



DIRECTORS' COMMITTEE

INVESTMENT COMPANY INSTITUTE

April 26, 2004

Mr. Jonathan J. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street
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 Directors' Committee¹ appreciates the opportunity to submit comments on the recent proposal by the Securities and Exchange Commission relating to disclosure of the reasons for an investment company board's approval of an investment advisory contract.² The Proposing Release would require shareholder reports to include a discussion of the material factors, and the conclusions drawn from them, that formed the basis for the board's approval of any new advisory contract or contract renewal during the period covered by the contract. The proposal also would require enhanced disclosure concerning the basis for the board's approval of the contract in the Statement of Additional Information, as well as disclosure in the proxy statement of the basis for the board's recommendation that shareholders approve the advisory contract.

The Committee generally supports enhanced disclosure to shareholders of the reasons the board approved an investment advisory contract. This disclosure should promote shareholder understanding of the approval process and the role played by the board of directors in this process. However, we are concerned that some of the language in the Proposing Release mischaracterizes the board's role with respect to the approval of the advisory contract. In addition, the release implies that boards historically have not performed their legal obligations. We do not share this view. Finally, some of the proposed disclosures are inconsistent with the nature of investment companies and may not be in the best interest of shareholders. Discussion of these points is found below.

Enhanced Disclosure

The Directors' Committee generally supports enhanced disclosure to shareholders of the reasons the board approved the advisory contract. The proposal would increase the amount and specificity of this disclosure. It would also enhance the prominence of the discussion. The

¹ The Directors' Committee of the Investment Company Institute is comprised of 25 independent directors and 2 interested directors of 24 separate fund groups. The positions stated in this letter represent the views of the directors on the committee and not necessarily the views of the other directors serving on their respective boards.

² SEC Release Nos. 33-8364; 34-49219; IC-26350 (Feb. 11, 2004) ("Proposing Release").

Proposing Release seeks comment on the benefits of providing the new disclosure in multiple locations. In our opinion, it is overkill. In the interest of providing shareholders with disclosure in a location where they are most likely to read and benefit from it, we believe that this particular disclosure should be included in the annual shareholder report. Otherwise, the information may not be provided to shareholders of closed-end funds that are not required to maintain an effective registration statement. Funds maintaining effective registration statements should be permitted to cross-reference to their annual reports for the required disclosure. Similarly, proxy disclosure can be achieved through cross-reference.

Role of the Board

The definitive court case to which directors and their counsel have looked for guidance in evaluating standards to be applied under Section 36(b) sets forth the standard that the fee must be reasonable in relation to the services provided.³ In our experience, board deliberations regarding contracts have not been limited to the factors contained in *Gartenberg*, but they have served as a baseline in conducting a thorough analysis.

The Proposing Release notes that the purpose of the proposed additional disclosure is to “encourage fair and reasonable fund fees.” The language of the release could be viewed as a change by the Commission of the standard that has been applied under Section 36(b) by our courts: that is to ensure that fees are reasonable in relation to the services provided. We recommend that the Commission confirm that it is not seeking to impose a higher standard.

The Proposing Release also states that it is intended to “encourage fund boards to engage in vigorous and independent oversight of advisory contracts” and to “encourage fund boards to consider investment advisory contracts more carefully.” These assertions imply that fund directors, as a group, have failed to engage in the necessary oversight of mutual funds on behalf of their shareholders. Our experience is to the contrary. Most boards undertake diligent and extensive reviews to assure themselves that shareholders are paying a reasonable fee for advisory and other services they receive. Continued efforts to disclose advisory and other fund fees in a clear and simple manner will ensure that investors are made aware of these efforts. Unfortunately, the release could be read to attribute by implication the inattention of a few to the hundreds of independent directors who relentlessly act in their shareholders best interests. We encourage the Commission to revisit the language in the Proposing Release to address the negative implications it has for boards of directors.

Specific Disclosures

Selection of Adviser and Approval of Advisory Contract

The Proposing Release would require that the discussion include factors relating to the “selection” of the adviser. This choice of words suggests that the annual review and approval of the advisory contract is an annual opportunity to replace the investment adviser. This is not a

³ See *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983) (“*Gartenberg*”).

realistic recommendation.⁴ Our shareholders have purchased a fund's shares, most often with professional advice, with the expectation that the adviser they have chosen will be managing that fund. Under normal circumstances, we, the directors, do not second-guess that selection. Rather, we monitor the relationship to ensure that the shareholder is treated fairly. We seek changes in portfolio managers, or strengthening of portfolio management teams when performance is poor. Throughout the year, not just at contract renewal time, we monitor the services the adviser provides beyond investment management to assure ourselves that the administrative services for which the shareholder is paying are being well provided. It is not our role or function, except in the most egregious circumstances, to override the investors' choice of an adviser with one of our own choosing. We observe that, as a practical matter, the disruption that would be caused by annually changing advisers would be overwhelmingly confusing to shareholders, and not in their best interests.

Evaluation of Specific Factors

The Proposing Release specifies a number of factors that directors should consider in connection with the review of the advisory contract and that should be discussed in the recommended disclosure. While some of these factors are consistent with those set forth in *Gartenberg*, others extend beyond that analysis. We do not believe the Commission should by a rule attempt to dictate to boards the nature of their deliberations. The more the Commission dictates specific factors, the more likely it is that boards will regress to a "check the box" methodology, rather than use their business judgment to explore and evaluate numerous sources and conduct independent analyses.

For example, factors (4) and (5) would require that a board evaluate the extent to which economies of scale would be realized as a fund grows and whether fee levels reflect these economies of scale. While boards currently consider economies of scale, an analysis of the nature contemplated by these factors would be susceptible to reinterpretation by twenty-twenty hindsight. Furthermore, we wonder how one defines economies of scale in an industry where funds range in size from \$10 million or less to \$75 billion or more. We have great concern that suggestions of this nature will have a disproportionate negative impact on smaller funds because they will not have the resources to employ the third-party assistance that these suggestions imply is required.

Comparisons of Fees and Services Provided by Adviser

The Proposing Release would require that new disclosures indicate whether the board relied upon comparisons of the services to be rendered under the contract with those under other investment advisory contracts. In addition, the discussion must include how this analysis assisted the board in concluding that the contract should be renewed. Many boards currently consider such information and evaluate the similarities and distinctions among other advisory clients and contracts. We are opposed to the Commission mandating that boards rely upon fee and service comparison and other specific information in connection with the performance of their contract renewal responsibilities. There are well-established legal principles for contract evaluation. We suggest that boards and their counsel be accorded the appropriate discretion to consider these principles in light of the particular nature of their funds.

⁴ The Division of Investment Management discussed this issue in a report submitted to Richard H. Baker, Chairman of the House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, by SEC Chairman William H. Donaldson, dated June 9, 2003, at page 59.

Collateral Impact of Proposals

We suggest that added disclosure regarding advisory contract deliberations is unlikely to enhance shareholder understanding of total fund expenses and could, in fact, have a deleterious effect. Typically, contractual fees are somewhere between one-half and two thirds of a fund's expenses, but the management fees alone do not tell the story. Some funds have very low management fees and high administrative fees. Others have low expenses and high management fees. We note continuing improvement in the disclosure of the costs of fund ownership. However, we are concerned that the advisory contract disclosure may be viewed as all-inclusive when it tells only a part of the expense story. We also are concerned that the emphasis on the advisory contract may distract shareholders from equally important issues: the total cost of owning fund shares and the performance of that fund.

We appreciate the opportunity to submit comments on this proposal.

James H. Bodurtha
Chair
Directors' Committee

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

Paul F. Roye, Director