Investment Advisory and Distribution Contract Review

Agenda

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Regulatory Requirements

Investment Advisory Contracts

Section 15(a) Requirements

- A written contract must be executed and approved by a majority of the shareholders in order for any entity to act as an investment advisor to a registered investment company.
- The contract must describe all advisory service compensation to be made including:
    - Flat Fees
    - Performance Based / Fulcrum Fees

    Contracts may also include certain other provisions relating to:

    - Administrative Services
    - Soft Dollar Arrangements
    - Standard of Care
    - Use of Subadvisors
- It could continue for a period not more than two years from its execution, as long as the continuance is approved at least annually by the board of directors (none of whom is an interested person) or by a vote of a majority of the shareholders (initial approval requires the vote of a majority of the outstanding voting securities).
- It should provide that the contract may be terminated at any time (without penalty with 60 days, written notice) by the board of directors or by a vote of a majority of the outstanding voting securities shareholders.
- It must provide for automatic termination upon assignment.
- It should include agreements with unaffiliated subadvisors.

Section 15(c) Requirements

- The board of directors should have a duty to request information from the advisor necessary to evaluate the terms of the investment advisory contract:
    - Services provided by the adviser
    - Relative investment performance of the fund to its peers
    - Advisor profitability
    - Fee economics of scale (i.e., break points)
    - Comparison of service and fees charged by the advisor with those of the other contracts with the same adviser, including clients other types, such as pension or other institutional clients
    - Other compensation or possible benefits retained by the adviser and its affiliates arising from their advisory and or other relationships with the fund (including fund distribution, soft dollars).
- The renewal of the contract must be approved annually (in person) by a majority of the disinterested directors of the board (and also those that are not parties to the contract) at a meeting called for the purpose of voting on the matter.

Section 36(a)

- Authorizes the SEC to bring an action against an officer, director, investment advisor, underwriter, and/or a member of the advisory board for a breech of fiduciary duty involving personal misconduct.

Section 36(b)

- Deems the investment advisor of a registered investment company to have a fiduciary duty with respect to the receipt of compensation for service, or payments of a material nature, paid by such registered investment company, or by the security holders.
- Authorizes the SEC or shareholders to bring an action against an investment advisor, affiliate personal or any other person referenced in section 36(a) for breach of fiduciary duty relating to excessive compensation.
- May include certain limitations, such as:
    - Does not apply to compensation on transactions of underwriters or certain affiliated persons.
    - Plaintiffs have the burden of proof of demonstrating a breach of fiduciary duty.
    - No damages are recoverable for any period prior to one year before the action was instituted.
    - Damages cannot exceed the amount of compensation or payments received.
- Under the fiduciary obligations of 36(b) directors may need to review other service contracts, specifically those of material dollar amounts or those with a fund's advisor or affiliates.

In the case of Gartenberg v. Merrill Lynch Asset Management, Inc ("Gartenberg") certain key precepts regarding director fiduciary duties were introduced. These precepts were adopted by subsequent court cases and include:

- To be guilty of a violation of 36(b) the advisor-manager must charge a fee that 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.
- In determining whether a manager has been guilty of a breech of fiduciary duty through charging an "unfair" advisory fee the following should be evaluated: the nature and quality of services provided to fund shareholders; the profitability of the fund to the advisor-manager; fall-out benefits from the advisory relationship (i.e., personal trading fees); economies of scale; the extent of other non-advisory services provided to the advisor (transfer agency and/or administration); comparative fee structures (however, the relationship between the adviser and the fund tends to weaken the weight to be given to rates charged by advisors of other similar funds) and the competence independence and conscientiousness of the trustees.
- Comparison of large pension fund fees to those of money markets are inappropriate due to differences in the nature and extent of service provided.
    - Transaction volumes
    - Liquidity
    - Nature of investments

Disclosure Requirements

- In Investment Company Act ("ICA") Release No. 33-8433, the SEC requires disclosure of the board's policies and surrounding approval of advisory (and subadvisory) contacts in many shareholder communications, including shareholder proxies and semi-annual and annual shareholder reports (as applicable, depending when the shareholder votes or board approvals occur). (Reference to shareholder report disclosure must also be included in a fund's registration statement.)
- Key required disclosures related to the selection of the advisor and approval of advisory fees mirror those factors enumerated in Gartenberg and include:
    - Quality of service to be provided
    - Investment performance of the fund and the advisor
    - Cost of service to be provided and profits to be realized by the investment adviser and its affiliates
    - The extent of economics of scale and their impact on fund fees
- Principle officers are required to attest to the accuracy of the board's evaluation process description included in the shareholder reports through their Form NCSR certifications.

Regulatory Requirements

Distribution Contracts

Distribution Contracts

Section 15(b)

- A written contract must be executed in order for any principle underwriter for a registered open-end company to offer for sale any security
- Could continue for a period not more than two years from its execution, as long as the continuance is approved at least annually by the board of directors (whom are not interested parties) or by a vote of a majority of the shareholders (initial approval requires the vote of a majority of the outstanding voting securities).
- Should provide for automatic termination upon assignment.

Section 15(c)

- The renewal of the contract must be approved annually (in person) by a majority of the disinterested directors of the board (and also those that are not parties to the contract) at a meeting called for the purpose of voting on the matter.

Distribution Contracts, continued

Section 12b-1

- Prior to the passage of Rule 12b-1, it was illegal for any registered open-end investment company to act as a distributor of securities for which it was the issuer except through an underwriter.
- Section 12b-1(a)(2) deems that an investment company will be acting as a distributor if it engages directly or indirectly in financing any activity (including advertising, compensation of underwriters, dealers and sales personnel and the printing and mailing of prospectuses to other than current shareholders), which is primarily intended to result in the sale of share issued by the company.
- Per Sections, 12b-1(b)(1) and 12b-1(b)(2) a registered investment company may act as a distributor of securities of which it is the issuer if any payments made by it related to distribution are pursuant to a written plan, approved by a majority of the outstanding voting securities, or by a vote of all directors and by those directors who are not interested parties.

Distribution Contracts, continued

- Per 12b-1(b)(3) the distribution plan must provide that:
  - It could continue in effect for a period not more than one year from the date of its execution or adoption, as long as the continuance is approved at least annually by the board of directors and by those whom are not interested parties.
  - The directors shall review, at least quarterly, a report of the purpose and amounts expended for the purposes of the plan.
  - The contract may be terminated at any time (without penalty with 60 days written notice) by the board of directors (whom are not interested parties) or by a vote of a majority of the outstanding voting securities shareholders.
  - It is automatically terminated in the event of its assignment.
- Per 12b-1(b)(2) all material changes to plan fees must be approved by a vote of the majority of shareholders and any material amendments must be approved by majorities of the board of directors and of the disinterested directors.
- Section 12b-1(d) requires that the directors must evaluate any information as may reasonably be necessary to make an informed determination of whether such plan should be implemented or continued. Minutes describing the factors considered and the basis for the decision must be retained.

Distribution Contracts, continued

Per ICA Releases Nos. 10862 and 11414 the factors to be considered by the directors during plan evaluation should include:

- "The need for independent counsel or experts to assist the directors in reaching a determination;
- The nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate;
- The causes of such problems or circumstances;
- The way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved;
- The merits of possible alternative plans;
- The interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other persons are made in such a manner as to constitute the indirect financing of distribution by the company;
- The possible benefits of the plan to any other person relative to those expected to inure to the company;
- The effect of the plan on existing shareholders; and
- In the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders."

Contract Review and Approval

Investment Advisory

Services Provided

The nature and quality of services to be provided are required to be evaluated.

Nature

- Advisory Services fee contracts may incorporate some administrative services to be offered by the Advisor including:
  a. Compensation of Officers
  b. Occupancy
  c. Compensation of Interested Directors
  d. Stationary, Supplies and Printing
  e. Determination of Prices
  f. Prospectus Costs
  g. Outside Counsel
  h. Federal Registration/Filing Fees
  i. Compensation of Non-Interested Directors
  j. Shareholders Reports
- Other direct benefits to the advisor arising from the advisory relationship (i.e., distribution, soft dollars, etc.) should be considered.

Quality

- The complexity of each fund's investment strategies should be considered, (i.e., capital appreciation, growth, growth and income, income and total return) as more complex strategies generally require higher service levels.
- Generally, equity and international funds more expensive to manage due to research costs.
- The qualifications and experience level of advisory personnel and the overall quality of the investment process should be evaluated (i.e., performance results). Turnover in investment personnel should also be considered.
- Advisor policies and procedures should be reviewed, including Code of Ethics, Revenue Sharing, Director Brokerage, Soft Dollars and Trade Allocation. The results of regulatory, internal and external audits may be referenced to indicate compliance effectiveness.

Investment Performance

The performance and after-tax performance of the Fund should be compared relative to its benchmark and/or its Morningstar and/or Lipper Peer groups.

- Morningstar and/or Lipper Peer groups should be comprised of funds with similar investment strategies (and may be consistent with those used in the prospectus). Consideration should be given to the removal of outliers (those funds with performance in the top or bottom one percent) as to not skew comparative results.
- Usually the performance of only one class is compared, however, performance of the remaining classes can generally be derived through the inclusion of class specific expenses (i.e., 12b-1 fees).
- Performance should be disclosed for multiple periods, i.e., one month, three months, year to date, three and five years and should include peer group median and percentile rankings. Morningstar ratings should be disclosed**.**
- Trends in performance at the fund and sector level should be considered in the evaluation of advisor service quality.
- Portfolio turnover and transaction costs absorbed by the fund should be analyzed. Portfolio turnover of peer group funds should also be compared.

Advisor and Fund Profitability

Profitability analyses should be on a fund by fund basis and reflect only those revenues and expenses associated with management of the mutual fund business. Profitability reviews can be prepared for all revenue line items, including administration and 12b.1 distribution fees, however, this information is considered additional. As this information can be complex, directors should consider the use of external counsel and/or experts.

Advisory

Revenues

Revenues should represent those fees directly earned for management of the funds. Reimbursements of management fees should be included and directly attributable to those funds that have been reimbursed. If they can be recouped this should also be disclosed. Any revenue sharing or side agreements with third or related parties need to be detailed and the benefits of soft dollar arrangements should be considered.

Expenses

Advisor costs should be allocated based on methodologies that best reflect their cost drivers. Only costs related to servicing the funds should be allocated. The allocation methodology of expenses to institutional, separate, pension or other accounts should be reviewed the validity of the revenue and expense data and allocation methods should be evaluated. (It should be noted, however, that unless the fund has a 12b-1plan, sales and promotional expenses should not be included. It has been the SEC's position that if the advisor's distribution experts are allowed in establishing the advisory fee, then the directors are indirectly authorizing the use of fund assets for distribution (ICA Release 10252)).

Sub advisor fees should be included in the expense line for the funds they advise. Consideration should also be given to include subadvisor expenses (if subadvisor is an affiliate).

Administration

Revenues

Revenues should represent those fees earned by the advisor for administrative services (usually a fixed basis point charge).

Expenses

Will represent primarily indirect cost allocations from the advisor but could include fund specific expenses, i.e., printing, mailing, legal, etc. costs.

Advisor and Fund Profitability, continued

Distribution

Revenues

Revenues should represent total 12b-1 fees by fund and include any retained sales or deferred sales loads paid by investors. Any distribution waivers should be included and attributed to the appropriate fund.

Expenses

Direct costs that relate to a specific fund (for instance trail commissions) should be accrued to that fund. Indirect expenses associated with marketing should be allocated to the funds based on suitable criteria (i.e., sales, assets, etc.).

Expense Caps/Wavers

Should be included and attributed to the appropriate fund. The nature and duration of each cap/waiver should be described.

Taxes

Should be accrued at the maximum corporate rate for the advisor on the net profitability/loss of the fund.

Consolidated Profitability

Should be disclosed by fund and revenue line.

Advisor and Fund Profitability, continued

Sample Cost Allocation Strategies

Allocation Methodology	Description of Allocation Methodology	Examples
Firm Wide Headcount	Cost centers that provide firm wide services must have allocations that reflect the portion of their costs which benefit other cost centers.	Human Resources
Assets	Cost center allocation percentages are calculated based on assets under management.	Investment Management
Estimate of Time Spent	The costs are allocated based on the time to provide support and services to a profit center.	Administrative Services
Allocation of Space	Allocations are based on each department's square foot usage as a percentage of the total square footage of the property. Additionally, common areas are allocated to each group based on the cost center's square footage allocation.	Facilities
System Parameters	Hardware and software costs are allocated based on actual and estimated usage.	Technology

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Fee Comparisons

- Lipper peer groups can be the same or different than those used for performance analysis. Peer groups should be composed of funds of similar type (i.e., open vs. closed), investment objective, load structure, and asset size.
- Presentations should include, at the minimum, management fee and total expense ratios. Fund management fee structures should be described, including economics of scale achieved through break-points, performance incentives or all inclusive fee arrangements. Generally, only one fund per advisor is included in the same peer group and peer groups tend to be comprised of less than 20 funds. The use of custody credits or other third party reimbursements should be discussed. The use of fee waivers and caps should be detailed. Comparisons should include the lowest, highest and average in the peer group. Quintile and percentage rankings are often included.
- Graphical presentation through scatter diagrams presentation can be used to pictorially demonstrate fund fees relative to peer group funds and certain other criteria (i.e., asset size).

Contract Review and Approval

Distribution Contracts

Distribution Contracts

All distribution contracts are required to be evaluated under the requirements of Section 15(b), 12b-1 and the fiduciary requirements of Sections 36(a) and (b).

Per ICA Releases Nos. 10862 and 11414 the factors should be considered by the directors during plan evaluation should include:

- **The need for independent counsel or experts to assist the directors in reaching a determination;**

  Due to the complexity of the information to be evaluated the SEC's proposed rule 12b-1 required the use of external experts.

- **The nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate;**

  What issue is the use of fund assets to fund distributions designed to cure?

- **The causes of such problems or circumstances;**

  What is the root problem of the funds "issue"? If it is fund performance, increasing fund assets may not be an acceptable alternative.

- **The way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved;**

  Approximately how much is going to be expended, on what, and how long should it take for the anticipated benefits to be recognized?

- **The merits of possible alternative plans;**

  Will using fund assets to bolster sales cure the issue of the fund or is there an alternative solution (i.e., change in investment strategy)?

Distribution Contracts

- **The interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other persons are made in such a manner as to constitute the indirect financing of distribution by the company;**

  If the plan is approved, what will be the effect on the advisor's distribution expenditures?

- **The possible benefits of the plan to any other person relative to those expected to inure to the company;**

  What are the expected benefits to the advisor and other parties?

  What will be the net increase in advisory fees due to the increase in assets?

- **The effect of the plan on existing shareholders; and**

  If the shareholders pay a sales load coming into the fund how do they benefit from an increase in fees related to distribution?

- **In the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders.**

  Has the plan worked as anticipated? Are the shareholders better off?

Other Considerations

- A contract review committee with a written charted should be established to evaluate and approve fund contracts.
- Formal, written recommendations should be provided by the contract committee to the full board for consideration.
- Legal counsel should brief all board members on their fiduciary and 15(c) regulatory responsibilities.
- Other third parties can also be engaged to assist in contract evaluation.
- The SEC is continuing to monitor the quality of information independent directors are given during the 15(c) process. SEC inspection reviews conducted during fiscal 2006 noted weakness in many registrant's 15(c) procedures.