



Consumer Federation of America

**Fund Democracy**  
*The Mutual Fund Shareholder's Advocate*

August 21, 2006

BY ELECTRONIC AND U.S. MAIL

Ms. Nancy Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Dear Ms. Morris:

We are writing on behalf of Fund Democracy and the Consumer Federation of America to express our continued strong support for the requirement that mutual fund boards be led by an independent chairman and be comprised of 75% independent directors and to urge the Commission to act quickly to reaffirm that rule.

As the Commission itself has previously concluded, we believe the independent fund governance rules are necessary to ensure that fund boards can operate effectively as a check on fund managers' conflicts of interest. The recent market timing, late trading, breakpoint, and sales abuse scandals have demonstrated that the independence and effectiveness of mutual fund boards need to be strengthened to protect the interests of America's 91 million mutual fund shareholders. The Commission specifically found these scandals resulted from "a serious breakdown in management controls" that demonstrated a need to strengthen fund governance. Indeed, the Commission found, after it adopted the governance requirements, that "the level of wrongdoing, and the corresponding investor losses, were in fact significantly greater than was known at the time." The Commission also noted the fund "adviser's monopoly over information about the fund and its frequent ability to control the fund's agenda" militated for enhancing the independence and effectiveness of fund directors.

***Since the rules were adopted, the Commission has not suggested and no one has presented any evidence that the foregoing assumptions have any less force.*** In fact, the current option backdating scandal further supports (though in a separate context) the Commission's previous determination that effective corporate governance depends critically on active, independent oversight by directors. Where management reports to a different shareholder base from the one to which the directors owe their allegiance, as is the unique situation in which we find mutual funds, even stronger governance rules are necessary. Congress expressly agreed, legislating over 60 years ago that at least 40% of a

mutual fund board be independent. The Commission's promulgation of dozens of exemptive rules that weaken the fund regulatory structure created by Congress surely support the need for enhanced independence of boards of funds that rely on those rules.

Fortunately for investors, the court has repeatedly rejected the substance of industry challenges to the rules and instead has upheld both the authority of the Commission to adopt these rules and the basis for its action. The last ruling from the court essentially left only the collection of cost data on the rules and a weighing of their costs and benefits to be completed before the rules could become law.

### ***Costs of Compliance are Minimal***

As we have previously noted, the argument that the costs of an independent chairman and 75% independent board are too burdensome is absurd. The independent governance requirements for mutual funds may, in fact, be among the least -- if not the least -- expensive fund rules ever adopted. The view that compliance costs were likely to be minimal was taken into account by the Commission when adopting the rule originally. ***The Mutual Fund Directors Forum has since found that the actual costs of compliance were even lower than the estimates relied upon by the Commission and that the requirements were "likely to have a negligible impact on a fund's operating costs."***<sup>1</sup>

More recently, commenters have confirmed the MFDF's findings. The independent trustees of the MFS Funds, for example, described the additional cost of an independent chair as "modest," especially when considering that the board otherwise would have had to pay for a lead independent director. The same trustees found that the 75% rule would result in no additional costs. Even independent trustees who for whatever reason do not believe that having an independent chair would give them more authority admit that cost is not the issue.<sup>2</sup> As stated by Meyrick Payne, a fund governance expert acknowledged by the Commission, "the incremental cost [of an independent chair] would be approximately \$15 million, a minuscule percentage of both the \$70 billion in total mutual fund fees and the \$9.5 trillion in mutual fund assets." These findings are consistent with the Commission's earlier finding that, "[w]hether the two conditions are viewed separately or together, even at the high end of the ranges, the costs of compliance are minimal."

### ***Potential Benefits to Investors are Significant***

It seems to belabor the obvious to state that a fund board with an independent chair will be more independent than one where the CEO of the fund manager serves as

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<sup>1</sup> Mutual Fund Directors Forum, Cost Implications of an Independent Chair and a 75 Percent Independent Board at 1 (2005) at <http://www.mfdf.com/UserFiles/File/ReportofSurvey.pdf>.

<sup>2</sup> See, e.g., Letter from Independent Directors of the Vanguard Funds (July 31, 2006) ("it is not the direct financial cost of implementing the rule that concerns us most.").

the chair. As explained by Clayton Yeutter, independent chairman of the OppenheimerFunds, the:

“salient issue is that non-independent chairmen have an inherent conflict of interest in carrying out their responsibilities. The most obvious example, of course, is that they inevitably negotiate with themselves when it is time to renew the adviser contract. I find it inexplicable that leaders of the industry would wish to defend this conflict of interest, now or in the future.”<sup>3</sup>

It is worth noting that this view has been embraced by every living former SEC chairman.<sup>4</sup>

Since the Commission began its consideration of these rules, nothing has been added to the record to undermine its determination that an independent chair would benefit shareholders by enhancing the authority of fund boards. Instead, additional support for that position has emerged. For example, the independent trustees of the MFS Funds have found that the “independent chair (as would be required by the Governance provisions) has been a significant benefit to the MFS Funds and their shareholders. The existence of an independent chair has expanded, in a meaningful way, the influence of the Independent Trustees over Board and committee proceedings.” As noted by the Mutual Fund Directors Forum, the only independent association of independent fund directors, a fund chairman:

can control meeting agendas, the tone and tempo of board meetings, the topics discussed, the amount of time spent on each topic, and the order in which topics are discussed. Without this degree of authority, independent directors may find it difficult to deal with an investment adviser, who already is in a position to dominate the board through its substantial informational and administrative advantages.

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<sup>3</sup> See also Letter from John Hill, Independent Chairman, Putnam Funds (May 12, 2004) (expressing Putnam Funds’ board’s support for rules and noting that there are “significant areas of concern to both independent and affiliated chairpersons where there is not an identity of interest: advisory fees, soft dollars, 12b-1 fees and other expenses paid by fund shareholders to investment management companies. . . . the dollars involved in these conflicting interests are massive.”); Letter from Fergus Reid, Independent Chairman, JP Morgan Funds (May 18, 2004) (“if a board chairman is part of or connected with the management company, or a service company, in any way he (she) can never be truly free of the appearance of self-interest.”).

<sup>4</sup> Letter from David Ruder on behalf of Richard Breeden, Harvey Pitt, G. Bradford Cook, Roderick Hills, Harold Williams, & Arthur Levitt (June 15, 2004).

To deny that it makes a difference whether a fund chairman is independent is to deny that there is any meaningful difference between the role of a board chairman and that of non-chairman directors.

### ***Conclusion***

In summary, the costs of the fund governance rules are likely to be even more negligible than the Commission estimated when it concluded that they were greatly outweighed by the rules' benefits. The obvious next step is for the Commission to reaffirm the rules and finally allow them to take effect.

We are frankly disturbed that the Commission has cast doubt that it will take this obviously pro-investor action, first by inexplicably delaying its request for comments on the rules' costs and then by requesting comments on issues that go well beyond costs. As we noted in our April 18 letter to Chairman Cox in response to the Court decision, “[a]ny delay in acting to finalize the rules, especially in light of the Commission's strong commitment to and investment in their adoption, will undermine confidence in our markets and the Commission's own rulemaking process.” Should the Commission now back away from the rules in light of clear evidence of their minimal costs, the message to investors would be clear -- that every final Commission action is, in fact, open for reconsideration based on the leverage of private interest groups and prevailing political winds. Industry need only challenge the rule in court, and repeatedly lose on the merits, until a change in Commission make-up leads to an administrative surrender.

At the risk of sounding like hectoring parents, we would like to remind the Commission that the purpose of SEC rulemaking is not to find compromises -- although that may be tempting for a Commission that has been divided on this matter -- but to protect investors and promote efficient markets. This rulemaking should not be about achieving unanimity, particularly if that unanimity is achieved by discarding hard-won investor protections in order to pacify baseless industry complaints. In order to counter this message that the Commission's delay has already unfortunately sent, we strongly encourage the Commission to adopt promptly the independent chairman and 75% independent board rules, which are clearly necessary for the protection of investors and to promote confidence in our markets.

We appreciate your consideration of our comments.

Respectfully submitted,

Mercer Bullard  
Founder and President  
Fund Democracy, Inc.

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

cc: Chairman Christopher Cox  
Commissioner Paul Atkins  
Commissioner Roel Campos  
Commissioner Kathleen Casey  
Commissioner Annette Nazareth  
Andrew Donohue, Director, Division of Investment Management  
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