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Investment Company Governance; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–26520; File No. S7–03–04]

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Investment Company Governance

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting amendments to rules under the Investment Company Act of 1940 to require investment companies (''funds'') that rely on certain exemptive rules to adopt certain governance practices. The amendments are designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve.

DATES: *Effective date:* September 7, 2004.

Compliance date: January 16, 2006.

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SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to: rules 0–1(a) [17 CFR 270.0–1(a)]; 10f–3 [17 CFR 270.10f–3]; 12b–1(c) [17 CFR 270.12b–1(c)]; 15a–4(b)(2) [17 CFR 270.15a–4(b)(2)]; 17a–7(f) [17 CFR 270.17a–7(f)]; 17a–8(a)(4) [17 CFR 270.17a–8(a)(4)]; 17d–1(d)(7) [17 CFR 270.17d–1(d)(7)]; 17e–1(c) [17 CFR 270.17e–1(c)]; 17g–1(j)(3) [17 CFR 270.17g–1(j)(3)]; 18f–3(e) [17 CFR 270.18f–3(e)]; 23c–3(b)(8) [17 CFR 270.23c–3(b)(8)]; and 31a–2 [17 CFR 270.31a–2] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the ''Investment Company Act'' or the ''Act'').[1]

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I. Background

In January 2004, the Commission proposed amendments to improve the governance standards of investment companies (*i.e.,* funds).[2] These amendments provide for greater independence of fund boards in the case of funds that rely upon certain exemptive rules that allow funds to engage in transactions that would otherwise be prohibited under the Investment Company Act and that present conflicts of interest between the fund and its management company. These amendments expand upon the fund governance amendments we adopted in 2001, which require that any fund that relies upon those exemptive rules must have a governance structure that provides, among other things, for a board that has a majority of independent directors.[3] In light of recent developments, we now believe that the 2001 amendments do not go far enough in addressing the need for independent fund boards.[4]

We proposed these rule amendments, along with a number of other initiatives,[5] in the wake of a troubling series of enforcement actions involving late trading of mutual fund shares, inappropriate market timing activities, and misuse of nonpublic information about fund portfolios.[6] When we

[1] Unless Otherwise noted, all references to statutory sections are to the Investment Company act of 1940.

[2] Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004) [69 FR 3472 (Jan. 23, 2004)] (''Proposing Release''). In 2001, we adopted amendments that require any fund that relies upon certain exemptive rules to have (i) a board that has a majority of independent directors; (ii) the independent directors select and nominate independent directors; and (iii) independent directors, if they hire counsel, hire only counsel that does not have substantial ties to fund managers. Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)] (''2001 Adopting Release'').

[3] In this Release we are using ''independent director'' to refer to a director who is not an ''interested person'' of the fund, as defined by the Act. *See infra* note 23.

[4] As one commenter on the proposal noted, ''The current requirement for a bare majority of independent directors does not adequately assure that these directors will dominate the decision-making process.'' Letter from Consumer Federation of America, *et al.,* to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), File No. S7–03–04 (''Consumer Federation Letter'').

[5] *See, e.g.,* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26350 (Feb. 11, 2004) [69 FR 7852 (Feb. 19, 2004)] (proposing release) and 26486 (June 23, 2004) [69 FR 39798 (June 30, 2004)] (adopting release); Investment Adviser Codes of Ethics, Investment Company Act Release No. 26337 (Jan. 20, 2004) [69 FR 4040 (Jan. 27, 2004)] (proposing release) and 26492 (July 2, 2004) [69 FR 41696 (July 9, 2004)] (adopting release); Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release Nos. 26298 (Dec. 17, 2003) [68 FR 74732 (Dec. 24, 2003)] (proposing release) and 26464 (June 7, 2004) [69 FR 33262 (June 14, 2004)] (adopting release) (''Breakpoint Disclosure''); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release Nos. 26287 (Dec. 11, 2003) [68 FR 70402 (Dec. 17, 2003)] (proposing release) and 26418 (Apr. 19, 2004) [69 FR 22300 (Apr. 23, 2004)] (adopting release) (''Market Timing Disclosure''); Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26375A (Mar. 5, 2004) [69 FR 11762 (Mar. 11, 2004)]; Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 (Feb. 24, 2004) [69 FR 9726 (Mar. 1, 2004)]; Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) [68 FR 70388 (Dec. 17. 2003)].

[6] *See, e.g., In the Matter of Alliance Capital Management, L.P.,* Investment Company Act Release No. 26312A (Jan. 15, 2004) (finding that an investment adviser violated its fiduciary duty to the fund by failing to disclose agreements, and making special accommodations, to permit select investors to engage in market timing transactions in exchange for the maintenance of ''sticky assets,'' and finding that the investment adviser divulged material nonpublic information about portfolio holdings); *In the Matter of Putnam Investment Management, LLC,* Investment Company Act Release No. 26255 (Nov. 13, 2003) (finding that an investment adviser failed to disclose potentially self-dealing transactions in shares of funds managed by several of its employees, failed to have procedures reasonably designed to prevent misuse of material nonpublic information, and failed to reasonably supervise the employees who committed violations); *In the Matter of James Patrick Connelly Jr.,* Investment Company Act Release No. 26209 (Oct. 16, 2003) (finding that a former executive of an investment adviser to a fund complex approved agreements that permitted select investors to engage in market timing transactions in certain funds in the complex, in exchange for the maintenance of sticky assets); *In the Matter of Steven B. Markovitz,* Investment Company Act Release No. 26201 (Oct. 2, 2003) (finding that a former hedge fund trader violated the federal securities laws and defrauded investors by engaging in late trading of mutual fund shares). *See also In the Matter of Pilgrim Baxter & Associates, Ltd.,* Investment Company Act Release No. 26470 (June 21, 2004) (finding that the investment adviser violated the federal securities laws by failing to disclose to funds' board of directors or shareholder that its principal was engaged in self-dealing transactions through significant ownership stake in a hedge fund engaged in market timing of fund managed by him, by permitting market timing despite prospectus disclosure to the contrary, and by disclosing material nonpublic portfolio information to a broker-dealer whose customers engaged in market timing the funds); *In the Matter of Strong Capital Management, Inc.,* Investment Company Act Release No. 26409 (May 20, 2004) (finding that investment adviser violated its fiduciary duties to the funds by (i) failing to disclose to the funds' boards or shareholders the conflicts of interest created when the adviser

proposed these amendments, we expressed concern that the enforcement actions in many cases reflected a serious breakdown in management controls. We observed that, in some cases, the fund was used for the benefit of fund insiders, often the management company or its employees. In addition, we had recently adopted a new rule creating the position of fund chief compliance officer, which reports directly to the board on compliance matters.[7] The proposed fund governance standards would complement that rule by placing fund boards in a better position to demand that management adhere to the highest of compliance standards.

Our proposed rules also reflected broader concerns with the governance of mutual funds. We noted that the Act and our rules rely heavily on fund boards of directors to manage the conflicts of interest that advisers have with funds they manage. We noted that a fund adviser is frequently in a position to dominate the board because of the adviser's monopoly over information about the fund and its frequent ability to control the board's agenda. We questioned the ability of a management-dominated board to undertake the many important tasks assigned to the board by the Act and our rules, including negotiating the advisory fee, approving a 12b–1 plan, and resolving conflicts between the fund and the management company.[8]

We proposed to amend ten commonly used exemptive rules under the Investment Company Act (''Exemptive Rules'') [9] to require the funds relying on those rules to follow improved governance standards.[10] These rules rely on the independent judgment and scrutiny of directors, including independent directors, in overseeing activities that are beneficial to funds and fund shareholders but that involve inherent conflicts of interest between the funds and their managers. These are the same Exemptive Rules that we amended in 2001. These further amendments provide for greater fund board independence and are designed to enhance the ability of fund boards to perform their important responsibilities under each of the rules.[11]

The proposal engendered a substantial amount of interest. We received nearly 200 comments from fund investors, management companies, independent directors to mutual funds, as well as members of Congress. We also received several comments from organizations that had a more general interest in corporate governance issues. Most commenters supported our efforts to strengthen fund governance, but many were divided on some of our proposals. Some commenters believed the proposed amendments did not go far enough; others recommended certain modifications.

We recognize that these amendments might not have prevented all of the abuses that were uncovered in the enforcement actions discussed above. Nevertheless, if funds are to engage in the transactions permitted by the Exemptive Rules [12] and effectively

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allowed hedge fund to market time certain funds and that the chairman frequently traded certain funds, including a fund for which he served as portfolio manager, (ii) providing hedge fund manager nonpublic portfolio information for certain funds, and (iii) filing fund prospectuses that failed to disclose that the adviser would make exceptions to the disclosed policies discouraging market timing in instances where the fund's chairman or the adviser benefited); *In the Matter of Massachusetts Financial Services Company,* Investment Company Act Release No. 26409 (Mar. 31, 2004) (sanctioning fund investment adviser for failing to disclose to the fund board that the adviser had entered into arrangements with approximately 100 broker-dealers under which the fund adviser agreed to make certain cash payments or direct fund brokerage to certain broker-dealers in return for preferred treatment in promoting fund sales).

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

[8] Directors are generally responsible under state law for the oversight of all of the operations of a mutual fund, and the Investment Company Act assigns many specific responsibilities to fund boards. For example, fund boards must evaluate and approve a fund's advisory contract and may unilaterally terminate the contract. *See* section 15 of the Act [15 U.S.C. 80a–15].

[9] The Exemptive Rules are:

Rule 10f–3 (permitting a fund to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate, if the fund directors, including a majority of the independent directors, approve procedures governing the purchases and review quarterly reports on purchases);

Rule 12b–1 (permitting use of fund assets to pay distribution expenses pursuant to a plan approved by the fund directors, including a majority of the independent directors);

Rule 15a–4(b)(2) (permitting a fund board to approve an interim advisory contract without shareholder approval when the adviser or a controlling person receives a benefit in connection with the assignment of the contract, if the fund directors, including a majority of the independent directors, review and approve the contract);

Rule 17a–7 (permitting securities transactions between a fund and another client of the fund investment adviser, if the fund directors, including a majority of the independent directors, approve procedures governing the transactions and review quarterly reports on transactions);

Rule 17a–8 (permitting mergers between certain affiliated funds if the fund directors, including a majority of the independent directors, request and evaluate information about the merger and determine that the merger is in the best interests of the fund and its shareholders);

Rule 17d–1(d)(7) (permitting a fund and its affiliates to purchase joint liability insurance policies if the fund directors, including a majority of the independent directors, annually determine that the policies are in the best interests of the fund and its shareholders);

Rule 17e–1 (specifying conditions under which a fund may pay commissions to affiliated brokers in connection with the sale of securities on an exchange, including a requirement that the fund directors, including a majority of the independent directors, adopt procedures for the payment of the commissions and review quarterly reports of any commissions paid);

Rule 17g–1 (permitting a fund to maintain joint insured bonds and requiring fund independent directors to annually approve the bond);

Rule 18f–3 (permitting a fund to issue multiple classes of voting stock, if the fund board of directors, including a majority of the independent directors, approves a plan for allocating expenses to each class); and

Rule 23c–3 (permitting the operation of an interval fund by enabling a closed-end fund to repurchase shares from investors, if the directors adopt a repurchase policy for the fund and review fund operations and portfolio management in order to assure adequate liquidity of investments to satisfy repurchase payments).

Last October we proposed a new exemptive rule, rule 15a–5, that also would be conditioned on meeting the fund governance standards that are currently included in these ten exemptive rules. *See* Exemption from Shareholder Approval for Certain Subadvisory Contracts, Investment Company Act Release No. 26230 (Oct. 23, 2003) [68 FR 61720 (Oct. 29, 2003)]. As we stated when we proposed the fund governance amendments we are adopting today, if we adopt rule 15a–5, we intend to condition its use on compliance with the revised fund governance standards. *See* Proposing Release, *supra* note 2, at n.16.

[10] These rules (i) exempt funds or their affiliated persons from provisions of the Act that can involve serious conflicts of interest and (ii) condition the exemptive relief on the approval or oversight of independent directors. *See* Proposing Release, *supra* note 2, at text accompanying n.16.

[11] For the reasons discussed throughout this Release, we believe that amending the Exemptive Rules to provide for greater board independence and to enhance a board's ability to perform the responsibilities under those rules is necessary and appropriate in the public interest and is consistent with the protection of investors and the purposes of the Act. *See, e.g.,* section 6(c) (authority of the Commission to conditionally exempt a person or transaction if it is ''necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.''). Each of the Exemptive Rules permits a fund to engage in transactions or conduct that presents significant conflicts of interest and that otherwise would be restricted or prohibited by the Act. As the Commission already determined when it made similar amendments to the Exemptive Rules in 2001, establishing conditions for the Exemptive Rules based on the independence of the fund board is appropriate to address the types of conflicts Congress identified in the Act. The amendments therefore are well within the Commission's broad authority to ''conditionally or unconditionally exempt any person, security, or transaction'' from any provision of the Act. *See also infra* Statutory Authority section.

[12] As we stated when we proposed the fund governance amendments that we adopted in 2001, the amended rules do not require all funds to adopt these measures. Although the Commission urges all funds to consider adopting the measures to strengthen the independence of their boards, funds that do not rely on any of the Exemptive Rules will not be subject to these requirements. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 FR 59826 (Nov. 3, 1999)] (''1999 Proposing Release'') at text preceding n.34.

manage the conflicts of interest inherent in those transactions, greater board independence is needed. We are adopting them substantially as proposed.

II. The Role of Independent Directors

Before we discuss the rules we are today adopting, we wish to take this opportunity to make some observations about the role of fund directors and, in particular, independent directors.

A. Managing Conflicts of Interest

Fund independent directors play a central role in policing the conflicts of interest that advisers inevitably have with the funds they advise. Many fine individuals today ably serve investors in this capacity. We do not intend that this rulemaking, or the statements we have made about the need for reform of the mutual fund regulatory framework or mutual fund governance, be construed in any way as a challenge to their integrity or commitment to investors. Our efforts today are designed to strengthen the role that independent directors play and to support their work on behalf of fund shareholders. The amendments are intended largely to preserve the current system of fund governance that on the whole has served mutual fund investors well, while addressing its weaknesses.

To be truly effective, a fund board must be an independent force in fund affairs rather than a passive affiliate of management.[13] Its independent directors must bring to the boardroom ''a high degree of rigor and skeptical objectivity to the evaluation of management and its plans and proposals,'' particularly when evaluating conflicts of interest.[14] They must commit their time and energy, and devote themselves to the principles set forth in the Investment Company Act and state corporate and trust law under which the fund is organized.

While the Investment Company Act contains many important requirements with which a fund must comply, the paramount principle that must prevail, and should animate all decisions directors are called upon to make, is that a fund must be managed on behalf of its investors rather than on behalf of the adviser or other affiliated persons of the fund.[15] Directors should be highly skeptical of arguments that merely rationalize the resolution of conflicts in favor of the fund adviser, and should seek results that advance the best interest of fund shareholders.

B. Approving the Advisory Contract and Advisory Fees

Section 15(c) of the Act prohibits a person from serving as an investment adviser to a fund except pursuant to a contract that has been approved by a majority of directors who are not parties to the contract or interested persons of any such party, *i.e.,* the independent directors. Section 15(c) requires fund boards to consider whether to approve the terms of the contract, including the amount of the advisory fee based on, among other things, information provided by the fund adviser. These procedural requirements do not supplant the state law duties of loyalty and care that oblige directors to act in the best interest of the fund when considering important matters the Act entrusts to them, such as approval of an advisory contract and the advisory fee.[16] Nor does the disclosure of the advisory fee in the prospectus relieve the independent directors of the obligation to negotiate the amount of the fee and assure that fund shareholders share in the economies of scale achieved by the growth in fund assets, by, when appropriate, reducing advisory fees.[17]

Section 15(c) also provides that the directors of a fund have a duty to request and evaluate, and the investment adviser has a duty to furnish, the information reasonably necessary to evaluate the terms of an advisory contract. Directors should frame their information requests broadly to obtain complete information relevant to their consideration of the advisory contract, and should include inquiries related to the adviser's material conflicts of interest with the fund and how the adviser deals with those conflicts. Regardless of the scope of the information request, fund advisers have an affirmative obligation under section 206 of the Advisers Act to disclose material information regarding conflicts of interest to the fund and its board.[18]

We reiterate our statement in the Proposing Release that fund

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[13] *See* Division of Corporation Finance, Securities and Exchange Commission, Staff Report on Corporate Accountability (Sept. 4, 1980) (printed for the use of Senate Committee on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.) at F2 (noting importance of corporate boards of directors in overseeing performance of corporate management).

[14] Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability,* 89 Geo. L. J. 797, 798 (2001). ''[T]here are industries where the case for independence is compelling. The best example here is the mutual fund industry, where conflicts of interests are commonplace and traditional checks on managerial overreaching, such as vigorous shareholder voting and hostile tender offers do not exist.'' *Id.* at 814.

[15] Section 1(b)(2) of the Act [15 U.S.C. 80a–1(b)(2)] (''[T]he national public interest and the interest of investors are adversely affected * * * (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders * * *'').

[16] *See* S. Rep. No. 91–184, at 4902–03 (1969) (''The directors of a mutual fund, like directors of any other corporation, will continue to have * * * overall fiduciary duties as directors for the supervision of all of the affairs of the fund.''); Burks v. Lasker, 441 U.S. 471, 478–79 (1979) (''The [Investment Company Act] does not purport to be the source of authority for managerial power; rather, the Act functions primarily to '[impose] *controls* and *restrictions* on the internal management of investment companies.' * * * The ICA and the [Investment Advisers Act] * * * do not require that federal law displace state laws governing the powers of directors unless the state laws permit action prohibited by the Acts, or unless 'their application would be inconsistent with the federal policy underlying the cause of action' * * *.'') (emphasis in original) (citations omitted). *See also* Green v. Fund Asset Management, L.P., 245 F.3d 214, 226 (3d Cir. 2001).

[17] *See* Stanley J. Friedman, *The Role of Outside Directors in Negotiating Investment Company Advisory Agreements,* 24 Rev. Sec. & Commod. Reg. 49, 57 (1991) (''[T]he negotiation of investment advisory agreements and renewals is a [serious] business in which the participation of independent directors who are 'qualified, fully informed, and * * * conscientious' will not only benefit the investment company and its shareholders but will also greatly enhance the position of the investment adviser in litigation.''); American Bar Association, *Fund Director's Guidebook,* 59 Bus. Law. 201, 223 (2003) (''The 1940 Act contains important provisions governing the relationship between the adviser and the fund's board of directors in *negotiating* an advisory contract.'') (emphasis added); David A. Sturms, Mutual Fund Regulation, Part III: Regulation of the Adviser and the Fund Portfolio, PLIREF–MFR § 6:7 (2002) (''[T]he 1940 Act sets forth a specific framework for governing the relationship between the adviser and the fund's board of directors in *negotiating* an advisory contract.'') (emphasis added); Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations And Governance: Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, 108th Cong., 2d Sess., 7–8 (Feb. 26, 2004) (statement of David S. Ruder, Professor, Northwestern University School of Law (''[Fund directors] must bargain with the adviser regarding the costs of its services * * *'')) (*http://banking.senate.gov/files/ruder.pdf*). *See also* Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 986 (S.D.N.Y. 1987) (''This is not a case where a contract was rubber-stamped by docile individuals; this is a case where competent, aggressive individuals analyzed the facts and *actively bargained* to obtain a better deal for the Fund.'') (emphasis added); SEC, Public Policy Implications of Investment Company Growth, *reprinted* in H.R. Rep. No. 89–2337, at 127 (1966) (''Advisory Fees and the Limitations of Disclosure'').

[18] 15 U.S.C. 80b–6. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 201 (1963) (noting that an investment adviser may not trade on the market effect of his recommendations without ''fully and fairly revealing his personal interests in these recommendations to his clients''); Vernazza v. SEC, 327 F.3d. 851, 860 (9th Cir. 2003) (noting that investment advisers had a duty to disclose any potential conflicts of interest accurately and completely). *See also In the Matter of Putnam Investment Management, LLC, supra* note 6.

shareholders stand to benefit substantially when the process of negotiation between fund independent directors and investment advisers leads to lower fees.[19] We reaffirm the views we expressed in a statement accompanying a recently settled enforcement proceeding, that the best way to ensure that funds obtain fair and reasonable fees is through a marketplace of vigorous, independent and diligent mutual fund boards, coupled with fully informed investors who are armed with complete, easy-to-digest disclosure about the fees paid and the services rendered.[20] We have recently adopted and proposed new disclosure requirements designed to provide fund investors with this information.[21]

C. Selecting and Nominating Candidates for Independent Directors

The incumbent independent directors of most funds have the responsibility to select and nominate new independent directors.[22] The Investment Company Act provides minimum criteria for persons to qualify as independent directors, and independent directors who satisfy those criteria meet the requirements of the Act.[23] We urge independent directors to look beyond those requirements and examine whether a candidate's personal or business relationships suggest that the candidate will not aggressively represent the interests of fund investors. Persons who have served as executives of the fund adviser or who are close family members of employees of the fund, its adviser or principal underwriter would, in our view, be poor choices for candidates, although they may meet the minimum statutory requirements.[24] We recognize that ''legal'' independence does not equate with ''real'' independence. We therefore encourage independent directors, in selecting and nominating other independent directors, to identify individuals who have the background, experience, and independent judgment to represent the interests of fund investors.[25]

III. Discussion of New Rules

We are amending the ten Exemptive Rules under the Act[26] to require that any fund that relies upon any of those rules[27] satisfy the fund governance standards set forth in rule 0–1(a)(7): (i) at least 75 percent of the directors of the fund must be independent directors or, if the fund board has only three directors, all but one of the directors must be independent directors; (ii) the chairman of the board must be an independent director; (iii) the board must perform a self-assessment at least once annually; (iv) the independent directors must meet separately at least once a quarter; and (v) the independent directors must be affirmatively authorized to hire their own staff.[28] We are also amending rule 31a-2 as proposed, to require that a fund retain copies of written materials that the board considers when approving the fund's advisory contract.[29]

A. Board Composition

As discussed above, when Congress passed the Investment Company Act, it relied on independent directors to protect the interests of fund investors. A principal purpose of the amendments is to strengthen the independent directors' control of the fund board and its agenda, so that the interests of investors are paramount. Although the Exemptive Rules currently require a simple majority of the board to be independent and the independent directors to separately approve the transactions covered by those rules, we are concerned that many boards continue to be dominated by their management companies. Accordingly, the amendments provide that each fund relying on any Exemptive Rule must have a board of directors whose independent directors constitute at least 75 percent of the board or, if the fund has only three directors, all but one of the directors must be independent.[30] Most commenters supported the 75 percent amendment.[31] Some commenters recommended that we adopt an even higher percentage.[32] We

[19] Proposing Release, *supra* note 2, at n.30 and accompanying text.

[20] *See* Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, L.P., SEC Press Release 2003–176 (Dec. 18, 2003).

[21] *See, e.g.,* Market Timing Disclosure, *supra* note 5; Breakpoint Disclosure, *supra* note 5; Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 26372 (Feb. 27, 2004) [69 FR 11244 (Mar. 9, 2004)]; Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26341 (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)]; Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)].

[22] As in effect before these amendments, the Exemptive Rules have required that, for any fund relying on any of the rules, the independent directors must select and nominate other independent directors of the fund. *See, e.g.,* rule 10f–3(c)(11)(i) [17 CFR 270.10f–3(c)(11)(i)]. Before we proposed to amend the Exemptive Rules in 1999, we had already included a similar condition in rule 12b–1 and rule 23c–3. *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)]; Repurchase Offers By Closed-End Management Investment Companies, Investment Company Act Release No. 19399 (Apr. 7, 1993) [58 FR 19330 (Apr. 14, 1993)]. *See also* 1999 Proposing Release, *supra* note 11, at n.30.

[23] In this Release we are using ''independent director'' to refer to a director who is not an ''interested person'' of the fund, as defined by the Act. Section 2(a)(19) of the Act [15 U.S.C. 80a–2(a)(19)] defines ''interested person'' of a fund to include (i) any affiliated person of the fund; (ii) any member of the immediate family of any natural person who is an affiliated person of the fund; (iii) any interested person of any investment adviser of or principal underwriter for the fund; (iv) any person, or partner or employee of any person, who acted as legal counsel for the fund during the last two completed fiscal years of the fund; (v) any person who executed portfolio transactions for the fund or loaned money or property to the fund during the past six months, or any affiliated person of such a person; and (vi) any natural person who the Commission has determined is an interested person because of his or her material business or professional relationship with the fund during the past two years.

[24] *See* Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing A Culture of Independence and Effectiveness* (June 24, 1999), at 12–13 (''ICI Advisory Group Report'') (recommending that former officers or directors of a fund's investment adviser, principal underwriter, or certain of their affiliates not serve as independent directors of the fund); Investment Company Institute, *Resolution of the Board of Governors of the Investment Company Institute* (Oct. 3, 2003) (resolving that ICI members adopt practices to disqualify persons with certain family relationships from serving as independent directors of funds) (*http://www.ici.org/issues/dir/03_fund_gov_best_stmt.html*).

[25] The annual self-assessment performed by the board under the amended rules also may enable independent directors to identify subject areas, such as valuation of portfolio securities, in which the board needs future independent directors to have expertise. *See infra* Section III.C.

[26] *See supra* note 9.

[27] The fund governance conditions of the Exemptive Rules apply to investment companies, including registered investment companies and business development companies, if they rely on these rules.

[28] Rule 0–1(a)(7) [17 CFR 270.0–1(a)(7)], which defines the term ''fund governance standards,'' incorporates the following fund governance requirements with which funds have had to comply since 2001 in order to rely upon any of the Exemptive Rules: (i) a fund's board must have a majority of independent directors, (ii) the fund's independent directors must select and nominate any other independent directors, and (iii) any person acting as legal counsel to the independent directors must be an ''independent legal counsel.'' *See* 2001 Adopting Release, *supra* note 2. The majority independence condition also is being revised to a 75 percent independence condition.

[29] We are also adopting technical amendments to rule 10f–3 to revise certain cross-references within the rule.

[30] *See* rule 0–1(a)(7)(i).

[31] We received approximately 98 comments on this proposed amendment. Comments were submitted from investors, directors (both interested and independent), funds, trade associations, and fund service providers.

[32] *See, e.g.,* Letter from Tom Walker to Jonathan G. Katz, Secretary, SEC (Mar. 9, 2004), File No. S7–03–04 (recommending that fund boards be completely independent); Letter from John and Judy Hesselberth to Jonathan G. Katz, Secretary, SEC

Continued

do not believe that we need to go that far—there are good arguments for maintaining a management presence on the board. Other commenters questioned whether a slightly lower super-majority requirement (*e.g.,* two-thirds) would suffice.[33] We believe the 75 percent requirement adopted by Congress in section 15(f) of the Act will better assure that the independent directors can carry out their fiduciary responsibilities.[34] This requirement was designed to help resolve ongoing conflicts of interest, which can result from the sale of an advisory firm.

Requiring that each fund that relies upon any Exemptive Rule have a board of directors whose independent directors constitute at least 75 percent of the board, will help ensure that independent directors carry out their fiduciary responsibilities. Management controls the day-to-day activities of the fund and has significantly greater access to information about the fund than do the independent directors. This information gives the management directors a significant advantage over the independent directors in setting the board's agenda and potentially dominating board deliberations. The amendments seek to resolve this imbalance. As one commenter noted, ''For fund boards to have credibility as they fulfill this responsibility, the board must be firmly under the control of those directors whose sole responsibility is to look out for the interests of shareholders.'' [35]

A fund board whose independent directors constitute at least 75 percent of the fund board should strengthen the hand of the independent directors when dealing with fund management,[36] and may assure that independent directors maintain control of the board [37] and its agenda.[38]

The final rule differs from the proposed rule in one respect. The proposed rule would have required simply that any fund relying on an Exemptive Rule have a board of directors with at least 75 percent independent directors. Some commenters from funds with small boards expressed concern about the costs of hiring new directors to meet this requirement. A 75 percent standard would require a three-person board with two independent directors to either replace its inside director with an independent director, hire an additional independent director to satisfy the new standard, or seek the resignation of the interested director. We are sensitive to the costs of our rules and therefore have modified the final rule to include an exception for boards with three directors. The final rule provides that a board with three directors satisfies the independence requirement if all but one of the directors (*i.e.,* two directors) are independent.[39]

B. Independent Chairman of the Board

We are adopting an amendment to require that any fund that relies on an Exemptive Rule have a chairman of its board who is an independent director.[40] We received approximately 152 comments on this amendment, which was the most controversial among the fund governance standards we proposed. The comments were divided between those supporting and those opposing the amendment. Those supporting the amendment,[41] including investors and investor groups, stated that an independent chairman would provide many benefits, including better protection of fund shareholders.[42]

A fund board's primary responsibility is to protect the interest of the fund and its shareholders, which may be adversely affected by the substantial ongoing conflicts of interest of the fund management company.[43] The consequences of these conflicts are well demonstrated by many of our ongoing enforcement actions involving late trading, inappropriate market timing and misuse of nonpublic portfolio information.[44] We believe that a fund board is in a better position to protect the interests of the fund, and to fulfill the board's obligations under the Act and the Exemptive Rules,[45] when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser.[46]

(Feb. 24, 2004), File No. S7–03–04 (recommending that the percentage be 100%).

[33] *See, e.g.,* Letter from Association for Investment Management and Research to Jonathan G. Katz, Secretary, SEC (Mar. 19, 2004), File No. S7–03–04.

[34] *See, e.g.,* Letter from John E. Murray, Jr., Lead Director, The Federated Funds, to Jonathan G. Katz, Secretary SEC (Mar. 11, 2004), File No. S7–03–04 (''Murray Letter''). A few commenters recommended that the independence requirements established by the Investment Company Act be tightened. Letter from Independent Directors of the Vanguard Funds to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), File No. S7–03–04. See section 2(a)(19) (definition of ''interested person'').

[35] Consumer Federation Letter, *supra* note 4. *See also* Letter from David Certner, Federal Affairs, AARP, to Jonathan G. Katz, Secretary, SEC (Mar. 12, 2004), File No. S7–03–04 (''Certner Letter'') (''By requiring that three-quarters of board members—including the chairman—be independent, the proposed rule helps to ensure that this oversight function will be controlled by individuals whose sole obligation is to ensure that shareholders' interests are protected'').

[36] As we noted when we proposed these amendments, section 15(f) of the Act, which provides a safe harbor for the sale of an advisory business, requires that fund directors who are independent of the adviser constitute at least 75 percent of the fund board for three years following the assignment of the advisory contract, and that no unfair burden be imposed on the fund. 15 U.S.C. 80a-15(f). This increased independence of the board was designed to help protect the fund from receiving unfair treatment in circumstances involving potential conflicts of interest. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 140 (1975) (''These conditions are designed to prevent any unfair burden from being imposed on the investment company in connection with such a transaction.''). Because the Exemptive Rules permit certain transactions that involve potential harm to the fund as a result of conflicts of interest, *see supra notes* 10–11 and accompanying text, we anticipate that a 75 percent level of independence will similarly equip fund boards to monitor and guard against such harms in connection with the activities of the fund undertaken in reliance on those Rules.

[37] As one commenter noted, a 75 percent level can be more effective than a simple majority in ensuring control of the board by independent directors if one or more independent directors are absent from a board meeting. *See* Consumer Federation Letter, *supra* note 4 (''[I]f one or more of the independent directors has a mediocre attendance record, the majority [of independent directors] may in reality function as a minority.'').

[38] Control of the board and its agenda by fund management can hinder the ability of the directors to oversee the fund's operations under the Exemptive Rules. *See, e.g.,* Repurchase Offers by Closed-End Management Investment Companies, Investment Company Act Release No. 19399 (Apr. 7, 1993) [58 FR 19330 (Apr. 14, 1993)] (noting the need for active independent director involvement in the oversight of rule 23c–3 because the determination of the amount of each repurchase offer presents a potential conflict of interest between the investment adviser and shareholders: the investment adviser may be interested in making a small repurchase offer in order to retain maximum assets under management).

[39] *See* rule 0–1(a)(7)(i).

[40] *See* rule 0–1(a)(7)(iv).

[41] *See, e.g.,* Certner Letter, *supra* note 35. *See also* Letter from James J. McMonagle to William H. Donaldson, Chairman, SEC (Jan. 14, 2004), File No. S7–03–04 (''McMonagle Letter''); Letter from Patricia Rizzolo to Jonathan G. Katz, Secretary, SEC (Feb. 24, 2004), File No. S7–03–04.

[42] *See supra* note 11.

[43] *See* 2001 Adopting Release, *supra* note 2. *See also* S. Rep. No. 76–1775, at 6–7 (1940); S. Rep. No. 91–184, at 5–6 (1969); Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation 255–263 (1992).

[44] *See supra* note 4.

[45] *See supra* note 9 (describing the responsibilities of fund directors and independent directors to oversee fund activities pursuant to the Exemptive Rules).

[46] A number of our Exemptive Rules require the board to address the fund's activities in circumstances involving these conflicts of interest. *See, e.g.,* rule 12b–1(b)(2) (requiring the fund board to approve the plan for using fund assets to pay for the distribution of fund shares); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)] (noting the conflicts of interest between the fund and its adviser when fund assets are used for distribution of shares); rule 17a–8 (requiring directors to request and evaluate information reasonably necessary to determine that the merger of the fund with an affiliated fund is in the fund's best interests, and to determine that the interests of fund shareholders will not be diluted as a result of the merger); Investment Company Mergers, Investment Company Act Release No. 25666 (July 18, 2002) [67 FR 48511 (July 24, 2002)] (discussing some of the factors that directors should

The board chairman can play an important role in setting the agenda of the board, and in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. The chairman can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the long-term interests of investors.[47] We believe that a fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.

Those opposing the amendment, including some independent directors, argued that it would deprive the independent directors of the ability to choose for themselves the most qualified and capable candidate to serve as chairman and thereby undermine the directors' ability to carry out their responsibilities.[48] To be clear, the amendments we are adopting today do not prevent the independent directors from choosing the most qualified and capable candidate. That candidate, however, cannot serve two masters.

Some asserted that independent directors would not have sufficient knowledge or be as well prepared to lead the board through its many tasks, unless the board chairman is affiliated with the adviser and therefore is able to obtain needed information from the advisory firm.[49] They similarly argued that the independent chairman might be drawn into the day-to-day management of the fund. As noted above, we believe a board chairman typically plays an important role in setting the agenda of the board and determining what information is provided to the board. An independent chairman will undoubtedly consult with management in carrying out its functions, as well as in leading the board through its various tasks. But the final decisions in setting the agenda will be made by someone independent of management.[50] Moreover, the chairman is in a unique position to set the tone of meetings, and to encourage open dialogue and healthy skepticism. We believe an independent chairman is better equipped to serve this role. Finally, representatives of management would still be responsible for the day-to-day operations of the fund, would continue to be able to serve as fund directors and would have access to information from the adviser. We do not believe that this amendment will deprive the board of management's knowledge and judgment.

If the board is to provide effective oversight of the management company, there may be times when it must be prepared to say ''no'' to the manager's chief executive officer.[51] We do not mean to suggest that the relationship between the board and the management company need be adversarial. Indeed, we believe that a crucial challenge to every fund board involves establishing an appropriate balance between cooperation *with* the management company and oversight *of* the management company. Our primary concern, and the one that has led us to adopt this amendment, is that too often the proper balance has not been achieved, particularly where an executive of the adviser has exerted a dominant influence over the board. While having an independent chairman should not disadvantage a board that is properly balanced, it may significantly benefit one that is not.

Some have argued that the Commission needs to demonstrate conclusively that there is a link between having an independent chairman and increased performance or decreased fund expenses.[52] The Commission considered its own and its staff's experience, the many comments received, and other evidence, in addition to the limited and conflicting empirical evidence. From this, we

consider in approving affiliated fund mergers); rule 15a–4 (permitting temporary contract between fund and investment adviser without shareholder approval); Temporary Exemption for Certain Investment Advisers, Investment Company Act Release No. 23325 (July 22, 1998) [63 FR 40231 (July 28, 1998)] at text accompanying notes 24–25 (noting the responsibility of the board under rule 15a–4 to determine that the scope and quality of services under the temporary contract are at least equivalent to those under the previous contract, and noting that the board is empowered to terminate the temporary contract upon short notice, in order to allow it to act quickly if advisory services decline in quality).

47 *See* Letter from Anne J. Mills, Trustee, to Jonathan G. Katz, Secretary, SEC (Feb. 2, 2004), File No. S7–03–04 (stating that while appointing a lead independent director has improved involvement of independent trustees, ''it is still difficult to influence the Board meeting agenda to assure full discussion of the more important items. Having an independent chair will significantly change the dynamics of the board meetings.''); Letter from Ashok N. Bakhru, Chairman of the Board and Independent Trustee, Goldman Sachs Trust and Goldman Sachs Variable Insurance Trust, to Jonathan G. Katz, Secretary, SEC (Mar. 9, 2004), File No. S7–03–04 (supporting the amendment and adding that ''It has been our experience that the chairman can provide an important and meaningful role in the preparation of board agenda and in fostering the dialogue between fund management and the independent directors on fund-related matters.'').

48 *See* Letter from Investment Company Institute to Jonathan G. Katz, Secretary, SEC (March 10, 2004), File No. S7–03–04; Murray Letter, *supra* note 34.

49 *See* Letter from F. Pierce Linaweaver, Chairman of the Committee of Independent Directors, T. Rowe Price Mutual Funds, to Jonathan G. Katz, Secretary, SEC (Feb. 25, 2004), File No. S7–03–04.

50 *See* Letter from Chairman Michael G. Oxley, House Committee on Financial Services, to William H. Donaldson, Chairman, SEC (May 20, 2004), File No. S7–03–04 (''I believe the Commission's independent chairman proposal would eradicate the self-dealing by interested, management-affiliated chairmen and its harmful effects on mutual fund shareholders.'') (''Chairman Oxley Letter'').

51 We received a particularly insightful comment letter from a fund independent director who stated that his board's appointment of an independent chairman was instrumental in causing the board to switch fund advisers. *See* McMonagle Letter, *supra* note 41 (stating that the mutual fund of which the author was an independent director changed the advisory contract from one adviser to another, and observing that ''[i]f the Chairman of the [mutual fund's board] had not been independent, I am satisfied that we would not have moved the advisory contract.'') (emphasis omitted). *See also* Letter from David S. Ruder, Chairman, and Allan S. Mostoff, President and Treasurer, Mutual Fund Directors Forum, to Jonathan G. Katz, Secretary, SEC (May 14, 2004), File No. S7–03–04 (stating that the Mutual Fund Directors Forum will recommend as a best practice that fund boards be chaired by an independent director, because that approach would enhance the power and authority of independent directors and eliminate the chairman's conflicts of interest).

52 We 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. Commenters did not refer us to any pre-existing studies that spoke to this issue. One commenter submitted a study that it commissioned in response to the proposal, that sought to ascertain a correlation between independent chairmen and the performance and expenses of funds. With regard to performance, the study found a correlation between funds with management chairmen and higher performance. The study noted, however, that this correlation may be due to ''other important differences [than independence of the chairmen] that may have impacted performance results,'' such as the prevalence of independent chairmen among bank-sponsored fund groups. With regard to fund expenses, the study found, depending on the method of calculation, lower (but not statistically significant) expenses associated with independent chairmen funds, or higher expenses for those types of funds. The study stated that the expense analysis comparisons were less clear than with the performance results, and ''differ considerably depending on what expense measure is used.'' *See* Geoffrey H. Bobroff and Thomas H. Mack, Assessing the Significance of Mutual Fund Board Independent Chairs, A Study for Fidelity Investments (Mar. 10, 2004) (attached to Letter from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company to Jonathan G. Katz, Secretary, SEC (Mar. 18, 2004), File No. S7–03–04)). On the other hand, some commenters viewed the data differently and concluded that ''[i]ndependently-chaired funds did only slightly better in terms of returns, but at lower cost * * *. Even accepted at face value, Fidelity's data constitute muddy and unpersuasive evidence for continuing to allow senior management company officials to sit in the fund chairman's chair.'' 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. *See also* Letter from John A. Hill, Chairman, The Putnam Funds, to William H. Donaldson, Chairman, SEC (May 12, 2004), File No. S7–03–04.

believe that having independent chairmen can provide benefits and serve other purposes apart from achieving high performance of the fund. In this regard, corporate governance experts have pointed more generally to the value that an independent chairman brings to a corporate board of directors.[53]

We harbor no illusions that the designation of an independent chairman will address all of the compliance and other problems confronting funds.[54] The rules we are adopting today are part of a larger package of regulatory reforms designed both to prevent the compliance failures of yesterday and to strengthen a fund board's ability to deal with compliance challenges of the future. A key element of that larger package is our rule requiring each fund to designate a chief compliance officer who reports directly to the fund board.[55] With the information about fund compliance matters now required by our rule 38a–1, and the information about advisory contract renewal required by section 15(c) of the Act, fund boards are better able to fulfill their responsibilities.[56]

We carefully considered alternatives suggested to us by commenters, including designation of a lead independent director and increased reliance on board committees chaired by independent directors. A lead independent director could provide useful leadership to the independent directors when dealing with the board chairman,[57] and independent committee chairmen may provide important services to the fund. Neither of these arrangements, however, would create a position that is likely to be filled by a person with sufficient stature within the fund complex to serve as an effective counterweight to a fund chairman who may also be the chief executive officer of the management company.[58] Further, as commenters pointed out, ''[a]ppointing a lead director does nothing to ensure that independent directors control the agenda, information requests, and terms of board debate.'' [59] Commenters recommended a variety of other alternatives, including having the audit committee chair set the agenda. We believe that the board's agenda should be under the control of an independent director.

Our action today should not be construed as diminishing the value that executives of the adviser, including the adviser's chief executive officer, bring to the fund boardroom. We fully expect that these executives will continue to serve on fund boards, although not in the capacity of chairman, and thus will have every opportunity to engage the board on issues important to the fund investors as well as the management company.[60] Similarly, to the extent that some executives of the adviser leave fund boards in order to meet the supermajority requirement, we expect that they will continue to participate, in appropriate circumstances, in board and board committee deliberations.

C. Annual Self-Assessment

We are also amending the Exemptive Rules to require fund directors to evaluate, at least once annually, the performance of the fund board and its committees.[61] This evaluation must include a consideration of the effectiveness of the committee structure of the fund board [62] and the number of funds on whose boards each director serves. Most commenters supported this amendment, and we are adopting it as proposed.

This annual self-assessment requirement is intended to improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness. Moreover, the requirement should help fund boards to identify potential weaknesses and deficiencies in the board's performance. The amendment does not require that the board's self-assessment be in writing. Nevertheless, we would expect that the minutes of the board would reflect the substance of the matters discussed during the board's annual self-assessment.[63]

D. Separate Sessions

We are also amending the Exemptive Rules to require independent directors to meet at least once quarterly in a separate session at which no directors who are interested persons of the fund are present.[64] Commenters supported

[53] *See* Ira M. Millstein and Paul W. MacAvoy, *Proposals for Reform of Corporate Governance, in* The Recurrent Crisis in Corporate Governance 95, 119 (2003) (''The first important initiative is for the [corporate] board * * * to develop an identified independent leadership, by separating the roles of chairman of the board and CEO and appointing an independent director as chairman. Independent leadership is critical to positioning the board as an objective body distinct from management. * * * The board cannot function without leadership separate from the management it is supposed to monitor. On behalf of the shareholders, the board must be enabled to obtain the information necessary to monitor * * * the performance of management * * *.''). *See also* Consumer Federation Letter, *supra* note 4 (''In light of the fact that the board's chief responsibility is to police conflicts of interest and ensure that shareholders' interests are protected, it is also symbolically important that the chairman be independent. Putting a representative of the investment adviser in this position creates the appearance, and inevitably in some cases, the reality, that the fox is guarding the henhouse.'').

[54] One commenter, however, provided statistics indicating that a large majority of mutual fund families implicated in recent scandals have had management-affiliated chairmen at some point during the alleged or admitted violations. Chairman Oxley Letter, *supra* note 50.

[55] *See* Compliance Programs, *supra* note 7.

[56] Section 15 requires that fund directors, including a majority of independent directors, approve the fund's advisory contract each year. The directors must approve the advisory contract initially, and annually thereafter if it continues in effect for more than two years. Section 15(a) and (c) of the Act [15 U.S.C. 80a–15(a) and (c)]. It also requires that the directors first obtain from the adviser the information reasonably necessary to evaluate the contract so that directors would have adequate information upon which to base their decision about the advisory contract generally and the advisory fee in particular. Section 15(c) of the Act [15 U.S.C. 80a–15(c)].

[57] *See* ICI Advisory Group Report, *supra* note 24, at 25 (recommending that independent directors designate one or more lead independent directors).

[58] *See* Letter from Fergus Reid III to William H. Donaldson, Chairman, SEC (May 18, 2004), File No. S7–03–04 (''The Lead Director concept is flawed—A lead director is immediately at a disadvantage when dealing with a strong interested chairman. To assert him or herself, the lead director must oppose or go around the wishes of an interested chairman. This creates tension and ill will and is rarely politically expedient''). The by-laws of some funds may state that the board chairman is an officer of the fund. Under the amendments we are adopting today, a fund in those circumstances that relies on an Exemptive Rule would need to amend its by-laws, because an officer of the fund is an interested person of the fund. *See* section 2(a)(19)(A)(i) of the Act [15 U.S.C. 80a–2(a)(19)(A)(i)] (definition of ''interested person''). Funds whose by-laws do not contain such a requirement also may wish to amend their by-laws to require that the chairman be an independent director, as a good corporate practice, to help ensure that a fund relying upon any Exemptive Rule satisfies these fund governance standards. In either case, funds would have to disclose the appointment of any new chairman and the changes to by-laws in their filings with the Commission.

[59] *See* Consumer Federation Letter, *supra* note 4.

[60] Rule 0–1(a)(7)(iv) provides that a fund may rely on an Exemptive Rule only if an independent director serves as chairman of the board of directors of the fund, presides over meetings of the board of directors and has substantially the same responsibilities as would a typical chairman of a board of directors. In response to the amendments we are adopting today, some funds might be tempted to circumscribe the role of the independent chairman to preserve the current role of an interested board chairman. We caution against such action, which may result in the loss of multiple exemptions from provisions of the Act and multiple violations of the Act. For example, a fund could not designate an interested director to preside over meetings or set meeting agendas, or name an interested director as a ''co-chairman'' of the board. We would not, however, consider temporary performance of a chairman's duties (*e.g.*, due to a chairman's illness or inability to attend) by an interested director (*e.g.*, by a vice chairman) as a failure to meet the requirements of rule 0–1(a)(7)(iv).

[61] *See* rule 0–1(a)(7)(v).

[62] The requirement is designed to focus the board's attention on the need to create, consolidate or revise the various board committees, such as the audit, nominating or pricing committees, and to facilitate a critical assessment of the effectiveness of current board committees.

[63] *See* Proposing Release, *supra* note 2, at n.37.

[64] *See* rule 0–1(a)(7)(vi).

this provision, which is designed to give independent directors the opportunity for a frank and candid discussion among themselves regarding the management of the fund, including its strengths and weaknesses.[65] The rule does not specify the matters that should be discussed by the independent directors at the separate executive sessions, although we expect that the independent directors would use this forum to discuss, among other things, their views on the performance of the fund adviser and other service providers.

E. Independent Director Staff

The final amendment to the Exemptive Rules we are adopting today requires funds to explicitly authorize the independent directors to hire employees and to retain advisers and experts necessary to carry out their duties.[66] Commenters supported this amendment, which is designed to enable independent directors to hire employees and others who will help them deal with matters beyond their expertise. We expect that the amendment should help independent directors address complex matters and provide them with an understanding of the practices of other mutual funds.[67] Fund shareholders should receive substantial benefits because we expect that these requirements will help to ensure that independent directors are better able to fulfill their role of representing shareholder interests.[68]

F. Recordkeeping for Approval of Advisory Contracts

Finally, we are amending rule 31a–2, the fund recordkeeping rule, to require that funds retain copies of the written materials that directors consider in approving an advisory contract under section 15 of the Investment Company Act.[69] Commenters supported this amendment, and we are adopting it as proposed.[70] The amendment requires funds to retain the materials for at least six years, the first two years in an easily accessible place.

The recordkeeping amendment is designed to improve the documentation of a fund board's basis for approving an advisory contract, which would assist our examination staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. The amendment underscores the importance of the information requests that precede the directors' consideration of the advisory contract. Further, it may encourage independent directors to request more information, and this information may enable them to obtain more favorable terms in advisory contracts.

IV. Effective Date; Compliance Date

The amendments to the Exemptive Rules will become effective on September 7, 2004.

After January 15, 2006: (i) persons may rely upon any of the Exemptive Rules (rules 10f–3, 12b–1, 15a–4(b)(2), 17a–7, 17a–8, 17d–1(d)(7), 17e–1, 17g–1(j), 18f–3, and 23c–3) only if they comply with all of the ''fund governance standards'' as defined in rule 0–1(a)(7);[71] and (ii) funds must begin to comply with the recordkeeping requirements of amended rule 31a–2.

V. Paperwork Reduction Act

As discussed in the Proposing Release, the amendment to rule 31a–2 contains a ''collection of information'' requirement within the meaning of the Paperwork Reduction Act of 1995[72] because the amendment to rule 31a–2 will require funds to retain copies of the written materials that boards consider in approving advisory contracts under section 15(c) of the Investment Company Act. Funds have to retain these materials for at least six years, the first two years in an easily accessible place for our examiners. This collection of information is necessary for our staff to use in its examination and oversight program. Responses provided in the context of the Commission's examination and oversight program are generally kept confidential. The collection of information requirement is mandatory and is in the form of an amendment to a currently approved collection of information requirement, the title of which is ''Rule 31a–2, 'Records to be preserved by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.' ;'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The approved collection of information associated with rule 31a–2 to be revised by the amendments

[65] We anticipate that the frank and candid discussion among the independent directors also would cover the fund's activities pursuant to the Exemptive Rules. The independent directors, for example, could discuss the use of fund assets to pay for the distribution of fund shares under rule 12b–1 and the fund's 12b–1 plan adopted by the board. *See supra* note 46.

[66] *See* rule 0–1(a)(7)(vii). The amendment does not *require* independent directors to hire employees or retain advisers or experts.

[67] Some of the Exemptive Rules, for example, require that fund directors oversee complex transactions. *See, e.g.*, rule 10f–3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate if the fund's board, including a majority of its independent directors, (i) approves procedures regulating purchases of these securities and (ii) determines at least quarterly that the purchases complied with the board-approved procedures). The rules also require directors of funds relying on the rules to exercise vigilance in protecting funds and their investors. *See, e.g.*, Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 22775 (July 31, 1997) [62 FR 42401 (Aug. 7, 1997)], at n.52 and accompanying text (the fund's board should be ''vigilant'' not only in reviewing the fund's compliance with the procedures required by rule 10f–3, but also ''in conducting any additional reviews that it determines are needed to protect the interests of investors''). Directors may need to hire staff to help conduct these reviews.

[68] One of the most useful advisers independent directors should consider engaging is their own counsel. Although we are not requiring independent directors to have their own counsel, we agree with the American Bar Association's view that ''[t]he complexities of the Investment Company Act, the nature of the separate responsibilities of independent directors and the inherent conflicts of interest between a mutual fund and its managers effectively require that independent directors seek the advice of counsel in understanding and discharging their special responsibilities.'' American Bar Association, *Report of the Task Force on Independent Director Counsel, Subcommittee of Investment Companies and Investment Advisers, Committee on Federal Regulation of Securities, Section of Business Law: Counsel to the Independent Directors of Registered Investment Companies* at 3 (Sept. 8, 2000). *See generally* James D. Cox, *Symposium: Lessons from Enron, How Did Corporate and Securities Law Fail? Managing and Monitoring Conflicts of Interests: Empowering the Outside Directors with Independent Counsel,* 48 Vill. L. Rev. 1077 (2003). If independent directors do hire their own counsel, and their fund relies on any of the Exemptive Rules, such counsel must be an ''independent counsel.'' Rule 0–1(a)(7)(iii).

[69] *See* rule 31a–2(a)(6). *See also supra* note and accompanying text.

[70] We did not receive specific comment on the detailed questions on which we sought comment pursuant to section 31(a)(2) of the Act [15 U.S.C. 80a–30(a)(2)], *i.e.*, whether there are feasible alternatives to the proposed amendment that would minimize the recordkeeping burdens, the necessity of these records in facilitating the examinations carried out by our staff, the costs of maintaining the required records, and any effects that the proposed recordkeeping requirements would have on firms' internal compliance policies and procedures. We have nevertheless considered those issues in the course of adopting this recordkeeping rule amendment. We do not believe that there are any feasible alternatives to the amendment that would minimize recordkeeping burdens, and, as discussed above, the records are necessary to facilitate the examinations carried out by our staff. Finally, we are not aware of any adverse effects that the recordkeeping requirement will have on the nature of firms' internal compliance policies and procedures. In fact, we anticipate that the recordkeeping requirement will facilitate fund internal compliance programs because the fund's compliance staff will be able to monitor the information on which directors rely in approving the fund's advisory contract.

[71] After the effective date but before the compliance date of the amendments, a person that relies on an Exemptive Rule must continue to meet the fund governance requirements of the Exemptive Rules we adopted in 2001 concerning a majority of independent directors, independent director self-selection and self-nomination, and independent legal counsel. *See* Proposing Release, *supra* note 2.

[72] 44 U.S.C. 3501 to 3520.

displays control number 3235–0179. The Commission submitted the collection to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB has approved the collection of information under control number 3235–0179 (expiring on July 31, 2007).

The amendment to the collection of information requirement for rule 31a–2 is necessary for our compliance examiners to determine whether fund boards have met the requirements of section 15 of the Investment Company Act when approving investment advisory contracts. Our compliance examiners will review these materials to gauge a fund board's fulfillment of the requirements of section 15 of the Act.

As discussed above, we are adopting the amendment to rule 31a–2 and this collection of information requirement as proposed. In the Proposing Release, our staff estimated that each fund will spend a total of 0.5 hours annually and a total of $9.46 for clerical time to comply with this amendment.[73] In the Proposing Release, we solicited comments on the accuracy of these estimates. None of the comments received specifically addressed our estimates of the costs associated with the collection of information requirement.[74] Our staff continues to estimate that each fund will spend a total of 0.5 hours annually and a total of $9.46 for clerical time to comply with this amendment. Because of the increase in the number of registered funds to 5,132 funds, however, our staff estimates that the total hour burden of the collection of information requirement for all funds is 2,566 hours and a total of $48,548.72 annually to comply with this amendment.

VI. Cost-Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules. As discussed in section III above, these amendments require that funds relying on any of the Exemptive Rules adopt certain governance practices that are designed to enhance the independence and effectiveness of fund boards. We also are adopting amendments to require that funds maintain materials considered by a fund board when approving an advisory contract. In the Proposing Release, we identified probable costs and benefits of each of these proposed amendments that we are adopting today, and we requested public comment on our analysis of the costs and benefits of each of these amendments.

We expect that funds and fund shareholders are likely to benefit from the amendments because they are designed to strengthen the role of independent directors so that fund boards can more effectively manage conflicts of interest, monitor service providers, and protect the interests of fund shareholders. Boards that satisfy these conditions should be more effective at exerting an independent influence over fund management and other fund service providers because the fund independent directors are more likely to be primarily loyal to the fund shareholders rather than the fund adviser.

A. Benefits

The amendments seek to promote strong fund boards that effectively perform their oversight role. By increasing the independence of fund boards, the amendments are designed to improve the quality of the oversight of the process for the benefit of fund investors. Vigilant and informed oversight by a strong, effective and independent fund board may help to prevent problems such as late trading and market timing. These benefits may increase investor confidence in fund management. While these benefits are not easily quantifiable in terms of dollars, we believe they are real, and that the amendments will strengthen the hand of independent directors to the advantage of shareholders.[75] A fund board whose independent directors constitute at least 75 percent of the fund board should strengthen the hand of the independent directors when dealing with fund management, and may assure that independent directors maintain control of the board and its agenda.[76]

We expect that requiring fund boards to be chaired by an independent director will provide similar benefits to increasing the percentage of independent directors. Because the chairman of a fund board can have a substantial influence on the fund board agenda and on the fund boardroom's culture, we expect that this requirement will advance meaningful dialogue between the fund adviser and independent directors and will support the role of the independent directors in overseeing the fund adviser. Further, we expect that the opportunity for frank and candid discussions among independent directors that will result from the rule amendments will increase the effectiveness of the independent directors.[77]

The amendment to require an annual self-assessment of the effectiveness of the board and its committees is intended to improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness. Moreover, the requirement for fund boards to perform an annual self-assessment should help fund boards to identify potential weaknesses and deficiencies. All but one of the comments received expressed support for a requirement that boards perform a self-assessment.

We expect that the requirement that independent directors must meet at least once quarterly in separate sessions, without the presence of directors who are interested persons, likewise will improve fund performance by strengthening the role of independent directors and fostering better communications and greater cohesiveness among the independent directors. Commenters were supportive of this proposal.

We expect that the amendment to require funds to explicitly authorize independent directors to hire employees and to retain advisers and experts will help independent directors address complex matters and provide them with an understanding of the practices of other mutual funds. Fund shareholders should receive substantial benefits because we expect that these requirements will help to ensure that independent directors are better able to fulfill their role of representing shareholder interests. Most commenters expressed support for this amendment. These commenters agreed that fund boards already have the authority to hire

[73] In the Proposing Release, we estimated that 5,124 funds would incur costs under this requirement. To calculate these costs, our staff used $18.92 per hour as the average cost of clerical time. We now estimate that there are 5,132 registered funds that may incur costs under this amendment.

[74] *See* Letter from James H. Bodurtha, Chair, Directors' Committee, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), File No. S7–03–04 (stating that ''We believe that the retention costs should be minimal and should not be a consideration in the implementation of this proposal. Requiring retention, in our opinion, will not change practices in terms of the volume of information requested by directors in connection with their review of the advisory contract.'') (''ICI Letter'').

[75] For a more complete discussion of the benefits to shareholders and boards in overseeing a fund's activities under the Exemptive Rules, *see supra* Section III.

[76] The majority of commenters generally agreed that increasing the independence of fund boards was beneficial to fund shareholders. Some commenters recommended that the percentage of independent directors be greater than 75 percent or that the conditions for being an independent director be stricter.

[77] Commenters were divided as to the relative benefits of this requirement. *See supra* text following note 40.

employees, but that this is a useful amendment.

Finally, the recordkeeping amendment is designed to improve the documentation of a fund board's basis for approving an advisory contract, which will assist our examination staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. The amendment to rule 31a–2 underscores the importance of the information requests that precede the directors' consideration of the advisory contract. Further, it may encourage independent directors to request more information, and this information may enable them to obtain more favorable terms in advisory contracts. Comments generally were supportive of this amendment.

B. Costs

The amendments will impose additional costs on funds that rely on an Exemptive Rule by requiring them to satisfy the fund governance standards in rule 0–1(a)(7). The amendments will require that independent directors constitute at least 75 percent of the fund board or, if the fund board has only three directors, will require that all but one director be independent.[78] Therefore, a fund that does not already meet this standard may: (i) Decrease the size of its board and allow some interested directors to resign; (ii) maintain the current size of its board and replace some interested directors with independent directors; or (iii) increase the size of its board and elect new independent directors. If a fund holds a shareholder election, it will incur costs to prepare proxy statements and hold the shareholder meeting. A fund also will incur costs of finding qualified candidates and compensating those new independent directors.[79] As noted in the Proposing Release, our staff has no reliable basis for determining how funds would choose to satisfy this requirement and therefore it is difficult to determine the costs associated with electing independent directors.[80] As discussed in section III above, under the proposed amendments, boards that have three directors, unlike fund boards that have four or more directors, would have to be composed of all independent directors in order to meet the 75 percent requirement or, alternatively, would incur costs to increase their board size to four directors. In response to concerns about the effect of the requirement on boards with only three directors, the exception to the 75 percent requirement we are adopting permits boards with three directors to have all but one director be independent.

The amendments also require: (i) An independent director to be chairman of the board; (ii) directors to perform an evaluation of the board and its committees, at least once annually; (iii) independent directors to meet in an executive session at which no director who is an interested person of the fund is present, at least once quarterly; and (iv) independent directors to be given specific authority to hire employees and retain experts. As discussed in the Proposing Release, our staff is not aware of any out-of-pocket costs that would result from the first three items because these requirements could be satisfied at a regularly scheduled board meeting.[81] A few comments expressed concern about costs of requiring separate executive sessions at least once quarterly. However, as discussed in the Proposing Release, we expect that most funds would choose to satisfy this requirement by having directors meet at a breakout session of regularly scheduled board meetings, which would impose no additional transportation and little or no accommodation costs for the directors. Therefore, we expect that the costs of complying with this requirement would be minimal. With regard to the fourth item, our staff is not aware of any costs associated with hiring employees or retaining experts because boards typically have this authority under state law, and the rule would not require them to hire employees or retain experts.

Our staff expects that the amendment to require funds to retain copies of materials considered by the board in approving advisory contracts would result in some increased recordkeeping costs. Our staff anticipates that the increased costs will be limited, however, because many if not most funds already maintain the documents that the proposed amendment would require them to keep. Even for firms that do not already maintain such records, our staff anticipates that the costs of the amendment will be limited.[82] This recordkeeping proposal merely requires the retention of documents already prepared. Further, as with other records, funds would be able to maintain the required records electronically. For purposes of the Paperwork Reduction Act, our staff estimated that each fund will spend a total of 0.5 hours of clerical time annually, at a total of $9.46, to comply with this proposal. We requested comment on the number of funds that already retain these materials, and on the costs of retaining such materials. We did not receive any comments specifically addressing this issue.[83]

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with 5 U.S.C. 604 relating to the amendments to the Exemptive Rules and the Commission's rules on investment company governance. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with 5 U.S.C. 603 and was published in the Proposing Release.[84]

A. Reasons for and Objectives of the Amendments

As described in Section I of this Release and in the Proposing Release, the Investment Company Act relies heavily on fund boards of directors to manage conflicts of interest that the fund adviser inevitably has with the fund. The reasons for these amendments are that the breakdown in fund management and compliance controls evidenced by our enforcement cases raises troubling questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds. The objectives of the amendments, which apply to funds relying on any of the Exemptive Rules, are to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve and to effectively oversee management of the fund.

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[78] As indicated in the Proposing Release, our staff estimated that nearly sixty percent of all funds currently meet this requirement. *See* Proposing Release, *supra note* 2 .

[79] Under some circumstances a vacancy on the board may be filled by the board of directors. *See* section 16(a) of the Investment Company Act [15 U.S.C. 80a–16(a)].

[80] With respect to the requirements related to independent selection and nomination of other independent directors and independent legal counsel, this amendment incorporates the current requirements of the Exemptive Rules, and therefore these amendments do not impose new costs.

[81] There may, however, be indirect costs associated with these provisions. An independent chairman, for example, may choose to hire staff for assistance in carrying out his or her responsibilities as chairman. We have no reliable basis for estimating those costs.

[82] For purposes of the Paperwork Reduction Act, our staff estimates that each fund would spend approximately 0.5 hours annually maintaining records of documents reviewed by fund boards when approving advisory contracts. *See* Proposing Release, *supra* note 2, at Section IV.

[83] *See* ICI Letter, *supra* note 74.

[84] *See* Proposing Release, *supra* note 2, at Section VI.

B. Significant Issues Raised by Public Comment

In the IRFA, we requested comment on any aspect of the IRFA and specifically requested comment on the number of small entities that would be affected by the proposed amendments, the likely impact of the proposal on small entities, and the nature of any impact, and empirical data supporting the extent of the impact. We received a few comments on the impact on small entities.[85] Four commenters expressed concern about the costs associated with hiring new directors for funds with small boards to satisfy the requirement that 75 percent of the board be independent. These commenters also stated that the costs associated with the amendments would be great for small entities because of the costs of retaining independent legal counsel, the cost of paying for more directors, the costs of holding separate meetings for independent directors, the costs of hiring staff for independent directors and the costs of having an independent director serve as chairman.[86]

C. Small Entities Subject to the Amendments

A small business or small organization (collectively, ''small entity'') for purposes of the Regulatory Flexibility Act is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[87] Of approximately 5,132 registered investment companies, approximately 233 are small entities.[88] As discussed above, the amendments would require funds relying on an Exemptive Rule to comply with rule 0–1(a)(7) and all funds to retain records under rule 31a–2. Whether these amendments to the Exemptive Rules would affect small entities would depend on whether the small entities rely on an Exemptive Rule.[89] Under rule 31a–2, all small entities would be required to maintain records of materials considered by a fund board when approving an advisory contract.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The amendments do not introduce any new mandatory reporting requirements. The amendments contain new mandatory recordkeeping requirements. Any fund, regardless of size, is required to maintain records of written materials that directors consider to approve an advisory contract. The amendments also introduce new compliance requirements for any fund that relies on an Exemptive Rule. Any fund that relies on an Exemptive Rule is required to satisfy the fund governance standards in rule 0–1(a)(7), including having: (i) A board of directors whose independent directors constitute at least 75 percent of the board;[90] (ii) an independent director be chairman of the board; (iii) directors perform an evaluation of the board and its committees, at least once annually; (iv) independent directors meet in an executive session at which no director who is an interested person of the fund is present, at least once quarterly; and (v) independent directors be given specific authority to hire employees and other advisers.

E. Agency Action to Minimize the Effect on Small Entities

We are concerned about the impact of these amendments on small entities. In response to comments about the impact of the proposed 75 percent independence requirement on small fund boards, we are adopting an alternative for fund boards with only three directors.[91] Unlike fund boards composed of four or more directors, fund boards with only three directors would have to be composed of all independent directors in order to meet the 75 percent requirement or, alternatively, would have increase their board size to four directors. We are adopting an alternative to the 75 percent requirement for boards composed of three directors that would permit all but one director to be independent. With respect to the establishment of other special alternatives for small entities, we do not presently think this is feasible or necessary because these amendments are designed to strengthen the role of independent directors so that fund boards can more effectively manage conflicts of interest, monitor service providers, and protect the interests of fund shareholders. The need to strengthen the role of independent directors arises in part from problems uncovered in enforcement actions and settlements. Excepting small entities from the amendments could disadvantage fund shareholders of small entities and compromise the effectiveness of the amendments. Because we believe that small entities are as vulnerable to the problems uncovered in recent enforcement actions and settlements as large entities, shareholders of small entities are equally in need of more independent fund boards. Thus, specific measures must be undertaken by all funds, regardless of size, to increase the independence of boards to provide better oversight of service providers and compliance matters, to better manage conflicts of interest and to better protect fund shareholders.

VIII. Consideration of Promotion of Efficiency, Competition and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. The amendments requiring that funds adopt certain governance practices if they rely on any of the Exemptive Rules are designed to enhance the independence and effectiveness of fund boards. The amendment to require that funds maintain materials considered by a fund board when approving an advisory contract is designed to improve the documentation of a fund board's basis for approving an advisory contract, which would assist our examinations staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. We do not expect these amendments to have a significant effect on efficiency, competition and capital formation with regard to funds because the costs associated with the amendments are minimal and many funds have already adopted the required practices. To the extent that these amendments do affect competition or capital formation, we believe that the

[85] These commenters defined small entities as entities with assets ranging from assets under $218 million to assets under $100 million, as opposed to assets under $50 million.

[86] These amendments that we proposed and are adopting, however, do not require independent directors to retain independent legal counsel or to hire staff for independent directors, nor do these amendments require funds to increase the size of their boards.

[87] 17 CFR 270.0–10.

[88] Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

[89] We now estimate that there are 5,132 registered funds, of which 233 are small entities. As discussed in the Proposing Release, our staff estimates that approximately 90 percent of all registered investment companies, or 4,619 funds, rely on at least one Exemptive Rule. If 90 percent of all small entities rely on at least one Exemptive Rule, then approximately 210 funds that are small entities would rely on at least one Exemptive Rule and would therefore be affected by the amendments to the Exemptive Rules. *See* Proposing Release, *supra* note 2.

[90] If the board consists of three directors, however, the board need only include two independent directors.

[91] We estimate that 30 funds that are small entities have boards with only three directors.

effect will be positive because the amendments are likely to reduce the risk of securities law violations such as late trading in mutual funds and market timing violations, and thus increase investor confidence in mutual funds. In the Proposing Release, we solicited comments on our analysis of the impact of these amendments on efficiency, competition and capital formation. We did not receive any comments on our analysis.

Statutory Authority

We are amending rule 0–1(a) and the Exemptive Rules pursuant to the authority set forth in sections 6(c), 10(f), 12(b), 17(d), 17(g), 23(c), and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), 80a–10(f), 80a–12(b), 80a–17(d), 80a–17(g), 80a–23(c), and 80a–37(a)]. We are amending rule 31a–2 under the Investment Company Act pursuant to the authority set forth in sections 12(b) and 31(a) [80a–12(b) and 80a–30(a)].

Text of Rules

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

■ For the reasons set out in the preamble, the Commission is amending Title 17, Chapter II of the Code of Federal Regulations as follows.

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

■ 1. The authority citation for Part 270 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, and 80a–39, unless otherwise noted.

* * * * *

Section 270.0–1(a)(7) is also issued under 15 U.S.C. 80a–10(e);

* * * * *

■ 2. Section 270.0–1 is amended by adding paragraph (a)(7) to read as follows:

§ 270.0–1 Definition of terms used in this part.

(a) * * *

(7) *Fund governance standards.* The board of directors of an investment company (''fund'') satisfies the *fund governance standards* if:

(i) At least seventy-five percent of the directors of the fund are not interested persons of the fund (''disinterested directors'') or, if the fund has three directors, all but one are disinterested directors;

(ii) The disinterested directors of the fund select and nominate any other disinterested director of the fund;

(iii) Any person who acts as legal counsel for the disinterested directors of the fund is an independent legal counsel as defined in paragraph (a)(6) of this section;

(iv) A disinterested director serves as chairman of the board of directors of the fund, presides over meetings of the board of directors and has substantially the same responsibilities as would a chairman of a board of directors;

(v) The board of directors evaluates at least once annually the performance of the board of directors and the committees of the board of directors, which evaluation must include a consideration of the effectiveness of the committee structure of the fund board and the number of funds on whose boards each director serves;

(vi) The disinterested directors meet at least once quarterly in a session at which no directors who are interested persons of the fund are present; and

(vii) The disinterested directors have been authorized to hire employees and to retain advisers and experts necessary to carry out their duties.

■ 3. Section 270.10f–3 is amended by:
■ a. Revising the reference to ''paragraphs (b)(1)(iv) and (b)(2)(i)'' to read ''paragraphs (c)(1)(v) and (c)(2)(i)'' in paragraph (c)(3);
■ b. Revising the reference to ''paragraph (b)(10)(iii)'' to read ''paragraph (c)(10)(iii)'' in paragraph (c)(9);
■ c. Revising the reference to ''paragraphs (b)(10)(i) and (b)(10)(ii)'' to read ''paragraphs (c)(10)(i) and (c)(10)(ii)'' in paragraph (c)(12)(i);
■ d. Revising the reference to ''paragraph (b)(10)(iii)'' to read ''paragraph (c)(10)(iii)'' in paragraph (c)(12)(ii); and
■ e. Revising paragraph (c)(11).

The revision reads as follows:

§ 270.10f–3 Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate.

* * * * *

(c) * * *

(11) *Board composition.* The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

■ 4. Section 270.12b–1 is amended by revising paragraph (c) to read as follows:

§ 270.12b–1 Distribution of shares by registered open-end management investment company.

* * * * *

(c) A registered open-end management investment company may rely on the provisions of paragraph (b) of this section only if its board of directors satisfies the fund governance standards as defined in § 270.0–1(a)(7);

* * * * *

■ 5. Section 270.15a–4 is amended by revising paragraph (b)(2)(vii) to read as follows:

§ 270.15a–4 Temporary exemption for certain investment advisers.

* * * * *

(b) * * *

(2) * * *

(vii) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

■ 6. Section 270.17a–7 is amended by revising paragraph (f) to read as follows:

§ 270.17a–7 Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof.

* * * * *

(f) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7); and

* * * * *

■ 7. Section 270.17a–8 is amended by revising paragraph (a)(4) to read as follows:

§ 270.17a–8 Mergers of affiliated companies.

* * * * *

(a) * * *

(4) *Board composition.* The board of directors of the Merging Company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

■ 8. Section 270.17d–1 is amended by revising paragraph (d)(7)(v) to read as follows:

§ 270.17d–1 Applications regarding joint enterprises or arrangements and certain profit-sharing plans.

* * * * *

(d) * * *

(7) * * *

(v) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

■ 9. Section 270.17e–1 is amended by revising paragraph (c) to read as follows:

§ 270.17e–1 Brokerage transactions on a securities exchange.

* * * * *

(c) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7); and

* * * * *

■ 10. Section 270.17g–1 is amended by revising paragraph (j)(3) to read as follows:

§ 270.17g–1 Bonding of officers and employees of registered management investment companies.

* * * * *

(j) * * *

(3) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

■ 11. Section 270.18f–3 is amended by revising paragraph (e) to read as follows:

§ 270.18f–3 Multiple class companies.

* * * * *

(e) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

■ 12. Section 270.23c–3 is amended by revising paragraph (b)(8) to read as follows:

§ 270.23c–3 Repurchase offers by closed-end companies.

* * * * *

(b) * * *

(8) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

■ 13. Section 270.31a–2 is amended by:

■ a. Removing the word ''and'' at the end of paragraph (a)(4);

■ b. Removing the period at the end of paragraph (a)(5) and adding in its place ''; and''; and

■ c. Adding paragraph (a)(6) to read as follows:

§ 270.31a–2 Records to be preserved by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

(a) * * *

(6) Preserve for a period not less than six years, the first two years in an easily accessible place, any documents or other written information considered by the directors of the investment company pursuant to section 15(c) of the Act (15 U.S.C. 80a–15(c)) in approving the terms or renewal of a contract or agreement between the company and an investment adviser.

* * * * *

Dated: July 27, 2004.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins Investment Company Governance, Release No. IC–26520

We write jointly to dissent from the Commission's adoption of amendments to rules under the Investment Company Act of 1940 (''Investment Company Act'' or ''Act'') that generally require a fund's board of directors: (1) To be composed of directors, at least 75 percent of whom are independent, and (2) to be led by an independent director as its chairperson.[1] We support the rulemaking's commendable objective of strengthening investor protection for fund shareholders. However, we fear that the path chosen to achieve this objective may lead in the opposite direction—at a substantial cost to fund shareholders. Because the fund industry is a $7.6 trillion industry, it is easy to ignore or lose sight of the fact that the costs of regulatory requirements are ultimately paid by fund shareholders, for whom small differences in fees are of great importance.[2]

As the release indicates, although the benefits of the amendments are difficult to quantify, a majority of the Commission ''believe[s] they are real.'' [3] The majority postulates that the new independence requirements will ''strengthen the hand of the independent directors when dealing with fund management, and may assure that independent directors maintain control of the board and its agenda.'' [4] However, despite the existence of empirical data that could have been analyzed to evaluate potential benefits, the proponents provided no such analysis. Moreover, the majority speculates sanguinely that the benefits of these amendments will come at ''minimal'' cost to funds.[5] Positing that empirical evidence is unnecessary, the majority dismisses pleas for more deliberate action.[6] A particular standard of independence is not, in and of itself, a legitimate regulatory objective. Therefore, before we mandate that all funds meet any particular independence standard, it must be objectively linked (by more than anecdotal evidence and ''gut impression'') to real benefits for shareholders.

Existing Independence Requirements Are Sufficient To Ensure Meaningful Influence

Existing statutory and regulatory requirements already ensure that independent directors can make their voices heard and heeded. In enacting the Investment Company Act, Congress prescribed a fund board's independence requirements. Section 10(a) of the Investment Company Act requires that at least forty percent of a fund's board be independent.[7] Section 10(b)(2) of the Act requires, in effect, that independent directors comprise a majority of a fund's board if the fund's principal underwriter is an affiliate of the fund's adviser.[8] Moreover, certain board actions cannot be taken without approval by a majority of the independent directors. Most importantly, section 15(c) provides that a majority of the independent directors must approve advisory and underwriting contracts.[9] Certain Commission exemptive rules also require a majority vote by the independent directors in specific areas of conflict.[10] In addition, three years ago the Commission conditioned ten of its commonly-used exemptive rules on fund boards' having a majority of independent directors.[11] These rules are the same rules the Commission is amending today.[12]

The existing independence requirements already enable independent directors to set the agenda and determine the outcome of

[1] The change is effected by making these governance requirements conditions of ten commonly used exemptive rules. Because these rules are used by virtually all funds, these requirements are effectively universally applicable.

[2] *See, e.g.*, Securities and Exchange Commission, *Invest Wisely: An Introduction to Mutual Funds* (available at: http://www.sec.gov/investor/pubs/inwsmf.htm#key) (''Even small differences in fees can translate into large differences in returns over time. For example, if you invested $10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly $49,725. But if the fund had expenses of only 0.5%, then you would end up with $60,858—an 18% difference.'').

[3] *See* Section VI.A of the Adopting Release (''Benefits'').

[4] *See* Adopting Release, text accompanying note 75.

[5] *See* Section VIII of the Adopting Release (Consideration of Promotion of Efficiency, Competition and Capital Formation'').

[6] *See* Securities and Exchange Commission, Open Meeting Webcast, June 23, 2004 (available at: http://www.sec.gov/news/openmeetings.shtml) (dissenting views on the value of empirical data).

[7] *See* section 10(a). 15 U.S.C. 80a–10(a). Congress initially considered, but later rejected a majority independence requirement because of concerns ''that if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice.'' Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 109–110 (1940) (testimony of David Schenker). Since approximately 90 percent of funds utilize these exemptive rules, the majority is effectively mandating these changes for all funds. *See* Adopting Release at note 88. Given the clearly stated, legislatively prescribed independence mandates, we question whether the Commission is acting outside its authority under the Investment Company Act.

[8] 15 U.S.C. 80a–10(b)(2). *See also* section 10(c) (a majority of the board of a registered investment company may not consist of persons who are officers, directors, or employees of any one bank or bank holding company).

[9] 15 U.S.C. 80a–15(c). *See also* section 32(a)(1) of the Act (a fund's auditor must be selected by the vote of a majority of the fund's independent directors).

[10] Rule 17a–7, for example, requires that fund directors, including a majority of the independent directors, determine at least quarterly that all affiliated purchase and sale transactions were made in compliance with procedures adopted by the board, including a majority of the independent directors. 17 CFR 270.17a–7.

[11] Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)] (''2001 Adopting Release'').

[12] *See* Adopting Release at note 8.

decisions made by the board.[13] As the Commission noted three years ago, a majority requirement is sufficient to ''permit, under state law, the independent directors to control the fund's ''corporate machinery,'' *i.e.*, to elect officers of the fund, call meetings, solicit proxies, and take other actions without the consent of the adviser.'' [14] ''[I]ndependent directors who comprise the majority of a board can have a more meaningful influence on fund management and represent shareholders from a position of strength.'' [15] A majority of independent directors also can insist, if they determine that it would be beneficial, on an independent chairperson.

We are particularly troubled that the Commission has not shown that the reforms from three years ago were inadequate to achieve the stated goals. The new independence conditions took effect on July 1, 2002, so the Commission has allowed itself only two years to observe the effects of the amendments. Most importantly, the Commission has not even attempted the barest systematic assessment of the effectiveness either of those reforms or, more generally, of the statutory and rule-based fund governance requirements. We are also troubled that at the same time the majority raises the requirement for the number of independent directors, it notes that the directors who are legally ''independent'' may not really be independent.[16] The majority's concerns suggest a possible need for a change in the statutory definition of ''interested person'' under section 2(a)(19) of the Act rather than for an increase in the number of independent directors.[17]

A Seventy-Five Percent Independence Threshold Is Unnecessary

The majority's choice of seventy-five percent is puzzling. The majority points to the only section in the Investment Company Act that dictates this percentage, section 15(f).[18] The majority does not explain that section 15(f) is a safe harbor provision that ''make[s] clear that an investment adviser can make a profit on the sale of its business subject to two principal safeguards to protect the investment company and its shareholders.'' [19] Congress did not intend for it to serve as a universally-applicable requirement for fund boards.

The Commission could have imposed a two-thirds independence requirement, which most funds already satisfy, is consistent with best practices recommendations from the Investment Company Institute,[20] and was contemplated (but rejected in favor of a majority requirement) in connection with the 2001 fund governance changes.[21] Instead, the majority has chosen a seventy-five percent minimum, which forces approximately half of funds to make changes.[22] Again, the majority fails to give any real consideration to the costs of this change. The Adopting Release acknowledges that ''our staff has no reliable basis for determining how funds would choose to satisfy [the seventy-five percent] requirement and therefore it is difficult to determine the costs associated with electing independent directors.'' [23] Fund boards are able to avoid incurring the costs of hiring new independent directors by reducing the number of directors, but even this approach is likely to impose some costs, not the least of which is the loss of the insight and experience of directors who are removed from the board. Funds that conclude that it is in the interest of fund shareholders to retain existing interested directors will need to hire additional independent directors, a costly prospect.[24]

Mandating an Independent Chairperson Is Unwarranted

The rulemaking is characterized as being part of the solution to the late trading, market timing, and other fund abuses that have come to light over the past year. Its proponents claim that the enforcement cases we have brought to date in this area exhibit a telling pattern—approximately eighty percent of the funds involved had inside chairpersons.[25] However, because approximately eighty percent of *all* fund firms have interested chairpersons, this number suggests only that funds with inside chairpersons are proportionally implicated in the abusive activity. A common feature of these enforcement actions is that boards were not told of the formal or informal arrangements permitting market timing. An inside chairperson with access to information about day-to-day operations might be more likely than an independent chairperson to discover practices that are harmful to fund shareholders.[26]

When the amendments were proposed, we asked that a more thorough analysis be undertaken before effecting these significant changes in an industry that is of such importance to so many investors.[27]

[13] Last year, the staff noted the power already possessed by fund independent directors: ''[A]lmost all funds have boards with at least a majority of independent directors. Thus, one could question whether there is a need to mandate that a fund's chairman be independent because independent directors representing a majority of a fund's board already are in a position to control the board and, if they deemed it appropriate, could already influence the agenda and the flow of information to the board.'' Memorandum from Paul F. Roye, Director, Division of Investment Management, to William H. Donaldson, Chairman, SEC, re Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, at 50 (June 9, 2003) (available at: http://financialservices.house.gov/media/pdf/02–14–70%20memo.pdf) (''Baker Memorandum'').

[14] 2001 Adopting Release at text accompanying note 22.

[15] 2001 Adopting Release at text accompanying note 23.

[16] *See* Section II.C of the Adopting Release.

[17] ''Independent director'' is a term commonly used to refer to a director who is not an ''interested person'' as defined in section 2(a)(19). 15 U.S.C. 80a–2(a)(19). The Commission, of course, would need to petition Congress for such a change. Indeed, last year the staff asked Congress to consider revising section 2(a)(19) of the Act to give the Commission ''rulemaking authority to fill gaps in the statute that have permitted persons to serve as independent directors despite relationships that suggest a lack of independence from fund management.'' *See* Baker Memorandum, *supra* note 13, at 47.

[18] 15 U.S.C. 80a–15(f). Section 15(f) requires funds to maintain boards comprising at least seventy-five percent independent directors for the three-year period after an adviser has sold its advisory business to another entity. This provision was added by Congress to limit the effects of *Rosenfeld* v. *Black,* 445 F.2d 1337 (2d Cir. 1971). In that case, the court had held that it was a violation of an adviser's fiduciary duty to transfer an advisory contract to another adviser for profit.

[19] Committee on Banking, Housing and Urban Affairs, Report No. 94–75 to Accompany S. 249 (Apr. 14, 1975).

[20] *See* Investment Company Institute, Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness at 10–12 (June 24, 1999) (available at: *http://www.ici.org/pdf/rpt_best_practices.pdf).*

[21] *See* 2001 Adopting Release at note 25. The majority, conceding that ''there are good arguments for maintaining a management presence on the board,'' portrays itself as reasonable because it rejected the higher independence percentages recommended by some commenters. *See* Adopting Release at note [31] and accompanying text (citing Letter of Tom Walker to Jonathan G. Katz, Secretary, SEC (Mar. 9, 2004)), File No. S7–03–04 (''While your changes are moving in the right direction in advocating for a more independant [*sic*] boards. I believe it still allows for too much room for cornyism [*sic*] and nepotism to play out on what should be truley [*sic*] independant [*sic*] directors.''); Letter of John and Judy Hesselberth to Jonathan G. Katz, Secretary, SEC (Feb. 24, 2004), File No. S7–03–04 (''In addition the requirement that 75% of the directors of a mutual fund must be outside directors is sound. It probably should be 100%, but 75 is a step in the right direction from the current 50%.'').

[22] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), File No. S7–03–04 (stating that ''a change from the current [common industry] practice of a two-thirds supermajority to a seventy-five percent requirement would mean that at least half of all fund boards would have to change their current composition, according to Institute data.'').

[23] Adopting Release at text accompanying note [79] (footnote omitted).

[24] A survey found that in 2002, the median compensation for independent directors at the 50 largest fund groups was $113,000 a year and at the smaller fund groups was $18,000. *See* Rick Miller, In Off Year, these Cats Get Fatter: Fund Board Directors Collect a Big Pay Raise, Investment News, April 7, 2003, at 1 (reporting results of a survey conducted by Management Practice Inc.). This amount, of course, does not include up-front search costs and annual non-compensation costs associated with a director's performance of his or her duties.

[25] *See, e.g.*, Letter from Congressman Michael G. Oxley to Chairman William H. Donaldson (May 20, 2004).

[26] In pointing out this and other potential benefits that an interested chairperson might bring to a fund board, we do not intend to suggest that *all* boards should select an interested chairperson. To the contrary, we maintain that what works well for one fund board might not work well for every other fund board. Under certain circumstances, a fund board might conclude that an independent chairperson is essential. *See, e.g.*, Tom Lauricella, Strong Steps Down from Fund Board but Stays on as Head of Firm, Wall St. J., Nov. 3, 2003, at C12 (reporting that following Richard Strong's resignation from his post as chairman of the board of the Strong Mutual Funds, ''[t]he independent Strong directors have begun a search to replace Mr. Strong with a chairman who is independent from Strong Capital management'').

[27] At the Commission Open Meeting during which the Commission voted to propose the

Continued

Proponents of the rule undertook no such analysis, and the Commission did not use its resources to conduct such an analysis. The burden of proof lies with the regulator seeking to overturn the status quo rather than with the regulated.[28] The empirical data we did receive suggest that the amendments might *not* be beneficial. The data show a correlation between an inside chairperson and superior performance and no statistically significant negative effect on fees.[29] Indeed, many of the funds that report the best performance and lowest fees have inside chairpersons.[30]

A fact largely ignored by this rulemaking is that independent directors are not the only ones charged with protecting the interests of fund shareholders. An investment adviser has a fiduciary duty to act in the best interests of a fund it advises.[31] Further, *all* fund directors have a fiduciary duty to shareholders.[32] It is true that fund managers serve two constituencies—shareholders of the adviser and shareholders of the fund. The interests of these two groups are not, however, entirely at odds. Interested fund directors have an incentive to maximize fund performance because good performance matters to fund investors, who factor it into their investment decisions. Thus, market forces compel fund advisers to offer fund shareholders good performance for a reasonable fee in order to preserve the integrity and hence, marketability, of its brand. This rulemaking overlooks these market forces and seems to suggest that there is no counterweight to the pressure to impose fees on the fund.

Concluding nonetheless that investors would benefit from an independent chairperson, the majority ignores the costs fund investors will bear by the adoption of this requirement.[33] The majority did not identify ''any out-of-pocket costs'' associated with the independent chairperson requirement. Yet an estimated eighty percent of funds will need a new chairperson. If a sitting independent director accepts the position, the fund will need to pay him more to accept the new responsibilities.[34] If none of the sitting independent directors wants the job or none is qualified,[35] the fund will need to launch an expensive search. It may be difficult for funds to find an individual with the requisite industry experience whom they can afford to hire.

Moreover, in order to be effective at carrying out his or her responsibilities, an independent chairperson likely would have to hire a staff.[36] The majority addresses this issue only in passing by stating that the ''staff is not aware of any costs associated with hiring employees or retaining experts because boards typically have this authority under state law, and the rule would not require'' that an independent chairperson hire employees.[37] We cannot support a rule that rests upon such tortured logic and circular reasoning. As some commenters have noted, it is ironic that the majority, in its zeal to strengthen the independence of fund boards, has enacted a measure that takes away that independence of the board to select its own chairperson.[38]

The Commission Failed To Examine Alternatives

We fear that the Commission is acting simply to appear proactive. The Commission already has taken significant steps to address the recently uncovered abuses in the fund industry and to identify and address other potentially problematic issues. We have brought enforcement actions under existing laws and regulations to punish the wrongdoers.[39] We have also initiated meaningful regulatory reform. Recently, for example, we adopted requirements regarding the disclosure of market-timing policies,[40] enhancing the disclosure provided by funds about how their boards evaluate and approve investment advisory contracts,[41] and requiring funds and advisers to designate chief compliance officers.[42] In addition, we are considering initiatives on fair value pricing,[43] increased transparency of fund transaction costs and expenses,[44] pricing of

amendments, Commissioner Glassman requested that proponents and/or staff provide empirical data that would support the amendments.

[28] The application of ''Total Quality Management,'' the management philosophy of W. Edwards Deming, and a later variant, ''Six Sigma,'' would emphasize the importance of discerning whether the fund advisers' fraudulent activity (the variation from desired results) derives from a common cause or something aberrant in a particular adviser's management process—that is, a special cause. If common causes are to blame for the fraudulent activity, then the system is flawed and redesign is necessary. Special causes require more targeted solutions. As discussed below, the fact that funds with independent chairpersons seem proportionally implicated in this fraudulent activity indicates that the lack of an independent chairperson is not a common cause for the fraudulent activity by fund advisers. In addition, the empirical data that we have found this far supports this observation. Consequently, a redesign of the fund governance system is not indicated by the data. The majority's redesign of the system will not, and cannot be expected to, cure the flaws of the system.

[29] *See* Geoffrey H. Bobroff and Thomas H. Mack, Assessing the Significance of Mutual Fund Board Independent Chairs, A Study for Fidelity Investments (Mar. 10, 2004) (attached to letter from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company to Jonathan G. Katz, SEC (Mar. 10, 2002), File No. S7–03–04)). In an effort to support its position and rebut challenges that it has not considered any empirical evidence, the majority laments the fact that commenters did not submit any pre-existing studies and dismisses the findings of this study, which was commissioned in response to the Commission's request for comments on the proposed amendments. *See* Adopting Release at note 51. The majority's intimation that the data must be discounted because of the ''prevalence of independent chairmen among bank-sponsored fund groups'' is troubling if it is intended to suggest that bank-sponsored mutual funds are inherently inferior to their non-bank counterparts. We acknowledge that one study cannot conclusively resolve the debate about independent chairpersons, but its conclusions contribute to the debate. Boards of directors, not the Commission, should weigh the evidence to decide whether an independent chairperson would be beneficial for their fund shareholders.

[30] *Id.*

[31] *See Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971); *Brown* v. *Bullock*, 194 F. Supp. 207, 229, 234 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961). *See also* section 36(b) of the Investment Company Act [15 U.S.C. 80a–35(b)] (investment adviser of a fund has a fiduciary duty with respect to the receipt of compensation paid by the fund). More generally, investment advisers owe a fiduciary duty to their clients. *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963) (interpreting section 206 of the Investment Advisers Act of 1940).

[32] In addition to standard state law duties applicable to all corporate directors, fund directors have fiduciary duties under the Investment Company Act. *See* section 36(a) of the Investment Company Act. [15 U.S.C. 80a–35(a)].

[33] *See* Section VI.B (''Costs'') of the Adopting Release.

[34] According to one estimate, an independent chairperson could command a 25 to 50% premium over other board members. *See* Beagan Wilcox, Wanted: Independent Chairmen, Board IQ, July 6, 2004 (citing estimate of Meyrick Payne, senior partner, Management Practice).

[35] Independent directors have ''diverse backgrounds in business, government or academia.'' Investment Company Institute, Understanding the Role of Mutual Fund Directors, at 6. Fund independent directors without experience in the fund industry can apply their experiences in other areas to perform their responsibilities as independent directors, but may not be adequately equipped to handle responsibilities of board chairperson.

[36] Of necessity, both the independent chairperson and his or her staff are likely to be dependent on fund management and, therefore, may lose independent perspective on matters facing the board. Sir Derek Higgs recognized this in his review of corporate governance in Britain. *See* Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors (Jan. 2003) at 24 (explaining that, even if a chairperson is independent prior to appointment, thereafter he or she will work closely with management in carrying out his or her duties, so ''[a]pplying a test of independence at this stage is neither appropriate nor necessary.'').

[37] *See* Section VI.B (''Costs'') of the Adopting Release.

[38] The majority reassures independent directors that the amendments ''do not prevent the independent directors from choosing the most qualified and capable candidate.'' *See* Adopting Release, at text following note 47. We contend that a conscientious board might reasonably determine that the most qualified and capable candidate is someone with the deep familiarity with day-to-day fund operations. The majority apparently believes they know better.

[39] *See* Adopting Release at note 5.

[40] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26418 (Apr. 19, 2004) [69 FR 22300 (Apr. 23, 2004)].

[41] Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release 26486 (June 23, 2004) [69 FR 39798 (June 30, 2004)].

[42] Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)].

[43] These initiatives are described in Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26375A at Section II.F (Mar. 5, 2004) [69 FR 11762 (Mar. 11, 2004)].

[44] *See* Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26341 (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)] and Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs,

fund shares,[45] and fund distribution arrangements.[46]

We were hopeful when these board governance amendments were proposed that alternative measures would be considered. Requiring a fund to disclose prominently whether or not it had an independent chairperson, for example, would allow shareholders to decide whether that matters to them or not. Alternatively, we could have endorsed the lead independent director concept by requiring a fund's independent directors to appoint a lead director to represent the views of the fund's independent directors to fund management.[47] We could have required additionally that each major board committee be chaired by an independent director, who would have the authority to set the agenda of the committee. The advantage of these alternatives, in addition to being less costly, is that they leave the decision about the independent chairperson to the independent directors or the marketplace, rather than impose the requirement by regulatory fiat. The majority failed to give serious consideration to these alternatives.[48]

Under the cover of ''good atmospherics'' and the shroud of ''investor protection,'' the majority has decided to adopt measures the benefits of which are illusory, but the costs of which are real. We conclude that the majority has not justified this forced restructuring of the corporate governance of the vast majority of funds and fear that it provides investors with a false sense of security.

For the foregoing reasons, we respectfully dissent.

Cynthia A. Glassman,

Commissioner.

Paul S. Atkins,

Commissioner.

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Investment Company Act Release No. 26313 (Dec. 18, 2003).

[45] Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) [68 FR 70388 (Dec. 17, 2003)].

[46] Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 (Feb. 24, 2004) [69 FR 9726 (Mar. 1, 2004)].

[47] In 1999, the Investment Company Institute's Advisory Group on Best Practices for Fund Directors included among its recommendations the designation of one or more persons as a lead director. *See* Investment Company Institute, Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness at 25 (June 24, 1999) (available at: *http://www.ici.org/pdf/rpt_best_practices.pdf*).

[48] The majority acknowledged that these alternatives could be useful, but explained that funds would have difficulty finding persons of ''sufficient stature'' to act as ''an effective counterweight to a fund chairman who may also be the chief executive officer of the management company.'' *See* Adopting Release at text accompanying note 57. We question whether funds will find it easier to fill the position of independent chairperson with a person able both to act as an ''effective counterweight'' and also to fulfill the routine administrative responsibilities of running a fund board.