April 7, 2010

The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Troy A. Paredes, Commissioner
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Facilitating Shareholder Director Nominations (File No. S7-10-09)

Dear Chairman Schapiro, Commissioners Aguilar, Casey, Walter, and Paredes:

We are grateful for the opportunity to meet with you to discuss the effect that the recent proposal[1] to facilitate shareholders' ability to nominate directors will have on investment companies.

As proposed, the Commission's sweeping new proxy access requirements would apply to all public companies, including registered investment companies. As we discussed in detail at our meetings, the proposal, disappointingly, does not account for the most prevalent types of investment company boards – unitary or cluster boards—or for other stark differences between operating companies and today's complexes of investment companies. In addition, the Commission paid scant attention to investment companies when conducting empirical analysis in connection with the original proposal and the effect of the proposal on investment companies was not addressed at all by the Commission when it re-opened the comment period in December.[2]

Accordingly, we strongly recommend that the Commission exclude investment companies[3] from this proposal. The Commission instead should consider whether a proxy access proposal should

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[1] *See* SEC Release Nos. 33-9046; 34-60089; IC-28765 (June 10, 2009), 74 FR 29024 (June 18, 2009) ("Release 1").

[2] See SEC Release Nos. 33-9086; 34-61161; IC-29069 (December 14, 2009), 74 FR 67144 (December 18, 2009) ("Release 2").

[3] Our recommendation encompasses open-end investment companies, exchange-traded funds ("ETFs"), and business development companies ("BDCs"), which will be referred to collectively as "funds" or "investment companies" in this letter. Our comment letters on the proposal provide a more detailed discussion of the Investment Company Institute's and Independent Directors Council's views. See Letter from Paul Schott Stevens, President and Chief Executive Officer,

apply to investment companies at all, and, if so, how it could craft a new proposal better suited to the unique attributes of investment companies. Given the unique features of investment companies, as well as the size of the investment company universe, it is inappropriate for the Commission reflexively to "lump in" investment companies with operating companies under the proposal. Such rulemaking by default also has the potential to expose the Commission to legal challenge.[4]

We write now to reiterate some of the major points we discussed at our meetings and to submit for the record certain data and a legal memorandum in further support of our views.[5] We first discuss the most significant difference between investment companies and operating companies – the almost universal use of unitary or cluster boards of directors for investment companies – and then discuss the effect that the proposal could have on that structure if a shareholder nominee is elected. We also note that the empirical analysis with respect to investment companies is insufficient to meet the legal requirements to which the Commission is subject. Finally, we identify some specific concerns underlying the need for proxy access, and explain why those concerns do not apply to investment companies.

Benefits of Unitary and Cluster Board Structures

- There are sound practical and economic benefits[6] associated with unitary and cluster board structures, *none* of which were taken into account by the Commission.[7] These benefits include

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Investment Company Institute to Elizabeth Murphy, Secretary, United States Securities and Exchange Commission, dated August 17, 2009 and Letter from Michael S. Scofield, Chair, Governing Council, Independent Directors Council to Elizabeth Murphy, Secretary, United States Securities and Exchange Commission, dated January 14, 2010.

[4] As the Commission well knows, the United States Court of Appeals for the District of Columbia Circuit has emphasized the importance of adequately considering the costs regulated entities would incur in order to comply with a rule. See Chamber of Commerce v. Securities and Exchange Commission, 412 F.3d 133, 144 (June 21, 2005) ("uncertainty … does not excuse the Commission from its statutory obligation to do what it can to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation before it decides whether to adopt the measure."); American Equity Investment Life Insurance v. Securities and Exchange Commission, Case No. 09-1021 (July 21, 2009) (finding that the SEC's analysis of effects on efficiency, competition, and capital formation in adoption of rules related to indexed annuities was arbitrary and capricious, and remanding the matter to the Commission for reconsideration).

[5] See Information Regarding Registered Investment Companies Related to the SEC's Proxy Access Proposal, Investment Company Institute (March 26, 2010) ("Institute Report")(the attached report is identical to the one distributed at our February 4th meeting except with respect to additional detail regarding the distribution of long-term mutual funds by asset size on pps 1-4); and Memorandum to Investment Company Institute and Independent Directors Council From Eric F. Fess and Felice R. Foundos, Chapman and Cutler LLP Regarding Use of Confidentiality Agreements for "Non-Conforming" Directors, (February 24, 2010) ("Chapman and Cutler Memorandum") (memorandum regarding the effectiveness of confidentiality agreements) (copy attached).

[6] The Commission staff reexamined the adequacy of the governance structure for investment companies and concluded that the governance model embodied in the Investment Company Act "is sound and should be retained with limited

enhanced board efficiency and greater board knowledge of the many aspects of fund operations that are complex-wide in nature.

- Due to the detailed regulatory scheme established under the Investment Company Act of 1940, which governs all registered investment companies, many of the same issues arise for all of the funds that directors oversee. For example, fund directors are required to: establish standards for the valuation of portfolio securities; review the liquidity of certain types of portfolio securities; oversee fund brokerage, soft dollar, trade allocation and other compliance procedures; review and approve codes of ethics; and review and approve plans for allocating common expenses among funds in the same complex. The standards that govern directors' determinations in these areas apply to all funds in the same complex, and consistency among funds greatly enhances both board efficiency and shareholder protection, as there is less likelihood for compliance errors if all funds operate under consistent procedures.

- In addition, all funds are subject to the same disclosure standards, and many specific disclosures are similar for funds in the same complex, which facilitates director review of documents such as registration statements and shareholder reports. Fund accounting issues are similar across the entire complex. In addition, in order to assess adviser profitability and economies of scale, a fund board must understand the methodologies used by the adviser to allocate costs and profits among all funds in the complex.

- Business operations for investment companies within a complex tend to be quite similar. For example, funds within the same complex typically have a common investment adviser, principal underwriter, transfer agent, administrator, custodian, fund counsel, fund auditor, insurance carrier, and pricing service. Because of these commonalities, policies and practices within the fund family are fairly uniform.

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modifications." See Protecting Investors: Report of the Division of Investment Management (1992) at p. 253. Neither the recommended modifications nor the subsequent changes to strengthen investment company governance included proxy access requirements related to fund director nominations or the nominating process. Similarly, none of these recommendations or modifications related to unitary or cluster board structures. See also Sophie Xiaofei Kong and Dragon Yongjun Tang, Unitary Boards and Mutual Fund Governance (November 27, 1997) (finding strong evidence for unitary boards as an effective governance mechanism) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1033057. Cf. T. Robert Verkouteren vs. Blackrock Financial Management, 37 F. Supp. 2d 256 (February 4, 1999) (where the court recognized the prevalence of common boards within mutual fund complexes).

[7] A unitary board consists of one group of directors who serve on the board of every fund in the complex; a complex with a cluster board has two or more separate boards, each of which oversees a different group of funds. A recent ICI/IDC survey of fund complexes (representing 93 percent of the industry's total net assets) showed that 83 percent had a unitary board and 17 percent had a cluster structure.

- Because they are negotiating on behalf of multiple funds, unitary and cluster boards have a greater ability than single fund boards to negotiate with management over matters such as fund expenses; the level of resources devoted to technology; and compliance and audit functions.[8]

- For all of the foregoing reasons, director oversight of multiple funds within a complex has served shareholders well and disrupting this effective corporate governance mechanism should not be done without considerable forethought and good reason, *neither of which* was demonstrated by the Commission in the proxy access proposal.

Effect of Proposal on Unitary and Cluster Boards

- Under the Commission's proposal, if a shareholder in one of a complex's funds nominates a director who is elected, the complex will no longer be able to maintain its current unitary or cluster board structure.[9]

- Commission staff has stated that requiring shareholder-nominated directors to enter into confidentiality agreements will suffice to preserve the unitary and/or cluster structure. We strongly disagree. There are a number of practical and legal impediments to confidentiality agreements being sufficient to protect the interests of fund shareholders.[10] Further, neither of the Commission's Releases address the use of confidentiality agreements for this purpose.

- Although the use of unitary and cluster arrangements are quite common, within those structures there are other aspects of board organization that vary from complex to complex. The Commission's analysis does not take into account *any* of these differences, which are described in the Institute's Report.[11]

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[8] See Independent Directors Council Task Force Report, Director Oversight of Multiple Funds (May 2005), which can be accessed at http://www.idc.org/pdf/ppr_idc_multiple_funds.pdf.

[9] The proposal would affect both open-end and closed-end investment companies. Closed-end funds, like other listed issuers, are required to have annual shareholder meetings. Open-end investment companies periodically hold shareholder meetings, including with respect to mergers and material changes to investment advisory contracts. It is not unusual also to nominate directors for election at these meetings. Therefore, even though open-end investment companies are not required to have annual shareholder meetings, the Commission's proposal will affect them.

[10] *See* Chapman and Cutler Memorandum for a more detailed discussion.

[11] *See* Institute Report at pp.11-12.

The Need for Empirical Analysis

- In developing a proposal, the Commission must weigh its anticipated benefits against any resulting costs and burdens for investment companies generally and small funds in particular.[12] To date the Commission has not done so. For example, the Commission's use of empirical data to analyze the holdings information of some issuers to determine the proposed eligibility thresholds in Release 1 did not cover mutual funds or other types of investment companies.[13] The Commission's related analysis of share ownership and holding period patterns in Release 2 likewise did not cover mutual funds or other types of investment companies.[14]

Other Concerns that Are Not Relevant in the Investment Company Context

- Release 1 states that the proposal is designed to address declining governance practices. Yet the trend for investment company boards is to have strong governance practices, as demonstrated in a recent study prepared by the Investment Company Institute and the Independent Directors Council. For example, in nearly 90 percent of fund complexes, 75 percent or more of fund directors are independent and the vast majority of fund boards have an independent director serving as the board's chair or as lead independent director.[15]

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[12] The Commission is required to consider the impact that the proposal would have on competition, and is prohibited from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934. *See* Section 23(a)(2) of the Securities Exchange Act. The Commission also must consider, "in addition to the protection of investors, whether [the rule proposal] will promote efficiency, competition, and capital formation." *See* Section 3(f) of the Securities Exchange Act and Section 2(c) of the Investment Company Act. *See* Chamber at 143 (difficulty in determining the costs of a regulation "does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule it has proposed."). The Commission also is required to assess the impact of a proposed rule on small entities. *See* 5 USC 603 (regarding the requirement to prepare an initial regulatory flexibility act analysis).

[13] *See* Release 1 at note 129 ("The sample excludes mutual funds.") While BDCs, depending on their size, can be accelerated filers, large accelerated filers, or non-accelerated filers, Release 1 does not indicate whether the Commission analyzed holdings of BDCs as part of the analysis. Release 1 also does not indicate if the holdings of ETFs or closed-end funds were analyzed.

[14] The Commission's Division of Risk, Strategy, and Financial Innovation's supplemental analysis used data from Form 13F, which does not capture shares of open-end investment companies held by large institutional investment managers. While the form captures shares of closed-end funds held by large institutional investment managers, the Commission's analysis does not distinguish these shareholdings from shareholdings of operating companies. Accordingly, it is impossible to detect from the Commission's analysis the empirical effect of the proposal on any segment of the investment company industry or the industry as a whole.

[15] *See ICI/IDC Overview of Fund Governance Practices, 1994-2008* (copy attached).

- Release 1 further states that the federal proxy process may unintentionally frustrate shareholder voting rights. Yet the Commission did not make *any* mention of the fact that the Investment Company Act preserves the ability of investment company shareholders to participate in key decisions, unlike shareholders of operating companies (*e.g.,* investment companies are prohibited from engaging in a variety of transactions and activities unless they first obtain shareholder approval).[16]

* * * *

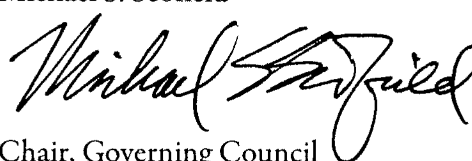
We hope our comments will help the Commission in its consideration of the many significant issues raised by amending the proxy rules to permit shareholder access to an investment company's proxy statement for the purposes of director nominations or related bylaw provisions. If you have any questions or need additional information, please contact Paul Stevens at (202) 326-5901, Karrie McMillan at (202) 326-5815, Dorothy Donohue at (202) 218-3563, or Amy Lancellotta at (202) 326-5824.

Sincerely,

Paul Stevens

President and Chief Executive Officer
Investment Company Institute

Michael S. Scofield



Chair, Governing Council
Independent Directors Council

cc: Andrew J. Donohue, Director, Division of Investment Management
Susan Nash, Associate Director, Division of Investment Management
Meredith B. Cross, Director, Division of Corporation Finance
Brian Breheny, Associate Director, Division of Corporation Finance
Henry T. C. Hu, Director, Division of Risk, Strategy, and Financial Innovation
David M. Becker, General Counsel, Office of the General Counsel
U.S. Securities and Exchange Commission

[16] *See Institute Report* at p. 14 for a more detailed discussion of shareholder rights under the Investment Company Act.

bcc: Kayla J. Gillan, Senior Advisor
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Information Regarding Registered Investment Companies Related to the SEC's Proxy Access Proposal

March 26, 2010

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Long-Term Mutual Funds With $10 million or Less in Total Net Assets[1]

Total Net Asset Range	Maximum Account Size to Meet 5% Threshold	Number of Funds[2]
$1 million or less	$50,000	27
$2 million or less	$100,000	82
$3 million or less	$150,000	123
$4 million or less	$200,000	165
$5 million or less	$250,000	217
$6 million or less	$300,000	255
$7 million or less	$350,000	291
$8 million or less	$400,000	328
$9 million or less	$450,000	365
$10 million or less	$500,000	400

1. Data as of December 2009.
2. These 2,253 mutual funds are part of 117 different fund complexes.

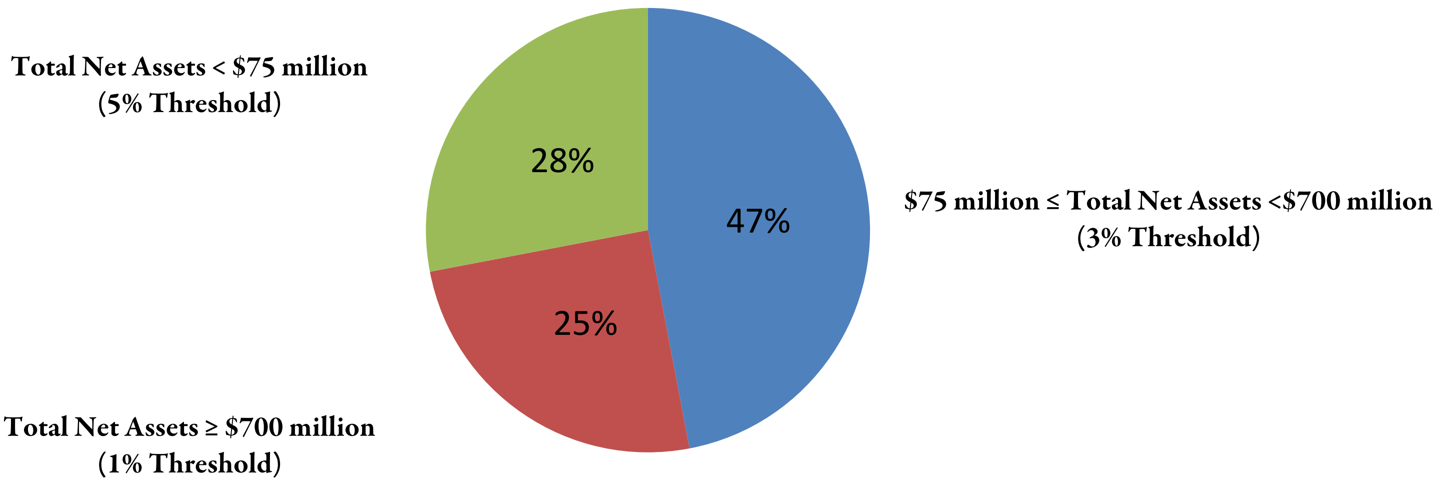
Five Smallest Registered Investment Companies by Type of Fund

Long-Term Mutual Funds[1]		Money Market Funds[1]		Closed-End Funds[1]	
Total Net Assets	5% Threshold	Total Net Assets	5% Threshold	Total Net Assets	5% Threshold
$50,000	$2,500	$1,651,000	$82,550	$4,306,000	$215,300
$61,000	$3,050	$5,158,000	$257,900	$4,632,000	$231,600
$177,000	$8,850	$7,549,000	$377,450	$18,459,000	$922,950
$213,000	$10,650	$8,571,000	$428,550	$19,725,000	$986,250
$351,000	$17,550	$9,102,000	$455,100	$20,339,000	$1,016,950

1. Data as of December 2009.

Source: Investment Company Institute

Distribution of Long-Term Mutual Funds by Total Net Asset Size[1]
December 2009



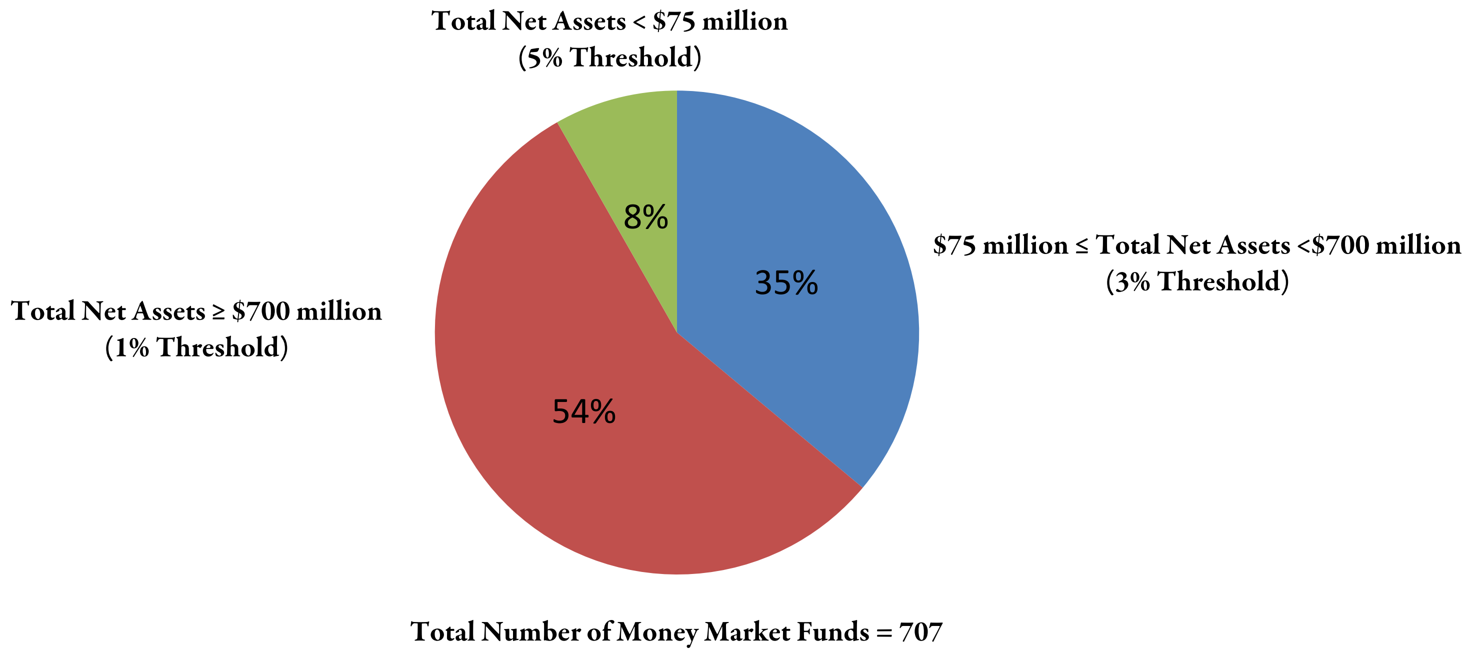
Total Number of Long-Term Mutual Funds = 7,603

1. Long-term mutual funds are those that have been open for at least one-year.

Distribution of Total Net Assets of Long-Term Mutual Funds

Ranking	Total Net Assets ($ millions)	5% Threshold	3% Threshold	1% Threshold
10th percentile	$19	$930,150		
20th percentile	$44	$2.2 million		
30th percentile	$83		$2.5 million	
40th percentile	$138		$4.2 million	
Median	$216		$6.5 million	
60th percentile	$343		$10.3 million	
70th percentile	$548		$16.4 million	
80th percentile	$951			$9.5 million
90th percentile	$1,962			$19.6 million
Maximum	$201,742			$2.0billion

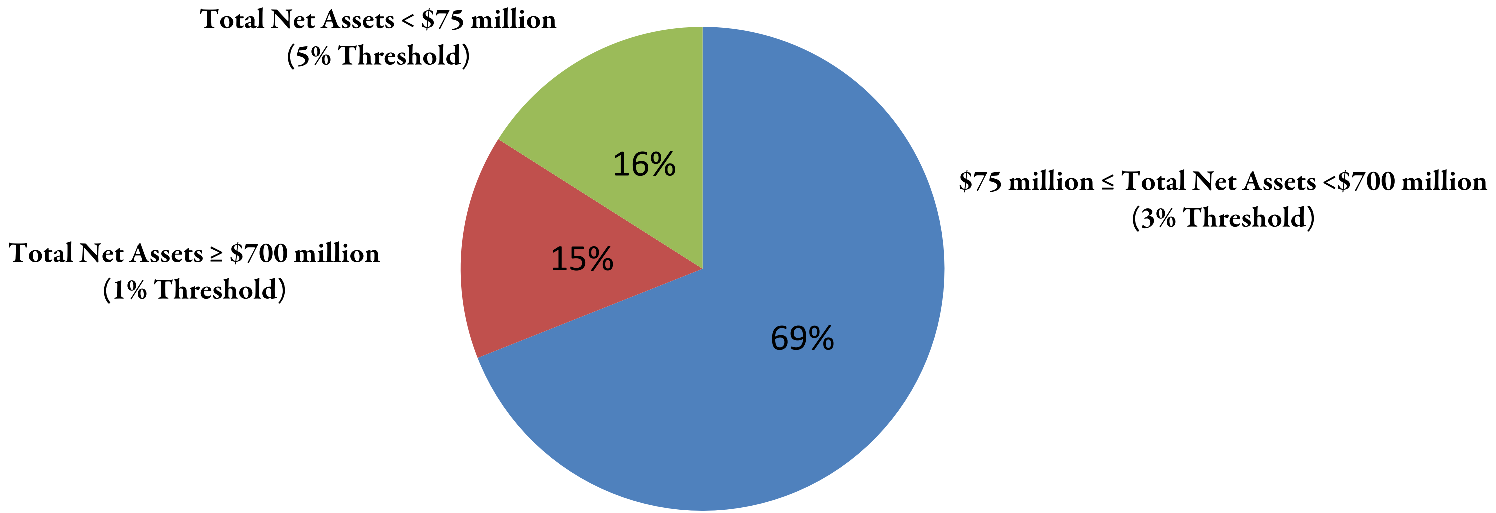
Distribution of Money Market Funds by Total Net Asset Size
December 2009



Distribution of Total Net Assets of Money Market Funds

Ranking	Total Net Assets ($ millions)	5% Threshold	3% Threshold	1% Threshold
10th percentile	$100		$3.0 million	
20th percentile	$208		$6.2 million	
30th percentile	$339		$10.2 million	
40th percentile	$518		$15.5 million	
Median	$844			$8.4 million
60th percentile	$1,382			$13.8 million
70th percentile	$2,477			$24.8 million
80th percentile	$5,138			$51.4 million
90th percentile	$13,442			$134.4 million
Maximum	$164,882			$1.6 billion

Distribution of Closed-End Funds by Total Net Asset Size
December 2009



Total Number of Closed-End Funds = 627

Distribution of Total Net Assets of Closed-End Funds

Ranking	Total Net Assets ($ millions)	5% Threshold	3% Threshold	1% Threshold
10th percentile	$57	$2.9 million		
20th percentile	$87		$2.6 million	
30th percentile	$125		$3.7 million	
40th percentile	$164		$4.9 million	
Median	$216		$6.5 million	
60th percentile	$293		$8.8 million	
70th percentile	$383		$11.5 million	
80th percentile	$540		$16.2 million	
90th percentile	$855			$8.5 million
Maximum	$3,805			$38.1 million

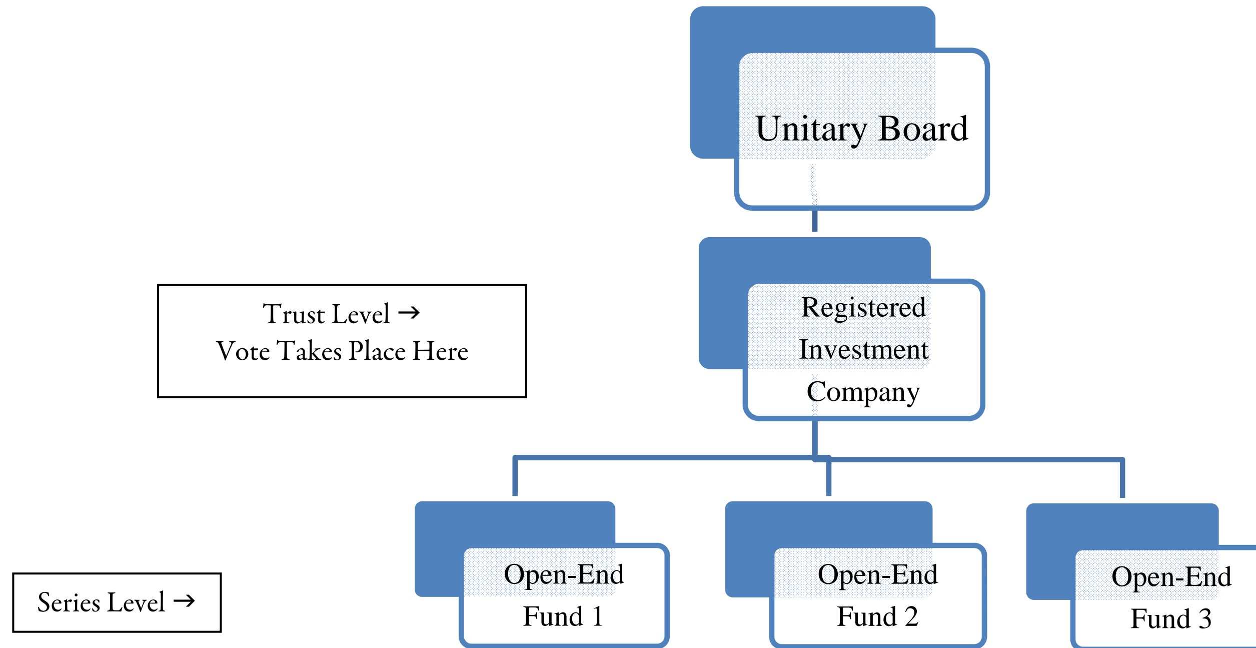
Data Regarding Fund Complexes with Multiple Registered Investment Companies

According to ICI research, fund complexes that are ICI members, on average, have five registered investment companies (although there may be multiple series/funds within each registered investment company). The maximum number of registered investment companies is 178. Both the median and the minimum is one registered investment company per complex. Members pointed out that it is typical for older fund groups, which have gone through mergers to have multiple registered investment companies. In addition, because closed-end funds are not permitted to be organized as series under the Investment Company Act, each will be a separately registered investment company.

Data Regarding Board Structure of Registered Investment Companies

- Most funds today are part of complexes comprised of multiple funds that share the same investment adviser and other key service providers. Boards of these funds generally are organized according to one of two models -- a "unitary" board consisting of one group of directors who serve on the board of every fund in the complex, or "cluster" boards consisting of two or more separate boards of directors within the complex that each oversees a different group of funds.
- A recent joint ICI and Independent Directors Council survey, covering approximately 93% of investment company assets under management, showed that of the complexes responding to the survey, 83% had a unitary board structure, and 17% had a cluster structure.
- ICI data shows that thirty-seven fund complexes that are ICI members have both closed-end and open-end funds.
- Thirty-one of these complexes responded to our most recent ICI/IDC Directors survey.
- Of the thirty-one respondents, seventeen have unitary boards and fourteen have cluster boards.
- Of the fourteen complexes with cluster boards, six have a board that oversees only closed-end funds.
- Of those six, two also have a different board that oversees both open-end and closed-end funds.
- Of the fourteen fund complexes with cluster boards, ten have boards that oversee both open-end and closed-end funds.

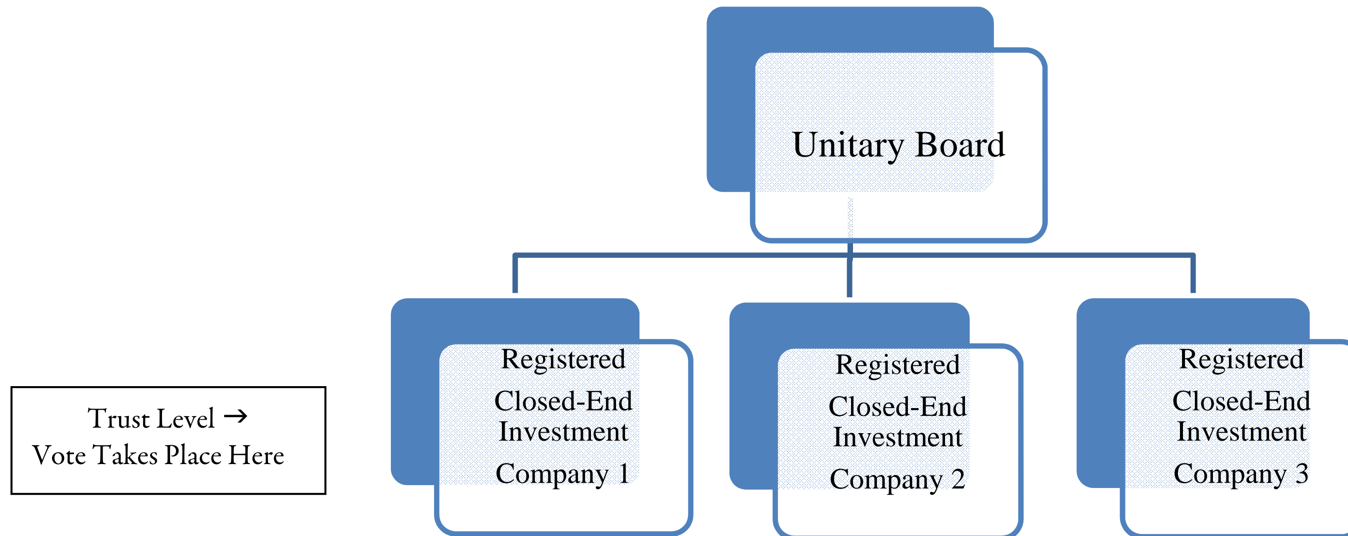
FUND COMPLEX A



Notes: This complex has one investment adviser. It has all retail funds with various investment objectives. The funds include a domestic equity fund, an asset allocation fund, and a socially responsible fund.

Since this complex consists of a single registered investment company, Rule 14a-11's net asset thresholds would apply to the complex as a whole (not on a series-by-series basis). A shareholder in any *one* of these series could nominate a director who then would be voted on by shareholders of all the series. If elected, that director then would be on the board overseeing *all* of the funds. If that director pursues an agenda that favors, for example, socially responsible investing over investing for economic return, this may lead to undesirable changes to non-fundamental investment policies to the detriment of, and contrary to the expectations of, the shareholders in the other series. The Commission should not facilitate the use of mutual funds as lightning rods for special interest shareholders seeking to effect change indirectly. Under current law, a shareholder-nominated director could be elected to the board through a proxy contest, which is much more expensive and less likely to occur, and even if it does occur, is less likely to succeed.

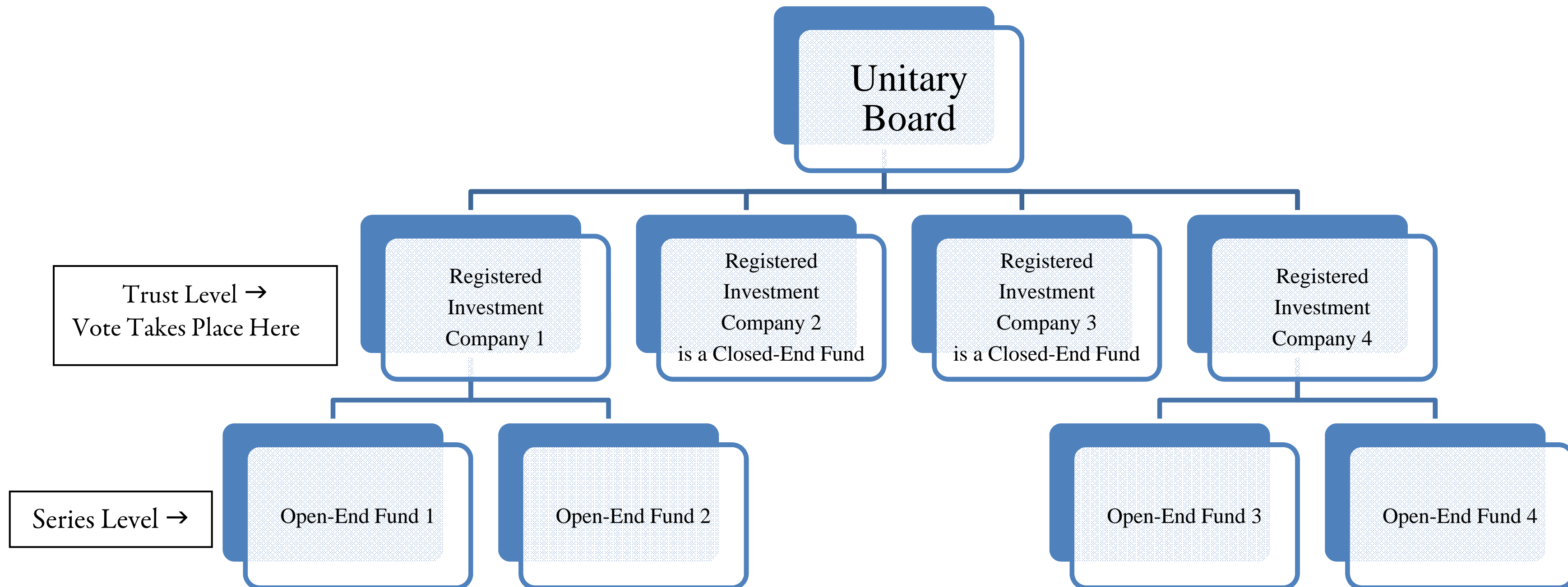
FUND COMPLEX B



Notes: This complex has two different investment advisers. The registered investment companies have various investment objectives. There is an international equity fund, a venture capital fund, and a municipal security fund.

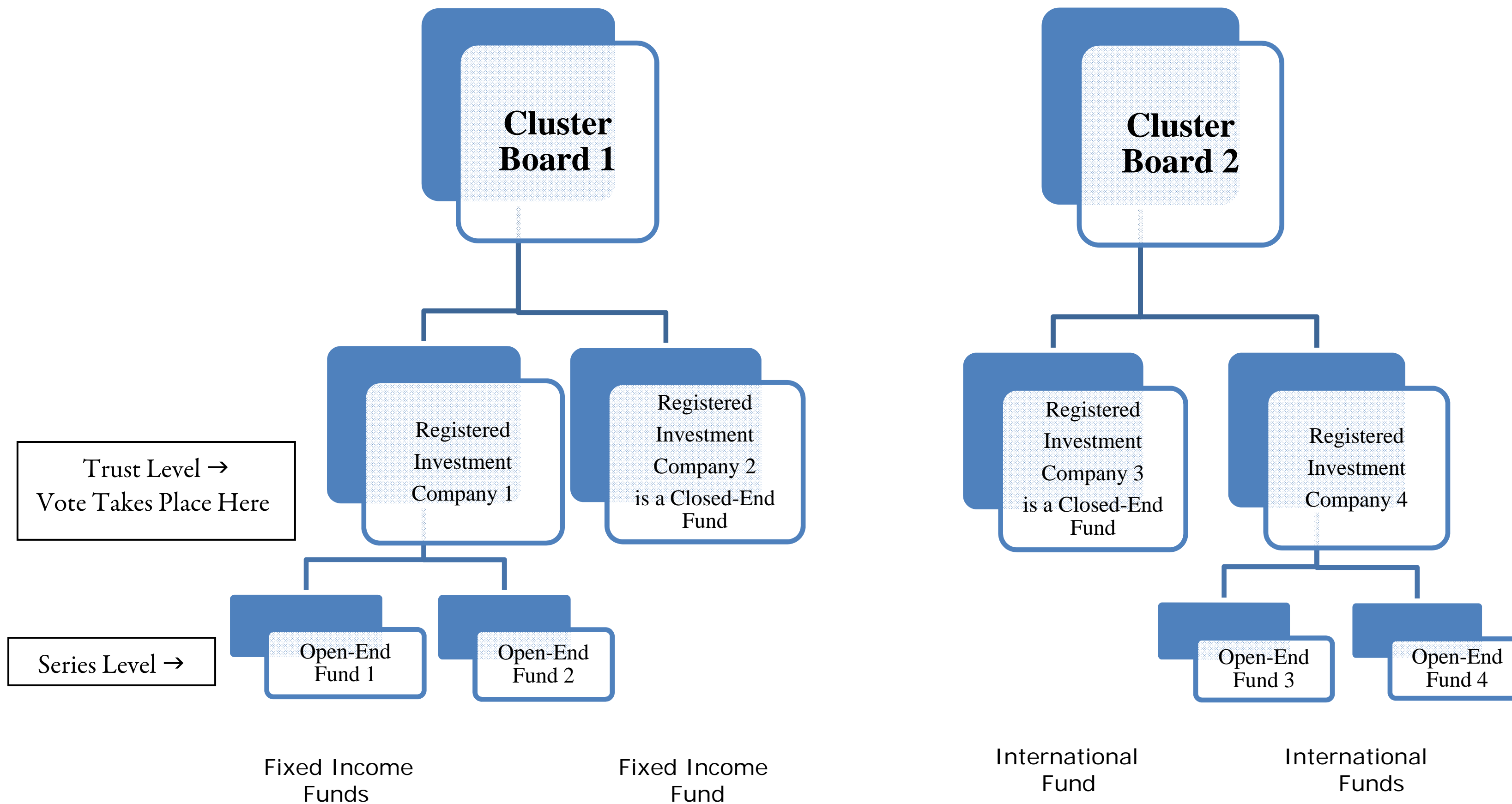
Today, each of these registrants conducts a proxy for the election of directors simultaneously and sets forth the same slate of directors for each. It is possible today for a dissident to mount a proxy contest with respect to one of the registrants and get a director elected for only that registrant. This occurs infrequently presumably because of the time and expense involved. Under proposed Rule 14a-11, it would be easier and less expensive for a shareholder to nominate a director because that nominee would appear on the registrant's proxy. If that nominee is elected, the complex will no longer be able to have a unitary board. They will have one board overseeing all the funds in the complex except the one with the new director, which will cause the fund to incur additional costs (at shareholder expense) and experience administrative difficulties. For example, arrangements would have to be made for that director to leave during any discussions that only pertain to other funds in the trust. Further, board materials would have to be customized for that director.

FUND COMPLEX C



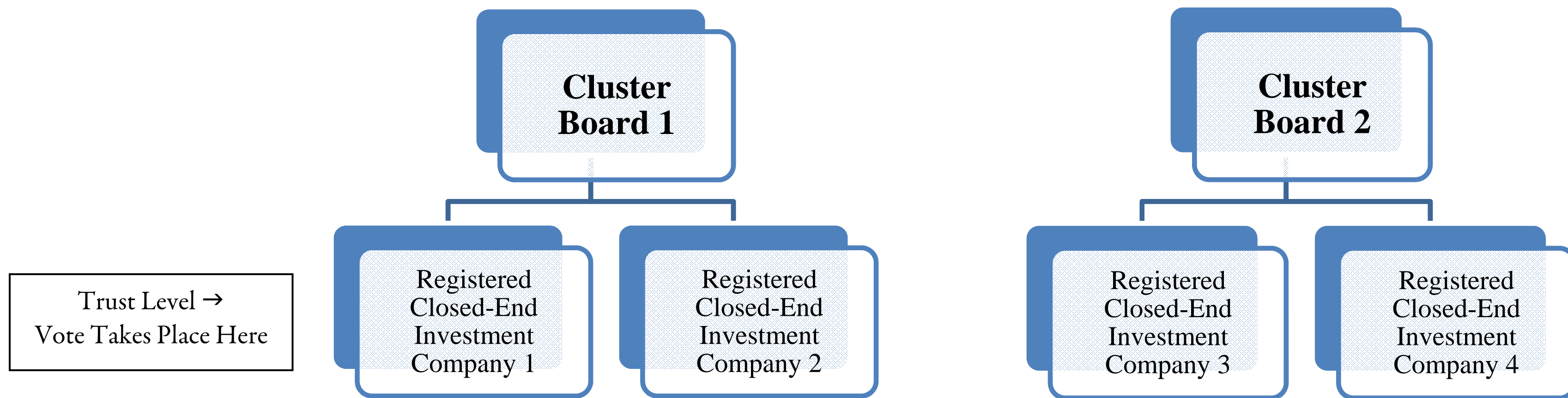
Notes: This complex has one investment adviser. It has retail equity funds and funds offered as variable annuity products. It also has single state municipal security funds organized as closed-end funds.

FUND COMPLEX D



Notes: This complex resulted from a merger of two complexes. Cluster Board 1 oversees all fixed income funds, some of which are organized as closed-end funds and some of which are organized as open-end funds. Cluster Board 2 oversees all of the international funds, some of which are organized as open-end funds and others as closed-end funds.

FUND COMPLEX E



Notes: This complex resulted from a merger of two other complexes. Cluster Board 1 oversees all retail funds, all of which are organized as closed-end funds. Cluster Board 2 oversees all of the funds offered through private wealth management services.

The Commission first should establish that there is a need for proxy access requirements regarding director nominations or related bylaw provisions in the investment company context. Only if it so determines, should it then develop a tailored proposal that is designed specifically for investment companies and weigh its anticipated benefits against any resulting costs. This analysis must include considering the impact of the application of proxy access to the multitude of fund board structures. The examples below, drawn from information provided by Institute members, demonstrate a myriad of fund board structures.

I. Complexes with Cluster Boards that Oversee Both Open-End and Closed-End Funds

1. Fund Complex 1 has two boards. It has separate boards for retail funds and funds offered through private wealth management services, largely because these funds existed as part of two fund complexes that merged. It has common directors for their closed-end and open-end funds.

2. Fund Complex 2 has seven boards. Four closed-end funds are dispersed among three of those boards. General historical reasons account for which boards oversee which funds (*i.e.,* boards were added as new funds were launched).

3. Fund Complex 3 has two boards. One board oversees all of its open-end funds and all but three of its closed-end funds. A second board oversees the other closed-end funds.

4. Fund Complex 4 has two boards. Board A oversees the 101 open-end and two closed-end funds Adviser A advises; these are all fixed-income funds. Board B oversees the 18 open-end and five closed-end funds Adviser B advises; these are all equity and international funds.

5. Fund Complex 5 has two boards. Board A oversees nine closed-end funds and approximately 60 open-end funds. Board B oversees open-end funds. This complex splits its clusters based on the nature of their customers; one board oversees funds with retail customers and the other oversees a fund of funds and variable annuity funds.

6. Fund Complex 6 has five boards. One oversees only closed-end funds, two different boards each oversee a distinct group of open-end equity funds, a fourth oversees open-end fixed income funds, and a fifth oversees open-end institutional fixed income funds and two retail closed-end funds.

7. Fund Complex 7 has one board for all of its open-end and closed-end funds except that a second board oversees its variable annuity funds.

8. Fund Complex 8 has two boards. One board oversees the approximately 110 open-end funds and 26 closed-end funds advised by Adviser A. A second board oversees approximately 80 open-end funds and 18 closed-end funds advised by Adviser B.

9. Fund Complex 9 has two boards. This complex has a number of open-end funds and three closed-end funds; one board oversees one closed-end fund and a group of the open-end funds and the other oversees two closed-end funds and the remaining open-end funds.

10. Fund Complex 10 has two boards. Both boards oversee both closed-end funds and open-end funds. Which fund is in which cluster is determined by the fund's investment objective.

II. Complexes with Cluster Boards that Oversee Solely Closed-End Funds

1. Fund Complex 1 has two boards. One board oversees two closed-end funds (because they are their only retail funds) and the other oversees their 14 open-end variable annuity funds.

2. Fund Complex 2 has two boards. One oversees three closed-end funds, and the other oversees all of its open-end funds and some additional closed-end funds.

3. Fund Complex 3 has five boards, one of which oversees only closed-end funds and another which oversees both open-end and closed-end funds.

4. Fund Complex 4 has two boards. One oversees one privately offered closed-end fund of funds. The other oversees all of its open-end funds.

5. Fund Complex 5 has four boards. One oversees all of its insurance funds and a second oversees its retail funds. Until recently, the retail funds included two closed-end funds, which since have been merged into an open-end fund. The adviser of the complex also administers, but does not advise, two international closed-end funds, each of which has its own board for reasons related to the fund's investment objective.

6. Fund Complex 6 has several boards. One board oversees two closed-end funds (because they are their only retail funds) and several other boards oversee their variable annuity funds.

Shareholder Rights Under the Investment Company Act

- The Investment Company supplements state law in a number of key respects by regulating shareholder participation in key decisions, unlike shareholders of operating companies.

- Registered investment companies are prohibited from engaging in a variety of transactions and activities unless they first obtain shareholder approval. These transactions and activities include changing from an open-end, closed-end, or a diversified company; borrowing money, issuing senior securities, underwriting securities issued by other persons, purchasing or selling real estate or commodities or making loans to other persons, except in accordance with the policy in its registration statement; or deviating from a stated policy with respect to concentration of investments in an industry or industries, from any investment policy which is changeable only by shareholder vote, from any stated fundamental policy, or changing the nature of its business so as to cease to be an investment company.

- In addition, a registered investment company's contract with its investment adviser and distributor (and any material amendments to those contracts) must be approved by a majority of outstanding voting securities; and any shareholder of a registered investment company may bring an action against the company's investment adviser for breach of fiduciary duty with respect to receipt of compensation for services or payments of a material nature paid by such company.

Board Oversight of Funds

Registered investment companies are overseen by a board of directors who have a fiduciary duty to represent the interests of fund shareholders. The Investment Company Act of 1940 and the rules under it impose significant responsibilities on fund directors in addition to the duties of loyalty and care to which directors are typically bound under state law.

One of the independent directors' most important statutory responsibilities is to annually evaluate and approve the contract between the fund and its investment adviser, including the adviser's fees. The 1940 Act imposes on the adviser a "fiduciary duty with respect to the receipt of compensation" for services paid by the fund and requires that a majority of the independent directors approve the contract. Directors participate in numerous meetings and consider and review hundreds if not thousands of pages of detailed information before approving the contract each year. Through a disclosure rule, the SEC has required boards to consider several factors when evaluating advisory contracts for approval, including the nature, extent, and quality of the services to be provided by the adviser, the investment performance of the fund, and the costs of the services to be provided. The SEC regularly examines fund boards' discharge of their statutory obligations, including the approval of advisory fees.

Another important responsibility of independent directors is to monitor potential conflicts of interest between the fund and the adviser or its affiliates. Conflicts may arise in arrangements or transactions between the fund and fund affiliates, such as in the use of affiliated broker-dealers or cross trades with affiliated funds. In some cases, SEC rules impose specific responsibilities on independent directors. For example, rules providing exemptions from 1940 Act prohibitions on affiliated transactions rely on directors to adopt appropriate procedures for these transactions and oversee compliance with them.

Among other responsibilities, fund directors also:

- Approve certain distribution plans (e.g., 12b-1 plans);
- Make fair value determinations for certain securities held by the fund;
- Approve the codes of ethics of the fund and the adviser;
- Oversee the compliance function, including approving the written compliance policies and procedures and approving the hiring and compensation of the fund's chief compliance officer; and
- Oversee the process by which fund disclosure (including prospectuses) is prepared, reviewed, revised, and updated.

These myriad responsibilities required by federal law are discharged within the framework of fiduciary duties established for directors under state corporate law. Directors must perform their duties in an informed and deliberate manner, and, to do so, they devote substantial time and consider large amounts of information related to various aspects of fund operations and management.

Chapman and Cutler LLP

MEMORANDUM

TO: Investment Company Institute
Independent Directors Council

FROM: Eric F. Fess
Felice R. Foundos

DATE: February 24, 2010

RE: USE OF CONFIDENTIALITY AGREEMENTS FOR "NON-CONFORMING" DIRECTORS

You have asked us to consider the feasibility of using confidentiality agreements to address issues arising when a director serves on the board of only one investment company in an investment company complex utilizing a unitary board structure where the other directors serve on the boards of all the funds in the complex. We refer to the individual director serving on only one board in a fund complex as a "non-conforming" director. As outlined below, we believe that confidentiality agreements cannot effectively eliminate the issues raised in this context and would be impracticable to implement and enforce.

UNITARY BOARDS ENHANCE EFFECTIVE GOVERNANCE AND REDUCE COSTS

As you are aware, the unitary board consists of one board of directors who serve on the board of every fund in the complex. Investment companies adopt this structure, in part, because it enhances good and effective governance given the nature of the structure of the investment company complex. Funds in the same complex generally are served by the same service providers and personnel and are governed by the same regulatory scheme, all of which raise common issues that can best be addressed by the directors across the complex. It is therefore more efficient and cost effective to shareholders to have a single board review and oversee common policies and procedures, which increases the board's knowledge and expertise with respect to the many aspects of fund operations that are complex-wide in nature. In light of this structure, the directors hold board meetings that simultaneously represent all the funds they oversee. In addition, the materials prepared for such meetings and the discussions at such meetings cover all the funds.

THE UNDERPINNINGS OF REGULATION FD MAY BE COMPROMISED

If a director is elected to only one board of a fund but does not serve as a director on the boards of the other funds in the complex, the non-conforming director will have access to all meetings of the funds in the complex and be provided with all the materials provided to the directors. As a result, the non-conforming director will have unfettered access to material non-public information with respect to the funds he or she does not serve (the "Unified Funds"). The

disclosure of material non-public information to a person outside the Unified Funds will raise concerns of selective disclosure, including under Regulation FD. Regardless of whether the non-conforming director falls within the categories of restricted persons enumerated in Regulation FD, the selective disclosure to the non-conforming director who gains an informational edge and has the ability to use that edge to profit from his or her superior access to material non-public information is exactly the type of selective disclosure Regulation FD was designed to prevent.

BROAD CONFIDENTIALITY AGREEMENTS WILL BE INEFFECTIVE

The non-conforming director does not owe any duty of trust, loyalty or confidence to the Unified Funds. Accordingly, it has been suggested that such funds could seek to enter into a confidentiality agreement with the non-conforming director to protect the funds from concerns of selective disclosure of material, non-public information under Regulation FD or other applicable law. Typically, confidentiality agreements are carefully tailored to the specific circumstances. With respect to complying with Regulation FD, the issuer normally has control over the particular information that it intends to disclose and can prepare the confidentiality agreement accordingly. However, in the case of board meetings, it would be impossible to anticipate all the material non-public information that may be disclosed during discussions at board meetings. In this context, a confidentiality agreement, therefore, would by necessity have to be unlimited in scope and duration to capture the myriad of material, non-public information that may be disclosed during the discussions and presentations at the meetings and in the board materials. Overly broad confidentiality agreements, however, raise concerns regarding enforceability.

NON-CONFORMING DIRECTORS WILL NOT EXECUTE BROAD CONFIDENTIALITY AGREEMENTS

A non-conforming director is not required to execute a confidentiality agreement.[1] Any such confidentiality agreement also presumably would include a restriction on trading on any material non-public information. Given the breadth of the scope of the agreement and trading restrictions, a non-conforming director likely will not be willing to sign such an agreement nor could the remaining directors legally compel the non-conforming director to enter into such agreement. As the non-conforming director has no fiduciary duty to the Unified Funds to keep information confidential and if a confidentiality agreement is not executed, the Unified Funds would have to resort to either (a) publicly disclosing all material non-public information provided to or learned by the non-conforming director or (b) hold separate meetings and prepare separate materials to prevent the non-conforming director from obtaining any material non-public information concerning the Unified Funds. The former alternative is not conducive to the ongoing functioning of the Board and would require the disclosure of material information about the funds to the detriment of shareholders. The latter alternative eliminates the administrative efficiencies gained with a unified board structure and increases administrative costs, particularly for the fund on which the non-conforming director serves, as it will have to bear its own costs for separate meetings.

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[1] We are not aware of any federal or state law or regulation that would require the non-conforming director to enter into a confidentiality agreement with the Unified Funds.

BROAD CONFIDENTIALITY AGREEMENTS PROVIDE INADEQUATE PROTECTION AS THERE IS NO MEANS TO MONITOR COMPLIANCE

If a confidentiality agreement is entered into with the non-conforming director, the Unified Funds and management have no means by which to ensure ongoing compliance with the agreement or assess its effectiveness. With respect to the Unified Funds, the non-conforming director is not subject to the same restrictions that assist in monitoring activities of directors. For example, the non-conforming director would not be subject to the Unified Funds' insider trading policies or the reporting and short-swing profits provisions contained in Section 16 of the Securities Exchange Act. In addition, Section 16 does not just rely on a statutory prohibition. Rather, there is a reporting mechanism that is intended to root out non-compliance with that prohibition. **Any protection provided by a confidentiality agreement that cannot be effectively enforced or monitored is illusory and of little value.** The goal is to keep the information confidential, not to provide a contractual basis to sue someone for violation of the agreement. The same would be true of any compliance policy adopted by a fund that could not be monitored. For example, Rule 38a-1 not only requires the adoption of compliance policies and procedures, but also their annual review to ensure continued effectiveness. As stated by Gene Gohlke, Associate Director of the Office of Compliance Inspections and Examinations, the goal of the annual review is to "determine if the firm's compliance program continues to reasonably and effectively prevent compliance issues from happening, detect those compliance issues that do happen and promote the prompt correction of the issues that occur."[2] A compliance policy merely adopted as such without any method to review and modify as necessary provides little protection against potential compliance violations and would be insufficient under Rule 38a-1. Similarly, a confidentiality agreement alone, without any means to evaluate it periodically, is merely a superficial show of protection.

CONFIDENTIALITY AGREEMENTS DO NOT ADDRESS OTHER PROBLEM AREAS, INCLUDING POTENTIAL LOSS OF ATTORNEY-CLIENT PRIVILEGE

A confidentiality agreement does not address other issues raised by having a non-conforming director present at Unified Funds' board meetings including a potential chilling effect on the deliberations among the remaining directors precluding effective decision-making; and the possible loss of attorney-client privilege between the remaining directors and independent legal counsel. As the directors to the Unified Funds have a fiduciary duty to act in the best interests of such funds and their shareholders, they may inevitably determine that it is in the best interests of such shareholders to operate meetings without the non-conforming director present and thus lose the efficiencies and enhanced governance gained through the unitary board structure.

In light of the foregoing, we believe that the use of confidentiality agreements does not adequately protect the Unified Funds from the risks associated with a non-conforming director serving on a board in a fund complex utilizing a unitary board structure.

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[2] Gene Gohlke, Examiner Oversight of "Annual" Reviews Conducted by Advisers and Funds (April 7, 2006).

OVERVIEW OF

Fund Governance Practices 1994–2008

KEY FINDINGS

» **FUND BOARDS, AS A GROUP, FOLLOW STRONG GOVERNANCE PRACTICES TO BEST SERVE THE INTERESTS OF SHAREHOLDERS.**

Studies of board practices indicate that over the past 14 years, fund boards have adopted such practices in advance of, or in the absence of, any regulatory mandate to do so.

» **AS OF YEAR-END 2008, INDEPENDENT DIRECTORS MADE UP THREE-QUARTERS OF BOARDS IN ALMOST 90 PERCENT OF FUND COMPLEXES.**

Between 2000 and 2008, the number of complexes reporting that independent directors hold 75 percent or more of board seats rose from 52 percent to 88 percent. Current SEC rules require only that funds relying on common exemptive rules have boards with a majority of independent directors.

» **NEARLY TWO-THIRDS OF FUND COMPLEXES REPORT HAVING AN INDEPENDENT BOARD CHAIR.**

Sixty-three percent of complexes reported having boards with independent chairs at year-end 2008. When complexes that have boards with independent lead directors are also considered, 84 percent of participating complexes reported having an independent director in board leadership at year-end 2008.

» **MORE THAN NINE IN 10 FUND COMPLEXES REPORT THAT SEPARATE LEGAL COUNSEL SERVE THEIR INDEPENDENT DIRECTORS.**

The total percentage of complexes reporting that independent directors are represented either by dedicated counsel or counsel separate from the adviser's has increased steadily, from 68 percent in 2000 to 96 percent at year-end 2008. More than half of complexes say their independent directors retain their own counsel—separate from both fund counsel and the adviser's counsel.

» **A VAST MAJORITY OF FUND COMPLEXES HAVE AN AUDIT COMMITTEE FINANCIAL EXPERT.**

While current rules require only that funds disclose whether or not the audit committee includes a financial expert, 97 percent of participating complexes report having a financial expert on the audit committee.

INVESTMENT COMPANY INSTITUTE AND INDEPENDENT DIRECTORS COUNCIL

Background

Fund boards perform an important role in the oversight of the $10 trillion fund industry. The Investment Company Act of 1940 (1940 Act) and its related rules impose significant responsibilities on fund boards and dictate elements of board structures and practices. Over the past several years, there has been increased focus by fund boards as well as regulators on ways to enhance fund governance. In 1995, the Investment Company Institute (ICI) began to document fund governance practices by collecting data from fund complexes biennially.[1] The Independent Directors Council (IDC) was formed in 2004, and since then, the studies have been conducted jointly by ICI and IDC.

Board practices have been influenced by changing attitudes toward governance as well as by regulatory actions (see "Fund Governance Developments" below). In 1999, for example, a panel of interested and independent fund directors convened by ICI identified 15 practices to enhance the independence and effectiveness of fund directors. Their recommendations were published as the *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (*Best Practices Report*).[2] Studies since 1999 document the effect of the *Best Practices Report* and other developments on board practices industrywide.

This overview provides common fund governance practices covering the period from 1994 through 2008, and is an update to the overview published two years ago.[3] While the complexes participating in each biennial study have varied over the years, an examination of the data reveals certain trends. To put these data in context, this overview includes information on fund assets managed by complexes that participated in each of the biennial studies, the average fund assets served per director, the average number of funds served, and selected independent director characteristics.

FUND GOVERNANCE DEVELOPMENTS

1999	SEC hosts roundtable discussion on fund governance.
1999	ICI publishes advisory group report on best practices for fund directors (*Best Practices Report*).
2001	SEC adopts rule amendments focused on board governance requirements (2001 SEC Rules).[4]
2004	SEC adopts rule amendments focused on board governance, including requirements that fund boards be composed of at least 75 percent independent directors and chaired by an independent director (2004 SEC Rules).[5]
2006	Federal appeals court invalidates requirements in the 2004 SEC Rules that fund boards be composed of at least 75 percent independent directors and chaired by an independent director.[6]
2006	SEC seeks additional comment on 75 percent independent director composition and independent chair requirements.[7]

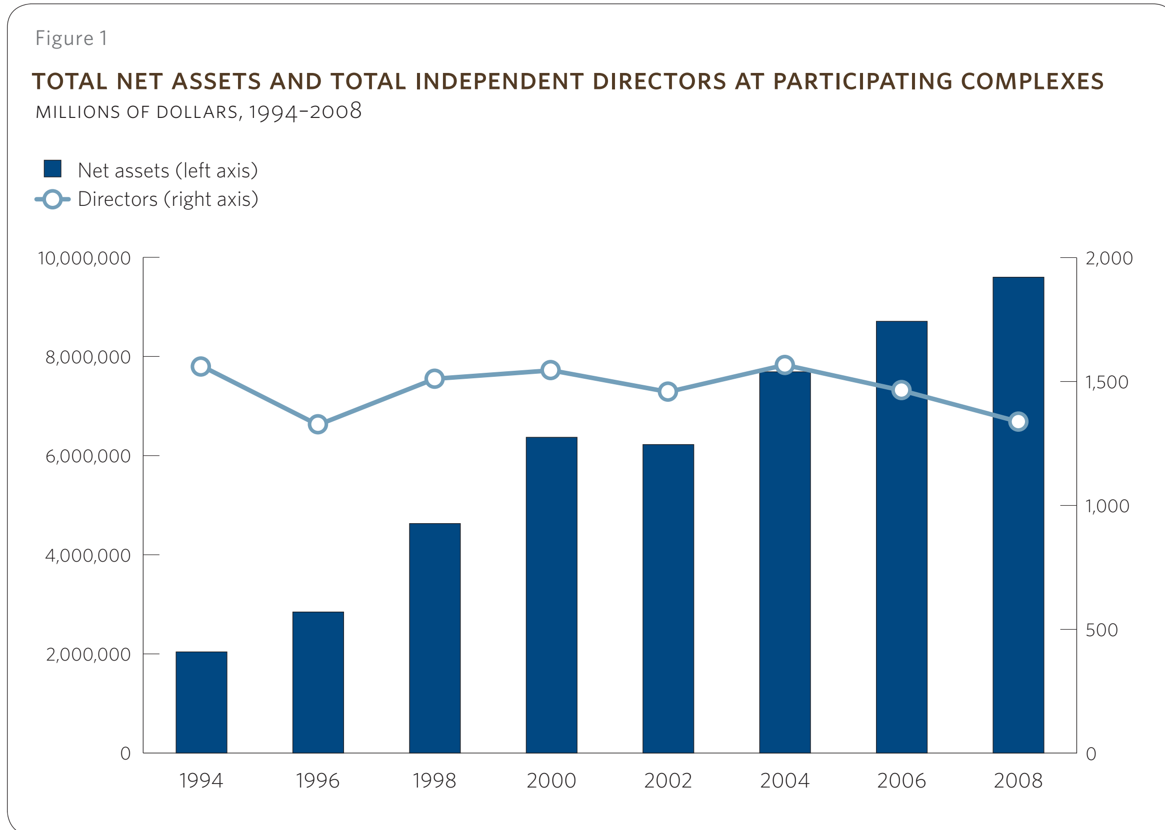
Fund Net Assets and Independent Directors at Participating Complexes

We present data on the aggregate fund net assets of complexes participating in each of the biennial studies to put our analysis in context. Further, we present the aggregate number of independent directors at these complexes. It should be noted that the number and identity of complexes participating in the studies change over time.

Figure 1

TOTAL NET ASSETS AND TOTAL INDEPENDENT DIRECTORS AT PARTICIPATING COMPLEXES

MILLIONS OF DOLLARS, 1994–2008



Fund Net Assets and Funds Served by Independent Directors

The average fund net assets served by independent directors has increased in each of the studies conducted over the 14-year period (Figure 2). The average number of funds served has been stable in recent years, but increased in 2008 (Figure 3). This increase may be attributable to changes in the study population.

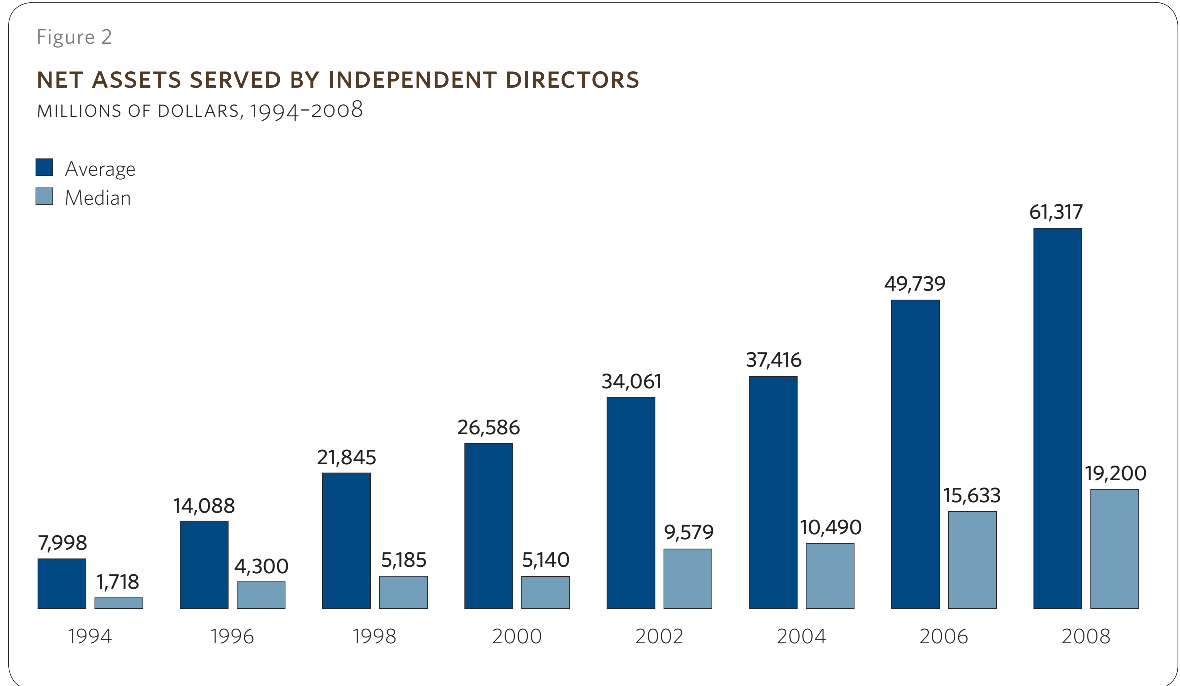


Figure 2

NET ASSETS SERVED BY INDEPENDENT DIRECTORS

MILLIONS OF DOLLARS, 1994–2008

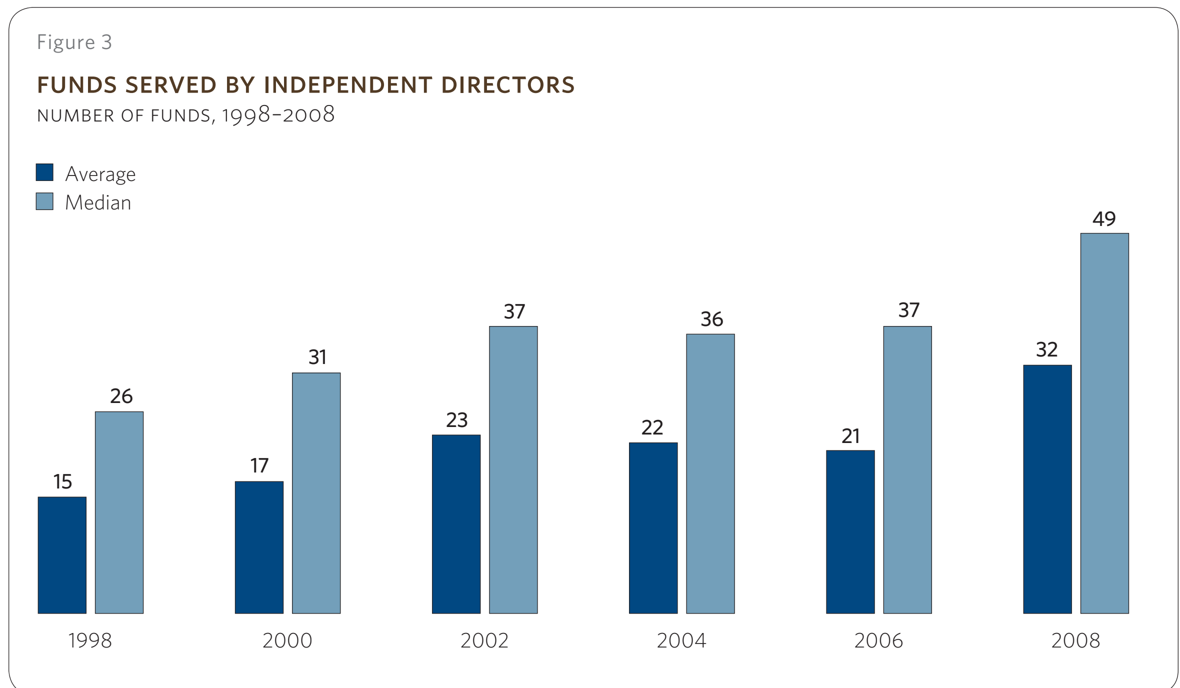


Figure 3

FUNDS SERVED BY INDEPENDENT DIRECTORS

NUMBER OF FUNDS, 1998–2008

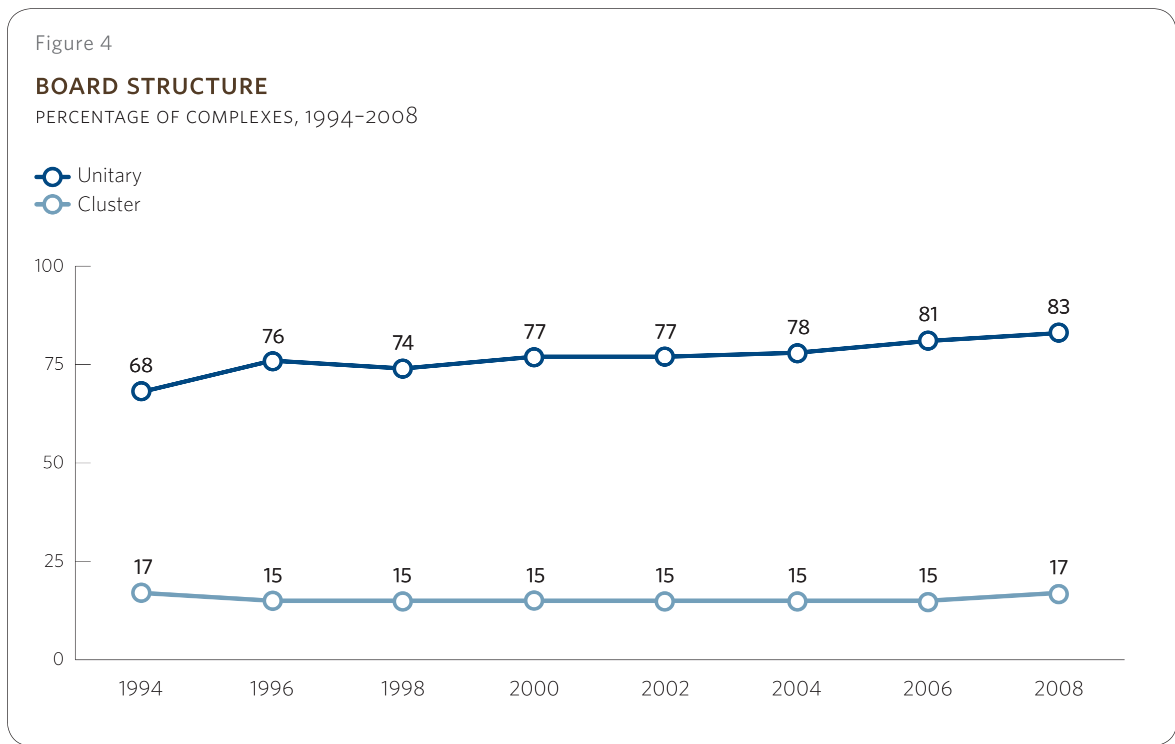
Board Structure: Unitary or Cluster Boards

Since 1994, most complexes have employed a unitary board structure, meaning that a single board oversees all funds in the complex. As of 2008, 83 percent of participating complexes have a unitary board structure. Some complexes, particularly large ones, have adopted a cluster structure where there are several boards within the complex, each overseeing a designated group of funds. The number and makeup of the clusters may be determined by a number of factors, including the type of funds (e.g., money market, institutional) or whether the funds in a particular cluster were acquired by the complex as a group. The percentage of participating fund complexes using the cluster structure over the last 14 years has remained relatively stable at around 15 to 17 percent (Figure 4). ICI's *Best Practices Report* recommends that complexes adopt either a unitary or cluster board structure rather than have a different board oversee each fund in the complex.

Figure 4

BOARD STRUCTURE

PERCENTAGE OF COMPLEXES, 1994–2008



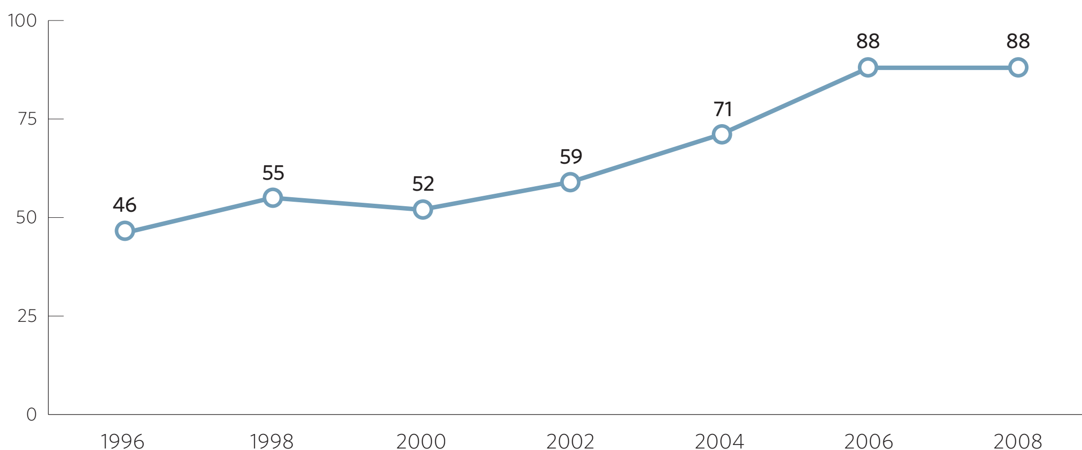
Complexes Where 75 Percent or More Board Seats Are Held by Independent Directors

Over the years, these studies have collected information on the number of independent directors relative to the total number of directors at a fund complex. Under the 1940 Act, independent directors—directors who are not "interested persons" of the fund under the 1940 Act—must constitute at least 40 percent of each board unless special circumstances (e.g., following a merger) dictate a higher percentage. ICI's *Best Practices Report* recommends that each board have a two-thirds majority of independent directors. The 2001 SEC Rules mandated a majority of independent directors for funds relying on certain exemptive rules, and the 2004 SEC Rules increased the required percentage to 75 percent independent directors on each board.[8] In 2006, a federal appeals court invalidated the 75 percent independent director requirement.[9] The SEC subsequently sought additional comment on that component of the fund governance rules, but has not taken further action. Whether the SEC will revisit this issue is uncertain.[10] Significantly, the number of complexes with a board composition of at least 75 percent independent directors has steadily increased in recent years (Figure 5). In 2004, the number of complexes with 75 percent of board seats held by independent directors increased to 71 percent, likely in response to the 75 percent mandate that was pending at that time. By 2006, the vast majority (88 percent) of complexes reported that 75 percent or more of the board seats at the complex were held by independent directors, and that percentage remained the same in 2008.

Figure 5

COMPLEXES WHERE 75 PERCENT OR MORE OF BOARD SEATS ARE HELD BY INDEPENDENT DIRECTORS

PERCENTAGE OF COMPLEXES, 1996–2008



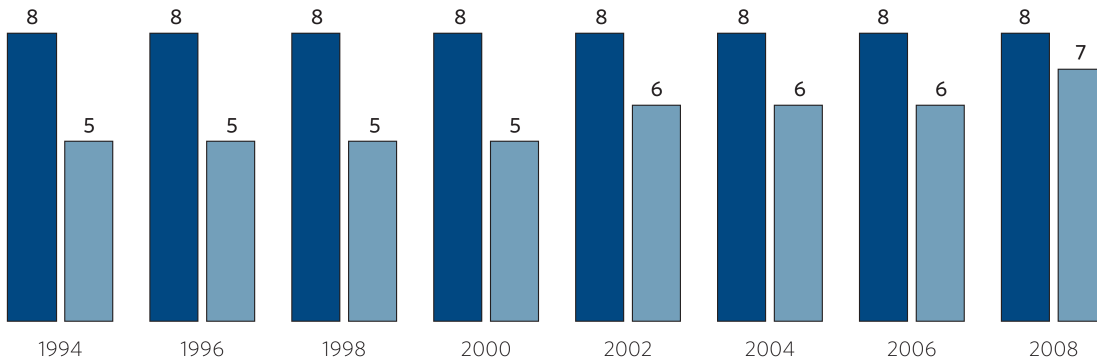
Number of Independent Directors for Each Complex

The number of independent directors in a given complex is influenced by the total number of directors on the board as well as the number of fund boards at the complex. The average number of independent directors per complex has remained unchanged over the course of the 14-year period (Figure 6). The median number remained constant through 2000 and increased slightly in 2002 and again in 2008. The 2002 rise may reflect the addition of independent directors on some boards in response to the 2001 SEC Rules requiring that independent directors make up a majority of each fund board. Results from the 2004 and 2006 studies did not appear to reveal a further increase in response to the 2004 SEC Rules, which raised the level of independent directors on each board to 75 percent.[11] These study results—along with the marked increase in the number of complexes with 75 percent of board seats held by independent directors—suggest that the higher composition of independent directors was achieved by decreasing the number of interested directors on the board. For the first time, the study reported the number of directors per board (in addition to the number for each complex). The median and average number of independent directors per board in 2008 was six. The study will continue to report the number of independent directors per board going forward.

Figure 6

INDEPENDENT DIRECTORS PER COMPLEX

1994–2008



Frequency of Board Meetings

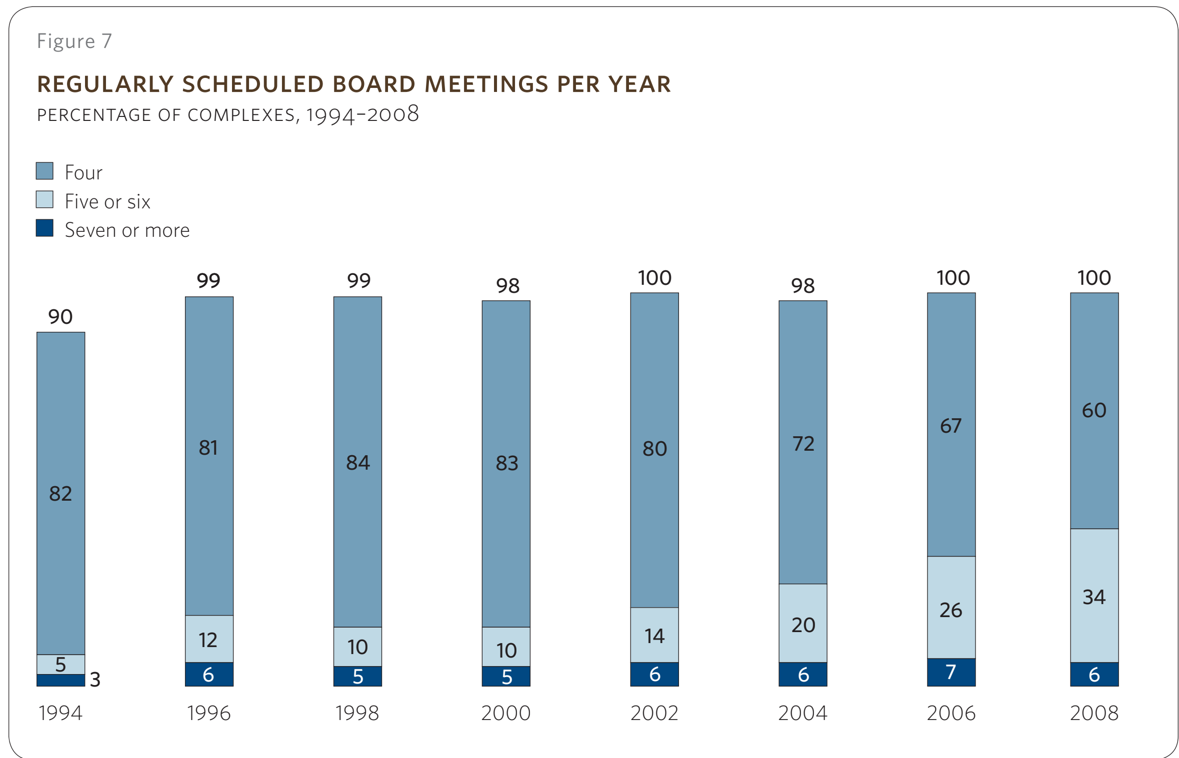
The frequency of regularly scheduled board meetings is not dictated by statute or rule. Approval of the advisory contract, among other duties, must occur annually at an in-person meeting, but the timing, length, and nature (e.g., in-person, telephonic) of the other meetings are matters to be determined by each board.[12] The decision on the frequency of meetings may be influenced by several factors, including the size of the board and the number of funds the board oversees. A board may also elect to meet less frequently but for more days each time. The workload for many boards has increased recently as a result of regulatory reforms and market developments, and the data, not surprisingly, reflect a move toward more frequent meetings (Figure 7). Forty percent of participating complexes indicate that they held five or more regularly scheduled in-person board meetings in 2008.

In actuality, however, fund directors quite often meet more frequently than called for by their regular schedule. Additional in-person or telephonic meetings are held, if necessary, to address specific issues.

Figure 7

REGULARLY SCHEDULED BOARD MEETINGS PER YEAR

PERCENTAGE OF COMPLEXES, 1994–2008



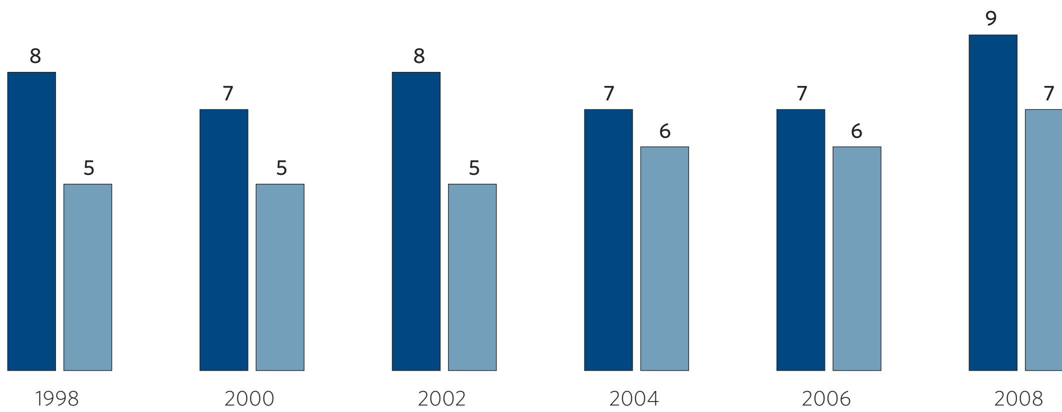
Board Meetings and Committee Meetings in Which Directors Participated

As noted, a board's regularly scheduled meetings may be augmented by nonscheduled or impromptu meetings. For that reason, since 1998, the studies have included information on the number of board meetings in which directors actually participated, either by phone or in person. Between 1998 and 2006, the number of board meetings averaged between seven and eight per year and increased to nine in 2008 (Figure 8). The turbulent market environment in late 2008 and the Department of Treasury's money market fund guarantee program may have prompted an increase in the number of impromptu board meetings. Some directors serving at cluster complexes may serve on more than one board. Such directors would normally attend four or more board meetings for each cluster they serve, and this practice likely would increase the reported average number of board meetings in which directors participated.

Figure 8

BOARD MEETINGS IN WHICH INDEPENDENT DIRECTORS PARTICIPATED
1998–2008

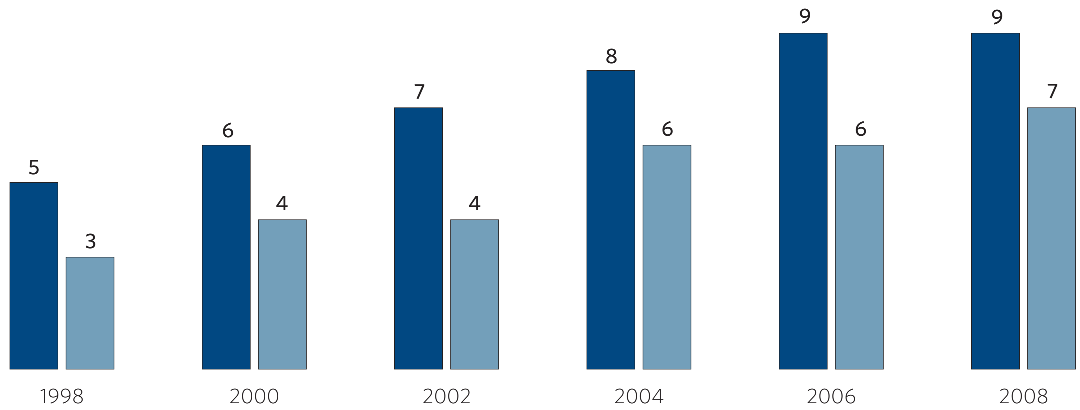
Average
Median



Quite often, committee meetings are held in conjunction with regularly scheduled board meetings. If necessary to accomplish their respective missions, committees may hold additional meetings. In addition, directors may serve on multiple committees.

Figure 9

COMMITTEE MEETINGS IN WHICH INDEPENDENT DIRECTORS PARTICIPATED
1998–2008



Independent Board Chair or Lead Director

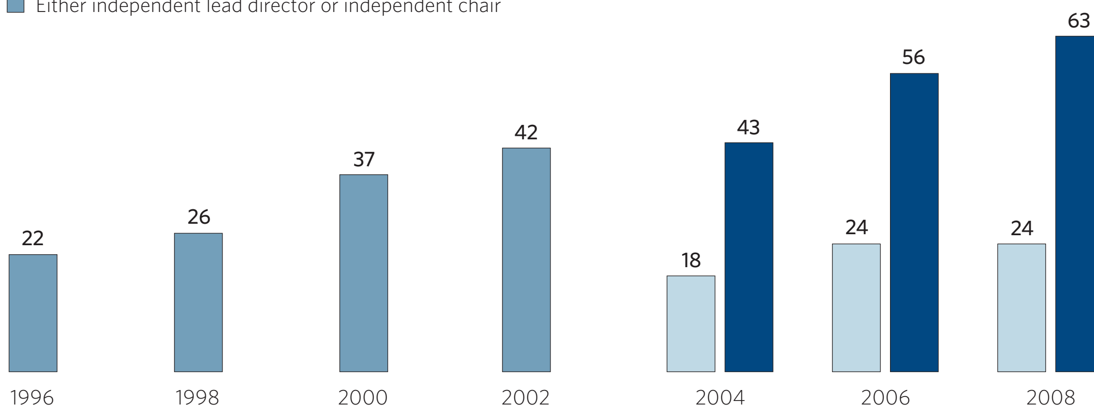
Board practices relating to independent directors serving as the board chair vary greatly. Prior to the repeal of the Glass-Steagall Act in 1999, independent board chairs were required for bank-sponsored funds. Some nonbank sponsored funds adopted the practice, but it was not widespread. Although no longer mandated after the enactment of the Gramm-Leach-Bliley Act in 1999, the independent chair practice was retained by most bank-sponsored funds. Other boards designated an independent director to serve as the primary liaison between independent directors and the adviser. This practice of designating an independent "lead director" was identified in ICI's *Best Practices Report* as an effective governance tool. The 2004 SEC Rules mandated an independent chair for all boards, but that requirement was invalidated by a federal appeals court.[13] In 2006, the SEC sought additional comment on that component of the fund governance rules, but has not taken further action. Whether the SEC will revisit this issue is uncertain.[14]

Beginning in 1996, survey participants were asked if they had either an independent board chair or an independent lead director, but they were not asked to distinguish between the two. The 2004 study, for the first time in the series, collected data separately on the incidence of independent board chairs and independent lead directors. The adoption of the 2004 SEC Rules and the board deliberations surrounding it resulted in a marked increase that year in the number of boards with independent board chairs. This trend continued in 2008 with nearly two-thirds (63 percent) of the participating complexes reporting that they have an independent board chair (Figure 10). As of year-end 2008, 84 percent of participating complexes reported having an independent board chair or an independent lead director.[15]

Figure 10

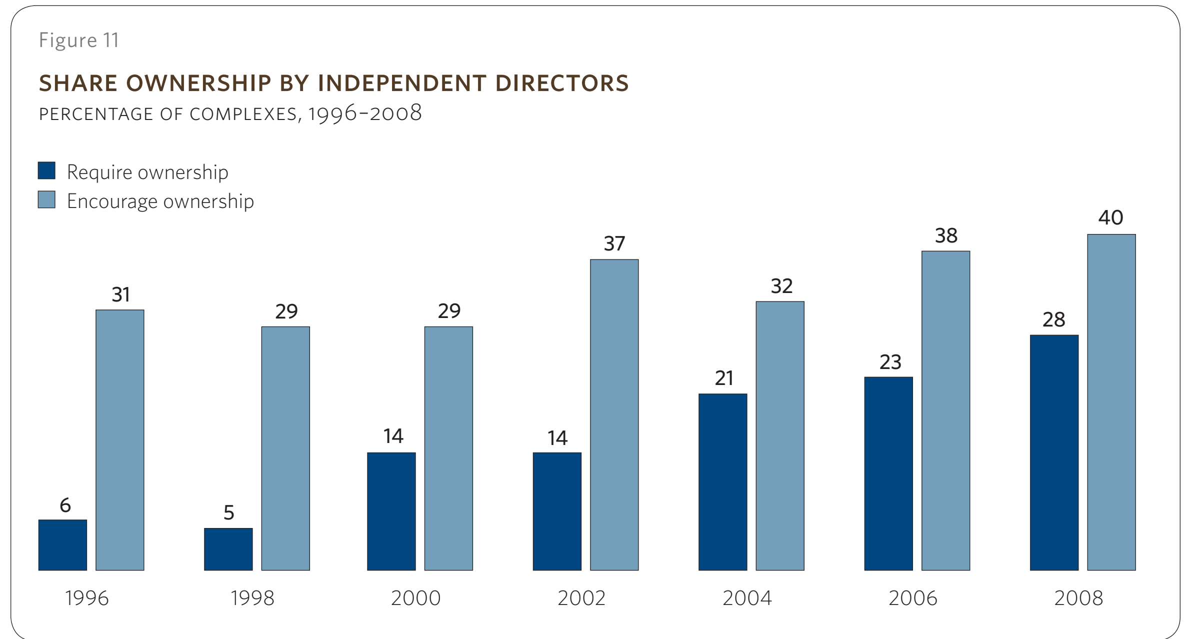
COMPLEXES THAT HAVE AN INDEPENDENT CHAIR OR INDEPENDENT LEAD DIRECTOR

PERCENTAGE OF COMPLEXES, 1996–2008



Independent Director Fund Share Ownership

While many directors choose to own shares of the funds they oversee, the practice is not routinely required. This issue attracts some attention because SEC rules require disclosure of fund share ownership by directors. The data indicate that the number of complexes formally requiring fund share ownership by directors has increased steadily since 1996 (Figure 11). As of year-end 2008, 28 percent of participating complexes reported that they have a formal policy requiring such fund share ownership. The segment of complexes encouraging, as opposed to requiring, ownership of fund shares was approximately 40 percent in 2008. ICI's *Best Practices Report* recommends that directors invest in the funds of the boards they serve.



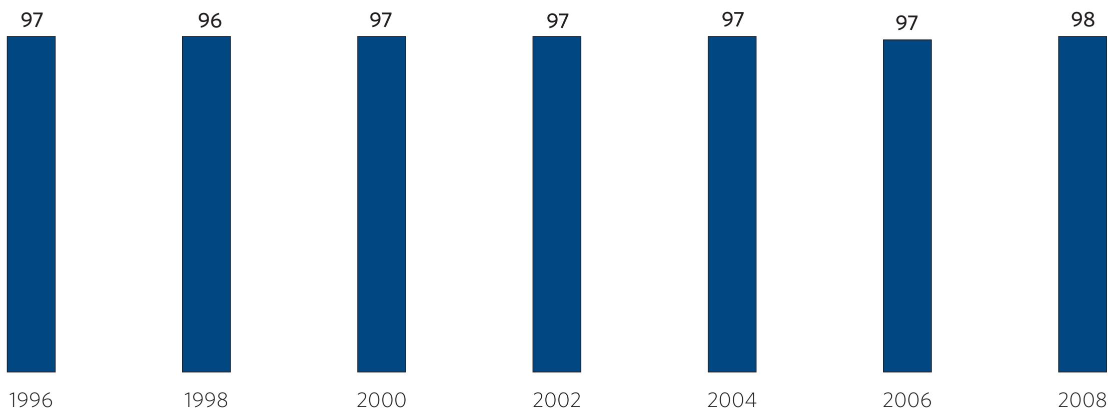
Director's Prior Affiliation with Complex

Director independence is important in a number of contexts. The 1940 Act provides that an individual is an "interested person" if he or she has certain personal, financial, or professional relationships with the fund, investment adviser, or principal underwriter. The SEC also may issue an order finding that a director who has had a material business or professional relationship with the fund, adviser, or principal underwriter within the past two fiscal years is an interested person.[16] ICI's *Best Practices Report* recommends always treating former officers or directors of the adviser, underwriter, or certain affiliates as interested persons in order to avoid any possible perception that such a director might not act in the best interests of shareholders. The studies reflect an appreciation for the letter and spirit of the law and industry best practices, as 98 percent of independent directors surveyed report never having been previously employed by the complex.

Figure 12

INDEPENDENT DIRECTORS NEVER PREVIOUSLY EMPLOYED BY COMPLEX

PERCENTAGE OF DIRECTORS, 1996–2008



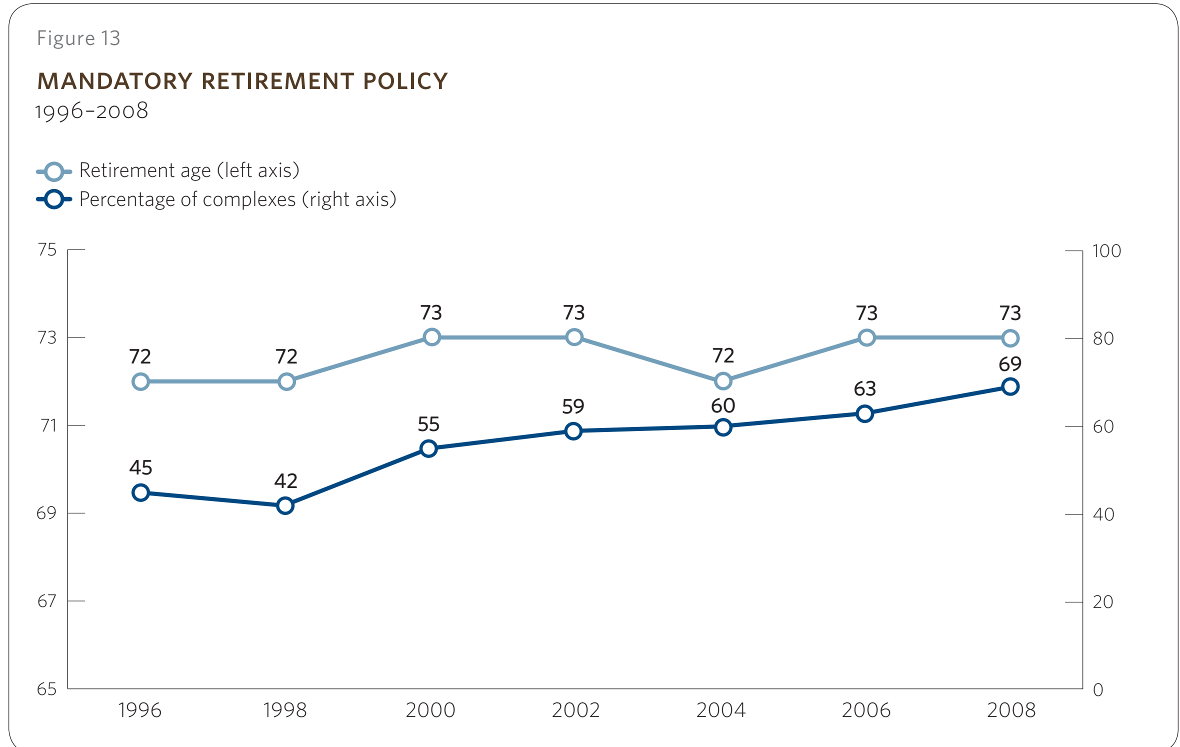
Mandatory Retirement Policy

No regulatory requirement relating to retirement policies exists for fund directors, but the topic may be addressed in a board's annual self-assessment. The studies began collecting data regarding mandatory retirement policies in 1996. Since then, the percentage of complexes that have formally adopted such policies has increased gradually, reaching 69 percent in 2008 (Figure 13). ICI's *Best Practices Report* recommends that fund boards adopt policies on the retirement of directors, but declined to specify the type of policy (e.g., retirement age, term limits) or a recommended retirement age. For those complexes with a mandatory retirement policy, the average mandatory retirement age has hovered around 72 or 73 years old over the 12-year period.

Figure 13

MANDATORY RETIREMENT POLICY

1996–2008



To help put a director's average retirement age in context, previous studies included the age of all directors participating in each biennial study and the number of years they had served their complexes as directors (Figure 14). Since 1996, the average age has edged up from 62 to 64, and the average number of years of service has increased from nine to 11 years (Figure 15).

Figure 14

AVERAGE AGE OF INDEPENDENT DIRECTORS

1996–2008

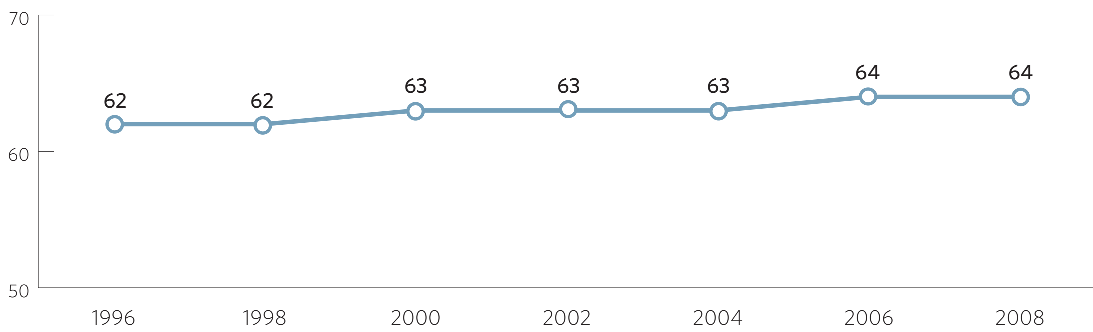
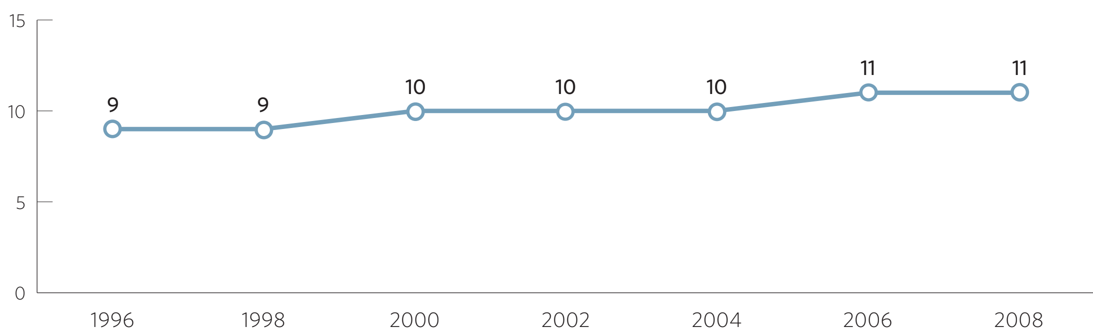


Figure 15

LENGTH OF SERVICE AT COMPLEX BY INDEPENDENT DIRECTORS

NUMBER OF YEARS, 1996–2008



Independent Counsel

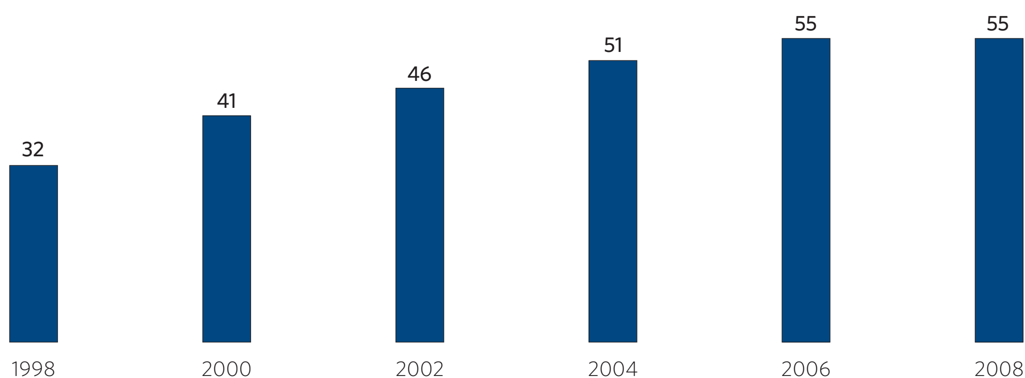
Fund boards employ a variety of arrangements in retaining counsel. Some independent directors have their own dedicated counsel, others formally retain counsel with the fund, and still others have no dedicated counsel but instead rely on counsel to the fund (or retain other counsel) on an as-needed basis. ICI's *Best Practices Report* recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The report acknowledges that directors may elect to have their own counsel or rely on counsel to the fund and, as the data demonstrate, directors increasingly recognize this practice as a key component of effective fund governance. The 2001 SEC Rules further provide that, if the directors were to have counsel, it must be "independent legal counsel" as defined, but they decline to mandate representation.

The studies have collected data concerning director retention of counsel and, though the form of the query in the survey questionnaire has varied over time, certain trends emerge. The data show that instances where directors retain their own counsel—separate from fund counsel and the adviser's counsel—have increased markedly, from 32 percent of participating complexes in 1998 to 55 percent in 2008 (Figure 16). These instances include arrangements in which the fund, adviser, and directors are served by different counsel, as well as arrangements in which the fund and adviser share counsel, but the directors have separate, dedicated counsel.

Figure 16

INDEPENDENT DIRECTORS HAVE SEPARATE COUNSEL

PERCENTAGE OF COMPLEXES, 1998–2008

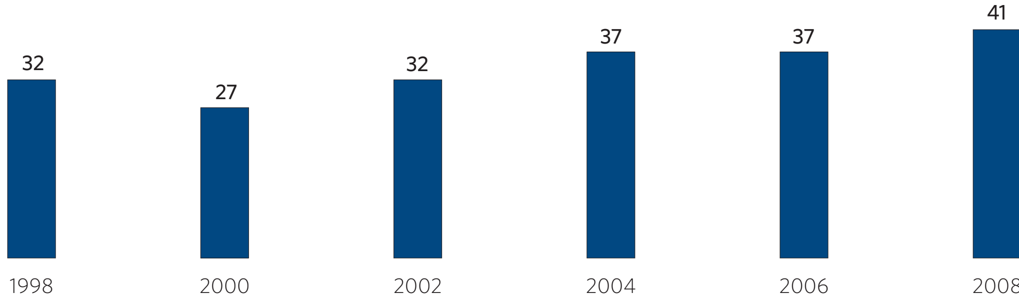


In instances where directors formally or informally rely on counsel to the fund, while the adviser is served by different counsel, the fund counsel would constitute "independent legal counsel." Complexes reporting that directors rely on fund counsel have increased from 32 percent of participating complexes in 1998 to 41 percent in 2008 (Figure 17).

Figure 17

INDEPENDENT DIRECTORS RELY ON FUND COUNSEL (DIFFERENT FROM ADVISER'S COUNSEL)

PERCENTAGE OF COMPLEXES, 1998–2008

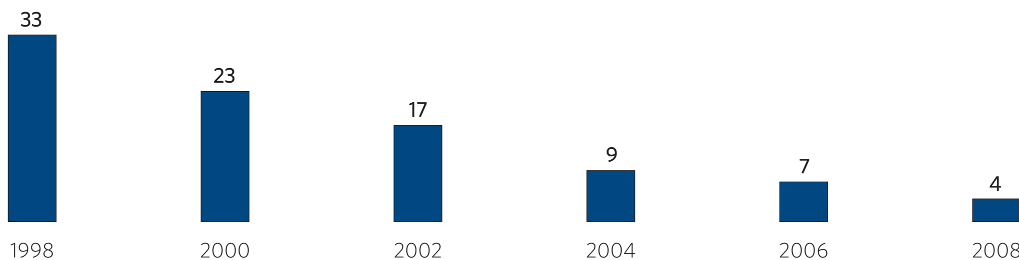


The percentage of complexes indicating that directors are not represented by counsel—and are not formally or informally relying on counsel to the fund—has declined sharply since 1998 (Figure 18). This decline was likely influenced by a number of factors, including ICI's *Best Practices Report*, the 2001 SEC Rules relating to independent counsel, and, most recently, the focus on director independence following the 2004 SEC Rules and litigation involving funds.

Figure 18

SAME COUNSEL REPRESENTS FUND AND ADVISER: INDEPENDENT DIRECTORS HAVE NO SEPARATE COUNSEL

PERCENTAGE OF COMPLEXES, 1998–2008



The data permit us to conclude that an increasing number of directors are represented by independent legal counsel. In fact, the total percentage of complexes indicating that directors either are represented by dedicated counsel or rely on the fund's counsel (different than the adviser's counsel) has increased steadily since the release of ICI's *Best Practices Report*, from 68 percent in 2000 to 96 percent in 2008. Given the increased amount of regulatory compliance matters being addressed by fund boards, such representation is beneficial to both the directors and the shareholders they represent.

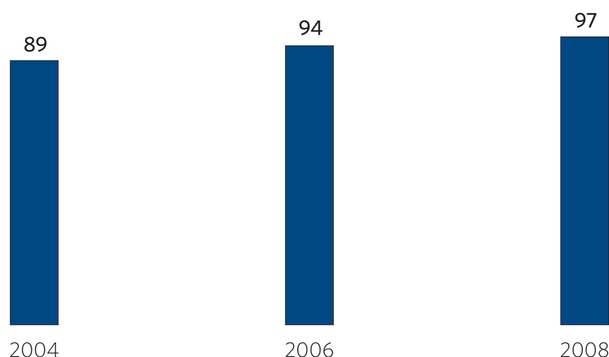
Audit Committee Financial Expert

In 2003, the SEC adopted rules that require funds to disclose whether they have at least one financial expert serving on the audit committee of the board and, if so, the name of the expert and whether the expert is independent of management. Funds that do not have an audit committee financial expert must disclose the reasons why.[17] Based on the new requirement, beginning in 2004, the studies include data on whether complexes have an audit committee financial expert. The vast majority (97 percent) of complexes have a financial expert serving on an audit committee, notwithstanding that they are not required to do so.

Figure 19

COMPLEXES WITH AUDIT COMMITTEE FINANCIAL EXPERT

PERCENTAGE OF COMPLEXES, 2004–2008



Conclusion

Fund governance practices have continued to evolve in response to emerging industry standards and often well in advance of, or in the absence of, explicit regulatory requirements. ICI and IDC will continue to document these and other trends in fund governance practices through their studies and will publish updated overviews every two years in conjunction with the biennial collection of data.

Notes

[1] ICI and IDC collect data on board practices from participating fund complexes through the *Directors Practices Study*. The first such study, conducted in 1995, collected data covering the year ended December 31, 1994, and 4,048 funds were represented. Subsequent studies covered 1996 (5,191 funds), 1998 (6,452 funds), 2000 (7,740 funds), 2002 (8,073 funds), 2004 (7,549 funds), 2006 (7,764 funds), and 2008 (7,690 funds). This overview will use the term "studies" to refer to all of the biennial studies collectively; results that are unique to a particular study will be identified by year.

[2] Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).

[3] ICI and IDC, *Overview of Fund Governance Practices* (1994–2006).

[4] Securities and Exchange Commission, Investment Company Act Release No. 24816 (January 2, 2001).

[5] Securities and Exchange Commission, Investment Company Act Release No. 26520 (July 27, 2004). The 2001 and 2004 SEC Rules imposed conditions on fund boards that rely on any one of 10 popular exemptive rules. Most funds rely on at least one of these rules. Accordingly, this overview will discuss the conditions as generally applying to all funds. Because the 2004 SEC Rules now mandate certain fund governance practices that previously were optional (i.e., that boards conduct self-assessments and that independent directors meet in separate sessions), we have discontinued collecting data regarding those mandated practices and do not include such data in this overview.

[6] *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890 (DC Cir. 2006). In 2005, the court stayed the effectiveness of the rule amendments requiring boards to be composed of 75 percent independent directors and have an independent chair until the litigation was concluded. See C*hamber of Commerce v. Securities and Exchange Commission*, No. 05-1240 (DC Cir. August 10, 2005).

[7] Securities and Exchange Commission, Investment Company Act Release No. 27395 (June 13, 2006) and Investment Company Act Release No. 27600 (December 15, 2006).

[8] See 2001 SEC Rules, note 4, supra, and 2004 SEC Rules, note 5, supra.

[9] See *Chamber of Commerce v. Securities and Exchange Commission*, note 6, supra.

[10] See 2006 SEC Releases, note 7, supra.

[11] As noted previously, a federal appeals court invalidated the 75 percent independent director requirement, and the SEC has sought additional comment on that component of the fund governance rules. See notes 6 and 7, supra.

[12] The frequency of board meetings is a topic that may be evaluated as part of the annual board self-assessment mandated by the 2004 SEC Rules. See also *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005).

[13] See *Chamber of Commerce v. Securities and Exchange Commission*, note 6, supra.

[14] See 2006 SEC Releases, note 7, supra.

[15] A small percentage (3.1 percent) of complexes (typically complexes with cluster boards) reported having both an independent chair and an independent lead director. For purposes of Figure 10, these complexes are included in the percentages of complexes having an independent chair or independent lead director for 2008. Similarly, 3.1 percent of complexes in 2004 and 2.8 percent of complexes in 2006 reported having both an independent chair and an independent lead director, and they are included in the separate 2004 and 2006 percentages in the chart.

[16] Under Section 2(a)(19) of the 1940 Act, the SEC also may issue an order finding a person who had a material or professional relationship with the principal executive officer of the fund, investment adviser, or principal underwriter; with any other fund having the same investment adviser, principal underwriter, or the principal executive officer of such fund; or with any controlling person of the investment adviser or principal underwriter, within the past two fiscal years, to be an interested person.

[17] Securities and Exchange Commission, Investment Company Act Release No. 25914 (January 27, 2003).

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

The Independent Directors Council (IDC) serves the fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors.

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U.S. Securities and Exchange Commission

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Your comments for file number S7-10-09 were received on April 7, 2010.

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Paul Stevens and Michael S. Scofield
Investment Company Institute and Independent Directors Council
Washington, District of Columbia

Email: gwen.kelly@ici.org

Comments:

Comments attached

Attachment 1: 4-7-10 Shapiro Comment Letter and Attachments.pdf

http://www.sec.gov/cgi-bin/ruling-comments