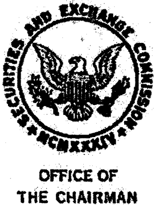

OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

MAY 24 1972

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Honorable John J. Sparkman
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, DC 20510

MAY 24 1972
Senator John Sparkman

Dear Senator Sparkman:

As you may know, in a letter dated March 10, 1972 replying to an inquiry dated November 23, 1971, from Senator Williams, Chairman of your Committee's Subcommittee on Securities, I stated that the Commission intended to recommend specific legislation to clarify and modify the Investment Company Act of 1940 in light of the decision in Rosenfeld v. Black as it may apply to transfers of mutual fund investment advisory organizations. The broad sweep of the language of the Court of Appeals in that case has cast substantial doubt on whether an investment adviser can make any profit when it sells its business. In this connection, I stated that the Commission believed that it would be in the public interest to remove the uncertainty in the mutual fund industry which has been generated by the Rosenfeld decision. Accordingly, we are herewith submitting proposed legislation designed to achieve this objective.

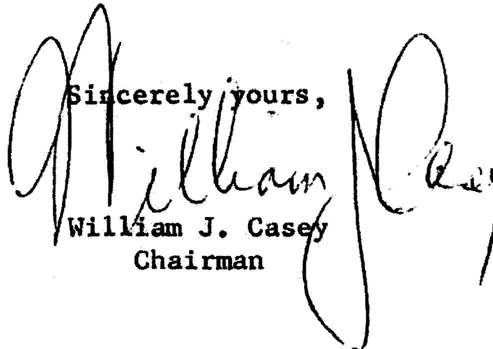
Generally, the proposed legislation would permit an investment adviser and its owners to obtain compensation, including profit, in connection with a sale of its business resulting in an assignment of its advisory contract with the fund, if certain conditions are met. The first condition is that, for a minimum of five years after a proposed new adviser is approved by fund shareholders, all of the directors, officers and other affiliated persons of the fund, must not be interested persons of the retiring adviser or the new adviser. The second condition is that the transaction or any express or implied terms, conditions or understandings must not impose an unfair burden on the fund for a two-year period after the transaction. Such a burden could arise, for example, where the transaction involves an arrangement with respect to the fund's brokerage commissions. A

definition of "unfair burden" along these lines is included in the proposal. In addition, the directors of a fund would be prohibited, when considering the terms of the advisory contract in the future, from taking into account the purchase price or any other consideration the new adviser may have paid in connection with the transaction which caused the assignment. Attached to the proposed legislation is a technical statement which explains these and other provisions in more detail.

This approach would rely on arms'-length dealing and proper execution of the fiduciary obligations of fund directors who consider the new adviser and, after the assignment, on the independent directors to avoid abuse. It would permit the selling adviser to negotiate an appropriate price with a buyer. The sale could be conditioned upon approval of the buyer as investment adviser as has been the practice. The buyer, however, would have to recognize that his satisfactory performance as adviser will be his only assurance of continuing the advisory relationship. It is our view that this approach should mitigate the dangers with which the Court of Appeals was legitimately concerned in the Rosenfeld case. Of course, in determining whether or not to recommend the new contract for shareholder approval, the directors of the fund, who have an obligation under Section 36(a) of the Act to refrain from a breach of fiduciary duty involving personal misconduct, would also be required to carefully scrutinize and evaluate any successor adviser, as well as the terms and conditions of such contract.

The proposed legislation has the unanimous approval of the Commission, and the Office of Management and Budget has advised us that it has no objection to our submitting the proposal to Congress from the stand-point of the program of the Administration. The Commission therefore recommends that the attached legislative draft be introduced as a bill and that your Committee support its passage.

Sincerely yours,



William J. Casey
Chairman

Enclosures

PROPOSED AMENDMENT TO SECTION 15
OF THE INVESTMENT COMPANY ACT OF
1940 TO ADD A NEW SUBSECTION (f)

(f) An investment adviser of a registered investment company, or an affiliated person of such investment adviser, may receive any amount or benefit in connection with a transaction which results in an assignment of an investment advisory contract with such investment company, provided that

(1) for a period of five years after the time of any such transaction, no affiliated person of such registered company (or successor thereto, by reorganization or otherwise) shall also be (A) an interested person of the investment adviser of such investment company or (B) an interested person of the predecessor investment adviser; and

(2) such transaction or its terms, conditions, or any understanding with respect thereto, express or implied, does not impose an unfair burden on the investment company. For purposes of this section, an unfair burden shall include any arrangement, during the two-year period after the time of such transaction, whereby the predecessor or successor adviser or any interested person of either such adviser receives or is to receive any compensation directly or indirectly (A) from any person in connection with the purchase or sale of securities or other property to, from or on behalf of such investment company or (B) from the investment company or its security holders for other than bona fide investment advisory or administrative services.

PRESENT SECTION 16(b) REDESIGNATED 16(c) AND A NEW SUBSECTION (b) ADDED AS FOLLOWS

(b) In the event of any transaction within the provisions of Section 15(f), the directors of the investment company who are interested persons of either party to the transaction shall resign effective at the date of commencement of the new advisory contract and the remaining directors of the investment company shall select, and propose to stockholders for election to the board of directors, the requisite number of other persons who are also not such interested persons in the manner specified in Section 10(e).

PROPOSED AMENDMENT TO SECTION
15(c) TO ADD A NEW PROVISION

Subsection (c) as amended would read as follows (new matter underscored):

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or interested persons of such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be duty of the directors of a registered investment company to request and evaluate and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such investment company, to take into account the purchase price or other consideration such person may have paid in connection with a transaction within the provisions of subsection (f).

TECHNICAL STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PROPOSED AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940 REGARDING TRANSFERS OF ADVISORY RELATIONSHIPS

The proposed legislation would amend Section 15 of the Investment Company Act of 1940 ("Act") by adding new subsection (f), amend Section 16 by renumbering subsection (b) as (c) and adding a new subsection (b) and would add a new provision to Section 15(c). The proposed amendments are intended to clarify and modify the law in light of the decision in Rosenfeld v. Black, 445 F. 2d 1337 (2 Cir. 1971), as it may apply to the assignment of a contract of an investment adviser of an investment company registered under the Act.

In that case, the Court of Appeals for the Second Circuit held that the general equitable principle that a fiduciary cannot sell his office is impliedly incorporated into Section 15(a) of the Act. Consequently, a retiring investment adviser breaches its fiduciary duty under the Act by receiving compensation which reflects either (1) payment contingent upon the use of influence to secure approval of a new adviser or (2) an assurance of profits the successor adviser will receive under the new advisory contract and renewals thereof.[1/]

The Commission believes that the principle that a fiduciary cannot profit from the sale of his office was appropriately applied under the

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1/ See 445 F. 2d at 1343, 1344.

circumstances of that case, which appears to have involved an outright sale by the investment adviser of its investment advisory contract with a registered investment company.[2/] The transfer of

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2/ The facts in the Rosenfeld case show that the outgoing investment adviser, Lazard Freres & Co., ("Lazard"), decided to terminate its relationship with the Lazard Fund ("the Fund"), a registered investment company. Ordinarily, a retiring adviser sells a controlling block of its stock or its assets. However, Lazard did not follow this route, but instead, entered into an agreement with Dun & Bradstreet, Inc. ("D&B") to transfer the advisory functions to Moody's Advisers & Distributors ("Moody's A&D"), a wholly-owned subsidiary of Moody's Investor Service, which in turn is a wholly-owned subsidiary of D&B. The transfer of advisory functions was accomplished by merging the Fund into Moody's Capital Fund ("Capital Fund"). Approval of the merger by the Fund's stockholders included approval of the new advisory contract between Capital Fund and Moody's A&D. Other agreements, which were contingent upon consummation of the merger, consisted of covenants or undertakings by Lazard, among other things, not to engage in the investment company business as an investment adviser or otherwise, and to provide or make available certain services to Capital Fund. As consideration for such agreements, D&B agreed to deliver to Lazard Freres, in installments over a period of five years, 75,000 shares of its common stock then worth about $2.7 million. In this connection, the Court stated that (445 F. 2d at 1344):

> . . . any payment made to the outgoing adviser by his successor in these circumstances over and above the value of any continuing services represents consideration not for the lawful assignment of the contract - which is prohibited - but primarily for the use of influence in securing stockholder approval of the successor who expects to profit from the post. While it is true that the advisory contract is not conceptually an asset of the Fund, it is equally true that the expectation of profits under the contract is not an asset which, under the Act, the adviser can assign outright. Hence, if plaintiffs are correct in asserting that Lazard's few covenants were only a minor part of the consideration for D&B's payment to Lazard, Lazard and D&B must have assumed that the outgoing adviser was in a position to help effect the transfer of his office and that his efforts in doing so were worth valuable consideration.

investment advisory functions in the Rosenfeld case did not involve the sale of the outgoing investment adviser's business through a sale of its stock or through a sale of its assets. However, the broad sweep of the language of the Court has cast substantial doubt on whether an investment adviser can make any profit when it sells his business in that manner.3/

The Commission believes that it would be in the public interest to remove the uncertainty in the mutual fund industry which has been generated by the Rosenfeld decision. Therefore, the Commission recommends legislation which would clarify and modify the applicability of the Investment Company Act, as interpreted by Rosenfeld, to transfers of investment advisory organizations.

The proposed amendments are intended to permit an investment adviser, or an affiliated person of an adviser to obtain a profit upon the sale or transfer of its stock, or in connection with any other transaction which results in an assignment of the advisory contract, if certain conditions are met. These conditions are designed to prevent a retiring investment adviser or an affiliate from receiving any payment or other benefit in connection with the sale of the business of the adviser where

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3/ In its discussion of S.E.C. v. Insurance Securities, Inc., 254 F. 2d 642 (9 Cir., 1958), cert. den., 358 U.S. 823 (1958), which involved the sale by controlling stockholders of an investment adviser of their stock to a new controlling group at a price 25 times its net asset value, the Second Circuit stated that ". . . there are passages in the opinion suggesting that in the court's view none of the excess of the price received by the controlling stockholders over the book value of their stock would be recoverable under any circumstances by stockholders of the investment company." The Court stated that it did "not wish to be understood as accepting these views," although it did not find it necessary to determine "whether the difference between a transaction such as that here before us and the sale of a controlling block of stock in a corporate adviser at a price reflecting the expectation of profits under a renewed contract with the corporation which the sellers were to aid in procuring, is sufficiently substantial to warrant a different result in this latter case." 445 F. 2d at 1346-1347.

such payment or benefit includes any amount reflecting certainty of succession to and assurance of continuation of the investment advisory contract. Preventing receipt by a retiring adviser of payments for these purposes should mitigate the dangers with which the Second Circuit was concerned in the Rosenfeld opinion. A detailed discussion of the statutory language follows:

Proposed Section 15(f)

Proposed Section 15(f) specifies that an investment adviser or an affiliate may receive any amount or benefit in connection with a transaction resulting in an assignment of such adviser's investment advisory contract, if the adviser or affiliate can establish that conditions in the provision of the subsection are met. Proposed Section 15(f) would apply only to a transaction which results in an assignment of the adviser's investment advisory contract. "Assignment" is defined by Section 2(a)(4) of the Investment Company Act as including "any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor." An assignment will ordinarily occur as a result of a transfer of a controlling block of the adviser's stock but this may also be accomplished, as indicated by the definition of assignment, indirectly by a sale of assets, or transfer or hypothecation of a contract or chose in action, as for example, a sale of non-voting stock.

The proviso in subsection (f) would not limit the value of the purchase price or other consideration which may be received or accrued by the retiring adviser or its affiliate. The proposal thus takes into

consideration the fact that a purchaser of the investment adviser may be willing to pay consideration for the business of an investment adviser over and above the fair value of its tangible assets in the hope or expectation of serving as investment adviser to the registered investment company in the future.

The first provision of proposed Section 15(f) requires, however, that for a period of at least five years subsequent to the time of any such transaction, all affiliated persons of the investment company, such as officers, directors, and employees, must not be interested persons of the company's investment adviser and of any successor adviser. This would be accomplished by making it unlawful during the five year period for the registered investment company involved in the transaction to have as an affiliated person any person who is also (1) an interested person of the investment adviser of such investment company or (2) an interested person of any predecessor adviser. These requirements would also apply to any successor to such an investment company where the successor becomes such by reason of a reorganization of the investment company or otherwise. For the purpose of determining who are interested persons, the definition in Section 2(a)(19)(B) of the Act would apply.

The second provision of Section 15(f) prohibits any assignment of an advisory contract which subjects the investment company to an unfair burden for a two-year period after the transaction. Such a burden could arise, for example, where the transaction involves an arrangement with respect to the

investment company's brokerage commissions. A definition of unfair burden along these lines is included in the section. The prohibition against unfair burden is limited to two years - the maximum period specified by the statute for the duration of the initial advisory contract with the new investment adviser. Thereafter, the investment company's board of directors, consisting entirely of disinterested persons, will be expected to continue this protection.

It is important to note that the proposed amendment does not provide for rate making or fixing of profits by either the Commission or a court. In this connection, however, in determining whether or not to recommend the new contract for stockholder approval, the directors of the investment company who now have a fiduciary duty to refrain from personal misconduct in the performance of their office, would of course be required to carefully scrutinize and evaluate the terms and conditions of such contract as well as the qualifications and capabilities of the proposed new adviser.

Proposed New Section 16(b)

Section 16(b) provides that in the event of a transaction causing an assignment within the provisions of Section 15(f), the investment company affected will achieve a board of directors as required by Section 15(f) by prompt resignation of any directors who become ineligible to serve. Further, in order to achieve maximum independence of any successor directors throughout the period contemplated by Section 15(f)(1) during which the board must consist entirely of persons who are not interested persons of the investment adviser, new Section 16(b) also provides for the selection of such successor directors, and their recommendation to shareholders for

election, by those members of the company's board of directors who themselves are not interested persons of the investment adviser. In this connection, the time periods specified in Subsection 10(e) would be applicable.

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In view of the provisions of proposed Section 15(f), and new Section 16(b), a prospective purchaser of the business of an investment adviser would know that automatic perpetual succession to and continuation of the advisory relationship could not be assured. The new adviser would have to service the investment company at arm's length and the arm's-length relationship would continue for at least five years after the consummation of the transaction which caused the existing advisory contract to be assigned. Because the proposed successor adviser would have to deal at arm's length with the investment company, there should be no assurance that a purchaser will automatically perpetuate an advisory relationship with the investment company. Therefore, the proposed amendment should have the tendency of limiting to a fair value the consideration which a purchaser would be willing to offer a retiring adviser for its stock or assets.

Proposed Amendment to Section 15(c)

The proposed amendment to Section 15(c) of the Act would make it clear that the directors of a registered investment company when evaluating the terms of an investment advisory contract, may not take into account the purchase price or other consideration that might have been paid by the

adviser in connection with an earlier transaction within the provisions of Section 15(f). The directors of the investment company would be expected to perform their fiduciary duties presently specified by Section 15(c) by requesting and evaluating all relevant information and considering the qualifications and performance of the adviser. Although this consideration could include the adviser's costs in servicing the investment company, such costs could not include any amount paid to a predecessor adviser or its affiliated persons.

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It is intended that these amendments would be prospective in application only.

The Commission believes that the proposed amendments would permit investment advisers and their affiliates to obtain fair returns for the risks they assume in organizing, promoting, and managing investment companies and, at the same time, would protect the interests of investment companies and their shareholders when the investment advisers of those companies engage in transactions resulting in the assignment of their investment advisory contracts.

PROPOSED AMENDMENT TO SECTION 15
OF THE INVESTMENT COMPANY ACT OF
1940 TO ADD A NEW SUBSECTION (f)

(f) An investment adviser of a registered investment company, or an affiliated person of such investment adviser, may receive any amount or benefit in connection with a transaction which results in an assignment of an investment advisory contract with such investment company, provided that

(1) for a period of five years after the time of any such transaction, no affiliated person of such registered company (or successor thereto, by reorganization or otherwise) shall also be (A) an interested person of the investment adviser of such investment company or (B) an interested person of the predecessor investment adviser; and

(2) such transaction or its terms, conditions, or any understanding with respect thereto, express or implied, does not impose an unfair burden on the investment company. For purposes of this section, an unfair burden shall include any arrangement, during the two-year period after the time of such transaction, whereby the predecessor or successor adviser or any interested person of either such adviser receives or is to receive any compensation directly or indirectly (A) from any person in connection with the purchase or sale ofsecurities or other property to, from or on behalf of such investment company or (B) from the investment company or its security holders for other than bona fide investment advisory or administrative services.

PRESENT SECTION 16(b) REDESIGNATED 16(c) AND A NEW SUBSECTION (b) ADDED AS FOLLOWS

(b) In the event of any transaction within the provisions of Section 15(f), the directors of the investment company who are interested persons of either party to the transaction shall resign effective at the date of commencement of the new advisory contract and the remaining directors of the investment company shall select, and propose to stockholders for election to the board of directors, the requisite number of other persons who are also not such interested persons in the manner specified in Section 10(e).

PROPOSED AMENDMENT TO SECTION
15(c) TO ADD A NEW PROVISION

Subsection (c) as amended would read as follows (new matter underscored):

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or interested persons of such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be duty of the directors of a registered investment company to request and evaluate and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such investment company, to take into account the purchase price or other consideration such person may have paid in connection with a transaction within the provisions of subsection (f).

TECHNICAL STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PROPOSED AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940 REGARDING TRANSFERS OF ADVISORY RELATIONSHIPS

The proposed legislation would amend Section 15 of the Investment Company Act of 1940 ("Act") by adding new subsection (f), amend Section 16 by renumbering subsection (b) as (c) and adding a new subsection (b) and would add a new provision to Section 15(c). The proposed amendments are intended to clarify and modify the law in light of the decision in Rosenfeld v. Black, 445 F. 2d 1337 (2 Cir. 1971), as it may apply to the assignment of a contract of an investment adviser of an investment company registered under the Act.

In that case, the Court of Appeals for the Second Circuit held that the general equitable principle that a fiduciary cannot sell his office is impliedly incorporated into Section 15(a) of the Act. Consequently, a retiring investment adviser breaches its fiduciary duty under the Act by receiving compensation which reflects either (1) payment contingent upon the use of influence to secure approval of a new adviser or (2) an assurance of profits the successor adviser will receive under the new advisory contract and renewals thereof.[1/]

The Commission believes that the principle that a fiduciary cannot profit from the sale of his office was appropriately applied under the

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1/ See 445 F. 2d at 1343, 1344.

circumstances of that case, which appears to have involved an outright sale by the investment adviser of its investment advisory contract with a registered investment company.[2/] The transfer of

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2/ The facts in the Rosenfeld case show that the outgoing investment adviser, Lazard Freres & Co., ("Lazard"), decided to terminate its relationship with the Lazard Fund ("the Fund"), a registered investment company. Ordinarily, a retiring adviser sells a controlling block of its stock or its assets. However, Lazard did not follow this route, but instead, entered into an agreement with Dun & Bradstreet, Inc. ("D&B") to transfer the advisory functions to Moody's Advisers & Distributors ("Moody's A&D"), a wholly-owned subsidiary of Moody's Investor Service, which in turn is a wholly-owned subsidiary of D&B. The transfer of advisory functions was accomplished by merging the Fund into Moody's Capital Fund ("Capital Fund"). Approval of the merger by the Fund's stockholders included approval of the new advisory contract between Capital Fund and Moody's A&D. Other agreements, which were contingent upon consummation of the merger, consisted of covenants or undertakings by Lazard, among other things, not to engage in the investment company business as an investment adviser or otherwise, and to provide or make available certain services to Capital Fund. As consideration for such agreements, D&B agreed to deliver to Lazard Freres, in installments over a period of five years, 75,000 shares of its common stock then worth about $2.7 million. In this connection, the Court stated that (445 F. 2d at 1344):

> . . . any payment made to the outgoing adviser by his successor in these circumstances over and above the value of any continuing services represents consideration not for the lawful assignment of the contract - which is prohibited - but primarily for the use of influence in securing stockholder approval of the successor who expects to profit from the post. While it is true that the advisory contract is not conceptually an asset of the Fund, it is equally true that the expectation of profits under the contract is not an asset which, under the Act, the adviser can assign outright. Hence, if plaintiffs are correct in asserting that Lazard's few covenants were only a minor part of the consideration for D&B's payment to Lazard, Lazard and D&B must have assumed that the outgoing adviser was in a position to help effect the transfer of his office and that his efforts in doing so were worth valuable consideration.

investment advisory functions in the <u>Rosenfeld</u> case did not involve the sale of the outgoing investment adviser's business through a sale of its stock or through a sale of its assets. However, the broad sweep of the language of the Court has cast substantial doubt on whether an investment adviser can make any profit when it sells his business in that manner.[3/]

The Commission believes that it would be in the public interest to remove the uncertainty in the mutual fund industry which has been generated by the <u>Rosenfeld</u> decision. Therefore, the Commission recommends legislation which would clarify and modify the applicability of the Investment Company Act, as interpreted by <u>Rosenfeld</u>, to transfers of investment advisory organizations.

The proposed amendments are intended to permit an investment adviser, or an affiliated person of an adviser to obtain a profit upon the sale or transfer of its stock, or in connection with any other transaction which results in an assignment of the advisory contract, if certain conditions are met. These conditions are designed to prevent a retiring investment adviser or an affiliate from receiving any payment or other benefit in connection with the sale of the business of the adviser where

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3/ In its discussion of <u>S.E.C. v. Insurance Securities, Inc.</u>, 254 F. 2d 642 (9 Cir., 1958), <u>cert. den.</u>, 358 U.S. 823 (1958), which involved the sale by controlling stockholders of an investment adviser of their stock to a new controlling group at a price 25 times its net asset value, the Second Circuit stated that ". . . there are passages in the opinion suggesting that in the court's view none of the excess of the price received by the controlling stockholders over the book value of their stock would be recoverable under any circumstances by stockholders of the investment company." The Court stated that it did "not wish to be understood as accepting these views," although it did not find it necessary to determine "whether the difference between a transaction such as that here before us and the sale of a controlling block of stock in a corporate adviser at a price reflecting the expectation of profits under a renewed contract with the corporation which the sellers were to aid in procuring, is sufficiently substantial to warrant a different result in this latter case." 445 F. 2d at 1346-1347.

such payment or benefit includes any amount reflecting certainty of succession to and assurance of continuation of the investment advisory contract. Preventing receipt by a retiring adviser of payments for these purposes should mitigate the dangers with which the Second Circuit was concerned in the Rosenfeld opinion. A detailed discussion of the statutory language follows:

Proposed Section 15(f)

Proposed Section 15(f) specifies that an investment adviser or an affiliate may receive any amount or benefit in connection with a transaction resulting in an assignment of such adviser's investment advisory contract, if the adviser or affiliate can establish that conditions in the provision of the subsection are met. Proposed Section 15(f) would apply only to a transaction which results in an assignment of the adviser's investment advisory contract. "Assignment" is defined by Section 2(a)(4) of the Investment Company Act as including "any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor." An assignment will ordinarily occur as a result of a transfer of a controlling block of the adviser's stock but this may also be accomplished, as indicated by the definition of assignment, indirectly by a sale of assets, or transfer or hypothecation of a contract or chose in action, as for example, a sale of non-voting stock.

The proviso in subsection (f) would not limit the value of the purchase price or other consideration which may be received or accrued by the retiring adviser or its affiliate. The proposal thus takes into

consideration the fact that a purchaser of the investment adviser may be willing to pay consideration for the business of an investment adviser over and above the fair value of its tangible assets in the hope or expectation of serving as investment adviser to the registered investment company in the future.

The first provision of proposed Section 15(f) requires, however, that for a period of at least five years subsequent to the time of any such transaction, all affiliated persons of the investment company, such as officers, directors, and employees, must not be interested persons of the company's investment adviser and of any successor adviser. This would be accomplished by making it unlawful during the five year period for the registered investment company involved in the transaction to have as an affiliated person any person who is also (1) an interested person of the investment adviser of such investment company or (2) an interested person of any predecessor adviser. These requirements would also apply to any successor to such an investment company where the successor becomes such by reason of a reorganization of the investment company or otherwise. For the purpose of determining who are interested persons, the definition in Section 2(a)(19)(B) of the Act would apply.

The second provision of Section 15(f) prohibits any assignment of an advisory contract which subjects the investment company to an unfair burden for a two-year period after the transaction. Such a burden could arise, for example, where the transaction involves an arrangement with respect to the

investment company's brokerage commissions. A definition of unfair burden along these lines is included in the section. The prohibition against unfair burden is limited to two years - the maximum period specified by the statute for the duration of the initial advisory contract with the new investment adviser. Thereafter, the investment company's board of directors, consisting entirely of disinterested persons, will be expected to continue this protection.

It is important to note that the proposed amendment does not provide for rate making or fixing of profits by either the Commission or a court. In this connection, however, in determining whether or not to recommend the new contract for stockholder approval, the directors of the investment company who now have a fiduciary duty to refrain from personal misconduct in the performance of their office, would of course be required to carefully scrutinize and evaluate the terms and conditions of such contract as well as the qualifications and capabilities of the proposed new adviser.

Proposed New Section 16(b)

Section 16(b) provides that in the event of a transaction causing an assignment within the provisions of Section 15(f), the investment company affected will achieve a board of directors as required by Section 15(f) by prompt resignation of any directors who become ineligible to serve. Further, in order to achieve maximum independence of any successor directors throughout the period contemplated by Section 15(f)(1) during which the board must consist entirely of persons who are not interested persons of the investment adviser, new Section 16(b) also provides for the selection of such successor directors, and their recommendation to shareholders for

election, by those members of the company's board of directors who themselves are not interested persons of the investment adviser. In this connection, the time periods specified in Subsection 10(e) would be applicable.

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In view of the provisions of proposed Section 15(f), and new Section 16(b), a prospective purchaser of the business of an investment adviser would know that automatic perpetual succession to and continuation of the advisory relationship could not be assured. The new adviser would have to service the investment company at arm's length and the arm's-length relationship would continue for at least five years after the consummation of the transaction which caused the existing advisory contract to be assigned. Because the proposed successor adviser would have to deal at arm's length with the investment company, there should be no assurance that a purchaser will automatically perpetuate an advisory relationship with the investment company. Therefore, the proposed amendment should have the tendency of limiting to a fair value the consideration which a purchaser would be willing to offer a retiring adviser for its stock or assets.

Proposed Amendment to Section 15(c)

The proposed amendment to Section 15(c) of the Act would make it clear that the directors of a registered investment company when evaluating the terms of an investment advisory contract, may not take into account the purchase price or other consideration that might have been paid by the

adviser in connection with an earlier transaction within the provisions of Section 15(f). The directors of the investment company would be expected to perform their fiduciary duties presently specified by Section 15(c) by requesting and evaluating all relevant information and considering the qualifications and performance of the adviser. Although this consideration could include the adviser's costs in servicing the investment company, such costs could not include any amount paid to a predecessor adviser or its affiliated persons.

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It is intended that these amendments would be prospective in application only.

The Commission believes that the proposed amendments would permit investment advisers and their affiliates to obtain fair returns for the risks they assume in organizing, promoting, and managing investment companies and, at the same time, would protect the interests of investment companies and their shareholders when the investment advisers of those companies engage in transactions resulting in the assignment of their investment advisory contracts.