

June 30, 2004

## Memorandum to Our Fund Clients and Friends

### Disclosure Regarding Approval of Investment Advisory Contracts

#### Introduction

The Securities and Exchange Commission (SEC) recently adopted rule and form amendments to require additional disclosure in shareholder reports and proxy statements of open- and closed-end management investment companies (funds) about board approval of investment advisory contracts.<sup>1</sup> The amendments add this disclosure to shareholder reports and remove similar disclosure from the statement of additional information (SAI).<sup>2</sup>

#### Compliance Dates

- *Effective Date:* **August 5, 2004.**<sup>3</sup>
- *Compliance Dates:* All fund shareholder reports for periods ending on or after **March 31, 2005**, and all fund proxy statements filed on or after **October 31, 2004**.

#### Additional Disclosure Requirements in Shareholder Reports

The amendments require a fund's shareholder reports to disclose, in reasonable detail, the material factors and conclusions that formed the basis for the board's approval of an investment advisory contract.<sup>4</sup> The disclosure requirement applies to any new investment advisory contract or contract renewal, including subadvisory contracts, approved by the board during the most recent fiscal half-year. Consequently, disclosure satisfying the disclosure requirement need only be included in the shareholder report covering the period in which the board approved the investment advisory contract.

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<sup>1</sup> *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, SEC Rel. Nos. 33-8433; 34-49909 and IC-26486 (June 23, 2004)(Adopting Release). The Adopting Release may be accessed at [www.sec.gov/rules/final/33-8433.htm](http://www.sec.gov/rules/final/33-8433.htm)

<sup>2</sup> In a case of shifting disclosure imperatives, the board approval disclosure, which will now be required in shareholder reports, was added to SAIs in 2001. Similar disclosure has been required in proxy statements since 1994.

<sup>3</sup> The effective date for the form amendments that remove the current SAI disclosure requirement is January 31, 2006. Prior to that date, a fund may omit the disclosure from its SAI if it has previously disclosed it in a shareholder report.

<sup>4</sup> The SEC also adopted similar amendments to Form N-3, the form used by insurance company managed separate accounts.

Because the additional disclosure is required in fund shareholder reports, which must be accompanied by Sarbanes-Oxley certifications, a fund's principal executive and financial officers will be required to certify the description of the board's evaluation and approval of an investment advisory contract. The SEC stated that the certifying officers could rely on information contained in the meeting minutes of the board or the fund's board could approve the discussion that is included in shareholder reports with respect to its approval of an investment advisory contract.<sup>5</sup>

The amendments remove the current SAI disclosure requirement with respect to board approval of any existing investment advisory contract. The amendments, however, require a fund's prospectus to state 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.

### **Disclosure Enhancements in Proxy Statements and Shareholder Reports**

The SEC adopted amendments to the existing proxy statement disclosure requirements to enhance the discussion of the material factors and conclusions that formed the board's basis for recommending that shareholders approve an investment advisory contract. The same enhanced disclosure will be required in shareholder reports.

The disclosure of the material factors and conclusions that formed the basis for the board's approval of an investment advisory contract must include a discussion of the 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 investment advisory contract. The disclosure must also include a discussion of the following specific 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;
- 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.

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<sup>5</sup> Funds will be required to retain copies of the written materials that directors considered in approving an investment advisory contract.

The discussion of these factors must be specific to the circumstances of the fund and the investment advisory contract.<sup>6</sup> If one of these factors is not relevant to the board's evaluation of an investment advisory contract, the disclosure must note this and explain the reasons why that factor is not relevant. The SEC stated that its intent was to achieve a degree of uniformity in the disclosure by requiring a fund to address each of the enumerated factors, whether substantively or by explaining why the factor is not relevant. This approach also would, in the SEC's view, allow a fund to tailor its disclosure to its particular circumstances (*i.e.*, board approval of advisory contracts with unaffiliated subadvisers).

The disclosure must also include a discussion of whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under an investment advisory contract with those under other investment advisory contracts. If the board relied upon a comparison of investment advisory contracts, the discussion must describe the comparisons that were relied on and how they assisted the board in concluding that the contract should be approved.<sup>7</sup>

In response to specific comments, the SEC emphasized that it is important that a fund disclose how a board evaluated and approved all investment advisory contracts, including contracts with non-sponsor advisers, such as unaffiliated subadvisers. The SEC stated that the amendments do not require disclosure of the amount of the fee paid to an unaffiliated subadviser if that information would not otherwise be required to be disclosed. Finally, the SEC noted that disclosure of specific proprietary information about the operating costs and profits of an investment adviser and its affiliates is not necessary to meet the requirement of how the board evaluated the costs of the services to be provided and the profits to be realized by the investment adviser and its affiliates.

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If you have any questions or need more information, please contact us at (202) 737-8833.

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<sup>6</sup> Conclusory statements or a list of factors will not satisfy the disclosure requirement. The disclosure must include a discussion about how the board evaluated each factor and the board's conclusions with respect to each factor.

<sup>7</sup> The SEC stated that this disclosure does not need to include a discussion of the types of comparisons that the board did not use.