April 26, 2004

Securities and Exchange Commission
c/o Jonathan G. Katz
Secretary
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-08-04; Comments on Proposed Rules Concerning Evaluation and Approval of Investment Advisory Contracts

Ladies and Gentlemen:

We appreciate the opportunity to comment on behalf of Wellington Management Company, LLP ("Wellington Management") and Grantham, Mayo, Van Otterloo & Co. LLC ("GMO") with respect to proposed rule and form amendments (collectively, the "Proposed Rules") described in Securities Act Release No. 33-8364 dated February 11, 2004 (the "Proposing Release").[1]

INTRODUCTION

The Commenting Parties. Wellington Management is a privately owned investment advisory firm registered as such under the Investment Advisers Act of 1940 (the "Advisers Act"), providing investment services to investment companies, employee benefit plans, endowments, foundations and other institutions. As of February 29, 2004, Wellington Management had investment management authority with respect to approximately $412 billion in assets. While Wellington Management is not a sponsor of

[1] The Proposing Release is also designated as Securities Exchange Act Release No. 49219 and Investment Company Act Release No. 26350.

any registered investment company, Wellington Management provides investment advisory services to registered investment companies sponsored by third parties. As of February 29, 2004, Wellington Management provided these services to approximately 175 registered investment companies with approximately $210 billion in assets.

GMO is also a privately owned investment adviser registered as such under the Advisers Act, providing investment services to investment companies, employee benefit plans, endowments, foundations and other institutions. Founded in 1977, GMO had investment authority with respect to over $60 billion in assets as of March 31, 2004. GMO is the sponsor of a registered investment company, GMO Trust,[2] which is used primarily by and for its institutional clients. However, GMO also provides investment advisory services to third party investment companies for which it is not the sponsor, and this has become an increasingly important business for GMO. For example, between 2002 and 2003, GMO's revenues from such services doubled.

Summary of Comments; Organization of Letter. Our principal comment is that, while we are generally supportive of the Proposed Rule, we believe it would be appropriate to require simplified disclosures rather than factors considered by fund directors in approving advisory arrangements involving investment advisers (hereinafter "Non-Sponsor Advisers") to registered investment companies that are sponsored by unaffiliated third parties.

The first section of this comment letter gives some factual background relevant to the arrangements for Non-Sponsor Advisers, including information about the robust and

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[2] Registration Nos. 811-04347 and 33-0298772.

competitive nature of this market segment. The second section proposes alternative disclosure relating to Non-Sponsor Advisers. The third section explains the legal basis for our alternative recommendation by analyzing the case law and other relevant jurisprudence under Section 36(b) of the Investment Company Act of 1940 (the "Company Act") as applied (or not applied) to Non-Sponsor Advisers, as well as jurisprudence from other areas that supports distinguishing Non-Sponsor Advisers from more traditional fund investment advisers.

I. Factual Background; Non-Sponsor Advisory Business

While the role of the Non-Sponsor Adviser can vary from fund to fund, there are certain generalities that inform our comments and, we believe, should inform the rulemaking of the Commission. In general, the services provided by a Non-Sponsor Adviser are limited to the day-to-day portfolio management of the relevant registered investment company or series thereof (hereinafter, a “fund”).[3] This means that the Non-Sponsor Adviser makes decisions for the fund about purchases and sales of portfolio securities, effects execution of these decisions, and takes primary responsibility for making sure those decisions are in compliance with the fund’s investment objectives, policies and restrictions. The Non-Sponsor Adviser is fundamentally responsible for investment performance and it is primarily on the basis of that performance, and price,

[3] In some cases, the Non-Sponsor Adviser provides these services to a discrete portion of a fund. See, generally, Rule 17a-10 under the Company Act (referring to a "discrete portion" of a fund's portfolio). For purposes of this letter the term "fund" also includes, where appropriate, such a discrete portion.

that the Non-Sponsor Adviser is retained for the relevant fund.[4] Non-Sponsor Advisers may also provide ancillary reports, such as performance attribution and portfolio management compliance reports that are incidental to its portfolio management activities. The services provided by Non-Sponsor Advisers are sometimes hereinafter referred to as "Core Advisory Services." Non-Sponsor Advisers are "affiliated persons" of a fund based solely on their status as "investment adviser" to the fund.

The role of the Non-Sponsor Adviser is defined as much by what it does do (day-to-day portfolio management) as by what it does not do. As opposed to the sponsor of the fund, a Non-Sponsor Adviser does not generally (1) impart its name to the fund, (2) have an affiliate that serves as the principal underwriter or other agent of the fund, (3) provide officers or employees to serve as directors/trustees of the fund, (4) oversee the organization, conduct and minuting of meetings of the board, including the preparation of board materials, (5) oversee the preparation of the fund's regulatory filings with the Commission (e.g., registration statements, proxies, Forms N-SAR and N-CSR, etc.), (6) coordinate the distribution of the fund's shares, (7) file tax returns for the fund or (8) oversee the transfer agency, custodial, legal and accounting services provided to the fund.

Generally, all of the services described in the prior clauses (1) through (8) (hereinafter referred to collectively as "administrative services") are provided by the fund's sponsor. In most cases the sponsor enters into an investment management agreement (a "Management Agreement") with the funds under which the sponsor or an

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[4] Obviously, when a Non-Sponsor Adviser is initially hired, the Non-Sponsor Adviser has no prior performance with the particular fund, but does have other investment performance that figures heavily in the hiring decision.

affiliate (the "Sponsor Adviser") agrees to provide both administrative services as well as Core Advisory Services, but then reserves to the Sponsor Adviser the right to hire another investment adviser -- a Non-Sponsor Adviser -- to provide the Core Advisory Services. In those circumstances, the Sponsor Adviser also agrees to oversee any Non-Sponsor Adviser and to recommend to the fund the hiring, retention and/or firing of any Non-Sponsor Adviser. In most cases, the Sponsor Adviser contracts for an all-in fee in the Management Agreement. The Sponsor Adviser then enters into a contract with the Non-Sponsor Adviser in which (1) the Sponsor Adviser agrees to pay the Non-Sponsor Adviser a fee for Core Advisory Services (but not any administrative services) and (2) the Sponsor Adviser reserves the right to terminate the Non-Sponsor Adviser.[5] The Management Agreement also usually provides that the Sponsor will provide the Core Advisory Services if the Sponsor terminates the Non-Sponsor Adviser or if, for any other reason, there is no Non-Sponsor Adviser.[6]

The market for Non-Sponsor Advisers is robust and competitive. Industry data shows, for example, that (1) long-term fund assets involving Non-Sponsor Advisers have

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[5] In some cases, the right of the Sponsor Adviser is not unilateral; it must also obtain the consent of the fund's board. Of course, the process of hiring a replacement Non-Sponsor Adviser requires board involvement since Sections 15(a) and 15(c) of the Company Act require approval of any contract with a new Sponsor Adviser by the board as a whole and by a majority of its directors who are not "interested persons" of the fund.

[6] Thus, in most cases, the Non-Sponsor Adviser serves as a sub-adviser. In some cases, the Non-Sponsor Adviser contracts directly with the fund. For example, each of GMO and Wellington Management serves as a Non-Sponsor Adviser to certain funds sponsored by The Vanguard Group, Inc. ("Vanguard") where Vanguard (the Sponsor Adviser) contracts directly with the fund to provide administrative and distribution services and the Non-Sponsor Adviser contracts directly with the fund to provide Core Advisory Services. In those cases, the business relationship of the Non-Sponsor Advisor to the fund, and in particular the services provided by the Non-Sponsor Adviser, are the same as those that would ordinarily be provided by a sub-adviser even though the Non-Sponsor Advisor is technically in privity of contract with the fund. In some cases the Non-Sponsor Adviser may also be in privity of contract with the fund for state tax and other regulatory reasons.

grown from $356 billion to $500 billion between 1998 and the end of 2003, (2) the number of portfolios involving Non-Sponsor Advisers is close to 800 and (3) Non-Sponsor Advisers now provide services to over 10% of long-term fund assets.[7] This market segment is not only substantial in its own right, its vitality introduces a critical element of competition by assuring that there is always a viable alternative to the traditional arrangements in which Sponsor Advisers also provide Core Advisory Services. And within the Non-Sponsor Adviser market segment itself there is particularly robust competition. Changes in the identity of Non-Sponsor Advisers are a sufficiently routine occurrence, for example, that a separate market has emerged for "transition managers" (e.g., Northern Trust, State Street Bank). These transition managers offer their services to a fund and its Sponsor Adviser as a way of ensuring that the transition of Core Advisory Services from one Non-Sponsor Adviser to another can be effected with minimal transaction costs, notwithstanding what is frequently a substantial reconfiguring of the portfolio in connection with the transition.[8]

Wellington Management and GMO believe this competition is a profoundly good thing for investors. In the case of funds that hire Non-Sponsor Advisers for Core Advisory Services, competition allows funds and their shareholders greater opportunities to access alternative providers of Core Advisory Services. There can also be opportunities for funds and their shareholders to secure Core Advisory Services at lower

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7 Source: Financial Research Corporation.

8 See also Investment Company Act Release No. 26230 (October 29, 2003) (the "MoM Release") n. 48 and accompanying text (changes in Non-Sponsor Advisers "not infrequent") (in the 13 month period ending October 2000, the American Skandia portfolios replaced 6 of 27 Non-Sponsor Advisers; in approximately the same period, 3 of 11 Non-Sponsor Advisers of PaineWebber PACE Select Advisors Trust were replaced).

rates than might be the case if a Sponsor Adviser provides Core Advisory Services and has the ability to discourage an active search for less costly alternatives.[9] Wellington Management and GMO both welcome this competition because they are positioned to succeed in a market less burdened by the rigidities inherent in traditional, captive arrangements. Wellington Management and GMO also believe this competition should be embraced by the Commission, both because of the direct impact it has on funds hiring Non-Sponsor Advisers for Core Advisory Services, but also because of the indirect impact competition will have on funds where Sponsor Advisers currently provide Core Advisory Services. As noted above, we believe that the emergence of this robust and competitive market among Non-Sponsor Advisers for Core Advisory Services should, on the margin, provide a viable alternative when a fund's directors conclude that the status quo involves substandard investment performance by a Sponsor Adviser and/or higher fees for Core Advisory Services.

The competition in the Non-Sponsor Adviser segment of the investment advisory business is a function of a number of factors, including (1) the relative operational ease with which the Sponsor Adviser can replace a Non-Sponsor Adviser, given continuity in the provision of administrative services,[10] (2) the absence of any institutional bias in favor of the Non-Sponsor Adviser, given the lack of representation of the Non-Sponsor

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[9] "Negotiations between the unaffiliated directors and fund advisors [affiliated with the principal underwriter and providing virtually all non-advisory services] over advisory fees would lack an essential element of arm's-length bargaining - the freedom to terminate the negotiations and to bargain with other parties for the same services." Report of the Securities and Exchange Commission on the Public Policy Implications of Growth, H.R. Rep. No. 2337, 89th Cong., 2nd Sess., 131 (1966) ("SEC Report")

[10] Cf. SEC Report (maintenance of records by Sponsor Adviser "as a practical matter . . . seriously hamper[s]" steps to lessen the adviser's operation or control of the fund).

Adviser on the board of the fund and (3) the fact that the fund is branded by, and associated with, the Sponsor Adviser--but not the Non-Sponsor Adviser--in the promotion of the fund.

All of these competitive factors are present, for example, in the emerging "open architecture" and/or "manager of managers" products in which a Sponsor Adviser promotes its own ability to identify and employ the "best in breed" Non-Sponsor Advisers on behalf of the fund.[11] These products have frequently sought and received the imprimatur of the Commission in exemptive orders allowing, inter alia, the replacement of Non-Sponsor Advisers without the fund shareholder approval that would otherwise be required under Section 15(a) of the Company Act.[12] Those orders have not only reduced procedural transaction costs associated with shareholder meetings, they have recognized and promoted price competition by allowing the funds to omit from their disclosure documents information about the fees paid to the Non-Sponsor Advisers.[13] To date, there have been over 100 manager of managers orders granted[14] and this emerging "open architecture"/"manager of managers" practice has been sufficiently widespread that the

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[11] "Open architecture" is a term used to connote access to non-proprietary Core Advisory Services and seems to be used, in particular, in the context of funds that support variable annuity and variable life insurance contracts. "Manager of managers" is a term used to emphasize that the principal adviser (the Sponsor Adviser) will use its best judgment, without regard to affiliation, in selecting investment advisers (Non-Sponsor Advisers) to provide Core Advisory Services.

[12] See, e.g., Hillview Investment Trust II (Investment Company Act Release Nos. 24853 (notice) and 25055 (order)); Sun Capital Advisers Trust (Investment Company Act Release Nos. 24368 (notice) and 24401 (order)).

[13] The exemptions have typically provided relief from the requirements of Item 15(a)(3) of Form N-1A, Item 48 of Form N-SAR, Item 22(c) of Schedule 14A under the Securities Exchange Act of 1934 and Rule 6-07 of Regulation S-X. See, e.g., Endeavor Series Trust, Investment Company Act Release Nos. 24054 (notice) and 24108 (order) and Frank Russell Investment Company, Investment Company Act Release Nos. 21108 (notice) and 21169 (order).

[14] MoM Release, n. 5.

Commission has proposed an exemptive rule to codify these exemptive orders as a way of promoting further competition among Non-Sponsor Advisers.[15]

The competition among advisers in open architecture/manager of manager situations and all other situations involving a Non-Sponsor Adviser reflects the fact that the relationship between the Sponsor Adviser and the fund, on the one hand, and the Non-Sponsor Adviser, on the other, is a truly arm's-length relationship. As the Commission stated in the MoM Release, the proposed exemptive rule "[relies] on the principal adviser, negotiating with each sub-adviser on an arm's-length basis and subject to the approval of the fund's boards, to determine the terms of the sub-advisory contract, including the amount of the sub-adviser's fee."[16] This is in vivid contrast to the situation involving the more traditional sponsored fund complex where the fund relies on administrative services and distribution services provided by the Sponsor Adviser and its affiliates, and where personnel of the Sponsor Adviser generally serve on the fund's board. It is that contrast between captive and arm's-length relationships that is the defining feature of a fund's relationship with a Non-Sponsor Adviser -- and that is the touchstone for our alternative proposal.

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[15] See generally, MoM Release (proposing Rule 15a-5 and amendments to various disclosure documents) (describing a "principal adviser" that, like a Sponsor Adviser: hires, supervises and, when appropriate, discharges subadvisers (text at n. 4); negotiates with the subadvisers "on an arm's length basis" (p. 6); enters into subadvisory contracts "terminable at any time by the principal adviser" (p. 8); selects sub-advisers "on the basis of the sub-adviser's performance, rather than on the basis of other business relationships" (p. 9); and is not affiliated with the subadviser (proposed Rule 15a-5(a)(2)(i)) (fund name could not contain a sub-adviser's name unless the name of the principal adviser precedes the subadviser's name).

[16] Id. at p. 6 (emphasis added).

II. Alternative Proposal

As indicated above, we are generally supportive of the Proposed Rule. We believe that the proposed disclosure can offer greater reassurance to the investing public in the context of Sponsor Advisers.[17] With respect to Non-Sponsor Advisers, however, we would respectfully request that the Commission adopt an alternative: that the relevant disclosure document disclose that the fund's board of directors has found (based on a certification of the Non-Sponsor Adviser or otherwise) that the arrangement with the Non-Sponsor Adviser is the result of arm's-length bargaining.[18]

We believe that this alternative is consistent with the fact that a fund board and the Sponsor Adviser have every incentive to seek the best combination of lower fees and better Core Advisory Services – to improve performance and, in the general case of the Sponsor Adviser, to reduce expenses[19] -- and that as a result the Non-Sponsor Adviser arrangements are in fact negotiated at arm's-length. In such instances, the purpose of the proposed disclosure -- to remind the board of its duty to evaluate on an arm's-length basis -- has already been achieved. In that case, no additional purpose is served by requiring

[17] GMO, in particular, is prepared to step up to the additional disclosures that would be required in the context of its proprietary funds, GMO Trust.

[18] In the alternative, the Commission could provide an exception to the proposed disclosure requirements for Non-Sponsor Advisers or restrict the mandatory factors disclosed to those that go into an arm's-length negotiation (i.e., relative performance of Core Advisory Services and the fees of the Core Advisory Services relative to the fees at which another investment adviser would be willing to provide comparable Core Advisory Services). MoM Release at pp. 7 and 9. In any case, the point we are making is that a good deal of the disclosure relevant and appropriate for Sponsor Advisers is inapposite in the context of Non-Sponsor Advisers.

[19] In those cases where a Non-Sponsor Adviser is in privity of contract with the fund, of course, the Sponsor Adviser does not reduce its expenses when fees for Core Advisory Services are reduced. See n. 6 supra.

disclosure of the factors[20] -- and some significant and undesirable costs may arise. First and foremost, additional disclosure may confuse investors both because of sheer volume, but also because that disclosure may imply to the investor that a board's evaluation of Non-Sponsor Advisers is the same as the review for Sponsor Advisers. Indeed, the risks of redundancy and confusion will be particularly acute where all of the factors (including profitability and price) will already be disclosed for the Sponsor Adviser. Second, if funds must disclose fees paid to Non-Sponsor Advisers, Non-Sponsor Advisers may be reluctant to offer discounts in their standard fee rates.[21] This will dampen competition both in the Non-Sponsor Adviser market segment and in the more general market for Core Advisory Services. Third, as noted above, both our firms are privately owned. The profitability of our firms is confidential, as is one of the most important profitability components -- the compensation of our investment advisory personnel. Wholly apart from the difficulties of calculating profitability,[22] we believe that the publication of that profitability will create a disincentive for our firms to compete against other firms for Non-Sponsor Adviser engagements and, depending on the specificity of disclosure -- which is wholly outside the control of the Non-Sponsor Adviser – may, over the long term, cause talented investment advisory personnel to work at other firms not providing investment advisory services to funds. It may also discourage other private firms from

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[20] Of course, consistent with Section 15(c) of the Company Act, every investment adviser (including a Non-Sponsor Adviser) would still have a duty to furnish, and the directors would still have a duty to request and evaluate, "such information as may reasonably be necessary to evaluate the terms of [the advisory] contract." The relevant information would be a function of the particular circumstances.

[21] See MoM Release, text accompanying n. 21.

[22] See, e.g., Schuyt v. Rowe Price Prime Reserve Fund, Inc., 633 F. Supp. 962 (S.D. N.Y. 1987) ("Schuyt"); Krinsk v. Fund Asset Management, Inc., 715 F. Supp.. 472, 489 (S.D.N.Y.) (apportionment of money market costs "is an art rather than a science").

entering the Non-Sponsor Adviser marketplace for Core Advisory Services. Thus, in addition to the costs of disclosure confusion, the Proposed Rules, if applied to Non-Sponsor Advisers, could have the opposite effect of what is intended -- the Proposed Rules would reduce the competition for Core Advisory Services in a segment of the market -- open architecture/manager-of-managers products -- that is truly competitive in offering superior Core Advisory Services and/or reduced prices for those Core Advisory Services. By reducing competition, the Commission would actually be causing a step back from the arm's-length negotiations that are the ideal the Commission is holding up to fund boards.[23]

III. Relevant Case Law Dealing with Sponsor Advisers and Other Jurisprudence

The Proposed Rules are disclosure rules. However, representatives of the Commission's staff have indicated that the Proposed Rules are being advanced, in part, to achieve the substantive result of encouraging the boards of funds to take a more active role in the evaluation and approval of investment advisory contracts,[24] and to do so in conformity with standards articulated by the courts in case law developed under Section

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[23] As indicated above at n.[18], at a minimum we would suggest that the mandatory factors in the Proposed Rules should be tailored for Non-Sponsor Advisers. We believe shareholder confusion could be limited and the anti-competitive impact on this market segment might be ameliorated if the Commission were to make it clear that the mandatory board factors need not include either (1) the actual fees charged by the Non-Sponsor Affiliate and its competitors or (2) the profitability to the Non-Sponsor Affiliate from the relationship. The Commission has already found it to be in the public interest to treat as confidential the fees paid to Non-Sponsor Advisers (see note 13 supra) and we submit that no statutory goal would be furthered and no fiduciary duty served by the disclosure of profitability where the negotiation involves no conflict but is instead conducted at arm's-length.

[24] See Remarks of Paul Roye, Director, SEC Division of Investment Management, in Palm Desert, CA, on March 22, 2004 at the 2004 Mutual Funds and Investment Management Conference.

36(b) of the Company Act.[25] While in this context we understand the Commission's decision to use disclosure requirements to achieve substantive regulation, it is important to be certain that the substantive regulation is tailored to the specifics of the situation. For the reasons set forth above, we do not believe that the substantive regulation should extend to Non-Sponsor Advisers with respect to Core Advisory Services. As the Proposed Rules explicitly build on the case law under Section 36(b), we believe it is appropriate to review that jurisprudence briefly for purposes of pointing out the extent to which that jurisprudence is either distinguishable or inapposite as it relates to a Non-Sponsor Adviser.

Case Law Under Section 36(b) of the Company Act. The Proposing Release cites to Gartenberg, a case in which shareholders of a money market fund brought actions against the fund, the fund's adviser and an affiliated broker claiming that the compensation received by the adviser was so disproportionately large as to constitute a breach of the adviser's fiduciary duty under Section 36(b) of the Company Act. In evaluating the reasonableness of the adviser's fee, the court developed a multi-factor analysis, reviewing (1) the adviser's cost in providing the service, (2) the nature and quality of the service, (3) the extent to which the adviser realized economies of scale as the fund grew larger, (4) rates charged by other advisers to similar funds, and (5) any fall-out benefits gained by the adviser and its affiliates. The Proposed Rule would require that funds include in their disclosure documents a discussion of

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[25] See, e.g., Proposing Release n. 34 and accompanying text (noting that the specific board factors required to be disclosed under the Proposed Rules are drawn from Gartenberg v. Merrill Lynch Asset Management Inc., 694 F.2d 923 (2nd Cir. 1982) (hereinafter "Gartenberg"); and Proposing Release n. 13 and accompanying text (referencing Burks v. Lasker, 441 U.S. 471 (1979) (hereinafter "Burks v. Lasker")).

> "factors relating to both the board's selection of the investment adviser and approval of the advisory fee and any other amounts to be paid by the Fund under the contract. This would include, but not be limited to, a discussion of the nature, extent, and quality of the services to be provided by the investment adviser; the investment performance of the Fund and the investment adviser; the costs of services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the Fund; the extent to which economies of scale would be realized as the Fund grows; and whether fee levels reflect these economies of scale for the benefit of Fund investors."[26]

The Proposing Release underscores that "the fund would be required to include a discussion including, but not limited to" those factors.[27]

The similarity of the factors in the Proposed Rules to the factors in Gartenberg (the "Gartenberg Factors") is intentional; they are taken directly from Gartenberg and its progeny. But, **Gartenberg and all subsequent reported cases under Section 36(b) deal with fees paid to Sponsor Advisers - not Non-Sponsor Advisers.** Gartenberg involved Merrill Lynch Asset Management (the Sponsor Adviser) and the Merrill Lynch Ready Assets Trust; Schuyt involved T. Rowe Price Associates, Inc. (the Sponsor Adviser) and Rowe Price Prime Reserve Fund, Inc.; Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), involved Franklin Advisers, Inc. (the Sponsor Adviser) and Franklin Custodian Funds, Inc. U.S. Government Securities Series; and Kamen v. Kemper Financial Services, Inc. 659 F. Supp. 1153 (N.D.Ill 1987), involved

[26] See, e.g., proposed Item 12(b)(10)(i) of Form N-1A (emphasis added).
[27] Proposing Release at p.5 (emphasis added).

Kemper Financial Services, Inc. (Sponsor Adviser) and its money market fund. None of these cases involved a Non-Sponsor Adviser.[28]

Indeed, to our knowledge, there is not one reported case under 36(b) involving a Non-Sponsor Adviser. Rather, the Gartenberg analysis and decision were based on the reality of the Sponsor Adviser's special influence – what the court referred to as the "unseverable relationship between the adviser-manager and the fund it services"[29] -- that arises when the Sponsor Adviser provides not only the Core Advisory Services but also the administrative services and when an affiliate of the Sponsor Adviser acts as principal underwriter. This "unseverable relationship" caused the Gartenberg court (1) to reject, explicitly, the idea that competitive fee rates, alone, should be the basis for evaluating the reasonableness of fees under Section 36(b), (2) to develop the Gartenberg Factors as a framework for judicial review and (3) to articulate the ultimate standard for review: whether the fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[30] We submit that because a Non-Sponsor Adviser, by definition, lacks any special

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[28] Other cases include Migdal v. Rowe Price-Fleming International, Inc. 248 F.3d 321 (4th Cir. 2001); Krinsk; Meyer v. Oppenheimer Management Corp., 707 F. Supp. 1394 (S.D.N.Y. 1988); and Strougo v. BEA Associates, 188 F. Supp. 2d 373 (S.D.N.Y. 2002).

[29] Gartenberg at p. 929. See also id. at p. 928 (traditional relationship "potentially incestuous") ("The Senate recognized that as a practical matter the usual arm's length bargaining between strangers does not occur between an adviser and the fund, stating: 'Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.' S.Rep. No. 91-184, *supra*, [1970] U.S. Code Cong. & Ad. News at 4901.")

[30] Gartenberg at p. 928.

influence over the fund board -- because its relationship to the fund is hardly "unseverable" -- the Gartenberg Factors used by the courts and the effectively identical factors in the Proposed Rule are substantially less compelling -- indeed they are an unnecessary factor in the board's deliberations.

To put it another way: the fees of the Non-Sponsor Adviser are not just theoretically in the range of what could have been the result of arm's-length negotiation, they are in fact the actual result of arm's-length negotiations.[31] In most cases, the fee paid to the Non-Sponsor Adviser comes out of the revenues of the Sponsor Adviser -- and even where the fee of the Non-Sponsor Adviser comes from the fund, it is the Sponsor Adviser that drives the process of selecting, evaluating and terminating Non-Sponsor Advisers.[32] Matters such as the profitability of the Non-Sponsor Adviser are really irrelevant to the fund board as a matter of substance and particularly confusing to investors.[33]

The Proposing Release also cites Burks v. Lasker, a case in which the court was called upon to evaluate whether a fund's disinterested directors could terminate a shareholders' derivative suit brought against the other directors. In concluding that Congress entrusted to a fund's independent directors the primary responsibility for looking after the interests of a fund's shareholders, the Court made the oft-repeated observation that the independent directors of a fund serve as "watchdogs," and the

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[31] See MoM Release at p. 6.
[32] Id. at p. 7. Cf. note 6 supra.
[33] See Gartenberg at p. 933 (shareholders were told that the trustees "who were the shareholders' watchdog representatives" had considered relevant information; "since the trustees have the primary responsibility under the [Company] Act, §36(b) does not mandate that the Fund shareholders be furnished with additional information . . ..").

Proposing Release cites the statement in the court's opinion that “Congress consciously chose to address the conflict-of-interest problem through the [Company] Act’s independent-directors section.”[34] Again, however, the rationale supporting this jurisprudence is just not applicable to the Non-Sponsor Adviser. There is no conflict of interest between the fund and its board, on the one hand, and the Non-Sponsor Adviser, on the other, because the Non-Sponsor Adviser has no representatives on the board. With respect to the risk of excessive fees, even directors that are “interested persons” of the Sponsor Adviser have no interests that would favor a higher cost Non-Sponsor Adviser over a cheaper one.[35] While the Sponsor Adviser may have a conflict that would lead in the opposite direction (e.g., a desire to hire a sub-par Non-Sponsor Adviser at a lower cost in order to retain more of the Sponsor Adviser’s fee) if the Sponsor Adviser pays the Non-Sponsor Adviser,[36] there is no need for the independent directors, in particular, to be “watchdogs” in respect of excessive Non-Sponsor Adviser fees. All of the directors should have the same, unconflicted interest in lower fees.[37]

We note that our discussion of Gartenberg and Burks v. Lasker is not intended as a wholesale rejection of Section 36(b) of the Company Act as applied to Non-Sponsor Advisers -- nor could it. Section 36(b) by its terms imposes a “fiduciary duty” on all investment advisers to mutual funds. But as Justice Frankfurter put it, “to say that a man is a fiduciary only begins the analysis”[38] because the responsibilities of the fiduciary vary

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34 Proposing Release at n. 13.

35 As we have noted, no director would be an "interested person" as a result of any relationship with the Non-Sponsor Adviser. See also the formulation in Rule 17a-10(a)(1) of "prohibited relationships."

36 See note 6 supra.

37 See MoM Release at p. 7.

38 SEC v. Cheney Corp., 318 U.S. 80 (1943), 85.

depending on the influence that the fiduciary has over the beneficiary, the relative knowledge and experience levels of the fiduciary and the beneficiary, and the discretion of the fiduciary.[39] A nominee, for example, is a fiduciary but has naked title and no discretion. At the other end of the spectrum, a common law trustee has possession of, and unfettered access to, the beneficiary's property and broad powers to deal in that property with third parties. The equitable owner fully intends to direct his or her nominee, whereas a trust beneficiary (e.g., a minor) may or may not be capable of exercising effective oversight of the common law trustee. What we are suggesting is that the "fiduciary duty" referred to in Section 36(b) is less acute for Non-Sponsor Advisers than for Sponsor Advisers because of the absence of conflicts and the competitive marketplace for Non-Sponsor Advisers. Consequently Non-Sponsor Advisers' fees are not what "could" have been the result of arm's-length negotiation, these are <u>in</u> <u>fact</u> the result of arm's-length negotiation. We believe this crucial difference supports our position: that the Proposed Rules should offer, as an alternative, disclosure of a finding by the fund's board that the approval of investment advisory contracts for Non-Sponsor Advisers have in fact been negotiated at arm's-length.

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[39] <u>See</u>, <u>generally</u>, Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795 (1983).

Other Relevant Jurisprudence. Other jurisprudence supports the proposition that arrangements involving Non-Sponsor Advisers should, as a matter of law, be treated differently from those involving Sponsor Advisers. This jurisprudence includes ERISA as well as positions of the Commission and its staff under the Company Act. We summarize these bodies of law below.

ERISA. In a number of instances, the Employee Retirement Income Security Act of 1974 ("ERISA") takes the position that a fiduciary or other "party-in-interest" may act vis-à-vis a pension plan as would a third party so long as the beneficiary has the benefit of the judgment and independence of another fiduciary. The broadest application of this principle is found in Prohibited Transaction Class Exemption 84-14, which exempts the investment decisions of a "qualified professional asset manager" (or QPAM) from certain party-in-interest prohibitions so long as, among other things, the QPAM is not a "related party" of the party-in-interest and so long as the party-in-interest does not have the power to appoint or terminate the QPAM. PTCE 84-14 was based on the "essential premise that broad exemptive relief … can be afforded to all types of transactions … if the commitments and investments of plan assets and the negotiations leading thereto are the sole responsibility of an independent investment manager."[40] Similarly, in the case of Core Advisory Services provided by Non-Sponsor Advisers, negotiations leading to the hiring, retention and/or dismissal of the Non-Sponsor Adviser are conducted by an "independent investment manager" – the Sponsor Adviser – and the fund board. The Sponsor Adviser has been hired by the fund precisely because of its expertise in

[40] CCH Pension Plan Guide, ¶16, 628 at p. 19,959.

evaluating Non-Sponsor Advisers and, for the reasons indicated above, has every incentive to serve the fund faithfully in this regard.

ERISA Prohibited Transaction Class Exemption 77-4 also acknowledges that greater flexibility is appropriate where a second fiduciary is involved in evaluating what might otherwise be prohibited per se as a party-in-interest transaction. PTCE 77-4 allows an adviser to a pension plan to place the assets of the plan in a registered investment company for which the plan adviser serves as investment adviser. The class exemption even admits of the possibility that the total expenses to the plan, and revenues to the adviser, could increase.[41] But the exemption is subject to the same safeguards -- the use of the mutual fund must be approved by an independent fiduciary.[42] Thus, the strictest of fiduciary standards -- and in many respects ERISA is even stricter than, for example, the Company Act[43] -- are inapplicable where a second fiduciary evaluates the terms of the arrangement. Once again, we believe that similar facts are present in Non-Sponsor Adviser arrangements and that the new disclosure in the Proposed Rules should have conforming modifications where the Sponsor Adviser and the board are negotiating the Non-Sponsor Adviser arrangements at arm's-length.

Company Act. Finally, the Commission and its staff have also recognized the distinction between a Sponsor Adviser and a Non-Sponsor Adviser in a number of instances and in all these contexts, we submit, the critical element is the degree of

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[41] See PTCE 77-4, paragraph (c) (condition that fees not paid by plan on amounts invested in mutual fund; does not preclude investment in mutual fund with higher fees).
[42] Id., paragraph (d).
[43] Compare, e.g., Rule 17a-7 under the Company Act with the Department of Labor position that ERISA prohibits cross trading among ERISA accounts.

influence -- perhaps even control -- exercised by a Sponsor Adviser with respect to the funds for which it provides administrative services and the total lack of influence or control exercised by the Non-Sponsor Adviser. Thus, in the case of funds with more than one Non-Sponsor Adviser, the Commission, in Rule 17a-10, felt it would be appropriate to exclude from the prohibitions on affiliated principal transactions -- one of the elemental provisions of the Company Act -- transactions where the affiliated person (or affiliated person of the affiliated person) has no relationship with the subadviser responsible for that "discrete portion" of the fund's portfolio entering into the transaction. The Commission was building on many exemptive orders in which the subadviser was implicitly found to have had little or no control over the funds they advised.[44] As the Commission very directly put it: "Ordinarily a subadviser has little power to overreach those funds, or portions of a fund, with which it is affiliated but which it does not advise."[45]

Rather than belabor this point, we identify below additional examples of the differentiated treatment for Non-Sponsor Advisers as further support for the proposition that distinctions between Sponsor Advisers and Non-Sponsor Advisers have ample precedent and should be applied in the context of the Proposed Rules.

- The exemptive orders forming the basis for proposed Rule 15a-4 (the manager-of-managers rule) distinguish Non-Sponsor Advisers

[44] Release No. IC-25557 (April 30, 2002) (proposing Rule 17a-10 and other exemptive rules) at note 41 and accompanying text.
[45] Id.

for purposes of the shareholder approval otherwise required under Section 15(a) of the Company Act;

- The Salomon Brothers, Inc. no-action letter (p.a.d, May 26, 1995) allowing certain affiliated party transactions, notwithstanding Section 17(a) of the Company, where the Salomon entity serving as a Non-Sponsor Adviser averred that it did not control the relevant fund (and the staff, without agreeing, did "note that, given its limited role in the management of a Fund's operations, a sub-adviser would be less likely to control a fund than its adviser");

- The adopting release for Rule 0-1(a)(6) under the Company Act (defining "independent legal counsel") in which the Commission clearly contemplated that providing legal services for a Non-Sponsor Adviser would be less of an impediment to a board's finding of independence than similar legal services performed for a Sponsor Adviser; [46] and

- Regulation S-X, Rule 2-01 (defining auditor independence) which in paragraph f(14)(ii) specifically carves out from the per se bar, ordinarily arising when certain services are provided to a Sponsor Adviser, the provision of those same services by the accounting

[46] Investment Company Act Release No 24816 (January 2, 2001) at 11 (indicating that directors could "differentiate" between a sponsor and a sub-adviser by "giv[ing] consideration to the nature of a sub-advisory relationship:).".

firm to "a subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser" (i.e., a Non-Sponsor Adviser).

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Summary. Both Wellington Management and GMO are generally supportive of the Proposed Rules. We believe, however, that, with respect to Non-Sponsor Advisers, the Proposed Rules should be modified so that, instead of requiring disclosure of all the factors weighed by the fund's board in evaluating the arrangements with Non-Sponsor Advisers, the board could instead simply report its finding that the arrangements were negotiated at arm's-length. We believe this alternative offers a meaningful opportunity to sustain a robust and competitive market among Non-Sponsor Advisers that should directly benefit all funds with Non-Sponsor Advisers and indirectly benefit all funds whose Core Advisory Services are provided by Sponsor Advisers. We submit that this alternative will minimize potentially confusing disclosure. The alternative finds solid support in the Section 36(b) case law that is the basis for the Proposed Rules. And we believe that the distinction between the influence and control of a Sponsor Adviser, on the one hand, and the arm's-length arrangements with Non-Sponsor Advisers, on the other, resonates with numerous other regulations, exemptions and interpretations under the Company Act and even the ordinarily stricter Employee Retirement Security Act of 1974.

We appreciate the consideration given to this letter and look forward to working with the Commission and its staff if or when final rules are adopted.

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