

## Advisory Contract Consideration Disclosure 2005 – Beyond the SEC, Gartenberg?

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### BACKGROUND

Effective in 2002, the SEC stipulated that investment company boards disclose the “factors considered” when they renewed or ratified advisory contracts (presumably) with current fund advisors. The shareholder disclosure was required in each N-1B filing (Statement of Additional Information), admittedly resulted in much boilerplate, was of limited use to investors in many cases, and did not effectively capture the intended ‘spirit’ of the disclosure requirement.

Effective in 2005, the SEC revised the disclosure requirements to not only change the targeted location (now shareholder reports), but also provided more specific guidance as to the obligatory items that must be cited as factors considered and how they may have impacted the decision to approve an advisory contract. In general, the SEC's explicit goal to ensure that the general thought processes behind a board ‘allowing’ an advisor to continue to manage a complex of mutual funds, and their necessary balancing of controlling factors, was readily evident.

Briefly, the SEC now requires that “renewal rationale” disclosure include:

- Nature and extent of the services to be provided by the investment advisor
- Quality of the services provided by the investment advisor
- Investment performance of the fund and the investment advisor (other accounts)
- Cost of the advisory and related services to be provided
- Profits realized by the investment advisor and its affiliates
- Extent to which economies-of-scale would be realized as a fund grows
- Whether fee levels reflect economies to the benefit of investors
- Other factors related to selection of a fund's advisor
- Note reliance on an analysis of “services rendered” under an advisory contract (or not)
- Types of other (comparable) investment vehicles that were considered
- Note if any factors considered not relevant?

While on the surface the above list appears to be reasonably comprehensive guidance on what the renewal rationale disclosure should include, the room for interpretation remains wide and boilerplate presumably still a risk. Regardless of the interpretive aspects of the SEC disclosure requirement, the current atmosphere has incentivized fund boards and sponsors alike to arguably focus more intently on this final step of the advisory contract renewal process. Many exemplary shareholder report disclosure samples now in the public domain bear out this claim. Perhaps most interesting, the SEC's detailed description of its requirements arguably serves to 'fortify' the widely recognized Gartenberg rulings on the appropriate considerations surrounding determination of fund fees' reasonableness and fairness.

## DISCLOSURE OF FACTORS CONSIDERED

Broadly speaking, the newest examples of contract renewal rationale are much more comprehensive and rigorous than their 2002 brethren. The breadth of disclosure still diverges fairly widely when funds (fund boards) discuss their factors considered, yet much of the boilerplate seems to have vanished. Admittedly, formats amongst funds in a complex do resemble one another; however, the data contained in the disclosure are not generic, but sometimes fund-specific. Disclosure of these more concrete fund data did not occur in the 'first pass' at requiring contract renewal rationale. The much more extensive list of factors considered was undoubtedly driven primarily by the SEC's detailed description of their expectations, the current governance atmosphere, and likely general trepidation by boards that they may miss citing a critical factor.

Using a sampling of eighteen (18) N-CSR shareholder report filings covering many top-tier complexes, a tally of the topics covered and some sample topical content may be summarized as such:

<u>Disclosure Topic</u>	<u>Implied Prevalence</u>	<u>Sample Content</u>	<u>Comments</u>
<b>Review Process</b>	Majority	Background, timing, independent meetings, board obligations memoranda, committees, proposal exchanges, counsel assistance, responses to questions, deliberations made fund-by-fund	Most cited the obligation to review the contract, but not specifics of the process
<b>Nature, Extent of Services</b>	All	Investment process, in-house research, variations in services rendered, other accounts managed, buy/sell disciplines, staff compensation structure, board support, at-cost services provided	Very clearly a core item
<b>Service Quality</b>	All	Quantity of resources, quality of resources, consistency in investment approach, other accounts managed by fund portfolio managers, advisor reputation, quality of non-investment services, code of ethics, compliance record, advisor reinvestment in business, benefits	Very clearly a core item

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		of large complex, portfolio transaction allocation policies, adherence to fair value procedures, accuracy of NAV computations, business recovery procedures	
<b>Performance Data</b>	All	Periods examined, actual returns and rankings, indices used for comparison, fund volatility, requested reasons for underperformance, plans to rectify below-average results, portfolio turnover	Very clearly a core item; few provided relative ranks
<b>Fee/Expense Data</b>	All	Use of peer groups, larger Universe data, advisory fees, administrative fees, distribution fees, total expense ratios, actual ranks, affiliated payments, expense credits, waivers, contractual management fee rates, median percentage benchmarks, separately managed account or institutional fee comparisons not deemed valid	Very clearly a core item; few provided relative ranks
<b>Advisor Profitability</b>	All	Cost of advisory services, pre-distribution/pre-tax margin, post-distribution/pre-tax margin, fund accountants' analysis, direct comparisons difficult, no generally accepted cost allocation methodology, impact of fees on profitability, soft dollar payments, other managed accounts, audit committee involvement, cost allocation methodology, changes to cost allocation methodology, fund versus complex-wide margin	Very clearly a core item
<b>Economies-of-Scale</b>	All	How realized, impact of various products and services, examination of non-breakpoint funds, administrative vs. advisory breakpoints, similar fund considerations (in aggregate), to what extent realized, affiliated transfer agent scale, aggregate asset impact, possible effect of new breakpoints on advisor's revenues	Very clearly a core item
<b>General Materials Reviewed</b>	Majority	Reports on investment results, trading practices, shareholder servicing, fund fee/performance comparisons, manager's operational structure, profitability, agreement terms, fees for funds vs. other managed accounts, economies-of-scale analyses	Many alternatively incorporated the cited content under different headings

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<b>Advisor Resource</b>	Minority	Personnel, experience, qualifications, corporate parent support, soft dollar payments, tools utilized, compliance staff, access to research, all revenue sources, back-up systems	Those without separate heading included under quality of service;
<b>Fall-out Benefits</b>	All	Administrative fees, brokerage transactions, transfer agency, fund accounting, product cross-selling, soft dollars	Very clearly a core item
<b>Compliance</b>	Minority	Record, review process, CCO selection, staff qualifications, quantity of resource	Many did not have separate heading
<b>No Information "All-Controlling"</b>	Majority	Factors weighed differently by individual trustees, all information reviewed was considered, not all factors relevant to every fund	Indicative of the general view that certain factors and conditions do not necessarily and categorically trump others
<b>Distribution Arrangements</b>	Minority	Revenue sharing (who? how much?), soft dollar payments, receipt of 12b-1 fees, the market(s) used for distribution, selling in both the direct and intermediary channels	Most mentioned revenue sharing and soft dollars, yet not more generic distribution topics
<b>Consultants Enlisted</b>	Majority	Data analysis provider(s), outside peer fund selection obtained, independent peer fund review, consultant recommendations considered, validation and input by third-party	The most prevalent mention was of data analysis provider Lipper
<b>Third-Party and Sub-Providers</b>	Minority	Quality of service, overall resource at its disposal, compliance procedures, research capacity, management, other client fee rates, operational 'standards' in line with main provider, nature and extent of services	Only applicable to several filers
<b>Conflicts of Interest</b>	Minority	Sub-providers, affiliated parties, brokerage, access persons, trade allocation	Viewed as not warranting a separate heading in most cases
<b>Trustee Objectives Up Front</b>	Rare	Issues that will be raised by the trustees during the review process, consolidation of the fund complex, more management fee breakpoints	Indicative of the belief that the contract review process could be facilitated through board objectives at the outset
<b>Additional Information Requested</b>	Minority	Transfer agency fee comparison, detailed economies-of-scale analysis, nature of data used in analysis, gross and net yield, sales and redemption data	Data requested beyond that already cited not prevalent
<b>Other Considerations</b>	Rare	Discussions and data shared throughout the year leading up to the review process, responses to regulatory developments, responsiveness to regulatory agency inquiries, willingness to waive fees, responsiveness to questions and issues raised by the Trustees, willingness to consider	Rather than separate heading, small mentions in other places, as warranted

		and implement changes	
<b>Conclusion</b>	Majority	Fees fair and reasonable, all relevant factors considered, used business judgment, decision viewed as in the best interest of shareholders, unanimous approval of contract continuation	Concluding paragraph was very brief in many cases; unanimous approval note rare

The SEC stipulations and the above samples would seem to indicate that “best practices” should include – in great detail – discussions of the reason for the contract renewal process, all relevant factors considered, advisor service quality levels, data considered, advisor costs and profitability, economies-of-scale, and fall-out benefits. The related disclosure should arguably include a discussion of how factors were considered, were inter-related, how they impacted the review process, that no one factor was all-controlling, and perhaps what board demands and/or actions emerged from the discussions.

Also implied from the sample excerpts is that several disclosure practices may neither be viewed as best practices nor prudent. Based on prevalence or blatant omission, disclosures viewed as not relevant or undesirable may include:

- Very specific performance or expense data and rankings
- Specifics of regulatory agency examinations
- Compliance program procedures
- Specifics of board proposals and advisor counter-proposals, if any
- Service quality metrics
- Economies of scale algorithms or details by asset class
- Profitability levels and precise allocation methods
- Weights given to certain factors considered
- Divergent board views
- Resource shortfalls or regulatory shortcomings
- The advisor’s position and/or retort on certain issues
- General numeric details of data considered
- By what level of board majority a contract was renewed
- If undertaken, serious consideration of ‘awarding’ a fund advisory contract to an advisor other than the original sponsor

Perhaps the reasons behind these omissions are painfully obvious to many business participants, yet undeniably warrant clear citation due to the nature of this exercise. One may easily surmise the above disclosures were excluded due to the room for interpretation and judgment, extenuating circumstances were not known to all readers, their possible inapplicability, and the potential for promoting frivolous lawsuits. Furthermore, even lengthier disclosure is unlikely to be read and brought to bear on fund analysis by very many investors.

## DISCLOSURE OF NOTE

Close examination of the disclosure examples revealed many unique and interesting passages that are worthy of note. Several reflected strong philosophical and possibly controversial positions while others merely echo general industry sentiment. Those most notable are excerpted below.

*“...the trustees informed management that they would be seeking fee breakpoints in connection with the renewal ...”*

*“... [renewal of the Advisory Contracts] consistent with [the advisor’s] fiduciary duty under applicable law.”*

*“...[the advisor] voluntarily decided in 2004 to stop using “soft” commission dollars to pay for market data ...”*

*“...while other allocation methods may also be reasonable, [the advisor’s] profitability methodologies are reasonable in all materials respects.”*

*“...the amount of profit is a fair, entrepreneurial profit for management of the fund.”*

*“...fund shareholders will achieve a certain level of economies of scale as assets under [the advisor’s] management increase at the fund complex level, regardless of whether (the advisor) achieves any such economies of scale.”*

*“[The board considers many factors, among the most material are:]...; the preferences and expectations of Fund shareholders and their relative sophistication; the continuing state of competition in the mutual fund industry;...”*

*“...the Board is aware that various courts have interpreted provisions of the 1940 Act...”*

*“The evaluation process is evolutionary, reflecting continually developing considerations.”*

*“The board focuses on comparisons with other similar mutual funds (rather than non-mutual fund products or services) because, simply put, they are most relevant. For example, other mutual funds are products most like the Fund, they are readily available to Fund shareholders as alternative investment vehicles, and they are the type of investment vehicles already chosen by the Fund’s investors. The range of their fees and expenses therefore appears to be a generally reliable indication of what consumers have found to be reasonable in the precise marketplace in which the Fund competes.”*

*“Although the board considers the profitability of the [advisor’s] organization as a whole, it does not evaluate, on a fund-by-fund basis, [the advisor’s] “profitability” and/or “costs” ...”*

*“In the Board’s view, the cost of performing advisory services on a fund-specific basis is both difficult to estimate satisfactorily and a relatively minor consideration in its overall evaluation.”*

*“...economies are likely to arise only when a fund grows dramatically, and becomes and remains very large in size.”*

*“...purchase and redemption activity, as well as the presence of expense limitations (if any), may offset any perceived economies.”*

*“The Board reviewed information on the status of Securities and Exchange Commission (SEC) and New York Attorney General (NYAG) proceedings against [the advisor] and certain of its affiliates...”*

*“...the board also considered projected savings to the Fund that would result from certain modifications in soft dollar arrangements.”*

*“The Board also considered management’s proposal to merge or liquidate some of these Funds.”*

*“In evaluating potential economies of scale, the Board considered (the advisor’s) proposal to implement a standardized breakpoint schedule for combined advisory and administrative fees for the majority of the funds of the same general asset type with the [group moniker] complex.”*

*“...confidence in the Adviser’s integrity and competence...”*

*“...the Adviser should generally be entitled to earn a reasonable level of profits ...”*

*“...the Adviser’s profitability would have been somewhat lower if it did not receive research for soft dollars...”*

*“The Adviser reviewed with the directors the significant differences in scope of services it provides to institutional clients and to the Fund.”*

*“...provision of non-advisory services involves costs and exposure to liability.”*

*“...fees charged the Fund reflect the costs and risks of the additional obligations.”*

*“The directors recognized that there is no direct relationship between the economies of scale realized by funds and any realized by the Adviser as assets increase, largely because economies of scale are realized (if at all) by the Adviser across a variety of products and services, and not only in respect to a single fund.”*

*“...no uniformity or pattern in the fees and asset levels at which breakpoints (if any) apply.”*

*“[Included with such profitability analysis]...and a three-year expense analysis with an explanation for any increase in expense ratio.”*

*“The board also took into account the transfer agent and shareholder services provided Fund shareholders by an affiliate of the Manager, noting continuing expenditures by management to increase and improve the scope of such services, periodic favorable reports on such service conducted by third parties such as Dalbar, and the firsthand experience of the individual Trustees who deal with the shareholder services department in their capacities as shareholders in one or more of the various [group moniker] funds.”*

*“The actual total expenses of each Fund were in the lowest quintile in their respective Lipper expense groups. While realizing that other factors such as the Manager’s profitability and economies of scale bear on the reasonableness of fees, the Board was satisfied with the management fee and total expenses of these Funds in comparison to their Lipper expense groups.”*

*“The Board also took into account management’s expenditures in improving shareholder services provided the Funds, as well as the need to meet additional regulatory and compliance requirements resulting from the Sarbanes-Oxley Act and recent SEC requirements.”*

*“...intending to monitor future growth in Fund assets and the appropriateness of additional management fee breakpoints...”*

*“...the Boards considered not only the specific information presented in connection with the meetings, but also the knowledge gained over the course of interacting with Funds Management...”*

*“...within a reasonable range of the median rates...”*

*“...the sub-advisory fees paid to [sub-advisor] had been negotiated by Funds Management on an arms-length basis and the [sub-advisor’s] separate profitability from their relationship with the Funds was not a material factor in determining whether to renew the agreements.”*

*“...[the advisor’s] established long-term history of care and conscientiousness in the management of the Funds...”*

*“The Trustees also noted that the range of services under the Agreements is much more extensive than under [the advisor’s] separate advisory (non-fund) client agreements, and that there are reasonable justifications for differences in fee rates charged between the two lines of business.”*

*“The Board did not consider in this review the profitability of the Adviser as the management fees and other expenses of the Funds were low compared to the category average and the peer group, therefore benefiting the shareholders.”*

*“...they also recognized that there is no direct relationship between the economies of scale realized by funds and any realized by the Adviser as assets increase...”*

*“...because different advisers have different cost structures and service models, it is difficult to draw meaningful conclusions from the comparison of fund’s advisory fee breakpoints with those of comparable funds.”*

*“...the Board focused on the negative returns of this Fund since its first year of operations and suggested that if this Fund were to continue in its present form, that management must take steps to improve its performance.”*

*“...overall fees paid to [the advisor] (investment advisory, administration, and shareholder service) contain the functional equivalent of breakpoints through four to five different share classes that reduce the fees paid to [the advisor] based on the asset level of the account.”*

*“...the Funds’ current multiple share class fee structure establishes a reasonable basis for realizing economies of scale for certain of the Funds’ expenses which may exist when account size increases.”*

*“The Board and the Committee further considered [the advisor’s] supervision of the fund’s third-party service providers...”*

*“The directors recognized that it is difficult to make comparisons of advisory fees because there are variations in the services that are included in the fees paid by other funds.”*

*“The directors noted that the expense ratios of some funds in the Fund’s Lipper category also were lowered by waivers or reimbursements by those funds’ investment advisers, which in some cases were voluntary and perhaps temporary.”*

*“... the fund and its shareholders have received reasonable value in return for those fees; and that renewal of the agreement is in the best interest of the fund and its shareholders.”*

Very clear after a review of the excerpted passages is that fund boards do not fully concur with one another on specific topics. The least homogenous and most contentious topics tend to focus around profitability, economies-of-scale, and diligence or transparency surrounding sub-providers. Yet, most importantly, a plethora of topics were raised by virtually every registrant – many significant factors are appropriately considered during the very complex, board-centric decision-making process that is 15(c). Furthermore, one might also note that certain considerations are noted several times under multiple topics. Given the broad nature of the subject matter and the natural overlap of the subjects, e.g., economies of scale and profitability etc., this phenomenon should be expected.

## **AUTHORING THE DISCLOSURE: PROCESS?**

An interesting and valid omission from the SEC disclosure requirements is the process by which the shareholder report language was authored and finalized. The precise source of the verbiage, board versus advisor involvement, the process used to create and/or negotiate the wording, and its relation to board discussions is not addressed. Frankly, KFS believes this level of underlying procedural detail is unnecessary and likely to fall on deaf investor ears. The bottom-line decisions and applicable factors considered are what are vital.

Yet, the omission of the process utilized to determine the disclosure does surface the question of what are best practices in this area. Boards and board committees should arguably ask themselves related procedural questions such as:

- Who should craft the language? Advisor's staff with board approval? Board counsel with approval? Board member(s) with full board sign-off?
- How involved should a fund's advisor be? Or, should they participate at all?
- How does a board determine what portion of topics discussed should be disclosed? What if certain trustees deem certain factors relevant while others do not?
- Should a committee assume the sole responsibility for the disclosure? Does the full board then vote to approve?
- What formal documentation should exist relating to discussions over the approved language?

Boards are well advised to raise the above questions – at a minimum – to ensure that they reach a level of comfort that the record of factors considered is accurate, fully representative of topics truly brought to bear on the renewal decision, reflect board consensus of what is relevant, and that the process of disclosure creation is free from bias.

## **LITIGATION POTENTIAL**

Many professionals in the fund business have opined that disclosure of advisory contract considerations by boards opens up the potential for litigation. KFS believes this is a valid concern. Shareholders dismayed with NYAG settlements and perceptions of fund governance shortfalls, with their suit-hungry litigators in tow, are arguably examining the contract renewal rationale wording for indications that board fiduciary duty has not been fulfilled.

It seems that the core of such claims would primarily rest on a shareholder's belief that: **1)** certain relevant factors were not properly considered; or **2)** factors were weighted improperly; or **3)** any

(noted) shortfalls in advisor service or performance did not reach the 'correct' conclusion. Based on the sample disclosures noted above, factors considered have been very comprehensive and the weights implicitly or explicitly afforded specific factors by certain trustees (or the board as a whole) have been properly omitted. Any advisory service levels viewed by a board as falling short have consistently been accompanied by mandated action plans or requests for 'plans to rectify' clearly noted. At first blush, it appears that the current wave of language does not open up much potential for litigation. Rather than lawsuit fodder, the language should appropriately give each shareholder a clear idea of why an advisor is basically re-selected by a board of trustees as the primary service provider. If he/she disagrees with the factors that were considered and the board's business judgment, then perhaps they should entertain casting a dissenting vote for the renewal process (redeem). Time will tell if the language will be a target and truly serve as a basis for litigation.

## CONCLUSION

The disclosure examples scrutinized very clearly indicate that the advisory contract consideration process is extremely complicated, potentially fraught with divergent viewpoints, and subject to judgment. While not all exemplary, disclosures have been lengthy, comprehensive, and necessarily vague as to specific boardmembers viewing certain factors as more 'compelling' and possibly trumping others considered. Given the inherent risks and criticality of this exercise, the approach witnessed is prudent and very understandable. An admirable balance between shareholder value and obvious risks appears to have been struck.

Many business observers may easily argue that the new disclosures witnessed to date transcend what was the direct result of the Gartenberg lawsuits and even go beyond what the SEC may have envisioned when they revised its contract review disclosure requirements.

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*Keil Fiduciary Strategies LLC (KFS) is a fund business consulting firm owned and operated by Jeff Keil. To obtain more information on consulting services offered by KFS please contact Mr. Keil at (303) 662-8180 or visit the firm's website ([www.keilfiduciarystrategies.com](http://www.keilfiduciarystrategies.com)).*