August 21, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

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

Dear Ms. Morris:

The undersigned are members of the Small Funds Committee of the Investment Company Institute.[1] We fully support the position set forth in the Institute's comment letter, which opposes the Commission's mandatory requirement that the boards of all funds that rely on certain exemptive rules have an independent chair, and recommends revising the requirement that such boards be comprised of no fewer than 75 percent independent directors to require a two-thirds supermajority of independent directors.[2] This letter is intended to supplement the Institute's comments by addressing the specific impact of these corporate governance requirements on small fund complexes.

Small funds represent an important segment of the mutual fund industry. In addition to providing choices for investors and encouraging competition,[3] they have historically been prolific sources of innovation and purveyors of highly specialized investment products.[4] For

[1] The Small Funds Committee was created over 25 years ago to bring together management company executives to discuss relevant business, operational, legislative, regulatory and general industry developments. The Institute defines small fund members as fund complexes with less than $2 billion in non-money market assets. We recognize that the Institute's definition of a small fund is broader than the SEC's which, as set forth in 17 CFR § 270.0-10, defines a small fund as a fund complex with net assets of $50 million or less. We believe that the SEC's definition is too narrow, inasmuch as it does not adequately capture all of the complexes that are disproportionately affected by the costs of complying with new regulations. More information about small funds and the Committee is included in Appendix A.

[2] *See* Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated Aug. 21, 2006, a copy of which is attached to this letter. The governance requirements under consideration are set forth in Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("Adopting Release").

[3] *See, e.g., The Success of America's Mutual Fund Marketplace: Benefiting Fund Investors*, Remarks by Paul Schott Stevens, President, Investment Company Institute, at AEI/Brookings Forum, March 15, 2006 (explaining that low concentration in the mutual fund marketplace, as evidenced by the large number of fund complexes, none of which is dominant, is a hallmark of a competitive industry).

[4] *See, e.g.*, Statement of Thomas O. Putnam, Founder and Chairman, Fenimore Asset Management, Inc./FAM Funds, *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Costs and Distribution Practices*, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 2nd Sess. (March 31, 2004), at 4-7 (describing the important role of small funds in the mutual fund industry,

example, money market funds, which now hold $2.2 *trillion* in assets, were first offered in 1971 by the Reserve Fund, at the time a small fund complex. Small fund complexes also popularized many other common investment products, including socially responsible and leveraged funds. Some specialized products, such as municipal bond funds for particular states, are still only available from small fund advisers.

Yet the very nature of their size means that small funds are more costly to operate per dollar of assets under management. To maintain competitive expense ratios, small fund advisers often accept lower margins, absorbing costs that in larger funds would be passed on to shareholders. Not infrequently, small fund advisers even operate one or more funds at a loss for an extended period of time in the hope that they will eventually gather enough assets in those funds to achieve economies of scale and profitability.

The cost to implement the fund governance requirements currently under consideration could have a meaningful impact on a small fund complex. Additionally, potential new entrants may be dissuaded from joining our industry, because of both the higher startup and ongoing compliance costs of these and other new regulatory requirements. Moreover, the requirements may create a disincentive for entrepreneurs considering the mutual fund industry. A company founder understandably may have concerns about the requirement that the board chair be an individual who by definition is, at least initially, unfamiliar with the company, and may come from outside the industry. Alternative business opportunities in the field of asset management with lower regulatory burdens, such as hedge funds and separately managed accounts, are therefore becoming increasingly attractive to entrepreneurs. Meanwhile, as discussed in the Institute's comment letter, the benefits of requiring an independent chair and a 75% independent board have not been established.

In assessing the rules under consideration, the Commission must take into account their possible effects on competition and capital formation.[5] Because of the potential impact of the costs on small fund complexes, as well as the disincentives created for potential market entrants, we urge that the Commission not require all funds to have an independent chair, but rather leave it to the independent directors to assess the costs and benefits specific to their situation and determine the most appropriate chair for their particular board. We further recommend that the requirement that fund boards be comprised of no fewer than 75 percent independent directors be revised to require a two-thirds supermajority.

Market Pressures on Small Fund Complexes

To appreciate the potential impact on small fund complexes of the requirements currently under consideration, it is helpful to understand the constraints imposed on small funds by the competitive nature of the mutual fund industry.

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including providing choice for investors, fostering competition, developing specialized and niche products and offering shareholders individual service and attention that cannot be matched by large funds).

[5] *See* 15 U.S.C. §80a-2(c).

Mutual funds face highly competitive pricing pressure in the marketplace. Expense ratios are a fundamental factor for investors and investment professionals when analyzing and comparing funds with similar investment objectives.[6] Shareholders are predominantly invested in mutual funds with low expense ratios. In 2005, nearly 90 percent of stock fund assets were in funds with below-average expense ratios.[7] At the same time, small funds tend to have higher expense ratios, in part because their fixed costs are spread over a smaller asset base.[8] For example, 80 percent of growth-oriented funds have operating expense ratios[9] between 69 basis points and 141 basis points, compared with an average of 136 basis points for growth-oriented funds offered by small fund complexes.[10]

Because their expense ratios already tend to be higher than average, small funds have a limited ability to pass higher regulatory costs on to their shareholders. Higher expense ratios are likely to make a fund less attractive to potential and existing shareholders. Indeed, investors can and do vote with their feet: in any given year, a quarter to a half of all mutual fund firms experience net outflows from long-term funds.[11] To avoid increasing expense ratios, small fund advisers often pay costs out of their own pockets that typically are charged to a fund. Similarly, many small fund advisers enter into expense cap agreements, under which they agree to limit the expenses charged to a fund, paying any excess costs themselves. Advisers may also offer fee waivers; while large and small funds offer fee waivers with similar frequency, the waivers offered by small funds tend to be substantially higher.[12] These practices suggest that, for funds to attract and retain shareholders, there is essentially a market-imposed constraint on their expense ratios.

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[6] *See, e.g.*, Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064 (March 13, 1998) [63 FR 13916 (March 23, 1998)], at 13924 (describing "the Commission's strongly held belief in the importance of fees and expenses in a typical investor's decision to invest in a fund"); Understanding Investor Preferences for Mutual Fund Information, Investment Company Institute (2006).

[7] *See* 2006 Investment Company Fact Book, 46th Edition, www.icifactbook.org, at 41. Similarly, according to an ICI analysis of confidential data submitted for the monthly *Trends in Mutual Fund Activity* report, from 2000 to 2005, 97 percent of investors' net new purchases of stock funds were in funds with below-average expense ratios.

[8] *See* Appendix B for more detail on expense ratios.

[9] An operating expense ratio is measured as the total expense ratio net of 12b-1 fees and waivers. 12b-1 fees are excluded because such fees represent the external costs of distributing a fund's shares, as opposed to the direct costs of operating a fund.

[10] Figure based on ICI calculations using expense data by share class for 2005 from Lipper LANA 4.0 database. Small fund expense ratios are consistently well above the asset-weighted average of funds in the same category. *See* Appendix B for more detail.

[11] Figure based on confidential data submitted to ICI for the monthly *Trends in Mutual Fund Activity* report.

[12] *See* Appendix C for more details on fee waivers.

Many small fund advisers appear to have little room to absorb additional fund costs. The median[13] of annual fund expenses paid by funds at small fund complexes, net of 12b-1 fees and waivers, is only $1.7 million.[14] These fund expenses cover fund costs[15] and management fees paid to the adviser to cover a core set of services, including investment advisory services.[16] From the management fee paid to the adviser, the adviser must pay its own operating expenses as well as any fund expenses it has assumed; the remainder, if any, is the adviser's pre-tax profit. These small fund advisers do not enjoy the operating margins necessary to absorb an unlimited stream of higher regulatory costs. Eventually, the costs of managing a small mutual fund complex could become prohibitive, and starting one may be substantially less appealing.

The Disproportionate Impact of Recently Imposed Regulatory Requirements

Because of the fixed costs inherent in many regulations, new rules tend to have a disproportionate impact on small funds. We recognize, of course, that small fund complexes have chosen to offer mutual funds and, consequently, to be regulated by the same rules as other mutual funds. Many rules have clear benefits to fund shareholders and are therefore worth the cost. Nevertheless, the SEC has an obligation to consider the effect of its regulations on small funds,[17] as well as on competition and capital formation.[18] To the extent that new rules raise barriers to entry for potential market participants and pressure margins of existing participants without any discernible benefits, the Commission is doing a disservice to investors and the market.

The recent rules comprising the SEC's fund governance "package"[19] have directly and indirectly increased the operating costs for small funds. For example, according to Lipper data, between 2003 and 2005, small fund complexes saw an overall increase in their legal costs,

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[13] For figures based on assets under management, the median is used because we believe it is more representative of the typical mutual fund complex than the simple average.

[14] Figures based on ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006. *See* Appendix D for more detailed information on average and median assets among different segments of the mutual fund industry.

[15] Fund costs include directors' fees, legal and audit costs, insurance, registration fees, fund accounting, transfer agency, and shareholder services.

[16] Core services often include fund administrative services and fund personnel, such as the CCO and other officers.

[17] *See* 5 U.S.C. §§ 601-612; 17 C.F.R. §270.0-10(a).

[18] *See* 15 U.S.C. §80a-2(c).

[19] In its Adopting Release, which included the governance requirements currently under consideration as well as related fund governance rules that have not been challenged, the SEC described the rules as part of a "package" to address concerns about the governance of mutual funds. The unchallenged requirements provide that fund boards must (1) perform annual self-assessments, (2) hold separate meetings of the independent directors at least once each quarter, and (3) have express authority to retain experts and hire staff. The other rules in the fund governance package are listed in Appendix E.

directors' fees, and audit costs of 25 percent;[20] many consider this cost increase to be an indirect result of the recent governance rules. For the median small fund complex, such costs represented 7 percent of fund expenses in 2005, up from 6-1/4 percent in 2003. Meanwhile, costs for legal, audit, and directors' services relative to fund expenses for the median large fund complex, which has assets of $10.6 billion, remained around 1-1/2 percent.

Several small fund members of the Institute have provided more detailed information on recent cost increases.[21] These firms have experienced sizable increases in their direct and indirect compliance-related expenses. For example, increases in compensation for directors have ranged from approximately 50 percent to over 100 percent. In addition, some firms have experienced substantial increases in legal fees, as well as increased compliance expenditures due primarily to the appointment of a chief compliance officer. Little by little, these added costs make small funds more costly for shareholders and, particularly when advisers choose to absorb some of the costs rather than pass them on to shareholders, make the mutual fund advisory business more expensive for small fund advisers.

Rules Under Consideration

In its Response to the Remand by the Court of Appeals, the Commission stated that:

> We find that the costs of the 75 percent condition and of the independent chairman condition are extremely small relative to the fund assets for which fund boards are responsible, and are also small relative to the expected benefits of the two conditions. We expect that the minimal added expense of compliance with these conditions will have little, if any, adverse effect on efficiency, competition and capital formation.[22]

While the costs to a fund complex with expenses equal to the industry average of $91 million may not be significant, we can assure the SEC that the costs of implementing these rules will impact those of us with expenses closer to $1.7 million (the median for small fund complexes), or even $4 million (the average for small fund complexes).[23] Further, as set forth

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[20] Figure based on ICI calculations using expense data by share class from Lipper LANA 4.0 database. Data represents only those funds that reported legal and audit costs and directors' fees separately for both 2003 and 2005.

[21] *See* Appendix F.

[22] Investment Company Governance, Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26985 (June 30, 2005) [70 FR 39390 (July 7, 2005)] at 39395 ("Remand Response").

[23] *See, e.g.,* Letter from F.E. James, Ph.D., James Investment Research, Inc., to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 6, 2004 (describing the costs to a small investment company of hiring and compensating an independent chair and noting that this "would cause many small investment companies to reconsider their decision to remain in the investment company business"); Letter from Maurice Schoenwald, Chairperson of New Alternatives Fund, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Feb. 9, 2004 (describing the substantial cost impact of the proposed rules); Letter from Richard F. Curcio, Chairman, The Valiant Fund, to the Securities and Exchange Commission, dated July 27, 2006 ("[t]he proposed rules will do nothing but add approximately $100,000 in costs that I as the advisor will have to pay. Since our management fee is capped, these costs cannot be passed on to shareholders.").

more fully in the Institute's comment letter, while an independent chairman or a 75 percent independent board may work well for some fund boards, we do not believe that the benefits of *requiring* these governance structures have been adequately established, particularly in light of their costs.

Independent Chair of the Board

In its examination of the costs of the independent chair requirement, the SEC considered a variety of costs, which are set forth in the Remand Response. The Commission acknowledged that fund complexes can comply with the requirement by elevating an existing independent director to the position of chair or recruiting a new independent director to serve as chair. In some cases, a fund complex (even a small fund complex) may need to do both if it has multiple fund boards. These decisions and their associated costs are particularly relevant for small fund complexes, as approximately half of them do not have independent chairs.[24]

The least costly alternative is to promote a qualified independent director to the position of chair. The SEC estimated that the cost of this option would range from $1,147 to $9,000 per fund, depending on how many funds the board oversees.[25] Confidential data on independent director compensation collected by the Institute and the Independent Directors Council is generally consistent with the SEC estimates.[26] For small fund complexes, the data suggests that the additional compensation is typically in the upper half of the range, as small fund complexes generally have far fewer funds over which to spread the fixed and growing cost of an independent chair.

[24] The Institute and the Independent Directors Council collect data on fund board practices and independent director compensation through their Directors' Practices Study. The most recently completed study collected data covering the year ended December 31, 2005 (the "Study"). It includes information reported by 185 complexes, representing approximately 88% of the industry's total net assets. These complexes reported information on 1,471 independent directors.

One hundred forty-seven of the complexes participating in the Study utilized the unitary board structure (one board overseeing all funds in the complex). Forty-six of these complexes reported total net assets of $2 billion or less. Fifty percent of the 46 complexes reported having an independent chair.

[25] The estimated fees for an independent chair were based on a 2003-04 survey by Management Practice, Inc. ("MPI") suggesting a median salary of $12,500 for a director overseeing 1-6 funds. The SEC added a 20 percent premium to account for possible cost increases since the survey ($15,000), and assumed that a chair would earn 50 percent more than other directors, and added another 20 percent ($15,000 x 0.5 x 1.2 = $9,000) for total compensation of $24,000, or $9,000 more than other directors. *See* Remand Response, *supra* note 22, at 39392-39395. It should be noted, however, that a more recent comment letter from MPI suggests that the annual average additional cost of compensating an independent chair is approximately $30,000. *See* Letter from C. Meyrick Payne, Partner, Management Practice, Inc., to Nancy M. Morris, Secretary, Securities and Exchange Commission, July 13, 2006.

[26] Compensation estimates from the 2004 Directors' Practices Study are consistent with, though moderately higher than, those originally reported by MPI and relied upon by the Commission, likely reflecting differences in timing, sample sizes, and the particular respondents in each of the surveys. Data from the 2005 Study also indicates that compensation for independent directors is increasing.

Two small fund complexes provided information about the additional costs of electing a lead independent director to the chair position. One complex, whose board elected its lead independent director as chair in 2004, incurred about $3,500 in additional compensation costs in the first year. The chair's fees increased another $6,500 the following year. The second complex has multiple boards, several of which elected lead independent directors as chairs in 2005. The additional compensation for the independent chairs ranged from $1,250 to $13,375, depending on the type of fund overseen. To keep the funds' expense ratios from rising as a result of these costs, the adviser cut its management fees on all of the affected funds, and reduced its management fee to zero for three of them.

For those small funds that opt to hire a new independent director to act as chair, the costs are even higher. The Commission's estimates suggest that compensation for an independent chair could be approximately $24,000 annually for a small fund complex.[27] This estimate is consistent with the 2004 data collected by the Institute and Independent Directors Council. The SEC also estimated that recruiting costs could be equal to the independent chair's first year compensation, for an additional $24,000.

In either case – whether an existing director is promoted or a new director is hired to act as chair – the SEC projected that an independent chair would require more assistance from independent counsel than an interested chair, at an estimated cost of $15,000. While it is difficult to isolate the increased use of counsel that is directly attributable to an independent chair, as opposed to other recent regulatory requirements, this estimate is consistent with data suggesting increased legal costs in recent years, and with the experience of several Small Fund Committee members.[28]

We do not suggest that the direct cost of complying with the independent chair requirement is by itself prohibitive for all small fund complexes. Indeed, some complexes have elected an independent chair in the past year in anticipation of the rule.[29] Even so, when added to the costs of other recent rules, the requirements will considerably increase the cost of doing business for small fund complexes, with virtually no demonstrable benefits.[30] Moreover, independent directors are uniquely positioned to thoroughly evaluate the costs and benefits specific to their situation and determine the most appropriate chair for their particular board. Such an analysis is particularly important in the case of small fund complexes, where the cost could impact the expense ratio, reduce an adviser's profitability, or require the scaling back of other expenditures, such as services provided to shareholders, to keep overall costs down.

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[27] *See supra* note 25.

[28] *See supra* notes 20-21 and accompanying text.

[29] The 2004 Directors' Practices Study found that only 38 percent of reporting small fund complexes had an independent chair, compared to 50 percent in 2005.

[30] The empirical evidence, discussed more thoroughly in the Institute's comment letter, does not show any demonstrable benefits from mandating an independent chair. *See* Letter from Elizabeth R. Krentzman, *supra* note 2.

Finally, the rule creates additional barriers and disincentives to enter the mutual fund industry. Founders of fund advisers often act as chairs of the funds they establish, particularly in the first years when few other people are intimately familiar with the company. Prohibiting this arrangement raises startup costs, both in terms of the expense of recruiting and paying an independent chair and the time and effort required to find a qualified person. In addition, company founders often have invested significant personal capital in the business, not to mention time and effort. Such individuals understandably may have concerns about the requirement that the board chair be an individual who may not have experience in the mutual fund industry and, at least at the outset, may be unfamiliar with the company. These added costs, both tangible and intangible, create disincentives for entrepreneurs in the asset management business to organize mutual funds.

Board Composition

While we support a supermajority independence requirement for fund boards, we believe that a two-thirds majority requirement is more appropriate than 75 percent. As discussed in the Institute's letter, a 75 percent requirement adds additional costs with no apparent benefit. The 75 percent requirement substantially reduces flexibility in board composition generally and, because small funds tend to have smaller boards,[31] reduces our flexibility even more than the average board.

In estimating the costs of implementing this rule, the SEC recognized that boards that do not already meet the 75 percent test may comply either by adding independent directors or reducing the number of interested directors. To explore what small funds have done in practice, ICI staff reviewed the board composition of the approximately 80 members of the Small Funds Committee.[32] Almost half of these boards met the 75 percent independence requirement in 2003. By 2005, nearly 80 percent met the requirement. Among those boards that restructured, approximately 60 percent only removed an interested director. The remaining 40 percent added independent directors as part of their restructuring.[33]

Funds whose boards added directors must pay additional directors' fees. The MPI study relied upon by the SEC found that median annual compensation for an independent director of a small fund complex ranged from $10,500 to $28,000. These estimates are consistent with the 2004 data gathered by the Institute and the Independent Directors Council.[34] In adding directors,

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[31] The average reported board size (both interested and independent directors) for small fund complexes is 5.6, compared to 7.8 for the 101 fund complexes with more than $2 billion in assets. *See supra* note 24.

[32] Funds report information on board composition in their Statements of Additional Information.

[33] There are good reasons to keep affiliated directors on the board. As the Advisory Group on Best Practices for Fund Directors explained in its 1999 report, among other things, board membership by representatives of the adviser facilitates more direct accountability on the adviser's part and a better exchange of information with the adviser, and subjects the representatives to the same fiduciary standards as independent directors. *See Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999).

[34] *See supra* note 26.

these funds may also have incurred recruiting and training costs, and possibly the costs of a proxy solicitation to comply with Section 16(a) of the Investment Company Act. Additionally, the SEC estimated that new independent directors would require more assistance from independent counsel, at an estimated cost of $9,000. Just as with an independent chair, it is difficult to isolate the increased use of counsel that is directly attributable to new independent directors, but this estimate is consistent with data suggesting increased legal costs in recent years, and with the experience of several Small Fund Committee members.[35]

Although many boards now meet the 75 percent test, they will have very little flexibility to address board turnover. Under a 75 percent requirement, a single resignation will more often require the board to act quickly to add a new independent director to maintain the appropriate balance, and potentially trigger the need for a proxy solicitation. Even if an election is not necessary, adding a new director consumes time and resources, and diverts the board's and management's attention from its other duties. Meanwhile, there is no evidence that this board structure is more beneficial to shareholders than a two-thirds majority.

The costs of the 75 percent requirement may also discourage entrepreneurs considering entering the fund business. Should a board have two interested directors (and therefore not qualify for the small board exception), six independent directors would be required from day one. It is worth noting that, particularly for a new company with an entire slate of new directors, it seems sensible to have at least two individuals on a board who are familiar with the business. As one group of independent directors, who already comprise a two-thirds supermajority (four of six), explained:

> Meeting a 75% requirement would require the addition of two new independent director positions, at an additional cost to our shareholders exceeding $20,000 per year. (Because of the small existing Board size and other circumstances, it would not be appropriate for either of the two interested directors to step down to increase the independent director percentage.) One has to wonder what a 75% majority of independent directors could accomplish that the Fund's existing 66-2/3 % cannot?[36]

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[35] *See supra* notes 20-21 and accompanying text.

[36] *See* Letter from the Independent Directors of Flaherty & Crumrine Preferred Income Opportunity Fund Inc., to William H. Donaldson, Chairman, Securities and Exchange Commission, dated Feb. 23, 2004.

We appreciate your attention to the disproportionate effects of these requirements on small funds, and would be pleased to offer our assistance in any way.

Sincerely,

/s/

The undersigned members of the Small Funds Committee of the Investment Company Institute:

Mark R. Anderson	President & COO	Integrity Mutual Funds, Inc.
B. Reuben Auspitz	Executive Vice President	Manning & Napier Advisors, Inc.
Michael E. Barna	Executive Vice President	Burnham Asset Management Corp.
Lesley Buck	Chief Compliance Officer	Matthew 25 Fund Inc.
Lynne M. Cannon	Director – T/A Services	Stratton Mutual Funds
John Deysher	President	Bertolet Capital LLC
Stephen J. Dodson	Chief Operating Officer	Parnassus Investments
Robert G. Dorsey	Managing Director	Ultimus Fund Solutions, LLC
Cynthia L. Dove	Director, Investment Services	Homestead Funds, Inc.
Allan D. Engel	President	Activa Asset Management, Inc.
Gabriel J. Gibs	Chairman & CEO	Volumetric Fund, Inc.
Daniel M. Hanrahan	Director of Mutual Fund Operations	The Catholic Funds
Thomas C. Henry	General Counsel and Secretary	The Ehrenkrantz Trust
Diana P. Herrmann*	President & CEO	Aquila Investment Management LLC
Mark A. Hoopes	Chief Compliance Officer	Adelante Capital Management LLC
Nicholas F. Kaiser	President	Saturna Capital Corporation
Geoffrey Keenan	EVP & COO	Gateway Investment Advisers, L.P.
Brenda T. Koelemay	CAO	Securities Management and Research, Inc.
John S. Larson	Managing Director	Gardner Lewis Asset Management L.P.
Terry Lee	President & CEO	Lee Financial Group
Jill W. Maggiore	Vice President & CCO	Wells Asset Management, Inc.
W. Richard Mason	General Counsel	Mosaic Funds
Susan B. McGee	President & General Counsel	U.S. Global Investors, Inc.
David B. McKinney	President	Reams Asset Management Co., LLC
Michael Mulcahy	Partner	Bridgeway Capital Management, Inc.
Joseph Neuberger	Senior Vice President	U.S. Bancorp Fund Services, LLC
Erik Olstein	President	Olstein & Associates, L.P.

* Chair of the Small Funds Committee.

Steven J. Paggioli	Trustee	Professionally Managed Portfolios
Thomas O. Putnam	Chairman	Fenimore Asset Management, Inc.
Shannon D. Radke	President	Viking Fund Management, LLC
Paul E. Rasmussen	Vice President	Sit Investment Associates, Inc.
J. Alan Reid, Jr.	President & CEO	Forward Management LLC
Gary S. Saks	Chief Operating Officer	Ironwood Investment Management LLC
Robert C. Schwartz	Director of Marketing	Schwartz Investment Counsel, Inc.
C. Troy Shaver	President & CEO	Dividend Growth Advisors, LLC
Elizabeth A. Watson	VP & General Counsel	Quantitative Investment Advisors, Inc.
Charles M. Weber	SVP & Associate General Counsel	Robert W. Baird & Co., Inc.
Thomas B. Winmill	President	Midas Management Corporation

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

Andrew J. Donohue, Director
Robert E. Plaze, Associate Director
Division of Investment Management

Chester Spatt, Chief Economist and Director
Office of Economic Analysis

Appendix A

The Institute defines small funds as fund groups with less than $2 billion in non-money market assets. Approximately 113 ICI member complexes meet this definition, or 36 percent all ICI member complexes.[1] The vast majority of them – 89, or 79 percent – hold long-term assets of less than $1 billion. On average, they hold $281 million in long-term assets, and their median size is $143 million.

The Small Funds Committee is comprised of 84 members of the Institute. Some member firms represented on the Committee are technically no longer small funds under the Institute's definition, because they now manage non-money market assets exceeding $2 billion. Such firms are welcome to remain on the Committee until they determine that they have more issues in common with larger fund complexes than with the Institute's small fund members. Additionally, members of the Committee include one small fund independent director and certain representatives of service providers who also act as officers for one or more small fund clients.

While not all small fund complexes are members of the ICI, our members are representative of small fund complexes generally. The small fund complexes reporting data to Strategic Insight have average total assets of $374 million, and their median size is $178 million.[2] See Appendix D for more detailed information.

[1] Twenty-one members of the ICI have long-term assets of $50 million or less.

[2] ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006. Under the SEC's definition of small fund complexes (those with assets of $50 million or less), 113 small fund complexes report to Strategic Insight, comprising 21 percent of all reporting complexes.

Appendix B

Operating Expense Ratios[1] for Selected Investment Objectives (2005)
(basis points)

Investment Objective	All Share Classes				Share Classes of Complexes with ≤ $2 billion[2]
	10th Percentile	Median	90th Percentile	Asset-Weighted Average	Simple Average
Aggressive Growth	84	115	151	76	152
Growth	69	105	141	71	136
Sector	84	120	167	86	154
Growth & Income	39	87	128	50	118
Income Equity	53	92	124	63	141
International Equity	88	130	175	100	166
Hybrid	57	98	134	71	136
Taxable Bond	45	73	104	69	88
Tax-Exempt Bond	48	64	86	55	80
Money Market	20	48	75	47	51

Source: ICI calculations using expense data by share class for 2005 from Lipper LANA 4.0 database.

1. Operating expense ratio is the total expense ratio net of 12b-1 fees and waivers.
2. Total net assets.

Appendix C

Fee Waivers of Small and Large Fund Complexes

	Complex Total Net Assets	
	> $ 2 billion	**≤ $ 2 billion**
Number of fund share classes		
Total	14,502	1,403
With a waiver	8,039	826
Percent with a waiver	55%	59%
Fee waivers[1] *(basis points)*		
25th Percentile	1	4
Median	3	15
75th Percentile	6	44
Simple Average	5	43

Source: ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006; includes only those share classes that reported expense data.

1. Among complexes offering fee waivers, waivers are computed by summing total dollars waived on all funds within a complex divided by the total assets of that complex.

Appendix D

Assets and Expenses by Size of Complex[1]

	AAll	Complex Total Net Assets		
		> $2 billion	≤ $2 billion	< $50 million[2]
Number of Complexes	547	182	365	113
Number of Funds Per Complex				
Average	13	33	3	1
Median	3	18	2	1
Complex Assets *(millions of dollars)*				
Average	$15,772	$46,652	$374	$19
Median	$515	$10,553	$178	$16
Complex Expenses *(millions of dollars)*				
Average	$91.1	$264.8	$4.0	$0.3
Median	$5.2	$78.4	$1.7	$0.2

Source: ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006; includes only those share classes that reported asset and expense data.

1. Expenses are estimated by taking expense ratios of each share class in a given complex times the assets of that share class and adding across all share classes within a given complex; expenses are measured net of 12b-1 fees and waivers.
2. This group is also included in the $2 billion or less category.

Appendix E

Additional Rules in the SEC's Fund Governance Package

1) ***Compliance Programs of Investment Companies and Investment Advisers***, Investment Company Act Release No. 26299, 68 FR 74714 (Dec. 24, 2003) (final rule)

2) ***Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings***, Investment Company Act Release No. 26418, 69 FR 22300 (Apr. 23, 2004) (final rule)

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5) ***Investment Adviser Codes of Ethics***, Investment Company Act Release No. 26492, 69 FR 41696 (July 9, 2004) (final rule)

6) ***Prohibition on the Use of Brokerage Commissions to Finance Distribution***, Investment Company Act Release No. 26591, 69 FR 54728 (Sept. 9, 2004) (final rule)

7) ***Mutual Fund Redemption Fees***, Investment Company Act Release No. 26782, 70 FR 13328 (Mar. 18, 2005) (final rule; request for additional comment); *see also* Investment Company Act Release No. 27255, 71 FR 11351 (Mar. 7, 2006) (proposed amendments)

8) ***Amendments to Rules Governing Pricing of Mutual Fund Shares***, Investment Company Act Release No. 26288, 68 FR 70388 (Dec. 17. 2003) (proposed rule)

Appendix F

Detailed Data on Compliance-Related Expenses for Selected Complexes

	Complex A	Complex B	Complex C	Complex D[1]	Complex E	Complex F	Complex G
2005 Directors' Fees	$1,068,300	$181,000	$76,700	$116,000	$126,750	$14,500[2]	$172,000
% change from 2003	58%	110%	121%	55%	44%	164%	77%
2005 Legal Costs	$862,500	$117,300	$76,400	$153,500	$31,700	n.a.	n.a.
% change from 2003	31%	90%	83%	3%	n.a.		
2005 CCO Costs[3]	$120,500[4]	$33,000	$145,000	$271,000	$31,350	n.a.	n.a.
2005 Insurance Costs	$378,800	$63,000	$84,000	$78,700	$54,250	n.a.	n.a.
% change from 2003	33%	31%	69%	18%	158%		

n.a. = not available

1. Percent change calculated from 2004 figures.
2. Compensation per director for each board and committee meeting, plus annual retainer fee.
3. Adviser may pay all or part of fund CCO salary and expenses.
4. Future increases will have to be absorbed by the adviser per funds' boards.

INVESTMENT COMPANY INSTITUTE

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August 21, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

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

Dear Ms. Morris:

The Investment Company Institute[1] is pleased to respond to the Commission's request for additional comment on rule amendments under the Investment Company Act of 1940 that would require virtually all fund boards to be comprised of at least 75 percent independent directors and to have an independent director as chair.[2]

As the Commission's release notes, the independent chair and 75 percent independent director requirements were invalidated by a federal appeals court earlier this year, but the court suspended issuing its mandate to give the Commission the opportunity to request further comment. In response to the court proceedings, the Commission announced that, in addition to requesting additional public comment, it is initiating a "top-to-bottom review" of its process for complying with legal obligations to analyze the economic impact of proposed rules.[3] We strongly support this review. We believe it is a worthwhile exercise that has the potential to strengthen the integrity of the Commission's rulemaking process.

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[1] The Investment Company Institute is the national association of the American investment company industry. More information about the Institute is included at the end of this letter.

[2] The requirements would apply to funds that rely on certain exemptive rules under the Investment Company Act. *See* Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("Adopting Release") at n. 9. Virtually all funds rely on one or more of those rules.

[3] *See* SEC Complies with Court Order on Mutual Fund Rules, SEC Press Release 2006-95 (June 13, 2006).

Like the Commission, the Institute supports strong and effective fund governance. With the benefit of additional practical experience and in light of regulatory and other developments since the Commission first proposed these requirements, the Institute continues to believe that the choice of a chairperson should be left to the members of the board, and continues to support a requirement that two thirds of a board's members be independent, rather than 75 percent.[4]

Close to three years have passed since the Commission issued its proposal, which was part of a comprehensive slate of reform proposals developed in response to revelations of mutual fund trading abuses in September 2003. Since that time, the Commission has adopted, and funds have implemented, numerous new rules aimed at improving investment company governance.[5] Those measures have accomplished a great deal in addressing the SEC's regulatory concerns.

Even though the independent chair and 75 percent board independence requirements have not gone into effect, the expectation that they might, the increased regulatory and public focus on fund governance, and some of the other new regulatory requirements have led many fund boards to review and some to change their structure and composition. Today, boards continue to operate successfully under a variety of governance models. Some boards have independent chairs and others do not. That different models persist shows that the considered judgments of fund directors can lead to different – but equally responsible and legitimate – conclusions as to which structure best serves the needs of a particular board and the interests of fund shareholders.

Importantly, most funds have a supermajority of independent directors, be it two thirds or 75 percent, which assures that the independent directors control the voting process. In addition, the independent directors must approve by a separate vote key matters such as a fund's advisory contract and any 12b-1 plan.[6] The chair's status (independent or not) and the exact proportion of independent directors on the board (two thirds or 75 percent) have no effect on these significant protections.

Against this backdrop, the Institute does not believe it has been shown that *mandating* that virtually *all* fund boards appoint an independent director as chair will produce benefits and therefore

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[4] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 10, 2004 ("2004 ICI Letter").

[5] In its adopting release for the requirements currently under consideration and related fund governance requirements that have not been challenged, the SEC described the requirements as part of a "package" to address concerns about the governance of mutual funds. *See* Adopting Release at n. 5 and accompanying text. The unchallenged requirements provide that fund boards must (1) perform annual self-assessments, (2) hold separate meetings of the independent directors at least once each quarter, and (3) have express authority to retain experts and hire staff. The other rules in the fund governance package are listed in Appendix A.

[6] Similarly, most of the other exemptive rules (in addition to Rule 12b-1) that would be amended to add the independent chair and 75 percent board independence requirements already condition the exemptive relief on the approval of the board, including a majority of the independent directors. *See id.* at n. 9.

we cannot support this requirement. In addition, while we support requiring a supermajority of independent directors on fund boards, we believe the Commission should adopt a two-thirds standard, rather than 75 percent.

Independent Chair Requirement

The Institute recommends that the Commission not pursue the independent chair requirement. An across-the-board requirement to appoint an independent chair is overly broad and unnecessary.

Fund Directors Are in the Best Position to Select the Most Appropriate Chair of the Board

As we stated in our previous comment letter, the selection of the best person to serve as chair of the board rightfully is, and should continue to be, a decision made by the directors themselves.[7] The directors are uniquely positioned to choose the most appropriate candidate for the position of chair, and in some cases that person may be an interested director.[8]

Since the Commission's initial proposal, many, if not most, fund boards have considered who should serve as chair. Institute research indicates that many boards have chosen an independent director as chair.[9] While some of these boards elected an independent chair in anticipation of the requirement taking effect, even in the absence of a requirement, independent directors are fully empowered to choose an independent chair if they wish, since they generally must comprise at least a simple majority of the board. As discussed further below, the Institute supports requiring that at least two thirds of the board consist of independent directors, which will further bolster the independent directors' ability to control the choice of a chair. A one-size-fits-all approach should not displace case-by-case board decisions grounded in the directors' exercise of their fiduciary obligations.

The Commission Has Not Demonstrated that Any Benefits of Mandating An Independent Chair Justify the Costs

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[7] *See* 2004 ICI Letter, *supra* note 4.

[8] Many experienced independent directors share this view. *See* Appendix B to this letter. *See also* Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins, Adopting Release, *supra* note 2, at 46392, n. 38 ("We contend that a conscientious board might reasonably determine that the most qualified and capable candidate is someone with deep familiarity with day-to-day fund operations.")

[9] According to a study of fund boards conducted by the Institute and the Independent Directors Council, 52.4 percent of responding fund complexes reported having at least one fund board with an independent chair at year-end 2005. *See* Investment Company Institute and Independent Directors Council, Directors' Practices Study: Practices and Compensation (August 2006) ("Directors' Practices Study"). The Directors' Practices Study includes information reported by 185 complexes, representing approximately 88 percent of the industry's total net assets. These complexes reported information on 1,471 independent directors.

The Institute recognizes that an independent chair arrangement works well for some boards. At the same time, we do not believe that the Commission has adequately demonstrated the benefits of *mandating* this governance structure for virtually *all* fund boards.

There Is No Empirical Evidence of Benefits

The Commission acknowledged the "limited and conflicting empirical evidence" of benefits when it first adopted the independent chair requirement.[10] The Institute is aware of only two studies examining the relationship between the status of the board chair and various measures of fund governance. These studies show no significant correlation.[11]

The Commission further noted that "[w]e are not aware of any conclusive research that demonstrates that the hiring of an independent chairman will improve fund performance or reduce expenses, or the reverse."[12] The Institute recognizes that performance and expense levels are not correlated with particulars of fund governance. Our review of the research analyzing these factors, including studies released after the Adopting Release, confirms that the evidence of these benefits is inconclusive.[13] Nonetheless, assuming *arguendo* that any correlation can be drawn on these issues, the studies of which we are aware suggest that funds with independent chairs have in the past generally had weaker performance and higher expenses than funds with management chairs.[14]

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[10] Adopting Release, *supra* note 2, at 46383.

[11] *See, e.g.,* Sophie X. Kong and Dragon Y. Tang, *Mutual Fund Governance: What Works and What Doesn't?,* unpublished working paper, Kennesaw State University (2006) (finding no significant correlation between independent chairmen and good governance as measured by Morningstar, Inc.'s Stewardship Grades); Stephen P. Ferris and Xuemin Yan, *Do Independent Directors and Chairmen Really Matter? The Role of Boards of Directors in Mutual Fund Governance*, unpublished working paper, University of Missouri (2004) (concluding that a fund's likelihood of being involved in the recent trading scandals was unrelated to whether the fund board had an independent chair).

[12] Adopting Release, *supra* note 2, at 46383, n. 52. The Commission also cited comments recognizing the lack of conclusive research. *See, e.g.,* Remarks by John C. Bogle, Founder and Former CEO, The Vanguard Group, before the Institutional Investor Magazine Mutual Fund Regulation and Compliance Conference (May 5, 2004), File No. S7-03-04, *quoted in* Adopting Release, *supra* note 2, at 46383, n. 52 (stating that the "data constitute muddy and unpersuasive evidence").

[13] In addition, as an SEC staff report to the Commission stated, such analyses are highly sensitive to method and data samples. *See* Exemptive Rule Amendments of 2004: The Independent Chair Condition: A Report in Accordance with the Consolidated Appropriations Act, 2005, Staff Report to the U.S. Securities and Exchange Commission, April 2005.

[14] *See, e.g.,* Geoffrey H. Bobroff and Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs,* paper prepared for Fidelity Investments (2004) (concluding that funds with independent chairs have not performed as well as those with interested chairs, and that their funds have had competitive to high expense levels, depending on how expenses are measured and aggregated); Stephen P. Ferris and Xuemin Yan, *supra* note 11 (finding no evidence that funds with independent chairs have had lower fees); J. Felix Meschke, *An Empirical Examination of Mutual Fund Boards,* unpublished working paper, University of Minnesota, 2005 (finding that funds with independent chairs have had higher fees and

The Commission's Goals Have Been Achieved in Other Ways

Acknowledging the inconclusive nature of the empirical research, the SEC relied on "its own and its staff's experience, the many comments received, and other evidence" in concluding that an independent chair can "provide benefits and serve other purposes…."[15] The purposes articulated by the SEC included addressing a perceived "breakdown in management controls."[16] The SEC also sought, through this requirement, to "place fund boards in a better position to demand that management adhere to the highest of compliance standards,"[17] and to "establish a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance."[18] These purposes have already been addressed by a combination of factors, including the other rules the Commission adopted as part of its fund governance package.[19]

For example, the compliance rules adopted in 2003 are designed to assure that funds and their advisers have in place effective compliance controls. The intense and sustained focus on such controls, greater sensitivity to conflicts of interest, and increased compliance testing occasioned by these rules are a more direct and effective way to address a perceived "breakdown in management controls."

In addition, in adopting the fund compliance rule, the SEC stated that the "rule provides the board with a powerful tool to exercise its oversight responsibilities over fund compliance matters," by providing the board with "direct access to a single person with overall compliance responsibility for the fund who answers directly to the board."[20] The rule provides for enhanced communication to the board about compliance matters. It requires, for example, that the chief compliance officer annually furnish the board with a report on the operation of the fund's compliance policies and procedures and those of its service providers, including its investment adviser. According to the Commission, the chief compliance officer is responsible for "keeping the board apprised of significant compliance events at the

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expenses but better performance than those with management chairs); Sophie X. Kong and Dragon Y. Tang, *supra* note 11 (presenting evidence that funds with independent board chairs have had higher fees and weaker performance, although the effects are statistically insignificant).

[15] Adopting Release, *supra* note 2, at 46383-84.

[16] *Id.* at 46379.

[17] *Id.*

[18] *Id.* at 46383.

[19] *See supra* note 2.

[20] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)], at 74722.

fund or its service providers and for advising the board of needed changes in the fund's compliance program."[21]

The rule's requirement that the chief compliance officer meet at least annually in an executive session with the independent directors "creates an opportunity for the chief compliance officer and the independent directors to speak freely about any sensitive compliance issues of concern to any of them."[22] The requirement under the fund governance rules that independent directors meet in an executive session at least quarterly provides another "opportunity for a frank and candid discussion among themselves regarding the management of the fund, including its strengths and weaknesses."[23] These discussions among the independent directors and with the chief compliance officer provide multiple opportunities for a board to assess management's performance and demand high standards of compliance. These regulatory enhancements further strengthen the hand of independent directors who, as noted above, already must constitute at least a simple majority of the board and must approve key items such as a fund's advisory contract and any 12b-1 plan by a separate vote.

Perhaps most importantly, the culture of the boardroom has evolved. According to several Institute members, regular executive sessions have increased cohesion among the independent directors, which has helped to foster meaningful dialogue between independent directors and fund management. Also, as a result of the annual board self-assessment requirement, directors continually revisit the effectiveness of how they operate. Even apart from any specific regulatory requirements, increased regulatory and public scrutiny, enforcement actions, and private litigation stemming from the trading scandals have heightened the attention of fund directors and fund management to the importance of maintaining a culture of compliance, regardless of whether the chair is independent. Thus, through a variety of different means, the SEC's goals in proposing the independent chair requirement have already been accomplished, diminishing the possibility of benefits flowing from the requirement.

<u>The Costs Are Not Justified in the Absence of Demonstrable Benefits</u>

It is an axiom of cost/benefit analysis that the lower the benefit of a proposal, the lower the acceptable cost for implementing it. As the Commission recognizes, there are costs involved in electing and maintaining an independent chair.[24] Institute members who have made the transition voluntarily confirm that having an independent chair imposes a variety of additional costs, such as increased compensation paid to the chair in recognition of his or her expanded responsibilities, costs to train a new chair, greater reliance on the board's outside legal counsel, and heavier utilization of management

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[21] *Id.*

[22] *Id.* at 74721.

[23] Adopting Release, *supra* note 2, at 46385.

[24] *See, e.g.,* Investment Company Governance, Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26985 (June 30, 2005) [70 FR 39390 (July 7, 2005)] at 39394-95.

staff. Such costs have a much greater impact on small funds.[25] These costs are in addition to the significant costs associated with implementing the other rules the SEC included in its fund governance package.

Where boards have decided that they are best served by having an independent chair, they have implicitly determined that the costs incurred to elect and maintain one are warranted. But given the lack of empirical evidence of benefits of an across-the-board requirement, the other new rules and outside forces that have already addressed the Commission's goals, and the successful experiences of boards with each structure, the costs of a one-size-fits-all requirement are not justified.

If Additional Measures Are Needed, There Are Less Costly and Disruptive Alternatives

To the extent the Commission continues to believe that additional measures are needed to address board independence, there are several less costly and disruptive alternatives to the independent chair requirement, many of which have been proposed by the Institute and others in previous comment letters.[26] For example, the Commission could require fund boards that do not have an independent chair to appoint a "lead independent director." Many boards already have done so in response to the recommendation of the Advisory Group on Best Practices for Fund Directors in its 1999 report.[27] A lead independent director can provide a source of independent leadership on the board. The main difference between this structure and an independent chair is that the lead independent director does not run board meetings. This alternative would preserve flexibility for directors to choose the arrangement that works best for their funds.

Another approach would be to require funds to disclose more prominently to shareholders whether they have an interested or independent chair. As Commissioner Atkins and former Commissioner Glassman have argued, this approach would allow investors to choose among funds on this basis if the status of the board chair is important to them.[28]

Board Composition

The Institute has long supported requiring a supermajority of independent directors, for the same reasons as the SEC. In 1999, the Advisory Group concluded that having a supermajority of independent directors on fund boards would help assure that independent directors control the voting

[25] *See* Letter from Members of the Small Funds Committee, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated August 21, 2006 ("Small Funds Letter").

[26] *See, e.g.,* 2004 ICI Letter, *supra* note 4.

[27] *See Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999).

[28] *See, e.g.,* Adopting Release, *supra* note 2, at 46393.

process, particularly on matters involving potential conflicts of interest. The Advisory Group specifically recommended that at least two thirds of the directors on a fund board be independent.[29] The Institute continues to support a requirement that codifies this practice, just as we did when the Commission first proposed a 75 percent standard. Most fund boards already comply with the recommended two-thirds supermajority standard.[30] A 75 percent requirement imposes additional costs on funds, but research has found no consistently evident benefits.[31]

The Institute recognizes that there are costs inherent in not only reaching but also maintaining a supermajority of independent directors.[32] Institute members have reported additional costs such as fees for additional independent directors, initial training for them, and a heavier burden on adviser staff to support the independent directors. If funds alter their board composition by either replacing one or more interested directors with independent directors or adding independent directors without eliminating interested directors, shareholder elections may be required pursuant to Section 16(a) of the Investment Company Act, adding the cost of a proxy solicitation. Finally, a supermajority requirement reduces the flexibility of a board to adjust after director turnover, potentially requiring the addition of new independent directors to maintain the appropriate balance. Even if elections are not required under Section 16(a), finding, appointing, and training new directors consumes time and resources, and diverts a board's and management's attention from its other duties.

While these costs may also be incurred under the Institute's proposed two-thirds requirement, they are amplified by a 75 percent requirement, most notably because of the reduced flexibility in board composition.[33] According to the Directors' Practices Study, the most common numbers of interested

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[29] *See Enhancing a Culture of Independence and Effectiveness*, *supra* note 27.

[30] According to the Directors' Practices Study, 80 percent meet the 75 percent standard, and 93 percent meet the two-thirds standard. *See* Directors' Practices Study, *supra* note 9. These results reflect the responses of 147 fund complexes in the study that utilize a unitary board structure (one board overseeing all funds in the complex) and exclude complexes that utilize a cluster structure (separate boards overseeing groups of funds within the complex).

[31] *See*, *e.g.,* Stephen P. Ferris and Xuemin Yan, *supra* note 11 (finding that the proportion of independent directors on a fund's board has had no influence on either fund fees or the likelihood that a fund complex was involved in the recent mutual fund scandal); J. Felix Meschke, *supra* note 14 (concluding that funds with a high proportion of independent directors have had higher expense ratios and worse performance than other funds); Sophie X. Kong and Dragon Y. Tang, *supra* note 11 (finding mixed and inconclusive results about the influence of a board composed of 75% or more independent directors on fund fees, fund performance, and the likelihood of being involved in the mutual fund scandal). *But see* Peter Tufano and Matthew Sevick, *Board Structure and Fee-Setting in the U.S. Mutual Fund Industry*, 46 JOURNAL OF FINANCIAL ECONOMICS 321 (1997), (concluding that mutual funds whose boards have a higher percentage of independent directors tend to charge lower fees).

[32] These costs, too, disproportionately affect small funds, and are discussed in more detail in the Small Funds Letter. *See supra* note 25.

[33] The rule contains an exception allowing boards with only three directors to have one interested director. *See* Adopting Release, *supra* note 2, at 46382.

directors on boards are one or two, and the most common board size is eight.[34] An eight-person board with two interested directors, for example, would be in violation of the requirement after a single independent director resigned, but would not be in violation of a two-thirds requirement until *three* directors resigned. Put another way, a board with two interested directors would need at least nine members overall – more than the average board – before it could withstand a single independent director resignation without needing a replacement. By contrast, under a two-thirds standard, even a seven-person board with two interested directors could withstand a resignation without needing to elect or appoint another independent director.[35]

These costs – both in dollars and decreased flexibility – come without any apparent corresponding benefit. Independent directors already vote separately on the most significant items that come before the board, including approval of the advisory contract and 12b-1 plans. With respect to these matters, the proportion of independent to interested directors should be irrelevant. More importantly, as discussed above, Institute members report that a culture of independence is already well developed on their boards as a result of a variety of factors including the compliance rule, executive session requirements, increased regulatory scrutiny, and the voluntary movement by many funds to increase the proportion of independent directors to at least two thirds. We do not believe that a requirement that 75 percent of the board be independent would further these objectives any more than a two-thirds requirement.

For these reasons, the Institute supports the Commission's efforts to require a supermajority of independent directors on all fund boards, but recommends that the Commission revise its proposal so as to require a two-thirds supermajority of independent directors.

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[34] *See* Directors' Practices Study, *supra* note 9. As indicated above, this board composition information is based on 147 complexes in the study that utilize a unitary board structure.

[35] There are good reasons to keep interested directors on the board. As the Advisory Group on Best Practices for Fund Directors explained in its 1999 report, among other things, board membership by representatives of the adviser facilitates more direct accountability on the part of the adviser and a better exchange of information with the adviser, and subjects those representatives to the same fiduciary standards as independent directors. *See Enhancing a Culture of Independence and Effectiveness, supra* note 27. *See also* Letter from Vern O. Curtis (an independent director of the Pimco funds) to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated July 13, 2006 ("It is reasonable that an advisor would want to have two seats on a board for continuity, convenience and training. A supermajority of 75% would require six independent directors, whereas a supermajority of 66-2/3% would require four independent directors.").

The Institute appreciates the opportunity to comment on these important matters. If you have any questions about our comments or would like any additional information, please contact me at 202/326-5815.

Sincerely,

/s/

Elizabeth R. Krentzman
General Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

Andrew J. Donohue, Director
Robert E. Plaze, Associate Director
Division of Investment Management

About the Investment Company Institute

The Investment Company Institute's membership include 8,719 open-end investment companies (mutual funds), 653 closed-end investment companies, 211 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.225 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households.

APPENDIX A

Additional Rules in the SEC's Fund Governance Package

1) ***Compliance Programs of Investment Companies and Investment Advisers***, Investment Company Act Release No. 26299, 68 FR 74714 (Dec. 24, 2003) (final rule)

2) ***Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings***, Investment Company Act Release No. 26418, 69 FR 22300 (Apr. 23, 2004) (final rule)

3) ***Disclosure of Breakpoint Discounts by Mutual Funds***, Release No. 26464, 69 FR 33262 (June 14, 2004) (final rule)

4) ***Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies***, Investment Company Act Release No. 26486, 69 FR 39798 (June 30, 2004) (final rule)

5) ***Investment Adviser Codes of Ethics***, Investment Company Act Release No. 26492, 69 FR 41696 (July 9, 2004) (final rule)

6) ***Prohibition on the Use of Brokerage Commissions to Finance Distribution***, Investment Company Act Release No. 26591, 69 FR 54728 (Sept. 9, 2004) (final rule)

7) ***Mutual Fund Redemption Fees***, Investment Company Act Release No. 26782, 70 FR 13328 (Mar. 18, 2005) (final rule; request for additional comment); *see also* Investment Company Act Release No. 27255, 71 FR 11351 (Mar. 7, 2006) (proposed amendments)

8) ***Amendments to Rules Governing Pricing of Mutual Fund Shares***, Investment Company Act Release No. 26288, 68 FR 70388 (Dec. 17. 2003) (proposed rule)

APPENDIX B

Excerpts from Selected Comment Letters filed by Independent Fund Directors on Independent Chairman Requirement (File No. S7-03-04)

"In our view, the "right" approach for any fund will depend on many factors, including the board's experience with the personnel and operations of the fund's management company, the level of meaningful dialogue and exchange of information between the independent directors and the management company, and the composition, backgrounds and dynamics of the board itself."

Letter from the Independent Directors of the Vanguard Funds to Nancy M. Morris, Secretary, SEC (July 31, 2006); see also Letter from the Independent Directors of the Vanguard Funds to Jonathan G. Katz, Secretary, SEC (March 10, 2004)

"We believe that in our case such a requirement would detract from fund governance. We have a chair who is a member of Nicholas Applegate's top management, and is in a position to know what is happening at the funds on a day-to-day basis. No independent director can have that knowledge, and without it, we do not believe that a chair could effectively lead our meetings."

Letter from George Keane, Chairman, Audit Committee of the Nicholas Applegate Funds, to Jonathan G. Katz, Secretary, SEC (March 10, 2004)

"A well-functioning board, as in the case of the Fidelity Funds board, can act independently and effectively without having an Independent Trustee serve as chairman. The key structural component of assuring that independent trustees are in a position to control the board is to ensure that they constitute a substantial majority of the board...."

Letter from the Independent Trustees of the Fidelity Funds to Jonathan G. Katz, Secretary, SEC (March 9, 2004)

"We strongly believe that a disinterested chair could actually weaken fund governance in many cases because a disinterested chair may not be able to effectively lead the board through a discussion of a detailed and complex agenda."

Letter from the Disinterested Trustees of EQ Advisors Trust to Jonathan G. Katz, Secretary, SEC (March 4, 2004)

"The proposed rule to require the chair be an independent director is not necessary and could interfere with the proper balance between the role of fund management and the role of independent directors. This is because it would impose a functional organization on the boards of all mutual funds that does not (and obviously cannot) take into account the unique dynamics of each board...."

Letter from the Independent Directors of the T. Rowe Price Mutual Funds to Jonathan G. Katz, Secretary, SEC (Feb. 25, 2004)