Concurring Views of Chairman Donaldson
at Open Commission Meeting
Commission Response to Remand by Court of Appeals

The last item on our agenda is a recommendation from the Division of Investment Management relating to rules we adopted last year to enhance the governance practices of mutual funds. As a condition to a mutual fund engaging in certain transactions involving conflicts of interest with the fund's management company, the rules require that the fund have a board with at least 75 percent independent directors and an independent chairman.

The Commission voted to approve these fund governance rules in June 2004, and we are acting today as a result of a recent decision by the District of Columbia Circuit Court of Appeals in a case brought by the Chamber of Commerce. In that case, the Court agreed with the Commission on two central points: first, that the Commission had the statutory authority under the Investment Company Act to adopt the fund governance rules; and second, that the Commission's underlying policy rationale for adopting the rules was reasonable.

However, the Court remanded two issues for our consideration. The Court instructed the Commission to further consider certain potential costs of the new rules, and to consider a potential alternative to the independent chair rule. Today's recommendation addresses the Court's concerns, which we take quite seriously.

Before turning to the specific issues raised by the Court, I would like to briefly put this rulemaking in perspective and highlight some of the very important benefits that I believe it will bring to investors and to the mutual fund industry.

When Congress enacted the Investment Company Act in 1940, it recognized that conflicts of interest in the mutual fund industry pose serious risks to fund shareholders. Funds are organized and operated by people whose primary economic interests lie outside the enterprise, and, without appropriate checks and balances, this structure can readily lead to abuse. To address the conflicts, Congress established minimum governance requirements under the Act, based on its determination that a fund's board of directors, particularly its independent directors, should serve as watchdogs to protect the interests of investors.

Congress also prohibited funds from engaging in certain types of affiliate transactions and other transactions that are most susceptible to abuse, while at the same time granting the Commission broad authority to provide exemptions when in the public interest. Since 1940, the Commission has adopted a variety of exemptive rules that permit otherwise prohibited transactions, but only under certain carefully tailored conditions, which include active oversight by independent directors.

Beginning in 2003, a series of scandals were uncovered in the mutual fund industry involving truly egregious, illegal and unethical behavior on the part of fund advisers. Advisers in a host of different fund complexes knowingly endorsed, among other abuses, late trading, market timing (including some advisers timing their own funds), directed brokerage, and selective disclosure to favored investors. The scandals resulted in enormous losses for investors, and revealed systemic breakdowns in compliance systems, weaknesses in fund governance structures and a significant betrayal of investors' trust.

The Commission responded to the scandals in a swift and comprehensive manner. We have brought numerous enforcement cases and obtained over $2.2 billion in disgorgement and penalties, which can be used to compensate harmed investors. In addition, in the last year and a half, the Commission has adopted a number of rules designed to ensure better compliance by funds and advisers with the federal securities laws, promote the accountability of fund officers and directors, and enhance disclosure to investors.

The fund governance rules are a critical component of the Commission's reform efforts. By strengthening the role of the independent directors, the rules enhance the ability of fund boards to provide badly needed oversight of the activities of their advisers and monitor conflicts of interest. The independent chair condition allows individuals who are truly free from conflict to exercise leadership in the boardroom. This point was underscored in a comment letter submitted by all seven of the living former Chairmen of the Commission, who wrote: "An independent mutual fund board chairman would provide necessary support and direction for independent fund directors in fulfilling their duties by setting the board's agenda, controlling the conduct of meetings, and enhancing meaningful dialogue with the adviser."

The Commission recognizes that there are fund chairmen who strive to represent the interests of fund investors in the boardroom while also serving as executives of the fund's adviser. But they undeniably face a central conflict of interest. When the CEO of a mutual fund's adviser is simultaneously serving as the chairman of the mutual fund itself, this person is in the untenable position of having to serve two masters. On the one hand, he or she owes a duty of loyalty and care to the mutual fund; on the other hand, the

person owes a separate duty to the shareholders of the fund's investment adviser. It is easy to see that these two duties are often in conflict, particularly when it comes to setting the level of fees the fund will pay the adviser.

The independent chair condition is the capstone of our series of mutual fund governance reforms that will help foster a culture in fund boardrooms based on transparency, arm's length dealing, and, above all, protection of the interests of fund shareholders. The rules will also, I believe, help to strengthen the compliance function at mutual funds by providing a truly independent body to which the chief compliance officer can report.

Before turning to today's proposals, I would like to underscore an important point. The recent opinion of the Court of Appeals upheld the validity of the fundamental rationale underlying the Commission's fund governance rules. The Court agreed with the Commission that strengthening the role of independent fund directors was a reasonable response to the risks of further abuse in the mutual fund industry. Moreover, as I noted a moment ago, the Court found that the governance rules fall within the Commission's statutory authority under the Investment Company Act and, specifically, that the emphasis on independent directors is consistent with the structure and purpose of the Act.

The Court identified two specific issues that required further consideration by the Commission. First, with respect to costs, the Court stated that the Commission should give further consideration to the potential costs of the 75 percent independent director condition and the independent chair condition. Prior to adopting the fund governance rules, the Commission sought and received comment on the costs associated with these conditions, and we concluded that the costs were minimal in relation to the benefits. As

instructed by the Court, today's proposal provides a detailed estimate of these potential costs, based on a variety of different possible approaches of complying with the new rules, and the Commission has carefully considered the potential impact of these costs. I will leave it to the staff to explain the numbers in greater detail, but suffice it to say that our analysis strongly confirms the conclusion that the potential costs to mutual funds of appointing independent chairmen, and ensuring that 75 percent of their directors are independent, are minimal when compared to the substantial benefits that these governance rules can bring in terms of reducing conflicts of interest and protecting investors.

Second, with respect to alternatives, the Court asked the Commission to give further consideration to an alternative to the independent chair condition that would require funds simply to disclose whether or not they have independent chairmen. This is an issue on which we received comment prior to adopting the independent chair rule last year, and today's proposal explains our reasons for rejecting the disclosure alterative. While many of our other rules are based on disclosure requirements, there are important reasons for taking a stronger, more substantive approach in the context of mutual fund governance. As I noted a few moments ago, the very structure of the typical mutual fund gives rise to serious conflicts of interest between the adviser and the shareholders, and this is the reason that Congress established flat prohibitions on certain types of fund transactions. For the Commission to grant exemptions from these prohibitions, we must see to it that investors are given assurances that their interests will be protected. As adopted, the independent chair condition will go a long way toward providing those

assurances. Relying solely on disclosure, on the other hand, would allow a flawed governance structure to continue in many funds to the detriment of fund shareholders.

Concern has been raised about the timing of the Commission's actions today. The Commission's actions today are fully consistent with the opinion of the Court of Appeals and with the other legal requirements applicable to Commission rulemaking. The issues raised by the Court are clearly defined, and the existing rulemaking record and other publicly available materials have permitted the Commission to address them in the manner contemplated by the Court without further notice and comment. Indeed, by not vacating the governance rules, but instead remanding them to the Commission without ordering any particular procedures, the Court contemplated that any deficiencies in the initial rulemaking could be cured without unnecessarily reversing course or restarting the rulemaking process.

Moreover, there are compelling policy reasons for the Commission to act expeditiously on these matters. As I have stated, the governance rules are a critical component of our reform efforts, and any further delay or ambiguity surrounding their implementation would disadvantage not only investors but fund boards and management companies, most of which have already begun the process of coming into compliance with the rules. By acting swiftly and deliberately to respond to the Court's concerns, the Commission will facilitate better decision-making and ultimately serve the interests of fund shareholders.

I would also point out that it is in the best tradition of this institution, and not at all unusual, for the Commission to act swiftly on important initiatives in response to market developments and other factors. In this case, the staff and this Commission have a

strong foundation of experience with the fund governance rules, and that experience has enabled us to address the issues raised by the Court within a relatively short period of time, albeit with the assistance of truly Herculean efforts on the part of our staff.

There is another important reason for us to act today. Our failure to act would, I fear, throw the future of this rulemaking into an uncertain limbo until a new Chairman is confirmed and the new Chairman is able to familiarize himself with the rulemaking record and the policy considerations weighing for and against the decision that we made last year. Today, however, we have intact the full complement of Commissioners who have spent the last year-and-a-half thinking about the issues raised in this rulemaking, and with my imminent departure from the Commission, today is the last opportunity to bring the collective judgment and learning of we five Commissioners to bear on the important questions presented to us by the Court.