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A legal update from Dechert's Financial Services Group

# SEC Adopts Amendments Expanding Disclosure Regarding Approval of Fund Investment Advisory Contracts

## Introduction

The Securities and Exchange Commission (the "SEC") adopted amendments to certain fund disclosure rules and forms (the "Amendments") under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, as amended (the "Investment Company Act"). These Amendments require registered open- and closed-end investment companies ("funds") to disclose additional information regarding the process by which a fund's board of directors/trustees (the "board") evaluates and approves the fund's investment advisory contracts.[1] Specifically, the Amendments mandate that funds:

- describe in their shareholder report the material factors and conclusions that formed the basis for the board's approval of any new investment advisory contract as well as any contract renewal, including subadvisory contracts, in the most recent fiscal half-year;
- include in their prospectus a statement informing shareholders that a discussion regarding the board's basis for approving any investment advisory contract is available in the fund's annual or semi-annual report to shareholders, as applicable;
- describe in their proxy statements with greater detail than previously required the basis for the board's proposal that shareholders approve an advisory contract; and
- have the principal executive and financial officers certify the description of the board's evaluation process based on their knowledge.

The Amendments require the board to make material disclosure in shareholder reports, in reasonable detail, even for the renewal of contracts approved by shareholders. The Amendments remove the existing requirement for disclosure in the Statement of Additional Information (the "SAI") of Forms N-1A, N-2, and N-3 with respect to the board's approval of any existing investment advisory contract in favor of requiring enhanced disclosure in shareholder reports and in proxy statements. The effective date of the Amendments is August 5, 2004; however, the Amendments are applicable with respect to board approvals of investment advisory contracts occurring on or after October 1, 2004, as discussed in greater detail under "Compliance Dates."

## Rules and Form Amendments to Enhance Disclosure

The Amendments enhance existing proxy statement and shareholder report disclosure

[1] *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, Release No. IC-26486 (June 23, 2004) (the "*Adopting Release*") available at http://www.sec.gov/rules/final/33-8433.htm.

requirements and require for the first time disclosure in shareholder reports regarding investment advisory contract approvals. The Amendments clarify and reinforce a fund's obligation to disclose, in reasonable detail, the material factors and conclusions that formed the basis for board approvals of any new or renewed investment advisory contracts, including subadvisory contracts. The Amendments are intended to provide timely information for shareholders and to encourage funds to provide more meaningful explanations. The SEC believes this will in turn encourage boards, and investors, to more carefully consider the costs and value of the services rendered by a fund's investment adviser. The Amendments were adopted substantially as proposed, with some modifications to address commenters' concerns.

**Differences from the Proposal**

The Amendments require that fund shareholder reports disclose all advisory contracts approved by the board during the most recent fiscal half-year.[2] The proposal originally excluded from the disclosure requirement any contract already approved by shareholders. The SEC concluded that comprehensive disclosure would better enable shareholders to remain up-to-date on advisory contract approvals, regardless of whether they received information regarding the approval of the contract during the fund's most recent fiscal half-year. The SEC noted that the boards have the same duty with respect to approval of an advisory contract, whether or not it is also approved by shareholders.

As a result of the inclusion of the disclosure in shareholder reports, the principal executive and financial officers will have to certify the description of the board's evaluation process based on their knowledge. (See "Practical Considerations for Implementation" for more information.)

The Amendments remove existing requirements for disclosure in the SAI of Forms N-1A, N-2, and N-3 with respect to board approval of existing investment advisory contracts. Once a fund begins disclosing in a manner consistent with the Amendments, it may remove the duplicative information previously required to be included in the SAI.

The Amendments require a fund prospectus to state that a discussion regarding the board's basis for approving any investment advisory contract can be found in the fund's annual or semi-annual report to shareholders, as applicable. This disclosure must appear adjacent to pre-existing prospectus disclosures regarding the fund's investment adviser. This disclosure must indicate the dates covered by the relevant shareholder report so that investors can easily request the appropriate report.

The Amendments also add an additional requirement to the specific factors the SEC requires a board to cover in its disclosure (the factors are listed below). That is, if any of the enumerated factors is irrelevant to a board's evaluation of an investment advisory contract, the disclosure must explain the reasons that factor was not considered relevant by the board.

**Selection of Adviser and Approval of Advisory Fee**

The Amendments require a fund to discuss both the board's selection of an investment adviser and its approval of the advisory fee and any other amounts to be paid under the advisory contract. The Adopting Release states that while the SEC does not expect a fund board to replace investment advisers routinely, the board does have a duty to monitor the adviser's performance under the contract, and to consider replacing the adviser if necessary. In the opinion of the SEC, the board's decision to renew an investment advisory contract constitutes the selection of an investment adviser.

**Factors to Be Addressed**

The fund's discussion of factors must state how the board evaluated each factor as it relates to the specific circumstances of the fund and the investment advisory contract. It is not sufficient for a board to state that it considered the amount of a fee without also stating its conclusion about the fee and how the fee affected the determination that the contract should be approved.

At a minimum, funds will be required to include a discussion of the following factors:

- 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 the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund;

[2] If the board approved a contract during the first half of a fiscal year, the disclosure would be required in the semi-annual report for the period but would not need to be repeated in the annual report. *Adopting Release* at 4.

- the extent to which economies of scale would be realized as the fund grows;
- whether fee levels reflect these economies of scale for the benefit of fund investors; and
- whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts (as further described below in "Comparison of Fees and Services Provided by Adviser").

In the Adopting Release, the SEC stated that it would be difficult for a board to reach a final conclusion as to whether to approve an advisory contract without reaching conclusions as to each material factor that forms the basis for the board's approval.[3]

As mentioned above, a fund is required to discuss its evaluation of each of these factors. Therefore, when a particular enumerated factor is inappropriate for consideration by a fund, the fund must include a discussion as to why that factor is not suitable for consideration by the board. The board may then include other factors so long as it discloses why it found them appropriate for consideration.

The Amendments do not require the board to disclose the amount of the fee paid to an unaffiliated subadviser if that information is not otherwise required to be disclosed. Manager of manager funds that are otherwise not required to disclose separately the fee paid to each subadviser face no requirement to disclose the fee. Further, with regard to costs and profits, disclosure of specific proprietary information about the operating costs and profits of the investment adviser and its affiliates is not necessary to meet the requirement of the amendment.

**Comparison of Fees and Services Provided by Adviser**

A fund's discussion must indicate whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts. These other contracts could pertain to the same or other investment advisers and could include contracts from other types of clients, such as pension plans and other institutional investors. If a board indicates that it relied upon a particular comparison, it will need to describe that comparison and how the comparison assisted the board in concluding the contract should be approved.

[3] *Adopting Release* at 8.

The Amendments do not require an enumeration of the types of comparisons the board did not use, such as comparison with pension funds and other institutional clients.

## Compliance Dates

The compliance dates regarding the enhanced disclosure requirements are as follows:

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| **Effective Date of Rule and Form Amendments:** | **August 5, 2004** |
| **Effective Date for Advisory and Subadvisory Contract Approvals:** | **All Board Approvals on or after October 1, 2004** |
| **Compliance Date for Shareholder Report Disclosure:** | **Reports for Fiscal Periods Ending on or after March 31, 2005[4]** |
| **Compliance Dates for Proxy Statement Disclosure:** | **Proxy Statements filed on or after October 31, 2004** |
| **Compliance Date for Form N-1A, N-2, and N-3 Amendments:** | **January 31, 2006[5]** |

## Practical Considerations for Implementation

The Amendments require that boards provide much more detail than previously required regarding their consideration of investment advisory contracts, and that the disclosure be included in shareholder reports certified by the fund's chief executive and financial officers. Therefore, not only will disclosure need to be

[4] The SEC selected the March 31, 2005 date so a fund will only need to comply with the new disclosure requirements prospectively. A board will need to begin the practice of disclosure with respect to board approvals occurring on or after October 1, 2004. The SEC noted that it will take time for a board to update recordkeeping procedures in light of the new disclosure requirements and to determine whether additional procedures for board approval are needed to enable the principal executive and financial officers to certify the disclosure.

[5] The Amendments remove the current SAI disclosure requirement with respect to the board's approval of any existing investment advisory contract. By January 31, 2006, every fund should have begun providing disclosure in its shareholder reports regarding the board's decision to approve the fund's investment advisory contract, making these disclosures duplicative. Prior to January 31, 2006, a fund may omit disclosure in its SAI as soon as it provides the required disclosure with respect to that board approval in a shareholder report.

more tailored, but funds also will need to carefully review and re-evaluate the process by which the board reviews advisory contracts.

The following are some practical considerations that should be addressed in implementing the Amendments:

- Prepare an action plan and develop a board education program over the upcoming months. Discuss the new requirements with the board and the impact on the contract review process. Determine whether the existing schedule for contract review should be re-evaluated.

- Review the information requested from the fund's investment adviser for purposes of the board's review in accordance with Section 15(c) of the Investment Company Act. Determine whether the questions elicit information with sufficient specificity in order for the board to be able to describe in detail its consideration of each of the factors required by the Amendments. The new disclosure should avoid any "boiler-plate" and conclusory statements.

- Involve the lead independent director, counsel to the independent directors, contract review committee chair, and/or independent chairperson in reviewing materials and setting the meeting agenda and discussion. Consider whether the assistance of a third party such as Morningstar and/or Lipper should be included in the evaluative process to substantiate the objectivity of the information sought and presented.

- Consider increasing a subadviser's time to produce relevant Section 15(c) information so the fund/lead independent director may have adequate opportunity to review the information and comment on it in advance of the board meeting.

- Remember that the disclosure must be made on a fund-by-fund basis. Accordingly, large fund complexes with a single board may decide to divide the fund complex into two subcomplexes (*e.g.*, fixed income funds and equity funds) for the renewal process to avoid having to overburden the fund disclosure documents with contract renewal information and/or to spread the approval process over two fiscal periods instead of at a single meeting.

- Focus on the board minutes and building a record. The minutes of the board meetings should be the foundation for the disclosure about the contract review process. They should also serve as an important diligence item for the chief executive and financial officers' certifications (see other suggestions below). Accordingly, before filing a fund's Form N-CSR, it may be advisable to obtain board approval of both the minutes of the contract renewal meeting and the required disclosure relating to the contract renewal process. Furthermore, with respect to boards that oversee multiple funds, the minutes should create a record on a fund-by-fund basis. A good record will also support reliance on the business judgment rule.

- A board should review the proposed disclosure and have an opportunity to comment on it.[6]

- Funds should also consider whether amendments are necessary to their disclosure controls and procedures, as well as their Rule 38a-1 compliance program, to incorporate a process addressing the enhanced advisory contract approval disclosure, including the collection, sourcing, and review of information collected.

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[6] At the SEC meeting approving the new rules, Chairman Donaldson inquired as to how the chief executive officer and financial officer could certify to the advisory contract approval language. The SEC staff responded that the officers could certify based on their knowledge and they could rely on board minutes and other board records for the certification. The staff also suggested that the board could subcertify to the disclosure that officers could rely on. The Adopting Release affirms the use of minutes and other records and adds that a fund's board could approve the discussion to be included in shareholder reports regarding its basis for approving an advisory contract to assist the officers in meeting their certification obligations.

## Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialservices.

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