

MEMO# 10183

August 6, 1998

SEC PROPOSES AMENDMENTS TO RULE 15A-4 UNDER THE INVESTMENT COMPANY ACT

1 SEC Release Nos. IC-23325, IA-1736 (July 22, 1998). [10183] August 6, 1998 TO: DIRECTOR SERVICES COMMITTEE No. 4-98 RE: SEC PROPOSES AMENDMENTS TO RULE 15a-4 UNDER THE INVESTMENT COMPANY ACT

The Securities and Exchange Commission has proposed amendments to Rule 15a-4 under the Investment Company Act of 1940, which permits an investment adviser, in certain circumstances, to advise an investment company under a short-term contract that the investment company's shareholders have not approved ("interim contract").¹ The proposed amendments, which largely codify prior exemptive orders, would: (1) extend the rule to new advisory contracts entered into as a result of a merger or similar business combination involving the fund's adviser or a controlling person of the adviser, in connection with which the adviser or a controlling person of the adviser receives a benefit; (2) increase the maximum number of days the investment adviser could serve under the rule; and (3) clarify the timing of board approval of an interim contract. The proposed amendments are summarized below, and a copy of the SEC's proposing release is attached. Comments on the proposed amendments to Rule 15a-4 are due to the SEC by September 30, 1998. If you have thoughts or comments concerning the proposal, please call either me at (202) 326-5813 or Barry Simmons at (202) 326-5823 by August 19, 1998. Adviser Mergers Adviser merger transactions can result in the assignment (and thus, the automatic termination) of advisory contracts, but are not covered by Rule 15a-4 because the adviser will have received money or other benefits as a result of the transaction. Rule 15a-4 is designed to deal with unforeseeable assignments of advisory contracts by permitting the board to act on an emergency basis to prevent the fund from being harmed by the absence of advisory services. By contrast, adviser mergers: (i) are often foreseeable, (ii) will benefit the adviser, and (iii) typically occur as a result of a transaction in which the fund is not a participant and in which its interests are not represented. In these cases, fund boards have more opportunity to protect the interests of the fund by, among other things, more closely evaluating the services it will receive under an interim contract. Therefore, the SEC has granted exemptive relief in connection with adviser mergers only upon certain additional conditions designed to protect the fund's interests until shareholders have had an opportunity to approve a new contract. The SEC is proposing to codify the relief provided in those orders based on similar conditions, as described below.

1. Terms and Conditions - In the case of an adviser merger, the proposed amendments would require that: (i) the interim contract generally contain the same terms and conditions as the most recent 2 This is in contrast to the condition in prior exemptive orders that required all the escrowed fees

to be returned to the fund if shareholders did not approve a new contract with the adviser. The proposed change would allow shareholders to withhold an adviser's profits if the shareholders do not approve a new contract, but permit the adviser to receive compensation for services rendered to the fund. advisory contract approved by shareholders ("previous contract"); (ii) the interim contract be approved by the fund's board of directors, including a majority of the independent directors, before the interim contract begins; and (iii) the board, including a majority of independent directors, find that the scope and quality of the advisory services to be provided under the interim contract will be at least equivalent to the scope and quality of the services provided under the previous contract. To allow the board to act quickly if the quality of the advisory services provided to the fund diminishes during the performance of the interim contract, the proposed amendments would require that the interim contract permit the board to terminate the contract on no more than ten calendar days' written notice to the adviser. The SEC requests comment on whether the rule should require the board to make specific findings regarding the interim contract and, if so, whether the rule should require any additional findings by the fund's board regarding the interests of investors. Comment is also requested on whether the rule should specify actions the directors should take to monitor the adviser's performance during the exemptive period, and whether the 10-day notice provision is necessary and, if so, whether ten days is a sufficient time period.

2. Placement of Advisory Fees in Escrow - The proposed amendments would require that advisory fees earned under the interim contract be held in an interest-bearing escrow account with a bank or the fund's custodian. If the shareholders approve the new advisory contract, the escrowed fees would be paid to the investment adviser in accordance with the interim contract. If the shareholders do not approve the new contract, however, the adviser would be compensated out of the escrowed fees for the actual costs of performing the interim contract, so long as the costs do not exceed the total compensation the adviser would have received under the interim contract.² Any remaining escrowed fees would be returned to the fund. Comment is requested on whether escrow arrangements encourage investment advisers to obtain shareholder approval prior to the adviser merger, and whether they create economic burdens for investment advisers, especially smaller or less capitalized advisers.

3. Costs of Shareholder Solicitation - In most adviser mergers, the advisers, not the funds, bear the expense of the transaction, including the costs of soliciting shareholder approval of the new advisory contract. Although this has been a condition in numerous exemptive orders, the Commission is not proposing to make this a condition in the rule, but rather requests comment on whether it should.

Length of Exemptive Period Rule 15a-4 currently exempts an investment adviser from the shareholder approval requirement for 120 days. The SEC has proposed to increase the period permitted by the rule to 150 days in order to allow funds more time to seek shareholder approval of the new advisory contract. Comment is requested on whether the rule should provide for a period longer than 150 days and whether the rule should allow funds that hold annual shareholder meetings (which is mostly closed-end funds) to postpone the shareholder vote on the contract until the next annual meeting.

Board Approval Under Section 15 of the Investment Company Act and Rule 15a-4, a fund's board must approve an interim contract at or before the time the fund enters into the interim contract. The proposed amendments would allow a board seven calendar days to approve an interim contract in circumstances in which the current rule would permit an investment adviser to serve a fund temporarily under a contract without shareholder approval. The proposed amendments also would facilitate a special meeting to approve an interim contract, by permitting the fund's board to participate by telephone or similar means of communication that allows all participants to hear each other at the same time. The SEC requests comments on whether the rule should include a grace period, and whether a seven day period provides sufficient time for a board to review the interim

contract and vote. Alternatively, comment is required on whether the rule should provide for a longer grace period but not provide an exemption from the requirement to vote in person. Marguerite C. Bateman Associate Counsel Attachment

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