COMMENT LETTER

September 30, 1998

Comment Letter on SEC Proposed Amendments Regarding Interim Adviser Contracts, October 1998

September 30, 1998

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

Re: Temporary Exemption for Certain Investment Advisers
(File No. S7-22-98)

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to respond to the Securities and Exchange Commission's request for comments on its proposal to amend Rule 15a-4 under the Investment Company Act of 1940 ("Investment Company Act").[2] The rule provides a temporary exemption from the shareholder approval requirement of Section 15(a) of the Investment Company Act by permitting an investment adviser, in certain circumstances, to advise an investment company temporarily under a contract that has not been approved by the fund's shareholders. The proposed amendments, among other things, would: (i) expand Rule 15a-4 to permit a fund to operate under an interim contract 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 such controlling person receives a benefit (collectively, "adviser mergers"); (ii) clarify the timing of board approval of an interim contract; and (iii) lengthen the amount of time a fund can operate under an interim contract.

The Institute generally supports the Commission's proposed amendments to Rule 15a-4. We are particularly pleased that the Commission has proposed to extend the exemption to include adviser mergers. Given the increasing numbers of these transactions, and the Commission's experience granting exemptive relief in this area, expanding the scope of the rule to cover such transactions is entirely appropriate. As discussed below, we recommend that the Commission adopt a general standard for board approval of an interim advisory contract in the case of an adviser merger, rather than requiring the board to make specific findings. We also recommend certain other modifications to the proposed amendments to make them more workable.

In its current form, Rule 15a-4 focuses primarily on the unanticipated termination of an advisory contract because it (1) has not been renewed, (2) has been terminated by the fund's directors or shareholders, or (3) has been assigned (and therefore terminated) under circumstances in which the adviser, or a controlling person of the adviser, does not receive any money or other benefit. In any of these "unforeseeable" circumstances, the rule permits an adviser to advise the fund temporarily for up to 120 days under a contract that the fund's shareholders have not approved, provided that the fund's board of directors, including a majority of directors who are not interested persons of the fund, approves the temporary contract, and the amount of compensation received under it is limited to the amount the adviser could have received under the most recent advisory contract approved by the fund's shareholders.

Investment Adviser Mergers

The proposed amendments would expand the exemption provided by Rule 15a-4 to cover adviser mergers. The Institute supports this expansion of the rule. As the Proposing Release indicates, it is often impractical for an investment adviser to secure prior shareholder approval of a new ("successor") advisory contract without causing a substantial delay in closing the merger transaction. The ability to rely on Rule 15a-4 could help advisers avoid significant adverse effects that such delays may cause, which may be detrimental to fund shareholders (such as the loss of key investment adviser personnel). Our specific comments on the provisions of the rule amendments governing adviser mergers follow.

Terms and Conditions. The proposed amendments would require, among other things, that: (i) the interim contract generally contain the same terms and conditions as the terminated (or "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 the 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. The Proposing Release requests comment on whether the rule should require the board to make specific findings regarding the interim contract.

The Institute supports the Commission's objective to ensure that the interests of shareholders are adequately protected. We do not believe, however, that it is necessary to require the board to make specific findings in order to meet this objective. Instead, the Commission should modify its proposed approach by incorporating a more general standard for board approval of the interim contract. Rather than (1) requiring the board to find that the scope and quality of the advisory services to be provided under the interim contract will be at least equivalent to those provided under the previous contract, (2) requiring that the interim contract contain a 10 calendar day termination clause, and (3) requiring that the interim contract contain, in all material respects, the same provisions as the previous contract, the Commission should require the board to find that the interim contract is in the best interests of investors.

We are concerned that the imposition of any more specific requirements, including those proposed by the Commission, could cause the board to focus only on those factors, to the exclusion of other potentially relevant considerations.[3] Moreover, we note that there could be circumstances in which the scope of services to be provided under the interim contract is not equivalent to that provided under the previous contract, and/or the terms and conditions are materially different, but where board approval nonetheless is appropriate.[4] A more general standard would provide the board with greater discretion in determining whether to approve the interim contract.[5]

Placement of Advisory Fees in Escrow. As noted in the Proposing Release, orders for exemptive relief from Section 15(a) in connection with adviser mergers have been conditioned on placing advisory fees earned during the interim period in an escrow account, payable to the adviser in accordance with the terms of the interim contract only if and when the fund's shareholders approve a successor contract with the adviser. Were the fund's shareholders to disapprove the successor contract, then all the escrowed fees would have to be returned to the fund. The proposed amendments would mirror these conditions, except that in the event a fund's shareholders did not approve the successor contract, the adviser would be compensated out of the escrowed fees, but only to the extent of the actual costs incurred in performing the interim contract, so long as the costs do not exceed the total compensation the adviser would have received under the interim contract. Any remaining escrowed fees would be returned to the fund.

The Institute supports the Commission's proposal to permit an adviser to be compensated for performing advisory services during the interim period. We do not believe it is necessary, however, to limit this compensation to the lesser of actual costs or the total amount in escrow if a successor contract is not approved. Given that the fees to be paid would be no greater than the fees paid under the previous contract (which, in accordance with Section 15(a), had already received board and shareholder approval), and presuming the adviser furnishes bona fide services to the fund in accordance with the interim contract, permitting it to earn a reasonable profit for its services should not be objectionable. Moreover, the Proposing Release does not identify, and we are not aware of, any abusive situations or potential problems that would explain why the more burdensome approach proposed by the Commission is warranted. For these reasons, we recommend that the fees earned during the interim period be remitted to the adviser regardless of whether the successor contract is approved or disapproved by fund shareholders.

Consistent with this recommendation, the Commission should not impose the proposed escrow arrangement. Any investor protection concerns regarding the payment of excessive management fees would be addressed by the board's determination that the interim contract is in the best interests of fund shareholders, combined with the requirement that the fee paid under the interim contract may be no greater than under the previous contract. The interim contract also would be subject to Section 36(b) of the Investment Company Act, which allows the Commission and fund shareholders to bring actions against an investment adviser for breach of its fiduciary duty with respect to the receipt of compensation from a fund.

Costs of Shareholder Solicitation. The Proposing Release notes that the Commission chose not to include in the rule a condition providing that funds may not be required to pay any of the costs of soliciting shareholder approval of the new advisory contract after an adviser merger, because it is not relevant to the issue of whether relief should be granted from the shareholder approval requirement of Section 15(a). The Institute agrees with the Commission's analysis and supports this position. Moreover, a fund's board of directors is in the best position to determine whether the fund should bear some, all or none of the costs of shareholder solicitation, based on its assessment of the particular circumstances relating to the merger transaction and the shareholder meeting.[6]

While the Commission opted against including a condition in Rule 15a-4 providing that funds may not be required to pay any of the costs of soliciting shareholder approval of a new advisory contract, the Proposing Release appears to cast doubt on the legitimacy of funds' bearing these costs.[7] These conflicting signals are troubling. If the Commission believes it is improper for funds to bear these costs, it should say so. If not, the Commission should refrain from creating uncertainty. Such uncertainty likely will discourage fund directors from exercising discretion with respect to an issue that—as indicated above— we believe is properly within their purview.

Board Approval

Section 15 and Rule 15a-4 currently require board approval of an interim contract at or prior to the time it is entered into by a fund. Under the proposed amendments, if the termination of the previous contract resulted from an unforeseeable event, the board would have up to seven calendar days in which to approve an interim contract. The Institute supports the Commission's proposal to grant the board a grace period, because convening a special meeting under these circumstances involves practical challenges. For example, the directors must receive due notice of the meeting, as well as sufficient information to enable them to make an informed decision to retain a new adviser. The new adviser needs sufficient time to prepare and present a written record supporting the approval of an interim contract. To provide adequate time for these actions, we suggest allowing the board at least ten business days to approve an interim contract.

The proposed amendments also would facilitate a fund's ability to hold a special board meeting by permitting board members to participate by telephone or similar means of communication that allows all participants to hear each other at the same time. The Institute supports the Commission's proposal as it could make it easier in many cases to convene and conduct the required meeting on relatively short notice.

Length of Exemptive Period

Currently, Rule 15a-4 exempts an investment adviser from the shareholder approval requirement for 120 days. The proposed amendments would extend the time period to 150 days. The Institute supports providing funds additional time to obtain a quorum of shareholders necessary to vote on an advisory contract.[8] We recommend, however, that the time period end as of the last day of the month in which the 150th day falls. This approach would minimize disruptions to the orderly management and administration of a fund by coordinating the termination period of the interim contract with a fund's normal financial, compliance and reporting cycles. Often, certain compliance tests are performed at month end, which also may be the end of a fund's annual or semi-annual fiscal period. Also, where there is an unforeseeable contract termination and the interim contract is not approved, the coordination process with the fund's new adviser (and with any affiliates of the new adviser that will be providing administration, transfer agency or other services to the fund) and any new officers of a fund will be substantially simplified if the interim contract terminates at the end of a month.

In addition, we note that the Proposing Release and the rule amendments are silent on when the exemptive period would begin, which could create ambiguity in the case of a contract termination resulting from an adviser merger.[9] Consistent with prior exemptive orders, we recommend that the time period begin as of the date the previous contract terminates.

The Proposing Release also requests comment on whether funds that hold annual shareholder meetings (typically closed-end funds) should be allowed to postpone the shareholder vote on the advisory contract until the next annual meeting. The Institute believes they should. Permitting these funds to delay a shareholder vote until the next regularly scheduled meeting would obviate the need for a special meeting and may increase the likelihood of obtaining a quorum sufficient to vote on the contract, thereby resulting in significant cost savings.

Technical Comments

The proposed amendments would define the term "fund" to mean an investment company. The Institute recommends that the definition be expanded to also include a series of an investment company.

The Institute also notes that the text of Section (b) of the proposed rule states that "a person may act as investment adviser for a fund under an interim contract after the termination of a previous contract as provided in paragraphs (b)(1) and (b)(2) of this section." The Institute notes that because these paragraphs are mutually exclusive (i.e., a previous contract may be terminated by either an unforeseeable or a foreseeable event, but not both) the word "and" should be replaced with the word "or" to clarify any ambiguity.

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The Institute appreciates the opportunity to comment on the proposed amendments to Rule 15a-4. If you have any questions concerning our comments or would like additional information, please contact me at (202) 326-5822 or Barry Simmons at (202) 326-5923.

Sincerely,

Frances M. Stadler
Deputy Senior Counsel

cc: Robert E. Plaze, Associate Director
Marilyn K. Mann, Senior Counsel
Penelope W. Saltzman, Assistant Chief
Division of Investment Management

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,288 open-end investment companies ("mutual funds"), 450 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.092 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

2 SEC Release Nos. IC-23325, IA-1736 (July 22, 1998), 63 Fed. Reg. 40231 (July 28, 1998) (the "Proposing Release").

3 It may be appropriate for the Commission’s adopting release to indicate that the board may consider these factors in connection with approving the interim contract.

4 One example would be a case where the previous contract encompassed both advisory

and administrative services, but the interim contract only covers advisory services because administrative services are to be provided under a separate contract. See, e.g., Franklin Templeton Group of Funds (pub. avail. July 23, 1997).

5 The rule should continue to require that the compensation to be received under the interim contract may not exceed the compensation that would have been received under the most recent advisory contract approved by shareholders.

6 For example, there may be additional matters on the agenda for the shareholder meeting.

7 In particular, the Proposing Release states that "issues may arise under other sections of the Investment Company Act if the fund pays the costs of soliciting shareholder approval of a new contract." Proposing Release at p. 15 (footnote omitted). The Release then cites various provisions of the Investment Company Act that, in our view, may not be applicable. See Proposing Release at n. 33.

8 The difficulties of obtaining votes from mutual fund shareholders are widely recognized. Often, shareholder meetings must be adjourned to solicit additional proxies in order to get a quorum. In these circumstances, the proposed amendment would help maintain the continuity of investment management services performed for the fund during the interim period.

9 For example, a fund’s board would be required to approve the interim contract before the previous contract terminates. In our view, board approval should not be the starting point for the exemptive period.
