



August 21, 2006

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

Re: Request for Additional Comment:  
Investment Company Governance;  
File No. S7-03-04

Dear Ms. Morris:

The Independent Directors Council<sup>1</sup> appreciates the opportunity to respond to the Securities and Exchange Commission's request for additional comment on rule amendments under the Investment Company Act of 1940 that would require a fund relying on certain exemptive rules<sup>2</sup> to have a board with no less than 75 percent independent directors and an independent chair.<sup>3</sup>

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<sup>1</sup> The Independent Directors Council serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors. The activities of the IDC are directed by a Governing Council; the participants in Council activities are directors of Investment Company Institute member funds. The Investment Company Institute's members collectively oversee 98 percent of all assets in U.S. mutual funds on behalf of approximately 89.5 million shareholders in more than 52.6 million households.

<sup>2</sup> 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 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) (the "Exemptive Rules").

<sup>3</sup> See *Investment Company Governance*, SEC Release No. IC-27395 (June 13, 2006). The SEC's request for additional comment on its proposed governance amendments is in response to the decision of the United States Court of Appeals for the District of Columbia in *Chamber of Commerce v. Securities Exchange Commission*, 443 F.3d 890 (D.C. Cir. 2006).

The IDC strongly supports efforts that strengthen the ability of fund boards to fulfill their oversight responsibilities and protect fund shareholders. Since 2001, the SEC has adopted a number of rules that advance this objective, including rules that increase the percentage of independent directors on virtually all fund boards, require that counsel to boards be independent, empower boards to hire staff and experts, require independent directors to meet in executive session, mandate an independent nominating committee, and provide for a chief compliance officer who reports to the board. We believe that, collectively, all of these initiatives have significantly and beneficially enhanced the effectiveness and authority of fund boards of directors.

To further strengthen the presence of independent directors and improve their ability to represent effectively the interests of shareholders, the SEC is requesting additional comment on rule proposals that would mandate that boards have a 75 percent majority of independent directors and elect an independent chairperson. (These rules were originally proposed for comment in January 2004.) For the reasons articulated below, the IDC supports the SEC's proposal to require a 75 percent majority of independent directors. We further support the objectives of the SEC in proposing the independent chair position. However, we do not believe that an independent chair should be mandated for all fund boards and oppose that portion of the SEC's proposal.<sup>4</sup>

### **Board Composition**

The SEC's proposal would require that the independent directors of a fund that relies on the Exemptive Rules constitute at least 75 percent of the board. If the fund has only three directors, all but one must be independent. When these rules were originally proposed, the Directors' Committee of the Investment Company Institute, the predecessor to the IDC, commented that it did not oppose the increase in independent board members to a supermajority.<sup>5</sup> Today, the IDC affirmatively supports the proposed 75 percent requirement.<sup>6</sup>

In 1999, a report by an Advisory Group assembled by the Investment Company Institute recommended an increase in the percentage of independent directors on each board from the 40

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<sup>4</sup> This letter focuses on the underlying purpose of these proposals, which the SEC has stated as the protection of funds and fund shareholders, and not on the cost of implementation.

<sup>5</sup> See Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from James H. Bodurtha, Chair, Directors' Committee of the Investment Company Institute, dated March 10, 2004, commenting on *Investment Company Governance*, SEC Release No. IC-26520 (July 27, 2004).

<sup>6</sup> According to an IDC web-based survey of fund board leaders conducted between July and August 2006, approximately 88 percent of responding fund leaders reported that their boards supported the 75 percent independence requirement. The survey includes information reported by 99 fund board leaders, representing approximately 50 percent of the industry's total net assets.

percent required by the Investment Company Act to a two-thirds majority (*i.e.*, 66 2/3 percent).<sup>7</sup> The Advisory Group concluded that the benefits of a two-thirds majority justified recommending it as a best practice and that a supermajority of independent directors “will help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund’s investment adviser.” In response to this best practice, many boards restructured themselves to ensure a two-thirds majority of independent directors. Other boards went further and ensured that 75 percent of their directors were independent. Indeed, according to our most current research on this issue, an overwhelming majority of fund boards already meet the SEC’s proposed 75 percent standard.<sup>8</sup>

While either a two-thirds or a 75 percent majority will enhance the authority and influence of the independent directors, we support increasing the required percentage of independent directors to 75 percent.<sup>9</sup> This is because the greater the number of independent directors on a board, the greater their control of the voting process, particularly when another independent director is unavailable to vote on a significant issue. Also, the greater the number of independent directors, the less the proportionate representation, and thus influence, of interested directors on the board. The result is that, with a 75 percent majority, independent directors can better assert their influence on the board and control the board’s oversight of the fund. For these reasons, we support the 75 percent independent director requirement.

### **Independent Chair**

The SEC’s proposed rules would additionally mandate that most fund boards appoint an independent chairperson. According to the SEC, this requirement is intended to promote a board

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<sup>7</sup> Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).

<sup>8</sup> According to an ICI/IDC survey of fund boards, as of year-end 2005, 80 percent of responding fund complexes met the 75 percent standard. See *Investment Company Institute/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 1,1471 independent directors.

<sup>9</sup> As a practical matter, a mandate that 75 percent of the board be independent directors, would reduce the flexibility of some boards’ composition. For example, a seven-person board could not have five independent and two interested directors and comply with the 75 percent requirement. And yet, there are defensible reasons for a board having more than one interested director – *e.g.*, continuity, experience, shared fiduciary obligation. Setting the bar at 75 percent might make this impossible for those boards that elect not to increase their size in response to a 75 percent requirement. Indeed, resolving this dilemma by increasing the board size might raise other issues, such the need to conduct a proxy solicitation and the resulting increased costs to shareholders. In recognition of these and other special circumstances, the SEC should consider providing relief (*e.g.*, through exemptions or otherwise) where appropriate from the 75 percent standard.

culture that is conducive to decisions favoring the long-term interests of fund shareholders. In the SEC's view, an independent chairman would control the board agenda and exert a strong influence on board deliberations. While the IDC supports the objective of enhancing the control of the board by an independent director, we do not believe that requiring all fund boards to have an independent chair is necessary to accomplish this objective. Instead, the selection of a person to serve as chair of the board is a decision each board should make for itself taking into account many factors, the most important of which is the best interests of fund shareholders.

The IDC has consistently supported strong and effective fund governance. Similarly, we have supported the SEC's efforts to strengthen the tools available to independent directors in order to better assure control of the information and processes essential to the directors' oversight responsibilities – as evidenced by our support for the SEC's proposed 75 percent independent director requirement. In our view, increasing the number of independent directors on a fund board to 75 percent, coupled with other governance reforms, such as separate meetings of the independent directors, independent nominating committees, and annual board self-assessments, sufficiently vests independent directors with the ability to assert their influence on the fund board and impact its activities. The success of these reforms in satisfying the SEC's objective of enhancing the independent directors' influence obviates the need to additionally mandate that all fund boards have an independent chair. Ironically, mandating an independent chair would deny all directors of a fund board – including the independent directors whose influence the SEC is trying to enhance through its reforms – their traditional and long-held prerogative to decide the leadership that best suits the fund and its shareholders.

All directors sitting on a fund board have a fiduciary obligation to the fund's shareholders. Fund shareholders are best served when the directors are empowered, as part of their fiduciary obligation, to elect a board chair – independent or interested – who is best suited to lead the board and serve the long-term interests of shareholders. Under current law, independent directors have the ability, based on their experience, prudence and informed judgment, to determine the governance structure that best suits their board culture and enables them to effectively and efficiently carry out their legal and fiduciary duties to shareholders. In exercising that power, as of December 2005, over 50 percent of fund boards have chosen to appoint an independent chair, even in the absence of a specific mandate.<sup>10</sup> Other boards have chosen to exercise their power by designating a lead director as recommended in 1999 by the ICI Advisory Group. In the view of these funds, a lead director structure is preferable and best serves the needs of the funds' shareholders.

In the course of preparing this letter, many independent chairpersons shared their experiences with their chosen governance structure. They were in agreement that theirs was a positive experience but, at the same time, many acknowledged that it was possible that similar benefits may be attainable under alternative structures. The IDC affirmatively encourages boards to undertake a critical review of

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<sup>10</sup> According to the Directors' Practices Study, 52.4 percent of responding fund complexes reported having at least one fund board with an independent chair at year-end 2005. See Directors' Practices Study, *supra* note 8.

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their boardroom structure, either as part of the annual self-assessment or as a discrete exercise, to determine whether an independent chair would strengthen the board's effectiveness and provide positive benefits for the board and the fund's shareholders.<sup>11</sup> Regardless of the board's conclusion after conducting such a critical review, it should have sufficient flexibility under the law to take whatever action it has determined to be in the best interests of the fund and the fund's shareholders. For this reason, the IDC opposes the SEC's proposal to mandate an independent chair for all fund boards.

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We appreciate the opportunity to comment on this proposal and offer our continued support in your efforts to strengthen fund boards and the role of independent directors.

Sincerely yours,

/s/ Robert W. Uek

Robert W. Uek  
Chair, IDC Governing Council

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  
U.S. Securities and Exchange Commission

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<sup>11</sup> In an effort to provide guidance to boards considering the appointment of an independent chair, in 2005, the IDC issued a Task Force Report, *Implementing the Independent Chairperson Requirement*. The report, which is available at [www.idc1.org](http://www.idc1.org), outlines issues boards should consider, including those relating to the responsibilities of the independent chair and the selection and compensation of the independent chair.