of-manager arrangement and pays its subadvisers directly. That fund pays its subadviser an advisory fee equal on an annual basis to 0.50% of average daily net assets. The principal adviser determines that it would be appropriate to recommend that the subadviser be replaced. The principal adviser negotiates a subadvisory agreement with a new subadviser that will provide services for 0.40% of average daily net assets. The fund's board and its principal adviser then face a dilemma. By entering into the new subadvisory agreement, they will reduce advisory fees paid by the fund by 0.10% per year. On the other hand, if in the future it becomes necessary to replace the new subadviser, the universe of potential replacement subadvisers will be more limited, because under the Proposed Rule the fund will now only be able to pay a maximum of 0.40% without seeking shareholder approval. A better outcome, but one arguably inconsistent with the Proposed Rule as currently drafted, would be to permit the fund to enter into a subadvisory agreement at the lower fee rate but preserve the fund's flexibility to enter into a future subadvisory agreement at the current higher rate – which has already been approved by shareholders – without seeking new shareholder approval.

The Proposed Rule also appears to incorrectly assume that a principal adviser currently lacks the ability to change the amount of advisory fees a fund pays. This is untrue with respect to a manager-of-manager arrangement in which a fund has multiple subadvisers compensated by the fund at different rates, as is the case with the CitiStreet Funds. Consider, for example, the following example, which is hypothetical but is based upon the CitiStreet Funds' actual situation:

> A fund has a principal adviser and two subadvisers, Sub A and Sub B. Sub A's advisory fee, as specified in its subadvisory contract, is equal to 0.25% on an annual basis of average daily net assets. Sub B's advisory fee, on the other hand, is equal to 0.75% of average daily net assets. Both Sub A and Sub B are paid directly by the fund, not by the principal adviser, which receives its own advisory fee equal to 0.25% of average daily net assets. The principal adviser, which supervises and oversees Sub A and Sub B, also has responsibility for allocating the fund's assets between the subadvisers. If for the prior year, Sub A was allocated 75% of the fund's assets and Sub B was allocated 25% of the fund's assets, then total advisory fees, assuming everything remained constant, would approximate 0.62%. For the coming year, the principal adviser decides that the fund's best interests require that it reallocate the fund's assets 25% to Sub A and 75% to Sub B. Again assuming all else remains constant, total advisory fees for the new year will end up approximately equal to 0.87%, because a greater percentage of the fund's assets are now allocated to a subadviser compensated at a higher rate.

In the above hypothetical, the principal adviser would reallocate a fund's assets in a way that increased the fund's advisory fees only if it determined that doing so was nonetheless in the interests of the fund and its shareholders. Permitting a fund to enter into a subadvisory agreement specifying an advisory fee approved by shareholders but higher than the current subadvisory fee offers at least the same protections. The fund would only enter into such a subadvisory agreement if the fund's board and the principal adviser determined that doing so was in the interests of the fund and its shareholders.

2. The Proposed Rule Would Stifle Competition and Innovation.

The Commission notes (in the text accompanying nn.68-70 of the Proposing Release) its obligation to consider the Proposed Rule's effect on efficiency, competition, and capital formation. We respectfully suggest that rather than fostering competition, adopting the Proposed Rule without the changes we suggest, while rescinding existing exemptive orders, would adversely affect competition. First, the CitiStreet Funds have entered into agreements, structured their fee arrangements and obtained shareholder approval, all in reliance on their current structure and the exemptive order obtained for that structure. We believe that other funds have done likewise. It would be unfair and inefficient to require the CitiStreet Funds to abandon their fee structure and the concomitant benefits to their shareholders.

Second, requiring that all manager-of-managers funds adopt the fee structure contemplated by the Proposed Rule would have the effect of discouraging innovation in products and fee structures. The CitiStreet Funds' fee structure gives shareholders an advantage that funds that use the Commission's assumed fee structure do not have: lower subadvisory fees mean lower total fees for the fund and its shareholders. The Proposed Rule discourages such innovation.

Third, as discussed above, the effect of the Proposed Rule would be to encourage a fund to pay all its subadvisers at the same rate. This reduces competition among subadvisers, who would not compete amongst each other on the basis of cost. Furthermore, this would cause subadvisory fees to be artificially high, given the Proposed Rule's disincentive to lowering subadvisory fees.

Revising the Proposed Rule

Consistent with the above analysis, CitiStreet Management respectfully suggests that the Proposed Rule be revised to permit a fund board to enter into new subadvisory agreements that would raise total advisory fees, provided that the new fees are no higher than previously authorized by shareholder vote, and that the principal adviser and its affiliates not receive any portion of the fee rate increase. We suggest that these conditions would safeguard shareholder interest and the purposes underlying the 1940 Act. Accordingly, we propose the following modification to paragraph (a)(1) of the Proposed Rule (with new language in *italics*):

> (1) No increase in fees. The subadvisory contract does not directly or indirectly increase the management and advisory fees charged to the fund or its shareholders *unless:*
>
> *(i) the subadvisory contract does not directly or indirectly increase the advisory fees paid to the principal adviser or to any affiliated person of the principal adviser or of the fund (other than by reason of serving as investment adviser to the fund); and*

> *(ii) total advisory fees charged to the fund are no greater than the maximum advisory fee that the fund's prospectus discloses has been approved by a majority of the outstanding shares of the fund.*

Rescission of Previously Issued Exemptive Orders

The Proposing Release states that the Commission "anticipate[s] rescinding" existing manager-of-manager exemptive orders upon adoption of the Proposed Rule. The Proposing Release suggests (in the text accompanying n.51) that leaving existing orders in place "might have an adverse effect on competition." The Proposing Release then requests comment on the effect of rescinding, or not rescinding, existing orders.

In the event the Commission does not revise the Proposed Rule as suggested above, CitiStreet Management would oppose the rescission of existing exemptive orders. As explained above, the Proposed Rule would have anticompetitive effects in its current form, would stifle product innovation, and could lead to artificially higher subadvisory fees. Permitting funds to continue to rely on their existing exemptive orders would ameliorate these adverse effects. Funds could rely upon the Proposed Rule as adopted, could rely upon their existing exemptive orders, or could seek a new exemptive order. Since most new funds would rely upon the Proposed Rule as adopted rather than seeking separate exemptive relief, the burden on the Commission and its staff would be slight.

Thank you for the opportunity to comment. If you have any questions about this letter, please do not hesitate to contact us at (202) 828-2000.

Very truly yours,

Christopher E. Palmer
Michael K. Isenman

cc: C. Hunter Jones, Assistant Director
Adam B. Glazer, Attorney
Office of Regulatory Policy
Division of Investment Management