Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609
Re: File No. S7-08-04
Proposed Rule: *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*

Dear Mr. Katz:

Morningstar, Inc. ("Morningstar") is pleased to provide comments on the Securities and Exchange Commission's (the "Commission") proposed rule, *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies* (the "proposal"). The proposal would amend rules and forms under the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Investment Company Act of 1940 to improve the disclosure provided by registered investment companies about how their boards of directors evaluate and approve, and recommend shareholder approval of, investment advisory contracts.

In general, we support the proposed rule and applaud the Commission for working to ensure timelier, more meaningful disclosure of the evaluation and approval by boards of investment advisory contracts. Disclosure as it currently stands is woefully inadequate, in our view. Current disclosure is buried in documents that we don't believe most fund shareholders read: the SAI and proxy statements. Further, the disclosure, such as it is, is all too often boilerplate language that sheds very little light on the rationale for the approval of an investment advisory contract. As your proposal notes, a pernicious consequence of this is that fund boards face little pressure to negotiate the best possible terms on behalf of the fund. We believe that the proposal has the potential to remedy many of these ills.

However, we would also note that the proposed disclosure would be greatly enhanced if it were coupled with efforts to otherwise increase the visibility of fund boards. As Morningstar, Inc. Managing Director Don Phillips stated in his recent testimony before Congress:

"Independence alone is no guarantee of good governance. We think a far more important issue is the visibility of the board. The typical fund investor is largely unaware of the corporate structure of funds. Few investors in, say, Fidelity Magellan think of themselves as the owners (alongside their fellow shareholders) of the fund. Instead, they think that Fidelity owns Magellan and they merely purchase its services. It's a notion that the fund industry doesn't discourage. Indeed, funds do little to draw attention to their corporate structure or the role of the board of directors, often relegating the names and biographical data of fund directors to the seldom-read statement of additional information.

To remedy this situation, Morningstar suggests that each fund prospectus begin with an explanation of the fund's corporate structure, such as the following: *When you buy shares in a mutual fund, you become a shareholder in an investment company. As an owner, you have certain rights and protections, chief among them an independent board of directors, whose main role is to represent your interests. If you have comments or concerns about your investment, you may direct them to the board in the following ways…*

By bringing more visibility to the fund's directors and by alerting shareholders to their role in negotiating an annual contract with the fund management company, the balance of power may begin to shift from the fund management company executives, where it now resides, to the shareholders, where it belongs." (Don Phillips' testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs in Washington, D.C., Feb 25, 2004.)

Thank you again for the opportunity to express our views regarding this proposal. We offer the following specific comments in response to your questions:

1. *Would inclusion of the proposed disclosure in reports to shareholders be useful to investors?*

We firmly believe the inclusion of the proposed disclosure in reports to shareholders would be useful to investors.

Current disclosure is buried in documents that we don't believe most shareholders read. In the case of the SAI, investors don't even receive the document unless they specifically request it from the fund company. In contrast, we believe the shareholder report is the one fund document that is most likely to be read by investors. It is sent to all or nearly all fund shareholders on a regular basis, and it contains information most would find highly valuable, including a discussion of performance and recent portfolio changes, a listing of current fund holdings and sector exposures, and audited financial statements.

As such, we believe that including the proposed disclosure in reports to shareholders would cast much needed light on the process by which fund advisors are selected and management contracts evaluated and approved.

2. *Should we expand our proposal to require disclosure in shareholder reports with respect to all investment advisory contracts approved by the board during the reporting period, including contracts that were also approved by shareholders?*

   We strongly support the expansion of the proposal to require disclosure in shareholder reports with respect to all investment advisory contracts approved by the board during the reporting period, including contracts that were also approved by the shareholders.

   Although contracts approved by shareholders are discussed in proxy statements, we don't believe the vast majority of shareholders take the time to read these documents. As noted above, we believe shareholder reports receive more scrutiny from investors than do proxy statements. Given that the goal of the proposal is to encourage fair and reasonable fees through increased transparency, we think it is imperative for shareholder reports to include disclosure with respect to all advisory contracts approved in the period, including those approved by shareholders.

   We also think one key to useful reporting is consistency. If the proposed disclosure only appears in shareholder reports for certain types of contract approvals, and not others, it may create confusion that undermines the goal of the proposal.

3. *Should disclosure regarding the basis of the board's approval of an advisory contract be required in any additional location (e.g., the prospectus, fund websites)?*

   We think the proposed disclosure should also be included in the prospectus. The prospectus is a document that investors are likely to review before investing in a fund. The inclusion of the proposed disclosure in the prospectus will allow prospective investors to evaluate the fund board's effectiveness in negotiating contract terms prior to purchasing a fund. This should further the proposal's goal by encouraging assets to flow to those funds with the boards that negotiate the best terms for their shareholders, thereby putting pressure on other fund boards to negotiate better terms. We suggest that the Commission require the proposed disclosure to appear prominently in the fees and expenses section of the prospectus. We also encourage the Commission to require the proposed disclosure on fund company websites. This is a low-cost way for funds to distribute the information, and would provide many investors with a quick, easy method to access it.

4. *Should disclosure regarding the basis of the board's approval of an existing investment advisory contract continue to be required in the SAI if we adopt the proposed shareholder reports requirement?*

   We believe disclosure regarding the basis of the board's approval of an existing investment advisory contract should continue to be required in the SAI if the proposal is not expanded to include the disclosure in the prospectus. Otherwise, we don't think it's necessary to continue including the disclosure in the SAI.

5. *If we remove the disclosure requirement from the SAI, should we require funds to include a cross-reference in the prospectus or the SAI to the disclosure in shareholder reports?*

   We believe cross-references would help investors more quickly locate this information, furthering the goal of the Commission's proposal.

6. *Are our proposed enhancements to the existing SAI and proxy statement disclosure requirements, which we are also proposing be included in the new shareholder reports disclosure requirement, appropriate?*

   We agree with the Commission that paragraph (c)(11) of Item 22 of Section 2401.14a-101 of the Code of Federal Regulations is in need of enhancement, and we think the proposed amendments to the paragraph represent a significant improvement over the existing language. However, we think the "Instruction" language at the end of the amendment could be clearer. Specifically, for each factor listed in the amendment and any others considered, the "Instruction" should require boards to: (a) State how the board evaluated each factor, and why; (b) state what the board concluded from the evaluation of that specific factor, and the basis for that conclusion, including any material quantitative data used to support the conclusion; and (c) state precisely how the conclusion reached with regard to a specific factor impacted the board's decision to approve the investment advisory contract.

7. *Will they result in more meaningful disclosure?*

   We believe the proposed enhancements will result in more meaningful disclosure, though we think that more specific language in the "Instruction" section would go even further in accomplishing the Commission's goals.

8. *Will the fact that we have enumerated certain specific matters that should be included in the discussion encourage funds to omit other, equally significant matters from the discussion?*

   We cannot say with any certainty whether or not the listing of specific factors will discourage funds from including other, equally significant matters from the discussion. However, we note that the proposed amendment would require funds to "Discuss in reasonable detail the material factors and the conclusions with respect thereto that form the basis for the recommendation of the board of directors that shareholders approve the investment advisory contract." This would seem to preclude funds from omitting any material factors. However, the Commission could make the language in this section more forceful to clarify that omission of material factors is not permitted. Such language, in combination with the passage of the new record-keeping proposal, should encourage funds to include all material factors in their discussions (see Investment Company Act Release No. 26323 (Jan. 15, 2004) [69 FR 3472 (Jan 23, 2004)].

9. *If a fund's board did not rely upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, should the fund be required to disclose the reasons why the board did not do so?*

   Yes. We don't believe such comparisons should always govern the decision to approve an investment advisory contract, but we believe any responsible board would at least seek to compare the terms of the contract under consideration with relevant terms for similar funds. If a board chooses not to make such a comparison, it should state why it made that decision. The disclosure should require enough detail to be meaningful. That is, a statement such as "We did not believe the comparison would be relevant" should be deemed noncompliant unless it also stated why the comparison was thought not to be relevant.

10. *Should a fund 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?*

Yes. We believe it is incumbent on fund boards to negotiate the best terms possible for each service provided for the funds they oversee. Requiring boards to disclose whether and how they separately evaluated the amounts paid for portfolio management services and services other than portfolio management should further this goal by increasing transparency.

11. *Is there any additional relevant information that we should require funds to disclose*

The proposal only requires disclosure for a new investment advisory contract or contract renewal approved during the semiannual period covered by the report, excluding contracts approved by shareholders during the period. As noted above, we encourage the Commission to expand the proposal to require disclosure in shareholder reports of those contracts approved by shareholders during the period. We also believe that the proposed disclosure should be reproduced in each semiannual and annual shareholder report, until a new disclosure is warranted by a new approval. The disclosure should be made in a location that is consistent in every report, and clearly marked. We believe this would enable investors to locate the relevant information quickly and easily in any shareholder report, regardless of whether or not a contract had been approved in the period, thus furthering the Commission's goal of encouraging fair and reasonable fees through increased transparency. If this is not done, the absence of disclosure in periods during which the contract was not up for approval could undercut the effectiveness of the proposal by creating confusion among investors regarding which reports the disclosure appears in, and by limiting access to the disclosure to those investors who received a copy of the shareholder report for the period in which the contract was approved.

Many funds rely on comparative data based on "peer groups" of other funds to evaluate fees. These peer groups can easily be constructed in a manner that causes the comparison of the fund to the peer group to return a favorable result for the investment advisor. We therefore believe the proposal should require funds to specify the source of any comparative peer group data used in the evaluation of the contract terms. In addition, funds should be required to disclose whether the investment advisor or any of its affiliates or agents exercised any influence over the construction of fund peer groups used in any comparative analysis, regardless of the source of the peer groups. This disclosure should be accompanied by a clear description of (a) the rationale for the methodology used in constructing the peer group, (b) the rationale for permitting the investment advisor to influence its construction, and (c) how the results would have differed if the investment advisor had not participated in peer group construction.

12. *Will any of our proposed disclosure requirements have a chilling effect on boards' consideration of investment advisory contracts?*

We believe just the opposite to be true. The more disclosure is required, the more pressure there should be on boards to negotiate the best possible contractual terms for their funds, causing them to engage all the more vigorously in the process.

13. *What should the compliance date for the amendments be?*

We do not have a strong opinion regarding the compliance date, but we encourage the Commission to require compliance as soon as is deemed practical. We see no reason why the proposed disclosure shouldn't be mandatory in all relevant documents filed with the SEC after December 31, 2004, at latest.