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Proposed SEC Rule: Disclosure Regarding Approval of Advisory Contracts by Directors of Investment Companies

The Securities and Exchange Commission (the "SEC") has proposed rule and form amendments under the Securities Act of 1993, as amended (the "Securities Act"), the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the Investment Company Act of 1940, as amended (the "1940 Act"): "Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies" (the "Proposed Rule").[1] Comments on the Proposed Rule must be submitted to the SEC by April 26, 2004. This memorandum outlines the requirements of the Proposed Rule.

I. Introduction

Registered management investment companies ("funds") are typically organized and sponsored by investment advisers. Investment advisers however often have different shareholders from funds, and adviser shareholders may have economic interests that diverge from the interests of fund shareholders. The issue of adviser fees is one example where the economic interests of fund shareholders differ from the economic interests of adviser shareholders. While fund shareholders prefer lower adviser fees so that they receive greater returns on their investment in the fund, shareholders of the fund's adviser often want higher fees so as to maximize profits.[2]

Section 15(a) of the 1940 Act requires any person serving as an investment adviser for a fund to have a written advisory contract that has been approved by a majority

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[1] Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 17 CFR Parts 239, 240 and 274; Release Nos. 33-8364, 34-49219, IC-26350, File No. S7-08-04: RIN: 3235-AJ10 (February 11, 2004).

[2] *Id.* at Section I.

vote of the fund's shareholders. Advisory contracts outline the fees to be paid by the fund to the fund's adviser and may not continue past two years unless an extension is approved at least annually by the fund board of directors or a majority vote of the fund's shareholders.[3]

Section 15(c) of the 1940 Act requires a majority of the fund's independent directors to approve the terms of the advisory contract and any renewal thereof.[4] However, all fund directors are required to request and assess adequate information as may be reasonably necessary to evaluate the terms of the advisory contract.[5] Since fund directors have fiduciary duties with respect to fund fees, the fund directors' evaluation must include consideration of the material factors applicable to a decision to approve the investment advisory contract.[6]

The SEC requires fund proxy statements that seek shareholder approval of an advisory contract to include a discussion of the material factors that form the basis of the fund board's recommendation that shareholders approve the contract.[7] The SEC also requires funds to provide similar disclosure in their Statement of Additional Information ("SAI") regarding the basis for the fund board's approval of an existing investment advisory contract.[8]

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3 15 U.S.C. 80a-15(a).

4 15 U.S.C. 80a-15(c).

5 *Id.*

6 Proposed Rule at Section I. *See Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y.), aff'd, 294 F.2d 415 (2nd Cir. 1961) ("By giving the directors the right to extend and terminate the [investment advisory] contract, the Act necessarily also imposes upon the directors the fiduciary duty to use these powers intelligently, diligently and solely for the interests of the company and its stockholders.").

7 Item 22(c)(11) of Schedule 14A. See Investment Company Act Release No. 20614 (Oct. 13, 1994) [59 FR 52689 (Oct. 19, 1994)] (adopting amendments to Schedule 14A).

8 Item 13(b)(10) of Form N-1A (registration statement for open-end management investment companies); Item 18.13 of Form N-2 (registration statement for closed-end management investment companies); Item 20(l) of Form N-3 (registration statement for separate accounts organized as management investment companies that offer variable annuity contracts); Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR

In the Proposed Rule, the SEC seeks to increase disclosure about the process of approving advisory contracts. The SEC believes that increased transparency with respect to advisory contracts would encourage fund boards to engage in more independent oversight of advisory contracts and assist investors in making informed choices among funds. The SEC acknowledges however that the Proposed Rule is, in part, a response to recent allegations that fund boards' review of advisory contracts may be perfunctory and that the level of fees charged by investment advisers to mutual fund clients is higher than those charged by the same advisers to pension plans and other institutional clients.[9]

II. Proposed Rule

The Proposed Rule would amend Forms N-1A, N-2 and N-3 and would require fund shareholder reports to discuss the material factors and the relevant conclusions that formed the basis for any fund board's approval of an investment advisory contract.[10] The required disclosure would be similar to the disclosures currently required in SAIs and fund proxy statements. The shareholder reports disclosure would be required for any new advisory contract or contract renewal, including subadvisory contracts, approved during the semi-annual period covered by the report, other than a contract that was approved by fund shareholders.[11] In the case of contracts approved by shareholders, a fund is already required

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3734, 3744 (Jan. 16, 2001)] (adopting requirement for disclosure in SAI of basis for board's approval of advisory contract).

9 *See e.g.*, John P. Freeman and Stewart L. Brown, Mutual Fund Advisory Fees: The Cost of Conflicts of Interest, 26 Iowa Journal of Corporation Law 609, 634 (Spring 2001); Special Report: Perils in the Savings Pool – Mutual Funds, The Economist, Nov. 8, 2003, at 65 (arguing that fund boards tend to "rubber-stamp" their advisers' contracts without question).

10 Proposed Rule at Section II. Open-end management investment companies use Form N-1A to register under the Investment Company Act and to offer their shares under the Securities Act. Closed-end management investment companies use Form N-2, and insurance company managed separate accounts that offer variable annuities use Form N-3.

11 Proposed Rule at Section II.

to provide similar disclosure in a proxy statement.[12] The Proposed Rule also would include several additions to the existing SAI and proxy statement disclosure requirements, and the SEC is proposing that these same additions be included in the new shareholder reports disclosure requirements.

Specifically, the Proposed Rule would require funds to discuss the following in shareholder reports, in SAIs and in relevant proxy statements:[13]

- factors relating to both the board's selection of the investment adviser, and its approval of the advisory fee and any other amounts to be paid under the advisory contract;
- the nature, extent and quality of the services to be provided by the investment adviser;
- the investment performance of the fund and the investment adviser;
- the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund;
- the extent to which economies of scale would be realized as the fund grows;
- whether fee levels reflect these economies of scale for the benefit of fund investors; and

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[12] See Item 22(c)(11) of Schedule 14A.

[13] Proposed Rule at Section II. Courts have used similar factors in determining whether directors have met their fiduciary obligations under Section 36(b) of the 1940 Act [15 U.S.C. 80a-35(b)]. *See, e.g.*, *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 929 (2nd Cir. 1982) (examining several factors, including "the adviser-manager's cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger and the volume of orders which must be processed by the manager").

- whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts – if the board relied upon such comparisons, the discussion would be required to describe the comparisons that were relied on and how they assisted the board in concluding that the contract should be approved.

Finally, the SEC notes that the existing proxy and SAI requirements state that conclusory statements or a list of factors will not be considered sufficient disclosure, and that a fund's discussion should relate the factors to the specific circumstances of the fund and the investment advisory contract. The SEC emphasizes in its release of the Proposed Rule that it would not be sufficient to state that the fund board considered the amount of the investment advisory fee without stating what the board concluded about the amount of the fee and how that affected its determination that the contract should be approved.[14]

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If you have any questions about the Proposed Rule or would like to consider submitting a comment on any part of the Proposed Rule, please do not hesitate to contact us. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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[14] Proposed Rule at Section II.