INVESTMENT COMPANY INSTITUTE

April 26, 2004

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

Re: *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies (File No. S7-08-04)*

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal relating to disclosure regarding approval of investment advisory contracts by investment company boards of directors.[2] The proposal would require each registered management investment company to provide disclosure in its reports to shareholders regarding the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of advisory contracts during the reporting period.[3]

The Institute supports providing disclosure about the basis for the board's approval of the advisory contract in a document that is more widely disseminated than the Statement of Additional Information. Making this information more readily available to shareholders may help them better understand one of the most important responsibilities of fund directors. In addition, the extent of disclosure currently required regarding board approval of advisory contracts has not been entirely clear, and we support the Commission's efforts to clarify the

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,595 open-end investment companies ("mutual funds"), 612 closed-end investment companies, 124 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.554 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] SEC Release Nos. 33-8364; 34-49219; IC-26350 (February 11, 2004), 69 FR 7852 (February 19, 2004) ("Proposing Release").

[3] Similar disclosure is currently required in funds' Statements of Additional Information and proxy statements. The proposal would require enhanced disclosure in these documents.

requirements. We have comments on several aspects of the proposal, including (1) how the requirements will be administered and the appropriateness of certain specific requirements, (2) the appropriate location for the disclosure,[4] (3) application of the requirements to advisory contracts with unaffiliated subadvisers, and (4) an appropriate transition period. Our specific comments are discussed more fully in Section II, below.

Before providing our specific comments on the proposal, however, we would like to address certain statements in the Proposing Release concerning the basis for the Commission's proposal. As discussed below, we are concerned with the accuracy and implications of these statements. We request that the Commission address these concerns in its adopting release because we believe it is important for the administrative record supporting Commission rulemaking to reflect accurately the context in which new regulatory requirements are being considered. In addition, further clarification of these issues may facilitate compliance with the new requirements.

I. Comments on the Proposing Release

A. Mutual Fund Fee Levels

In explaining the genesis of the Commission's proposal, the Proposing Release states, among other things, that the Commission is taking steps "to encourage fair and reasonable fund fees."[5] The Institute fully shares the Commission's view that mutual fund fees should be considered as an important element of an informed investment decision. The Commission has a strong record of developing disclosure initiatives that have significantly enhanced the transparency of mutual fund fees.[6] This transparency has enabled market forces to effectively regulate fund fee levels. We are hopeful that the statement simply expresses the goal of further improving such transparency, thereby bolstering market competition, and is not meant to imply that fund fees currently are excessive.

In fact, studies show that the overall costs that investors are paying to invest in mutual funds have declined significantly over time.[7] Moreover, assets and new investments are

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[4] Specifically, we recommend requiring summary information in the prospectus with more detailed information in the Statement of Additional Information, rather than disclosure in shareholder reports.

[5] Proposing Release at 7853.

[6] As the SEC staff has noted, "[m]any observers give the Commission high marks for requiring funds to disclose information about their fees in a format that is understandable to investors that facilitates comparison with the fees charged by other funds and other investment alternatives." Division of Investment Management, U.S. Securities and Exchange Commission, "Report on Mutual Fund Fees and Expenses" (December 2000) ("SEC Fee Study"), at 10. The Commission recently adopted new requirements for expense disclosure in fund shareholder reports that will further increase the availability of such fee information. SEC Release No. IC-26372 (Feb. 27, 2004) [69 FR 11244 (Mar. 9, 2004)] ("Shareholder Report Release").

[7] *See, e.g.,* Investment Company Institute, "The Cost of Buying and Owning Mutual Funds," *Fundamentals,* Vol. 13, No. 1, February 2004. The Commission's Division of Investment Management published a study of mutual fund fees in 2000 that also found a decline, from 1979 to 1999, in the total ownership costs of funds. (The study looked at "load classes," defined as fund share classes with 12b-1 fees higher than 25 basis points, classes with 12b-1 fees and

concentrated in lower cost funds.[8] These findings are not surprising, given the clear and prominent disclosure of fund fees required by the Commission and the highly competitive nature of the fund industry. In addition to benefiting from a vigorously competitive marketplace, mutual fund investors – unlike the consumers of any other financial product or service – are afforded additional protections against excessive fees. These include Section 15 of the Investment Company Act, which requires any increase in a fund's advisory fee to be approved by fund shareholders,[9] Section 36(b) of the Investment Company Act of 1940, which imposes a fiduciary duty on the fund's adviser with respect to the receipt of compensation from the fund, and board oversight of fund fees, which is discussed in Section I.B., below.

With respect to fund fee levels, the Proposing Release further states that "the level of fees charged by investment advisers to mutual fund clients, especially in comparison to those charged by the same advisers to pension plans and other institutional clients, has come under scrutiny."[10] It also mentions that "some have suggested that the advisory fees charged by investment advisers for equity pension funds are substantially lower than advisory fees charged by investment advisers for equity mutual funds because advisory fees for pension funds are negotiated through arm's length bargaining."[11]

We recognize that the Proposing Release was not necessarily embracing the suggestion it described. We feel compelled to respond, however, because the underlying research cited in the Proposing Release is deficient and its conclusion is clearly wrong. The Institute recently conducted an economic study of the fees charged by investment advisers to mutual funds as compared to the fees charged by investment advisers to pension plans.[12] The Institute's study, which is noted in the Proposing Release, found that when one compares the fees paid to

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contingent deferred sales charges, and funds with traditional front-end sales charges.) *See* SEC Fee Study, supra note 6.

[8] Brian Reid, Stephen Sevigny, and Bernhard Silli, "Mutual Fund and Economic Developments in 2003," Investment Company Institute *Perspective* (February 2004).

[9] A recent commentary on mutual fund fees noted that in 2002 and 2003 combined, only 138 funds (approximately 2% of the 7,000 total open-end funds) filed for a change in advisory fees. Five times as many funds requested to reduce their fees as those seeking a fee increase. *See* "Mutual Fund Fees: Facts, Trends, Economies of Scale, and Market Forces," *Strategic Insight Overview* (Jan. 2004) ("Strategic Insight Overview"), at 7.

The reference to "fair and reasonable" fund fees also is troubling because it could be interpreted by some to alter the current standard for fund advisory fees, which could inadvertently expose fund directors to additional liability. *See, e.g., Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983) ("To be guilty of a violation of §36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services being rendered and could not have been the product of arm's-length bargaining.").

[10] Proposing Release at 7853 (footnote omitted).

[11] *Id.* (footnote omitted).

[12] Sean Collins, "The Expenses of Defined Benefit Pension Plans and Mutual Funds," Investment Company Institute *Perspective* (December 2003).

investment advisers by mutual funds to those paid to investment advisers by pension plans for similar services, the fees are substantially similar.[13]

B. Board Oversight of Advisory Contracts

The Proposing Release cites, as another reason for the proposal, the Commission's belief that "[i]ncreased transparency will encourage fund boards to engage in vigorous and independent oversight of advisory contracts."[14] The Institute agrees that such oversight is among the most important responsibilities of fund directors, and we are hopeful that the proposed disclosure will help investors better understand the board's role. We have concerns, however, about the statement in the Proposing Release that "[s]ome have . . . argued that the process by which fund boards determine to renew advisory contracts is often cursory, at best," citing Congressional testimony by a fund industry critic that implies that the renewal process is deficient because fund boards rarely fire the adviser.[15]

Again, we recognize that the observation in the Proposing Release does not necessarily reflect the Commission's views. Nevertheless, the Institute respectfully submits that the criticism cited in the Proposing Release is premised on a misconception of the board's role with respect to approving and renewing fund advisory contracts. We believe it is important to clarify this point.

As the Commission's proposal makes clear, the contract review process under Section 15 of the Investment Company Act involves careful consideration by a fund's board of a variety of factors. It is our experience that fund directors take this responsibility very seriously.[16] It is

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[13] In so doing, the Institute's study refuted the findings of an academic study cited in the Proposing Release regarding the relative levels of advisory fees for pension funds and mutual funds. It pointed out that the academic study inappropriately compared the advisory fees of pension plans with the advisory fees of mutual funds without taking into account the differences between the two investment vehicles. That is, a pension plan's management fees only cover costs associated with portfolio management, while mutual fund management fees cover costs associated with business and administrative services required to operate the fund in addition to expenses arising from portfolio management. *See also* Strategic Insight Overview, *supra* note 9, at 15-16 (describing flaws in the academic study's methodology).

The Proposing Release asks if 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 services other than portfolio management. The Institute does not believe such disclosure should be required. In our view, it would not be helpful, and could be confusing or even misleading, to investors. While some boards may seek to do such an analysis, others may determine that it is unnecessary. Also, it may not be feasible in all cases. Disclosure that a board did not separately assess amounts to be paid for different services could inappropriately create the impression that the process followed by the board was somehow deficient.

[14] Proposing Release at 7853.

[15] *Id.* at n.19 and accompanying text.

[16] Consistent with this, the SEC staff has observed that the Commission's inspection program has found "that most boards of directors are obtaining the necessary information to evaluate the various types of fund fees and expenses." Memorandum from Paul F. Roye, Director of Division of Investment Management, to Chairman William H. Donaldson, regarding Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, dated June 9, 2003, ("2003 Roye Memorandum") at 49.

inappropriate, however, to measure the diligence of fund boards and their effectiveness in serving the interests of fund investors by reference to the frequency with which they fire fund investment advisers.[17] The Commission's staff expressly recognized this last year when it wrote that "[t]he infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that the legal standards that are applicable to the approval of investment advisory contracts are inadequate, or that independent directors have not been forceful enough in representing shareholders' interests. Fund directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds."[18]

As a legal matter, funds generally are organized as corporations or business trusts with a board of directors or trustees. Practically speaking, however, funds are a means through which investors obtain the services of the fund's sponsor or investment adviser. When investors become shareholders of a fund, they already have chosen the adviser in the context of the disclosures in the fund's prospectus and other documents that set forth the material facts concerning the adviser, the fund's investment objectives, strategy and risks, the management fee structure, and other expenses of investing in the fund. Thus, as a draftsman of the Investment Company Act has pointed out, "[T]he board of directors does not act in a vacuum . . . [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take action to change it except in unusual circumstances."[19]

Fund directors play a significant role in protecting the interests of fund shareholders through their oversight of the fund's management and operations, an important part of which involves the directors' annual review and approval of the advisory contract. But suggestions that because boards infrequently fire advisers, the contract review process is deficient, are misguided. These suggestions ignore both economic reality and investor expectations.

Along these same lines, the Institute is concerned that the Commission's proposal itself could unintentionally reinforce this misperception of the board's role in the contract review process. Specifically, the Proposing Release states that the proposal "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

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[17] Suggestions by critics that fund boards are supposed to negotiate the lowest possible advisory fee also reflect a misunderstanding of the board's proper role. As former Commission Chairman Arthur Levitt stated, fund directors are required to "make sure that fees fall within a reasonable band." Remarks of Arthur Levitt, U.S. Securities and Exchange Commission, at the Investment Company Institute, Washington, D.C. (May 15, 1998). Moreover, in enacting Section 36(b) under the Investment Company Act, Congress made clear that Section 36(b) does not require fund directors to negotiate a "cost-plus" type of contract with the fund's investment adviser. *See* S. Rep. No. 184, 91st Cong., 2d Sess. 4 (1970).

[18] 2003 Roye Memorandum, *supra* note 16, at 60.

[19] Jaretzki, Jr., Alfred, "Duties and Responsibilities of Directors of Mutual Funds," 29 Law and Contemporary Problems 777, 786 (1964).

advisory contract."[20] The Proposing Release provides no explanation of what the Commission intends by making specific reference to "the board's selection of the investment adviser" but in practice, as discussed above, the board does not "select" the investment adviser. Rather, by investing in a fund that a particular adviser has created, *investors* have selected the investment manager whom they believe will implement their investment strategy and provide shareholder services suitable to their needs at an acceptable cost.[21]

II. Specific Comments on the Proposal

A. Compliance with Disclosure Obligation

The Proposing Release notes that the Commission is proposing enhancements to existing disclosure requirements concerning board approval of advisory contracts (and proposes to include these same enhancements in the new shareholder report disclosure) to address concerns that some funds currently do not provide adequate specificity regarding the board's basis for its decision.[22] The Institute supports requiring funds to disclose, with adequate specificity, the board's basis for its decision to approve an advisory contract. Depending on how the Commission staff interprets this disclosure requirement, however, we are concerned that the result could be very lengthy disclosure that is not helpful to investors or a chilling of discussions among fund directors with respect to the advisory contract.[23] It would be sadly ironic if disclosure requirements designed to highlight the importance of the contract review process inadvertently compromised that process. Accordingly, we urge the Commission and its staff, in administering any new disclosure requirement, to bear in mind that the desire to maximize transparency must be carefully balanced against (1) the need to avoid overwhelming investors with overly detailed and voluminous disclosure and (2) the need to support directors' continued candid and rigorous execution of their contract review responsibilities.

In addition to this general recommendation, we are concerned that certain aspects of the proposal are at odds with judicial decisions interpreting Section 36(b) under the Investment

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[20] Proposing Release at 7854 (footnote omitted) (emphasis added). Thus, for example, proposed Item 12(b)(10)(i) of Form N-1A states that the disclosure of the basis for the board's approval of an advisory contract in fund SAIs should discuss "[f]actors relating to both the board's selection of the investment adviser and approval of the advisory fee and amounts to be paid by the Fund under the contract."

[21] Indeed, elsewhere in the Proposing Release, the Commission appears to recognize this. *See* Proposing Release at 7852 ("Unlike most business organizations, registered management investment companies ('funds') are typically organized by an investment adviser that is responsible for the day-to-day management of the fund.").

[22] *Id.* at 7854. We note that, notwithstanding the Commission's desire for specificity, there should be nothing inherently improper with providing similar disclosure for multiple funds in the same complex. The boards of such funds very likely engage in a review process that is fairly uniform across the funds, even though certain details necessarily will vary from fund to fund. It would be unfortunate if the Commission's disclosure requirements created a negative inference with respect to the development of a robust, consistent review process by fund boards.

[23] The Commission expressed an awareness of this concern in the Proposing Release, which specifically seeks comment on whether any of the disclosure requirements will have a chilling effect on boards' consideration of investment advisory contracts. Proposing Release at 7855.

Company Act and with industry practice. In particular, the proposal seems to require funds to disclose a conclusion reached by the board with respect to each factor considered.[24] As pointed out in the Proposing Release, courts have relied upon factors similar to those included in the proposal in determining whether fund directors have met their fiduciary duties under Section 36(b). In so doing, however, courts have considered all relevant factors, rather than any single factor, in deciding whether an adviser has properly acted as a fiduciary in relation to such compensation.[25] Moreover, as a factual matter, boards typically determine whether to approve or renew an advisory contract based on the totality of factors considered. Requiring disclosure of a separate conclusion with respect to each factor either would result in disclosure that presents an inaccurate picture of the board's actual process or would require boards to alter their practices in a way that is not required by law and does not make sense.

At the same time, the Institute agrees that it is appropriate for the Commission to require funds to discuss factors considered by the board in some detail and not just provide conclusory statements. For instance, with respect to the cost of the advisory services provided, funds could disclose information such as the types of costs incurred by the adviser and whether they changed materially since the previous contract renewal. Or, regarding performance, funds might disclose, for example, the time periods of the fund's performance that the board looked at and which performance standards the board used as a comparison for the fund's performance (*e.g.*, appropriate market indices and benchmarks). For the reasons discussed above, however, we request that the Commission make clear in the adopting release that directors are not required to reach, and funds are not required to disclose, a *conclusion* with respect to each factor considered by a board in its evaluation of an advisory contract.

Moreover, one of the specific factors included in the proposal is inappropriate. In particular, funds would have to disclose whether boards relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those of contracts with other types of clients (*e.g.*, pension funds and other institutional investors).[26] If the board relied on 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.

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[24] *See, e.g.*, Proposing Release at 7855 (noting that the Commission is clarifying existing disclosure requirements "by requiring that the fund's discussion state how the board evaluated each factor" and that, for example, "it would not be sufficient to state that the 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.") (footnote omitted).

[25] *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, *supra* note 9, at 929, citing S. Rep. No. 184, *supra* note 17 ("[t]he legislative history of Section 36(b) makes clear that Congress 'intended that the court look at all the facts in connection with the determination and receipt of such compensation, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation'").

[26] *See, e.g.*, proposed Item 12(b)(10)(i) of Form N-1A.

As discussed above, such a requirement would result in an "apples to oranges" comparison.[27] In fact, courts have determined that fees charged by investment advisers to large pension funds should *not* be used as a criterion for determining fair advisory fees for mutual funds because the nature and extent of the services required by pension funds and mutual funds differ sharply.[28] Consistent with this, as a matter of practice, it is our understanding that fund boards typically do not use such comparisons as a basis for approving or renewing advisory contracts. Thus, any such requirement would result in negative disclosure that would clutter the fund's disclosure documents and not be helpful to investors in evaluating whether to purchase or remain invested in a particular fund. Conversely, to avoid having to provide any such negative disclosure, fund boards may feel compelled to consider this factor, simply because of the disclosure implications, notwithstanding its lack of relevance. Accordingly, we request that the proposed disclosure regarding comparisons to pension funds and other institutional investors be eliminated from any final rule.[29]

Finally, as discussed above, the references to the board's "selection" of the investment adviser in the proposed disclosure requirements also are inappropriate. To avoid unintentionally perpetuating a misconception and possibly confusing funds seeking to comply with any new requirements, we recommend that the Commission delete such references from any final rule.[30]

B. Location of Disclosure

Under the Commission's proposal, disclosure regarding the basis of the board's approval of an existing investment advisory contract would be required in a fund's shareholder reports, with parallel disclosure in the fund's SAI and proxy statements. The Proposing Release requests comment on whether inclusion of the proposed disclosure in reports to shareholders would be useful to investors.[31] The Institute supports providing disclosure in a document that is more widely disseminated than the SAI, but we are not convinced that the shareholder report is the appropriate location. Instead, for the reasons discussed below, we recommend that summary information about the basis for the board's approval of the investment advisory contract be provided in fund prospectuses, with more detailed disclosure in the SAI.

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[27] *See supra* note 13.

[28] *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, *supra* note 9, at n.3.

[29] The proposed requirement to disclose whether the board relied upon comparisons of advisory contracts with other registered investment companies is appropriate and should be retained.

[30] *See, e.g.,* proposed Item 12(b)(10)(i) of Form N-1A, discussed *supra* note 20.

[31] Proposing Release at 7855. The Proposing Release also asks whether disclosure regarding the basis of the board's approval of an existing investment advisory contract should be continued in the SAI if the requirement for disclosure in shareholder reports is adopted and whether, if the disclosure is eliminated from the SAI, a fund should be required to include a cross-reference in its SAI to its shareholder report. *Id.*

First, according to the Proposing Release, one of the purposes of the proposed disclosure is to "assist investors in making informed choices among funds."[32] In contrast to the prospectus, which is delivered at the time of an investment and is specifically intended to serve as the basis for an investment decision, shareholder reports are sent to existing shareholders on a semi-annual basis. As such, these reports are neither designed nor particularly well-suited for the purpose of assisting investors in choosing among funds.

Second, the proposed disclosure may be quite lengthy, especially if a shareholder report relates to more than one fund or the fund has multiple advisers. The Commission has recently adopted amendments to improve the disclosure in shareholder reports.[33] Adding lengthy narrative disclosure to these reports could have the unintended consequence of making them less reader-friendly and possibly discouraging investors from reading them altogether.

Third, pursuant to Commission rules implementing the requirements of the Sarbanes-Oxley Act[34] with respect to investment companies, the information in shareholder reports must be certified by a fund's principal executive officer and principal financial officer. It seems inappropriate to require these *fund officers* to certify disclosure that explains the *board's* basis for approving the advisory contract, especially given that they might not even be present when the discussion takes place.[35] Certification of this information clearly was not contemplated by the Sarbanes-Oxley Act, and it would not serve the purpose intended by that Act.[36] Indeed, it is not clear what purpose it would serve.

For all of these reasons, we recommend requiring summary information in a fund's prospectus, with a cross-reference to more extensive information in the SAI.[37] Under this approach, all fund investors would receive information about the board's approval of the advisory contract (in the fund's prospectus rather than in shareholder reports), and they would be alerted to the availability of more detailed information. This would serve the Commission's goal of providing increased visibility to the disclosure but would do so in a way that would let investors decide how much information they wish to receive on this topic. In this way, it would

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[32] *Id.* at 7853.

[33] *See* Shareholder Report Release, *supra* note 6. In adopting the amendments, the Commission stated its belief that the amendments and new rules "will make these reports more effective vehicles for communicating information to investors." 69 FR at 11245.

[34] Pub. L. 107-204, 116 Stat. 745 (2002).

[35] Independent fund directors often meet in executive session to discuss approval of the advisory contract. Indeed, this is a recommended industry best practice. *See* Report of the Advisory Group on Best Practices for Fund Directors, June 24, 1999, at 24 ("The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.").

[36] As the Commission noted in the release adopting Form N-CSR, the Sarbanes-Oxley certification requirement "was intended to improve the quality of the disclosure that a company provides regarding its financial condition in its reports to investors." *See* SEC Release No. IC-25914 (Jan. 27, 2003) [68 FR 5348, 5349 (Feb. 3, 2003)].

[37] The summary information could appear in the section of the prospectus concerning management of the fund.

be consistent with the "layered approach" to disclosure of fund portfolio holdings recently adopted by the Commission, which the Commission described as "[making] more information available while permitting . . . investors to tailor the amount of information they receive to meet their particular needs."[38]

C. Disclosure Regarding Board Approval of Subadvisory Contracts

The Proposing Release states that disclosure would be required in shareholder reports for approvals of subadvisory contracts where shareholder approval of the contract is not required.[39] The Institute supports requiring disclosure concerning board approval of subadvisory contracts in these circumstances but, for the reasons discussed below, we recommend that the Commission revise the proposal to allow funds to provide more tailored disclosure concerning contracts with unaffiliated subadvisers.[40]

Contracts with unaffiliated subadvisers differ from contracts with a fund's principal adviser in certain important respects. For example, in a recent rule proposal involving these types of subadvisory arrangements, the Commission noted that the proposed rule largely relied on the fact that the principal adviser would negotiate the terms of the subadvisory contract "with each subadviser on an arm's length basis."[41] In addition, the principal adviser has supervisory obligations with respect to the subadviser(s) in these arrangements.[42] While fund boards have the same oversight and approval responsibilities with respect to contracts with unaffiliated subadvisers that they have with respect to any other advisory contract, they carry out these responsibilities in a way that takes into account the nature of the arrangements. In

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[38] Shareholder Report Release, *supra* note 6, at 11248.

If, notwithstanding our recommendation, the Commission decides to require the proposed disclosure in fund shareholder reports, it should require the proposed disclosure in annual (not semi-annual) reports to shareholders. As proposed, if a fund board considered an advisory contract during the first half of the fund's fiscal year, funds technically would be required to include the same disclosure twice in one year about the board's single consideration of the advisory contract (*i.e.,* in both the fund's semi-annual and annual report to shareholders). We believe that requiring the same disclosure in both reports is unnecessary and would be confusing for investors. In addition, for the reasons stated above, the Commission should not require certification of this information. Finally, if the disclosure is required in shareholder reports, little purpose would be served by duplicating the disclosure in SAIs. At most, a brief cross-reference in the SAI to the shareholder report should be required.

[39] *See* Proposing Release at n.30.

[40] Our comments concerning "unaffiliated subadvisers" address arrangements in which the fund's principal adviser enters into a contract with a subadviser that is not an affiliated person of the principal adviser or the fund other than by reason of serving as investment adviser to the fund. In some cases, a fund contracts directly with one or more advisers who are otherwise unaffiliated with the fund or its sponsor, and the same analysis should be applied to those situations.

[41] *See* Investment Company Act Release No. IC-26230 (Oct. 23, 2003) [68 FR 61720, 61722 (Oct. 29, 2003)] ("Manager of Managers Proposal") (proposing a rule that would codify exemptive orders permitting "manager of manager" funds to operate without obtaining shareholder approval when the fund's principal investment adviser hires a new subadviser or replaces an existing subadviser).

[42] *See id*.

particular, some of the factors that directors consider in approving a contract with an unaffiliated subadviser are different from those that the directors consider in connection with approving a contract with the fund's principal adviser.[43]

For example, in evaluating a contract with an unaffiliated subadviser, the directors likely would not consider the costs of the services to be provided and profits to be realized by the subadviser and its affiliates from the relationship with the fund, because this information is not "reasonably necessary to evaluate the terms" of the contract.[44] On the other hand, factors that *are* relevant and that directors typically *do* consider include the nature of the services provided (or to be provided), the subadviser's performance record, the subadviser's portfolio managers, the market for the services (*i.e.*, the price that another adviser would charge to perform comparable services), and the recommendations of the principal adviser.

The Commission's proposal does not reflect or accommodate these differences. Consequently, it would require funds to discuss factors that are not relevant in the subadvisory context, resulting in negative disclosure.

The Commission's proposal also does not take into account another characteristic of funds that employ unaffiliated subadvisers. Namely, it is not uncommon for these funds to have numerous subadvisers.[45] Under the Commission's proposal, such funds would have to provide very lengthy disclosure about approval of subadvisory contracts, which would not be helpful to investors and could distract them from focusing on more important information.[46]

To address these concerns, the Institute recommends that the Commission revise the proposal to require, in the context of board approval of contracts with unaffiliated subadvisers, disclosure that discusses considerations that are relevant in that context. We further recommend that the proposal call for streamlined disclosure, *i.e.*, disclosure that explains the basis for board approval of such subadvisory contracts on an aggregate basis. Put another way, the disclosure would describe the board's consideration of relevant factors for subadvisers as a group. A streamlined disclosure requirement under which funds would discuss board approval of subadvisory contracts in the aggregate would be consistent with the recent Manager of Managers proposal, which would permit funds to disclose subadvisory fees on an aggregate rather than an individual basis.[47]

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[43] We note that court cases that discuss factors similar to those included in the proposal involved board approval of contracts with affiliated advisers, not unaffiliated subadvisers.

[44] *See* Section 15(c) of the Investment Company Act. Moreover, given that the principal adviser and an unaffiliated subadviser are competitors, it is not realistic to expect that the subadviser would share this proprietary information.

[45] For example, we are aware of funds that have as many as 32 subadvisers.

[46] We note that, under the proposal, these funds would have to provide disclosure concerning the board's approval of the contract with the principal adviser. Moreover, the directors must take into consideration subadvisory fees when evaluating the terms of the principal adviser's contract with the fund.

[47] *See* Manager of Managers Proposal, *supra* note 41, at 61722.

D. Transition Period

The Proposing Release requests comments on an appropriate compliance date if the proposed disclosure requirements are adopted. The Institute recommends requiring compliance with the new requirements in disclosure documents filed with the Commission following a twelve-month transition period. This recommendation is based on our understanding that many fund boards meet once annually to consider all advisory contracts for the funds in a particular complex. The recommended transition period should permit fund boards to meet to approve advisory contracts on their regular annual cycle and funds to file their disclosure documents containing the new or enhanced disclosure on their regular updating schedule. The transition period also would appropriately accommodate the need for funds to comply with the final requirements on a prospective basis. It is important for the requirements to apply prospectively because of the possibility that, for contracts approved before the adoption of the new requirements, not all of the information that fund officials would need in order to prepare disclosure that complies with the new requirements necessarily will have been recorded.[48] A prospective requirement will allow funds and their boards to familiarize themselves with the details of the new requirements, and to refine existing procedures as necessary to ensure that the information needed to comply with the disclosure requirements is available to the persons charged with drafting the disclosure.[49]

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We appreciate the opportunity to comment on this proposal. If you have any questions or need additional information, please contact me at (202) 326-5824, Frances M. Stadler at (202) 326-5822, or Dorothy M. Donohue at (202) 218-3563.

Sincerely,

Amy B. R. Lancellotta
Acting General Counsel

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner

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[48] For example, as indicated above, board discussions of advisory contract approval often take place in executive sessions of the independent directors and records of these discussions that are sufficiently detailed to make it possible to fully comply with the new disclosure requirements may not exist. Whether such discussions are conducted in executive session or not, it is quite possible that some information that may be relevant for purposes of the new disclosure requirements could have been discussed but not specifically recorded in board minutes.

[49] The recommended transition period would be consistent with that provided by the Commission for funds to comply with disclosure amendments related to fund governance, including the existing requirements for disclosure concerning the basis of the board's approval of the advisory contract. *See* SEC Release No. IC-24816 (Jan. 2, 2001) [66 FR 3733, 3745 (Jan. 16, 2001)].

The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

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