

MEMO# 17118

February 19, 2004

SEC PROPOSES NEW DISCLOSURE REQUIREMENTS REGARDING BOARD APPROVAL OF INVESTMENT ADVISORY CONTRACTS

[17118] February 19, 2004 TO: DIRECTORS' COMMITTEE No. 5-04 RE: SEC PROPOSES NEW DISCLOSURE REQUIREMENTS REGARDING BOARD APPROVAL OF INVESTMENT ADVISORY CONTRACTS The Securities and Exchange Commission has proposed rule and form amendments under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 that would call for enhanced disclosure regarding the reasons for an investment company board's approval of an investment advisory contract.¹ The proposed requirements would apply to all registered management investment companies. The proposal is summarized below. Comments on the proposal must be filed with the SEC by Monday, April 26th. The Institute will hold a conference call on Wednesday, March 3rd, 2004 at 2:00 p.m. (EST.) to discuss the proposal. The dial-in number for the call is 888-396-9928 and the pass code is 51798. If you plan to participate on the call, please send an e-mail to Deborah Washington at deborah@ici.org. If you are unable to participate on the call, please provide your comments before the call, if possible, to Marguerite Bateman by phone (202-326-5813), fax (202-326-5839), or email (bateman@ici.org). The Proposal The proposal would require fund shareholder reports to discuss, in reasonable detail, the material factors, and the conclusions with respect thereto, that formed the basis for the board's approval of any investment advisory contract. The shareholder report disclosure would be required for any new investment 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 shareholders. 1 See SEC Release Nos. 33-8364, 34-49219, and IC-26350 (February 11, 2004) (the "Release"). A copy of the Release is available on the SEC's website at <http://www.sec.gov/rules/proposed/33-8364.htm>. 2 The proposed amendments also would require enhanced disclosure in a fund's Statement of Additional Information regarding the basis for the board's approval of existing advisory contracts, and in proxy statements regarding the basis for the board's recommendation that shareholders approve an advisory contract.² The information that would be required in each of these disclosure documents is discussed more specifically below. Selection of Adviser and Approval of Advisory Fee. The proposed amendments would clarify that the fund's discussion should include 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. Specific Factors. The fund would be required to include a discussion including, but not limited to, the following: (1) the nature, extent, and quality of the services to be provided by the

investment adviser; (2) the investment performance of the fund and the investment adviser; (3) 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; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale. Comparison of Fees and Services Provided by the Adviser. The fund's discussion would be required to indicate whether the board relied on comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies and other types of clients (e.g., pension funds). If the board relied on such comparisons, the discussion would be required to describe those comparisons and how they assisted the board in concluding that the contract should be approved. Evaluation of Factors. The Release states that the existing proxy and SAI requirements provide 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 proposal would clarify this by requiring that the fund's discussion state how the board evaluated each factor. The Release states as an example that it would not be sufficient to state that the board considered the amount of the 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. Request For Comments The Release requests specific comment on a number of issues including the following: (1) whether disclosure regarding the basis of the board's approval of an advisory contract should be required in any additional location (e.g., prospectuses, fund websites); (2) whether disclosure regarding the basis of the board's approval of an advisory contract should be removed from the SAI and/or replaced there with an appropriate cross-reference if that disclosure is required in shareholder reports; (3) whether a fund's board should be required to 2 Item 13(b)(10) of Form N-1A and Item 18.13 of Form N-2 currently require disclosure regarding the basis for board approval of an advisory contract. Item 22(c)(11) of Schedule 14A currently requires disclosure of the basis for the board recommending that shareholders approve an advisory contract. 3 disclose the reasons it did not rely on comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts; (4) whether a fund should be required to disclose whether, and, if so, how, the board separately assessed amounts to be paid for portfolio management services and amounts to be paid for other services; (5) whether the proposed disclosure requirements will have a chilling effect on boards' consideration of advisory contracts; and (6) what the compliance date should be for the proposed amendments. Marguerite C. Bateman Senior Associate Counsel