INVESTMENT COMPANY INSTITUTE

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March 10, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Investment Company Governance
File No. S7-03-04

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Commission's proposals that would require registered investment companies ("funds") that rely on certain exemptive rules under the Investment Company Act of 1940[2] to adopt specified governance practices.[3] Under the proposals, the boards of directors of funds relying on those rules would be required to (1) appoint an independent director as chairman, (2) have independent directors constitute at least seventy-five percent of the board, (3) perform annual self-assessments, (4) hold separate meetings of the independent directors at least once each quarter, and (5) have express authority to retain experts and hire staff. The Commission also proposes to amend Rule 31a-2 under the Investment Company Act to require that funds retain copies of written materials the board considers when approving the fund's advisory contract. According to the Proposing Release, the purpose of these proposals is to enhance the

[1] The Investment Company Institute is the national association of the US investment company industry. Its membership includes 8,625 open-end investment companies ("mutual funds"), 611 closed-end investment companies, 124 exchange-traded funds, and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.457 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] The exemptive rules include: Rule 10f-3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1 (permitting use of fund assets to pay distribution expenses); Rule 15a-4(b)(2) (permitting fund boards to approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract); Rule 17a-7 (permitting securities transactions between a fund and another client of the fund investment adviser); Rule 17a-8 (permitting mergers between certain affiliated funds); Rule 17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies); Rule 17e-1 (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j) (permitting funds to maintain joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of voting stock); and Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors).

[3] Investment Company Act Release No. 26323 (Jan. 15, 2004), 69 Fed. Reg. 3472 (Jan. 23, 2004) ("Proposing Release").

independence and effectiveness of fund boards and their ability to protect the interests of funds and fund shareholders.

The Institute strongly supports efforts that strengthen the ability of fund boards to fulfill their oversight responsibilities and protect fund shareholders. In 1999, the Institute convened an Advisory Group on Best Practices for Fund Directors ("Advisory Group"), which recommended a series of best practices for fund governance that was aimed at precisely the same goals.[4] Although many fund boards voluntarily adopted these recommendations, we believe that more of the best practice recommendations now should be codified as part of the Commission's regulatory scheme to improve the structure and processes of fund boards and promote investor confidence in the fund governance system. Most of the SEC's proposals – in conjunction with rules that have already been adopted by the Commission[5] – should help fund directors fulfill their important responsibilities, and we support them.

In particular, we support the proposals concerning annual self-assessments, separate meetings of the independent directors, authority to retain experts and hire staff, and recordkeeping. We do not believe, however, that it has been shown that the Commission's proposal to mandate that all fund boards appoint an independent director as chairman would produce the benefits the Commission hopes for and therefore we cannot support it. In our view, the selection of an appropriate person to be chairman of the board should be made by the independent directors and not by the Commission. Similarly, while we support requiring a supermajority of independent directors on fund boards – one of the best practices called for by the Advisory Group in 1999 – we believe that the Commission should adopt a two-thirds, rather than a seventy-five percent, standard. Many fund boards, following the recommendation of the Advisory Group, have adopted a two-thirds standard, and we do not believe that whatever marginal benefits might result from raising the standard to seventy-five percent would outweigh the costs and disruption of doing so.

Our comments on the Commission's proposals are discussed in greater detail in Section II, below. Set forth immediately below is a more general discussion of the role of fund directors.

I. The Role of Fund Directors

Recent events have caused many to focus on the fund governance system as an area in need of reform. It is important to recognize, however, that not all problems involving mutual

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[4] *See Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999). In October 2003, the ICI Board of Governors unanimously adopted a resolution recommending that mutual funds adopt additional governance best practices that would (1) prohibit close family members of persons associated with a fund or certain affiliates from serving as independent directors and (2) apply to mutual fund audit committees standards that are similar to those applicable to the audit committees of operating companies under Section 301 of the Sarbanes-Oxley Act. In 2000, we also supported the majority of the Commission's proposals to enhance the independence and effectiveness of fund boards of directors and to better enable investors to assess the independence of those directors. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Jan. 28, 2000 (commenting on the role of independent directors of investment companies).

[5] *See, e.g.,* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003), 68 Fed. Reg. 74714 (Dec. 24, 2003) ("Compliance Rule Adopting Release").

funds are corporate governance problems or reflect the failure of the director oversight system. The Institute strongly believes that the system itself remains fundamentally sound. That being said, we support reforms that will improve the system and promote investor confidence.

The Institute is concerned, however, that some of the current debate over fund governance matters – and even certain statements in the Proposing Release – may be based on, and could perpetuate, misconceptions about the role and responsibilities of fund directors. Therefore, before providing our specific comments on the Commission's proposals, we would like to address these misconceptions and describe the unique role of fund directors.

In contrast to other types of financial products, funds generally must be organized as corporations or business trusts under state law with a board of directors or trustees.[6] Like other corporate directors, fund directors are subject to state law duties of loyalty and care. Unlike other corporate directors, however, fund directors are subject to numerous specific obligations under the Investment Company Act and SEC rules.[7] The federal securities laws apply a comprehensive regulatory framework to mutual funds, and the specific responsibilities placed on fund directors reflect the highly regulated nature of the industry.[8]

Importantly, fund directors do not directly manage the operations of funds.[9] Rather, fund directors serve in an oversight capacity and, in the case of independent directors, serve as "watchdogs" guarding against potential conflicts of interest between a fund and the fund's

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[6] References to "directors" in this letter are meant to include trustees as well.

[7] The Investment Company Act and SEC rules prescribe corporate governance requirements for fund boards that are at least as stringent as those applicable to boards of operating companies. For example, funds already are subject to corporate governance requirements similar to the New York Stock Exchange requirements for listed companies approved by the Commission in November 2003, including requirements to have a majority of independent directors, to have a nominating committee composed entirely of independent directors, and to have a code of ethics. Fund boards also must have an audit committee composed wholly of independent directors or, alternatively, funds must have their shareholders vote on the selection of the independent public accountant. The implication in the Proposing Release that, with the current proposals, funds will be catching up to the corporate governance standards imposed on operating companies is simply wrong. *See* Proposing Release, *supra* note 3, at n. 14 and accompanying text.

[8] Unfortunately, the Proposing Release fails to acknowledge the existing, comprehensive regulatory scheme governing funds. For example, the Proposing Release states that "[b]ecause of its monopoly over information about the fund and its frequent ability to control the board's agenda, the adviser is in a position to attempt to impede directors from exercising their oversight role." Proposing Release, *supra* note 3, at 3473. This statement completely ignores specific protections that are provided by the Investment Company Act and SEC regulations. In fact, the Investment Company Act places the fund board in firm control of what information is important and what information it should receive. Under Section 15(c) of the Act, a fund's adviser is obligated to provide fund directors with the information that they request in connection with their annual review of the advisory contract. Moreover, under the Commission's new fund compliance program rule, fund boards are required to approve the appointment of a chief compliance officer who must report directly to the board. In addition, the chief compliance officer must meet separately with the fund's independent directors at least once annually. 17 CFR 270.38a-1.

[9] A statement in the Proposing Release could be read to suggest otherwise. It indicates that "[f]und boards are fully empowered with authority to manage all of the fund's affairs, although most delegate management responsibility to the fund adviser over whom they retain oversight responsibility." Proposing Release, *supra* note 3, at 3472. It is inaccurate to suggest, as this statement might, that the directors directly manage the business of the fund, except in the event that they decide to delegate that responsibility to an investment adviser of their choosing.

service providers.[10] As recently stated by Chairman Donaldson, the proper role of fund directors is "one of oversight and not full-time, day-to-day management of the fund's operations."[11]

One of the most important responsibilities of fund directors is the approval of the fund's contract with its investment adviser. The contract review process involves careful consideration of a variety of factors. In order to approve the contract or its renewal, the directors must determine that the management fee charged by the adviser bears a reasonable relationship to the services provided.[12] However, contrary to what some have suggested, directors are not required to engage in a competitive bidding process or to award the advisory contract to the adviser offering the lowest rates.[13] To do so would ignore both economic reality and investor expectations. The fact of the matter is that, notwithstanding their corporate structure, funds are products created by their sponsor or manager. When investors become shareholders of a fund, they have already made a deliberate decision to select an investment manager whom they believe will implement their investment strategy and provide shareholder services suitable to their needs at an acceptable cost. Investors do not expect the fund's directors to choose a new manager for them except in very unusual circumstances.

When they choose a fund, investors also have received comprehensive disclosure regarding the fees and expenses associated with that fund. The SEC recently adopted rules that will require funds to provide additional disclosure to investors about fees and expenses.[14] Prominent disclosure of fees, combined with the overall competitive nature of the mutual fund business[15] has led to a significant level of price competition among mutual funds. Assets and

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[10] The Investment Company Act generally requires that at least forty percent of a fund's directors be independent directors. In 2001, the Commission adopted rule amendments that require virtually all fund boards to have a majority of independent directors. Investment Company Act Release No. 24816 (Jan. 2, 2001), 66 Fed. Reg. 3734 (Jan. 16, 2001).

[11] *See* Chairman William H. Donaldson, *America's Need for Vigilant Mutual Fund Directors,* Remarks at the Mutual Fund Directors Forum (Jan. 7, 2004).

[12] *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

[13] Similarly, contrary to the implication in the Proposing Release, which refers to the directors' negotiation with the adviser and the benefits to shareholders "if such negotiation leads to lower advisory fees," directors are not supposed to "negotiate down" advisory fees every year. Requiring directors to negotiate the lowest possible fee would radically alter the economics of mutual funds and have the effect of discouraging new entrants into the fund market. (It likely also would cause some to exit the market.) The result would be a less vibrant, innovative and competitive fund marketplace. Given that mutual funds are the vehicle through which millions of middle class Americans invest to achieve their financial goals, it would be unfortunate to limit the choices available to these investors by imposing disincentives for competitors to enter (or to stay in) the market.

[14] Investment Company Act Release No. 26372 (Feb. 27, 2004), 69 Fed. Reg. 11244 (Mar. 9, 2004).

[15] The U.S. General Accounting Office (GAO) has described the mutual fund industry as one that features a large number of competitors, low barriers to entry, and product differentiation on the basis of performance, quality and services. U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 2000). The GAO report further noted that the industry was not concentrated. Consistent with this, Institute data show that in 2002, the five largest fund complexes managed 33% of total industry assets, the 10 largest fund complexes managed 46% of total industry assets and the 25 largest fund complexes managed 74% of total industry assets. Investment Company Institute, 2003 Mutual Fund Fact Book, at 40.

new investments in mutual funds are concentrated in lower-cost funds. And, the overall cost that investors are paying to invest in mutual funds has come down substantially over the last 20 years.[16] These costs are set primarily – as they should be – by the marketplace. Fund directors provide an *additional* level of oversight – one that is unique among all financial products and services. Directors are not, however, supposed to consider fees on a *de novo* basis. (If this were the case, it would make little sense to require *investors* to be provided with comprehensive disclosure about fees.) Rather, they are, as former SEC Chairman Levitt put it, required to "make sure that fees fall within a reasonable band."[17] They also must evaluate the continued propriety of fee rates in light of any material change in circumstances, such as economies of scale that may result from the growth of a fund.[18]

Advisory contract approval is just one of the responsibilities of fund directors. As mentioned above, they play a critical role in monitoring and protecting against conflicts of interest in a broad variety of areas, and they also are responsible for overseeing fund compliance more generally. It is not fair, however, to expect fund directors to prevent every possible problem from occurring. For example, suggesting that fund directors are responsible for the problems that have recently surfaced in the areas of market timing and late trading, when those problems were not brought to the attention of directors or occurred at an unrelated entity, seems particularly unwarranted.[19]

Our comments are not intended in any way to minimize the serious nature of the alleged abuses that have come to light in recent months, nor to question the need for a stronger regulatory regime. The Institute has supported the Commission's swift and aggressive efforts to address the recent problems by adopting the fund compliance program rule (which should greatly enhance the flow of information to directors and facilitate director oversight of fund compliance matters), and proposing rules to tighten the requirements applicable to the pricing of fund orders and to improve disclosure regarding market timing and selective disclosure of portfolio holdings, among other measures.[20]

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[16] *See, e.g.,* Investment Company Institute, "The Cost of Buying and Owning Mutual Funds" *Fundamentals*, Vol. 13, No. 1, February 2004.

[17] Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Investment Company Institute, Washington, D.C. (May 15, 1998).

[18] *See* S. Rep. No. 91-184, at 4048-50 (1970).

[19] By contrast, the Proposing Release seems to imply that the fault for these problems rests with the directors. Proposing Release, *supra* note 3, at 3473 ("In some cases, boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers . . . .").

[20] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 17, 2003 (commenting on the Commission's proposal relating to fund internal compliance programs); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Feb. 5, 2004 (commenting on the Commission's proposal relating to the pricing of fund shares); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Feb. 5, 2004 (commenting on the Commission's proposal to enhance disclosure by mutual funds in the areas of market timing, fair value pricing, and selective disclosure of portfolio holdings). The Institute also supported the Commission's recent proposal to improve prospectus disclosure concerning sales charge breakpoint discounts. Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange

The Institute likewise supports Commission action to improve fund governance. To this end, it is essential to ensure that any changes to the system are well grounded and will assist fund directors in carrying out their responsibilities to oversee fund shareholder interests.

II. Specific Comments on the Commission's Proposals

A. Independent Chairman of the Board

The Commission proposes to require that all fund boards have an independent director as chairman. While some fund boards may find that this structure works well for them, for the reasons set forth below, the Institute does not support a Commission mandate that all fund boards must adopt this structure.

First and foremost, we believe that the selection of an appropriate person to serve as chairman of the board rightfully is, and should continue to be, a decision made by the directors themselves.[21] Service on a fund board requires the exercise of prudent judgment on a variety of matters. As discussed above, the Investment Company Act and rules thereunder assign specific responsibilities to fund directors to oversee fund operations and, in the case of independent directors, to protect against potential conflicts of interest between funds and their service providers. The Commission's proposal, which essentially would prohibit fund directors from using their judgment to choose their own chairman, seems completely at odds with an overall regulatory scheme that relies on fund directors to make sound judgments in the vigilant exercise of their oversight responsibilities.[22]

Second, a government mandate to name an independent director as chairman, which would be unique in the corporate world,[23] is completely unnecessary in the fund context. This is

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Commission, dated Feb. 5, 2004. We also continually support providing greater resources to the SEC to enhance its inspection program.

The Institute also has called for numerous reforms on its own initiative, including clarifications or amendments to codes of ethics to include oversight of all trading activity in mutual funds offered or sponsored by the company with respect to purchases and sales by senior fund personnel, limitations on the use of soft dollars, and a ban on directing fund brokerage transactions to reward broker-dealers who also sell fund shares. *See* Mutual Fund Leaders Call for Fundamental Reform to Address Trading Abuses, ICI Press Release, October 30, 2003 and Mutual Fund Leaders Take Hard Stand on Soft Dollars, ICI Press Release, December 15, 2003 (available at www.ici.org).

[21] We note that Commissioner Atkins has expressed concern over whether "government should be telling funds – or any corporations – how to structure" their management, in a question and answer session following his address to the Tax Council Policy Institute. *See* BNA Regulation and Law (Feb. 12, 2004) at A-5. Similarly, twelve members of Congress recently wrote to Chairman Donaldson expressing concern over the Commission's proposal to require an independent chair for fund boards and stating that the "fund's directors are in the best position to decide whether having an independent chair is in the best interest of the fund's shareholders." Correspondence from selected members of the House of Representatives to Chairman Donaldson, dated Feb. 11, 2004.

[22] Similarly, we believe that the choice of a chair for board committees should be left to the judgment of directors and not mandated by law.

[23] In enacting the Sarbanes-Oxley Act to improve corporate governance of all types of issuers, Congress did not require an independent chairman of the board. Moreover, enhanced corporate governance requirements recently

because virtually all fund boards are required to have a majority of independent directors, meaning that the independent directors are in a position to select the most appropriate person – independent or not – to serve as chairman.[24] Moreover, the Investment Company Act and the rules thereunder require a fund's independent directors to vote separately on the most significant items that come before the board, including approval of the advisory contract.

Third, in addition to being unnecessary, the proposed independent chair requirement could deprive some funds and their boards of the most highly qualified candidate for the position of chairman. For example, a board may conclude that an interested director would be the person best suited to lead the board through detailed discussions of complex issues and that he or she could perform this function most effectively as chairman of the board. The Commission's proposal, however, would not permit the board to select that person for the position.

Finally, enshrining in the law an across-the-board requirement for funds to have an independent chairman might serve as the basis for imposing additional regulatory responsibilities on that individual, which raises concerns that such persons ultimately would be drawn into the day-to-day operations and management of a fund.[25] This result would be inconsistent with the proper role of fund directors, which (as discussed in Section I above) is one of oversight.

According to the Proposing Release, the Commission is concerned that, if the chairman also is an officer of the fund's investment adviser, the adviser may dominate the actions of the board of directors.[26] The Commission believes that a boardroom culture conducive to decisions favoring the long-term interests of fund shareholders may be more likely to prevail when the board chairman does not have the conflicts of interest inherent in his role as an executive of the fund adviser.[27] These statements belie the fact that independent directors already must

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adopted by the New York Stock Exchange, the American Stock Exchange and Nasdaq for listed companies did not include an independent chair requirement.

[24] Indeed, as discussed below, the Commission is proposing to require at least seventy-five percent of each fund board to be made up of independent directors; most fund boards already have at least a two-thirds supermajority of independent directors.

[25] Such concerns are not just theoretical. For example, legislation has been introduced that would require funds to have an independent chair and obligate that person to make a series of certifications as to matters which independent directors acting in an oversight capacity could not reasonably be expected to know (*e.g.,* that the fund "is in compliance" with certain policies and procedures, such as fund share pricing policies and procedures). *See* Section 204 of S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," as introduced by Senators Corzine and Dodd on November 25, 2003.

[26] This depiction does not seem to reflect the actual experiences of independent directors, some of whom have recently testified before Congress. *See, e.g.,* Statement of Vanessa C.L. Chang, Independent Director, New Perspective Fund, *Review of Current Investigations and Regulatory Actions regarding the Mutual Fund Industry: Fund Operations and Governance*, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 2d Sess. (Mar. 2, 2004) ("I have never felt inhibited in asking questions or raising issues that may not be on the agenda or in the book . . . . Our board regularly takes the initiative to identify matters for the adviser to report on at board meetings or in special sessions.").

[27] The Proposing Release also states that a fund board led by an independent director may be more effective in negotiating with the fund adviser regarding advisory fees. Proposing Release, *supra* note 3, at 3475. This statement

constitute a majority of fund boards and that, in practice, most fund boards have at least a two-thirds supermajority of independent directors.[28] The Commission's other proposals to enhance the independence and effectiveness of fund boards, discussed below, and current industry practices further minimize concerns that the adviser could dominate the actions of the board.

The Adopting Release requests comment generally on whether there are alternatives to an independent chair requirement that would serve the same or similar purposes, and specifically on the possibility of requiring that the chairman of the board be elected annually by both a majority of the board as a whole and a majority of the independent directors. The Institute would support such a requirement. An annual election requirement would put a formal process in place to enable the board of directors, particularly independent directors, to replace the chairman if they believe that he or she is not effective or that their concerns are not being addressed.[29] Alternatively, or in addition to an annual election, the Commission could require funds that do not have an independent chair (1) to appoint a "lead independent director" who can review the agenda for regular meetings and/or (2) to submit the agenda to the independent directors for review to ensure that matters of interest to independent directors are scheduled to be discussed at meetings.[30] These requirements would address any possible concerns that a chairman of the fund board who is affiliated with the adviser would control the board's agenda and thereby exclude matters not welcomed by the adviser.

B. Board Composition

As discussed above, fund boards currently are required to have a majority of independent directors. The SEC has proposed to require funds to have a board of directors whose independent directors constitute at least seventy-five percent of the board. We support

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has no factual basis. Indeed, several large fund complexes that are widely recognized as having fees that are lower than industry averages do not have independent chairmen of their fund boards. Moreover, this suggests that a problem exists when in fact there is none. Studies show that as individual funds have grown over time, their operating expense ratios (*i.e.,* the expense ratio excluding 12b-1 fees) have fallen, indicating that the funds have passed through cost savings from scale economies. *See, e.g.,* Investment Company Institute, "The Cost of Buying and Owning Mutual Funds," *supra* note 16, at 14.

[28] The Commission staff recently questioned the "need to mandate a fund's chairman be independent because independent directors, representing a majority of a fund's board, already are in a position to control the board, and, if they deem it appropriate, could already influence the agenda and the flow of information to the board." Memorandum from Paul F. Roye, Director of Division of Investment Management, to Chairman William H. Donaldson, regarding Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, dated June 9, 2003. Although this statement pre-dated the recent revelations of mutual fund trading abuses, those events do not change the fact that independent fund directors are already in a position to control the board.

[29] Of course, because fund boards already must include a majority of independent directors, the independent directors already are fully empowered to replace an ineffective chairman. An annual election would have the added benefit of requiring that independent directors periodically assess the effectiveness of the chair.

[30] The appointment of one or more "lead" independent directors was recommended by the Advisory Group. The House Financial Services Committee recently passed legislation that would amend Section 10(a) of the Investment Company Act to require funds that do not have an independent chairman of the board to select a lead independent director having certain minimum powers (including the authority to place items on the agenda for consideration). *See* Section 9 of H.R. 2179, the "Securities Fraud Deterrence and Investor Restitution Act," as passed by the House Financial Services Committee on February 25, 2004.

requiring a supermajority of independent directors. As the Advisory Group concluded in 1999, having more than a majority of independent directors on fund boards helps to assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest. Consistent with the recommendation of the Advisory Group, however, we urge that the required supermajority be two-thirds rather than seventy-five percent. Most fund boards comply with the recommended two-thirds supermajority standard,[31] and we do not believe, and there is no empirical evidence to suggest, that mandating a seventy-five percent supermajority would even marginally enhance the authority or effectiveness of the independent directors.[32]

Moreover, a change from the current practice of a two-thirds supermajority to a seventy-five percent requirement would mean that at least half of all fund boards would have to change their current composition, according to Institute data. Funds would be required to effect this change at a time when they could better channel those efforts to implement other new requirements that would have more direct benefits to investors. In the absence of any foreseeable benefit for fund investors, we believe that the increased disruption and costs that would be involved in implementing a seventy-five percent requirement are not justified. For these reasons, we recommend that the Commission revise its proposal to require that independent directors constitute at least two-thirds (or 66 2/3%) of fund boards.[33]

We note that, regardless of which standard the Commission adopts, many fund boards will have to reconstitute their membership to increase the proportion of independent directors. Some funds may need to obtain shareholder approval of new directors. The Proposing Release requests comment on whether an 18-month transition period would be sufficient. We believe that such a period would be appropriate in order to provide adequate time for all funds to comply with any applicable supermajority requirement.

C. Annual Self-Assessment by the Board of Directors

The Commission proposes to require fund directors to perform an evaluation, at least once annually, of the effectiveness of the board and its committees. The Commission hopes that the self-assessment process can improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness. The Institute supports the Commission's proposal and agrees that the process would strengthen the effectiveness of fund boards.[34]

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[31] According to our data, approximately seventy-five percent of fund boards already comply with the two-thirds supermajority standard.

[32] The Proposing Release does not provide any specific rationale for proposing a seventy-five percent requirement, as opposed to some other level over fifty-one percent.

[33] We also note that no other issuer of securities is subject to a requirement to have a supermajority – be it two-thirds or seventy-five percent – of independent directors on its board of directors.

[34] The Commission's proposal is consistent with the recommendation of the Advisory Group that fund directors periodically evaluate the board's effectiveness. We believe that in evaluating the board's effectiveness, fund directors will typically review whether there has been sufficient opportunity to consider issues that were raised during the year. As part of that evaluation, it is likely that directors would consider whether the frequency with which they meet and/or the time devoted to particular issues continues to be adequate under the circumstances.

According to the Proposing Release, the self-evaluation should focus on both substantive and procedural aspects of the board's operations. The Commission's proposal would leave for the directors to decide those aspects of board operations they should address in their evaluation, except for two procedural matters. The Commission would require directors to consider the effectiveness of the board's committee structure and to evaluate the number of funds on whose boards each director serves. The Institute supports requiring the directors to include these two specific matters in their self-assessment. We agree with the Commission that the two issues delineated are important and should be considered by fund boards at least once a year.

We also agree with the Commission's decision not to require written self-assessment reports. For the self-assessment requirement to achieve its intended goal, it is critical that there be a frank discussion of a board's performance. If directors were required to draft a formal document, there could be an inclination to be less critical and candid. Moreover, a requirement to formalize the self-assessment process would entail expenditure of time without any corresponding benefit. We also believe that the minutes of the board should be sufficient for the Commission's examination staff to verify that the board has undertaken a self-assessment at least once a year.

The Commission requests comment on whether it should restrict the number of boards on which a director serves. We strongly believe that it would not be appropriate for the Commission to dictate the number of fund boards on which a director should serve or the maximum number of directorships (fund or non-fund) any individual should hold. It would be extremely difficult to choose a fixed number that would be appropriate for every director in every fund group, and any number imposed by regulation would be arbitrary and not necessarily appropriate in all circumstances. Directors have varying commitments both inside and outside the fund boardrooms, and there is no universal optimal number of boards on which a director may serve that ensures that sufficient attention will be paid to the obligations of each board. The ability of a director to serve adequately on a board will depend on variety of factors and specifying a maximum number of board commitments will not necessarily improve the ability of directors to manage their workload.

Moreover, there are significant benefits to service on multiple boards that should not be overlooked, including providing the independent directors of those boards with an opportunity to obtain better familiarity with the many aspects of fund operations that are complex-wide in nature and with greater access to, and greater influence with, the fund's adviser. In fact, it was on this basis that the Advisory Group recommended that all fund complexes with any substantial number of funds generally adopt either a unitary or a cluster board structure.

Given the complexity and difficulty in standardizing the optimal number of boards on which a director should serve, we believe the Commission's proposal to require that the board self-evaluation include consideration of this issue is the best way to address it.[35] The

[35] We note that fund boards often use committees to address specific issues, and that the use of committees can be a helpful means for boards that oversee multiple funds to address issues that are complex-wide in nature. As indicated above, under the Commission's proposal, boards would be required to review the effectiveness of the committee structure as part of their annual self-assessment.

Commission's proposed approach will focus the directors' attention on the issue while providing the necessary flexibility to boards to determine what is appropriate in the particular circumstances. We also recommend that the Commission leave to the discretion of individual boards the determination of whether they need to adopt policies regarding service on other boards. Individual boards are in the best position to determine whether they need to adopt such policies as they evaluate their effectiveness.

D. Separate Meetings of Independent Directors

Under the proposals, the Commission would require that independent directors meet at least once quarterly in a separate session at which no interested persons of the fund are present. The purpose of this requirement would be to provide independent directors the opportunity for a frank and candid discussion amongst themselves regarding the management of the fund, to prevent any negative inferences from being associated with the calling of such sessions, and to strengthen the collegiality and cohesiveness of the independent directors.

The Institute supports the Commission's proposal and believes, as the Advisory Group previously stated, that separate meetings of the independent directors can enhance their independence and effectiveness. These meetings can provide independent directors the opportunity to assess candidly the management of the fund, including the adviser's performance, and consider areas for improvement. We also agree with the Commission that requiring separate meetings at least quarterly would be appropriate.

E. Independent Director Staff

The Commission proposes to require that funds explicitly authorize the independent directors to hire employees and others to help the independent directors fulfill their fiduciary duties. The Commission believes that the use of staff and experts may be important to help independent directors deal with matters that are beyond their expertise or help give them an understanding of better practices among mutual funds.

We agree that independent directors should be able to obtain expert advice as needed in order to be effective on matters that are beyond their experience and expertise and note that this was a best practice recommendation by the Advisory Group. The Advisory Group also recognized that obtaining expert advice would entail costs to the fund. Certainly, hiring staff also would be costly. We believe the Commission's proposal strikes an appropriate balance by not dictating that independent directors must hire their own staff. Depending on the fund complex, there may be sufficient assistance available or there may be other legitimate reasons why directors would not want to incur the expense of a permanent staff.

The Commission also requests comment on whether it should require that independent directors have an independent legal counsel. For the reasons discussed above, we do not recommend that the independent directors be required to hire independent counsel. We believe it is important and sufficient that the option to hire independent counsel is always available to independent directors. We are of the view, however, that it is appropriate for the independent directors to determine when and whether they need the advice of independent counsel.

F. Recordkeeping for Approval of Advisory Contracts

The Commission proposes to amend Rule 31a-2 under the Investment Company Act to require that funds retain copies of the written materials that directors consider in approving an advisory contract under Section 15 under the Act. Section 15 requires, among other things, that the directors request from the adviser the information reasonably necessary to evaluate the advisory contract for approval each year. The purpose of the proposal is to assist SEC examiners in determining whether the requirements of Section 15 were met and to underscore the importance of the information requests that precede the directors' consideration of the advisory contract.

We support the Commission's proposal to require funds to retain records of the information that their directors consider in approving advisory contracts. We agree that it is appropriate for the Commission to adopt a formal requirement in this area to assist the examination staff in confirming funds' compliance with the requirements of Section 15.

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We appreciate the Commission's consideration of our comments. We believe that most of the proposals would be helpful in strengthening the position and authority of independent directors and enhance their effectiveness in protecting the interests of fund shareholders. If you have any questions or need additional information, please contact Amy Lancellotta at (202) 326-5824, Frances Stadler at (202) 326-5822, or Jennifer Choi at (202) 326-5810.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

Paul F. Roye, Director
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U.S. Securities and Exchange Commission