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OF THE
UNITED STATES OF AMERICA

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August 21, 2006

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

Re: File No. S7-03-04; Release No. IC-27395

Dear Ms. Morris:

On behalf of the Chamber of Commerce of the United States of America ("Chamber"), I am submitting this letter in response to the Commission's request for additional comment on "Investment Company Governance"; Proposed Rule, 71 Fed. Reg. 35,366 (June 19, 2006). The Chamber is the nation's largest federation of business companies and associations. With substantial membership in each of the fifty states, the Chamber has an underlying membership of more than three million businesses, chambers of commerce, and business and professional organizations of every size and in every industry sector. One of the Chamber's associational purposes is to voice its members' concerns with costly and unnecessary federal regulations. Chamber members and their subsidiaries include mutual fund advisers that could be adversely affected by the two "governance" provisions at issue in this proceeding, the independent chair and 75 percent independent director requirements. Further, the Chamber itself invests in mutual funds and thus would be directly adversely affected by unnecessary and counterproductive regulation of mutual fund markets. We appreciate this opportunity to provide our views in response to the Commission's request for additional comment.

The Chamber is deeply committed to the protection of mutual fund investors—and to the promotion of efficiency, competition, and capital formation in the financial markets—but believes that the two provisions fall short of their stated goal and would in fact have significant adverse consequences for investors and the industry. The Commission should not intervene in the financial markets nor limit investor choice without first assembling compelling evidence of a *need* for further regulation, and without establishing as well that the proposed restrictions would *in fact* deliver the benefits promised. The independent chair and 75 percent independence provisions fall far short of these requirements. The provisions are a dramatic departure from Congress's own purposeful design for investment companies, effectively outlawing the governance model favored by many investors. These changes would be wrought at substantial cost—to smaller funds, competition, capital formation, and the mutual fund industry and investors as a whole—yet there is no evidence that altering the governance structure for mutual funds is needed or would be beneficial, particularly given other significant changes in mutual fund requirements.

In short, the two provisions would thwart investor choice and impose unjustifiable regulatory costs in pursuit of benefits that are wholly illusory. For these reasons and all the reasons discussed below, the Commission should close the rulemaking record without imposing any further regulatory requirements. If the Commission nevertheless concludes that some additional regulation is necessary, we urge it to adopt exclusively the "disclosure alternative," which would empower investors while avoiding harmful, costly, and intrusive regulation.

The comments that follow are divided into five sections:

- Section I discusses certain principles that the Chamber respectfully submits must guide the Commission in this proceeding, including the presumption against interfering in financial markets, changing corporate organization, and eliminating valued investor choices without strong evidence of a compelling need to do so. In assessing that need, this section explains, the Commission must focus on the specific activities and transactions regulated by the "exemptive" rules that would be amended; those rules may not be revised to implement general notions of proper corporate governance that are unnecessary to the performance of the exemptive rules themselves. And in fact, this section shows, the evidence does not show a need to amend the exemptive rules either to more effectively regulate exemptive transactions or to accomplish the broader purposes that the Commission has in the past articulated.

- Section II demonstrates that not only would the two provisions at issue fail to achieve their stated purpose, but their costs would far outweigh their speculative benefits. Particularly when discounted by risk, the potential consequences of an improper exemptive activity at a fund or fund family—an improvident joint insured bond, for example—does not warrant imposing millions upon millions of dollars in compliance costs on the mutual fund industry, costs that ultimately will be borne by investors.

- Section III explains that in addition to direct monetary costs, the provisions' adverse effects on efficiency, competition, and capital formation will harm the mutual fund industry (and investors) by stifling competition, erecting significant barriers to entry, and reducing the variety of funds available for investment. The provisions would have an adverse effect on the ability of small funds to compete and survive.

- Section IV discusses the advantages of management chairs and directors. Empirical evidence suggests that management-chaired funds outperform independent chaired funds. Moreover, management-chaired funds are a dominant investment option preferred by many investors who should not be deprived of the opportunity to choose that investment vehicle. The agency should permit the free market to determine what investment options are available to the public when, as here, there is no compelling evidence that the option at issue—the management-chaired fund—is less desirable than alternative products.

- Finally, Section V shows that if the Commission determines that it will amend the existing exemptive rules—and we believe that it should not—then the disclosure alternative should be adopted. Unlike the independent chair and 75 percent independent director requirements, the disclosure alternative would further the stated purpose of protecting funds and fund shareholders without disproportionate costs to the industry and shareholders and without undermining efficiency, competition, and capital formation.

I. The Commission Should Approach This Proceeding With A Presumption Against Interfering In Free Markets And In Favor Of Investor Choice, Particularly Given Congress's Decision To Permit Advisers To Play A Leading Role In Fund Governance; Proponents Of The Two Provisions At Issue Have Not Carried Their Burden Of Demonstrating That Significant Changes Are Necessary To Address Any Supposed Or Potential Problems Under The Exemptive Rules.

Several important considerations should bear heavily on the Commission's decision how to proceed in this matter. First, Congress itself decided not to require that fund boards be dominated by independent directors; the Commission's burden to justify a departure from that congressional decision is considerable. Second, any provision adopted by the Commission must be bottomed on exemptive transactions—the Commission has no general authority to regulate corporate governance—yet these provisions cannot be justified under the exemptive rules. Indeed, the provisions would not accomplish even their more general stated purpose, and in any event other regulations adopted by the Commission should be given time to work before funds and investors are saddled with this additional layer of costly regulation.

We note at the outset of these comments certain basic principles that we respectfully suggest should guide the Commission's reconsideration of the two disputed regulatory provisions. First and self-evidently, the burden for justifying any new federal law or regulation lies with the party proposing constraints on free markets, and the costs that come with them. Presumptively, market forces will drive toward the development and expansion of investment models that are preferred by investors and deliver optimal returns. Regulation risks interference with that process as well as increased costs and unanticipated consequences that could have potentially serious adverse effects on markets and investors. In this particular proceeding, we note two specific respects in which these concerns are manifest. First, the management-chaired fund historically has been the dominant model in the industry. As explained further below, it is a model preferred by many investors for sensible reasons, and there is substantial evidence that this model delivers better returns. For those reasons alone, a presumption exists against what would be the effective elimination of this model from the marketplace. Second, in prior stages of this matter and in the associated litigation the Commission has at times spoken somewhat casually of the ease by which mutual funds may reduce the size of their fund boards, as if this is an essentially cost-free change. Reasoning of this nature mistakenly assumes that existing corporate structures are achieved by happenstance, which—as just explained—conflicts with well-accepted theories of the firm and with the basic regulatory presumption against interfering with the markets in the absence of evidence of market failure or self-dealing.

A second important principle to guide the Commission's further consideration of these two regulatory provisions is that the provisions purposely subvert a model that Congress intended be available in the industry. The Investment Company Act of 1940 ("ICA" or "Act") generally requires that only 40 percent of a fund's directors be independent of the adviser that establishes and manages the fund. 15 U.S.C. § 80a-10(a). The legislative history of this provision is plain and undisputed: Congress wanted investors to be able to choose a fund in which the adviser played a leading role. In passing the Act, Congress explicitly considered *and rejected* a requirement that a majority of fund directors be independent. During deliberations, the legislative history shows,

> It was urged 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 . . . . [T]hat is why the provision for 40 percent of independents was inserted.

Hearings on H.R. 10065, at 109-10; *see also* 69 Fed. Reg. 46,378, 46,390 n.7 (Aug. 2, 2004). To be sure, in its decision in *Chamber of Commerce v. SEC*, 412 F.3d 133, 138-40 (D.C. Cir. 2005) ("*Chamber I*"), the court of appeals held that it lay within the Commission's legal authority to—on the basis of proper findings—require a larger role for independent directors in mutual funds wishing to rely on the Commission's exemptive rules. But that *legal* finding does not alter the significant *policy* consideration that, just as the Commission should pause and consider carefully before increasing regulatory costs and constraining market developments, so it should be particularly hesitant to interfere with a decision made by Congress and embodied in the very law the Commission is implementing.[1]

A third point, related to the two above, is that a presumption exists against limiting the investment choices available to the public. Mutual funds are required by law to be structured as entities, but the fact is they are viewed by the public as an investment product. And in the eyes of many, among that product's most important features is the adviser that developed it and is expected to guide its investment performance. However honorable, well-intended, and even knowledgeable independent directors may be, the fact is that for many—perhaps most—investors, it is the management capability and reputation of the adviser and not the leadership of unknown independent directors that is sought when a mutual fund product is purchased. In the words of one commenter in the initial proceeding, "The new rule requiring every Mutual Fund to have an Independent Chairman is wrong in our opinion. If we invest in a Fidelity Fund, which we do, we don't want an outsider Fund manager or non affiliated Fidelity person in charge." Comment of Ron & Nancy Cornell (June 24, 2004). The particular legal construct used by Congress to regulate the mutual fund industry should not cause the Commission to lapse into the error of regulating entities as if they were in essence corporations, when in fact their essence is altogether different.

Fourth and finally, any amendments to the ten exemptive rules that are the subject of this proceeding must, of course, be bottomed on the terms of those rules and the transactions they regulate. This is confirmed in the first decision of the court of appeals regarding this matter,

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[1] To be sure, the Commission already departed from the design of 15 U.S.C. § 80a-10(a) by requiring, in 2000, that a majority of directors be independent of the fund adviser in order for funds to rely on the exemptive rules. It should go without saying, however, that the statutory purpose and design should at the very least remain important considerations for the Commission, particularly in the case of such dramatic change as would be brought about by the two provisions at issue here.

where the court held that the Commission had the authority to adopt the provisions at issue as a prophylactic measure to "prevent future abuses *of exemptive transactions*." *Chamber I*, 412 F.3d at 141 (D.C. Cir. 2005) (emphasis added). It is on this ground that the Commission defended the two provisions in the first legal challenge, and it is on this ground that any amendments should be judged now. This Commission does not have, and the court of appeals did not confer, free-roving authority to regulate the corporate governance of mutual funds. Rather, as a legal matter this proceeding turns in substantial part on the "fit" between the amendments being considered and activities being regulated.[2] We now turn to that issue, for it is plain that no such "fit" exists.

A. The Two Provisions At Issue Cannot Be Justified As Necessary To Prevent Future Abuses In Exemptive Transactions.

An analysis of the existing terms of the ten rules that would be amended in this proceeding illustrates that the independent chair and 75 percent independence requirements are unnecessary to further the purposes of those rules. Rather, quite apart from the inordinate costs that would be imposed by these two provisions—discussed below—the amendments serve no useful purpose in light of the rules' existing terms and the activities the rules regulate.

Two examples will suffice (although the proponents of changing these ten rules have the burden of demonstrating the necessity of amending *each*). First, Exemptive Rule 17g-1(j), 17 C.F.R. § 270.17g-1(j), provides an exemption from Section 17(d) of the Act, 15 U.S.C. § 80a-17(d), for joint insured bonds provided and maintained by a registered management investment company and one or more parties. The exemption depends, among other things, on a majority of independent directors approving the bond at least annually. In light of this longstanding provision that the bond be approved by a majority of the independent directors, an amendment requiring that funds relying on the exemption have an independent chair and 75 percent independent board at all times, and for all purposes, is unnecessary and unjustifiably burdensome. Simply, this is already a decision that independent directors control. Even supposing there were reason to believe there may be future abuses in obtaining joint insured bonds (the rules' proponents have never argued that, nor suggested what form such abuses would take), there is no reason why those hypothetical abuses could not be addressed by, at most, requiring an independent director to chair that portion of the annual meeting where the subject of joint insured bonds will be taken up, and requiring that 75 percent of the directors voting be independent.[3]

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2 *See Radio-Television News Dirs. Ass'n v. FCC*, 184 F.3d 872, 888 (D.C. Cir. 1999) (rejecting a rule where the agency failed to "show[ ] a fit between its policy preferences and the actual . . . market in which the rules operate"); *see also General Electric Co. v. United States Dep't of Commerce*, 128 F.3d 767, 775 (D.C. Cir. 1997) (vacating agency rule and stating agency "fail[s] to exercise reasoned decisionmaking" when it does not explain how a rule interacts with existing provisions of law).

3 In justifying initial adoption of these provisions in 2004, the Adopting Release relied heavily on the asserted importance of the board chair "setting the agenda" for the board. 69 Fed. Reg. at 46383. Yet control of the agenda is not necessary to approving a bond when, under

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Second, Exemptive Rule 15a-4(b)(2), 17 C.F.R. § 270.15a-4, provides exemption from Section 15(a) of the Act, which generally makes it unlawful for a person or entity to serve as an investment adviser without a written contract that is approved by a majority of the fund's outstanding voting securities. 15 U.S.C. § 80a-15(a). Under the Exemptive Rule, an advisory contract not approved by a majority of outstanding voting securities is permitted on an interim basis when, among other things, a majority of independent directors reviews and approves the interim contract. Thus, even assuming there is reason to fear improper interim contracts—a concern for which once again no evidence has been provided—the independent chair and 75 percent independent director requirements are unnecessary in light of the longstanding requirement that any interim advisory contract be approved by a majority of independent directors. Further, agreement to a short-term interim contract does not warrant a prohibition on a fund having a management chair for *all purposes* and on a *long-term* or permanent basis.

The same critique may be made of the eight other rules that would be amended to add the two provisions at issue; it is the burden of the amendments' proponents to explain that under those rules as well, existing protections are deficient.

In sum, and as warned by a drafter of the ICA shortly after it was enacted, "there exists at times a temptation, in granting exemptions, to impose restrictions deemed wise by the agency but not warranted by the terms of the Act." Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 345 (1941). Out of respect for the lawful bounds on its authority, the Commission must fight that impulse, and should only adopt the provisions under consideration if they are necessary to furthering the exemptive rules themselves. And of that, there is no evidence.

B. The Provisions Do Not Accomplish Their Stated Purpose.

When the independent chair requirement and 75 percent independence provision were first adopted, the Commission attempted to justify them as necessary to protect against general misconduct in the management of mutual funds, including late trading, inappropriate market timing, and "misuse of nonpublic information about fund portfolios." 69 Fed. Reg. at 46,378. As just shown—and as ruled by the court of appeals—adoption of the provisions must be bottomed on the need with respect to exemptive transactions themselves. Even supposing, however, that those other objectives previously identified by the Commission were appropriate aims of exemptive rule amendments, there is no persuasive evidence or reason to believe the provisions under consideration would be effective in guarding against the abuses identified. For this reason as well, the provisions should not be adopted.

We are aware of no evidence that the previous scandals in the mutual fund industry had a connection with transactions permitted by the exemptive rules. To use an example above, Exemptive Rule 17g-1(j) authorizes certain joint insured bonds; neither the Commission nor any commenter has shown that the bonds led to market timing or any other of the abuses identified

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the terms of the existing exemptive rule, covered bonds already are required to be considered by the board annually.

by the Commission. In the face of this lack of evidence, the prior Commission contended that although there was no misconduct under the exemptive rules themselves, the fact that boards' current structure failed to stop late trading, etc., indicated that boards were not constituted to prevent misconduct in transactions under the exemptive rules either. That is, late trading was a "signal" that the rules were not adequately drawn to safeguard the exempted transactions.

That logic is flawed, and should be rejected for at least two reasons. First, the rationale of the provisions posits that the exemptive rules failed to address something they *don't* regulate (late trading, etc.), and that this signals their inability to address activities they *do* regulate (the exempted transactions). That is a *non sequitur*, of course. Second, the exemptive rules' failure to prevent late trading, etc., can only signal their inability to prevent abuses in transactions under the rules themselves if, among other things, the two sets of activities are subject to the same constraints. If the rules impose additional constraints on the activities they regulate, then their ineffectiveness as to other activities is a meaningless barometer. And that in fact is the case: For transactions under the exemptive rules, specific approval by a majority of independent directors is required. No such requirement exists for activities related to late-trading, etc. It therefore is illogical to infer that the exemptive rules' failure to prevent late trading signals their inability to prevent something they regulate by *different* and *heightened* means.

Moreover, the justification previously given for the provisions fails because its premise is mistaken *factually*: There simply is no evidence that funds with management chairs, or with fewer than 75 percent independent directors, permitted late-trading or other improper practices at a higher rate than firms with a smaller management role on the board. Accordingly, there is no basis to assume an independent chair, or more independent directors, is the solution to past problems.[4]

In the absence of such a direct correlation, attempts have been made to base the two provisions on the more general claim that directors with a slight attachment to a corporation will serve it better. In fact, however, evidence indicates that directors with a strong attachment are *more* attentive, since their financial welfare depends on it. *See* R. Franklin Balotti, Charles M. Elson & J. Travis Laster, *Equity Ownership And The Duty Of Care: Convergence, Revolution, Or Evolution?*, 55 BUS. LAW. 661, 665-66 (Feb. 2000) (citing evidence that a corporate director with a stake in the company is more vigilant than a director who holds no stock in the company). And with respect to mutual funds particularly, several academic studies—both individually and in combination—demonstrate no correlation between director independence and management fees, fund performance, or late-trading or other misconduct:

- One study used a comprehensive sample of mutual fund families from 2002 to examine whether board and chair independence are related to board effectiveness. Stephen P. Ferris & Xuemin Yan, *Do Independent Directors and Chairmen Really Matter? The*

[4] Indeed, in *Chamber I* the Commission suggested that independent directors were *part of the reason* improper fund practices had occurred. *See Chamber I*, SEC Brief at 24. If inadequate performance by independent directors was part of the problem, it certainly does not follow that having *more* independent directors holds the solution.

Role of Boards of Directors in Mutual Fund Governance (working paper at the University of Missouri-Columbia) (Nov. 2004), *available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract_ id=681526 (last visited July 31, 2006). Referring specifically to the Commission's adoption of the independent chair and 75 percent independent director requirements in the wake of the trading scandals, the study found "no evidence . . . that funds with a higher percentage of independent directors or independent chairmen charge lower fees," or that "the incidence of recent trading scandals is related to board and chair independence." *Id.* (Abstract); *Id.* at 1, 29.[5]

- A second study examined the association between governance characteristics and fund performance. Felix Meshcke, *An Empirical Examination of Mutual Fund Boards* (working paper at University of Minnesota) (Feb. 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=676901 (last visited July 31, 2006). The study found "no evidence that more independent boards are related to lower fees or higher fund performance," and concluded that there is "little impetus for the focus of the current debate on restricting mutual fund board structure." *Id.* at 4; *Id.* (Abstract).

- Another study examined fund flow data from 1994 to 2004 to analyze, among other things, the impact of strengthened corporate governance controls on the amount of outflows from funds involved in scandal. Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandal* (working paper at NYU Center for Law and Economics) (Jan. 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_ id=877896 (last visited July 26, 2006). Specifically, the study "collected data on the boards of the scandal funds for the year of the scandal to see how they correspond with the [then] new SEC rules, *i.e.*, whether they have an independent chairman [] and or a board with the requisite proportion of independent directors." *Id.* at 25. The study found "no statistically significant difference" in outflow between funds with independent versus management-chaired funds and funds with 75 percent independent directors versus those with a lower percentage of independent directors. *Id.* at 25–26. This "result is inconsistent with the hypothesis that stronger corporate governance ameliorates the impact of a scandal," the study noted. *Id.* at 26.

- New research suggests that funds in which managers own a stake often perform better than those with no manager investment. The study, conducted by researchers at the Georgia Institute of Technology and London Business School, determined that funds whose managers were personally invested in them at the end of 2004 delivered an average return of 8.7% the following year, as compared with only a 6.2% average return

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5 *See generally* Peter J. Wallison, Financial Services Outlook: *All the Rage: Will Independent Directors Produce Good Corporate Governance* (AEI, Jan. 2006) ("[M]any years of academic research have provided little empirical support for the idea that independent directors contribute to better corporate governance, and a number of detailed studies have shown either no relationship or a negative relationship between corporate governance performance and the presence of a large percentage of independent directors on corporate boards.").

for funds lacking manager ownership. *See* Eleanor Laise, *Another Way to Assess a Mutual Fund*, WALL ST. J., July 26, 2006, at D1.[6]

These studies confirm that there is no basis in hard data for the supposition that increasing the role of independent directors lowers adviser fees or protects investors. As explained at the outset of these comments, the burden in this proceeding lies with those who would increase regulatory requirements and funds' costs, constrain market forces and investor choice, and upset the balance and opportunity for investors purposely established by Congress when it enacted the ICA. That burden cannot be carried, indeed the weight of the evidence is against it.

C. Intervening Regulations Render The Provisions Unnecessary.

An additional factor militating against adoption of the independent chair and 75 percent independence requirements is other actions by the Commission that have further diminished the asserted need for these "governance" requirements. Together, these other actions have changed the dynamics of fund governance by further empowering independent directors and heightening sensitivities to potential conflicts of interest.

Among other things, the Commission has adopted the Chief Compliance Officer Rule, Rule 38a-1. Rule 38a-1 has increased the information available to independent directors, requiring chief compliance officers to engage in direct reporting on various material items to a fund's board and independent directors. *See* 68 Fed. Reg. 74,714 (Dec. 24, 2003). (In mid-2006, chief compliance officers were set to complete their first annual reports to fund boards.) The interactions among chief compliance officers and independent directors has sensitized independent directors to internal controls and the need to manage conflicts of interest.

Other rules adopted by the Commission include Rule 22c-2, which addresses redemption fees and funds' access to underlying trading activities in omnibus accounts. *See* 70 Fed. Reg. 13,328 (Mar. 18, 2005); 71 Fed. Reg. 11,351 (Mar. 7, 2006). Rule 204A-1 creates an investment adviser code of ethics (*see* 69 Fed. Reg. 41,696 (July 9, 2004), and amendments to Form N-1A require disclosure of funds' policies regarding market timing and selective disclosure of portfolio holdings. *See* 69 Fed. Reg. 22,300 (Apr. 23, 2004). The Commission also has adopted requirements that strengthen significantly the management contract approval and renewal process, including providing that shareholder reports now contain a detailed explanation of the

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6 The Commission previously suggested that "a large majority" of mutual funds—approximately 80 percent—implicated in recent "scandals" have had management chairs. 69 Fed. Reg. at 46,384 n.54. However, as the dissenters to the provisions stated accurately at the time—and which is still true today—"funds with inside chairpersons are proportionally implicated in the abusive activity." *Id.* at 46,391. In any event, the Commission cannot rely on its own (self-selected) enforcement data, as it did during the litigation, to establish relative rates of misconduct without establishing that the two types of funds were sampled at the same rate.

evaluation and decisionmaking by independent directors that led to approval or renewal of the management contract. *See* 69 Fed. Reg. 39,798 (June 30, 2004).

And of course, the majority of provisions in the Commission's governance rule were not challenged by the Chamber in the court of appeals and are now in effect. These requirements include that (i) independent directors meet separately at least quarterly; (ii) fund directors, at least annually, evaluate the performance of the fund and its committees, including the effectiveness of committee structure; and (iii) independent directors have the authority to retain experts and advisers. *See* 69 Fed. Reg. at 46,384-46,385.

In sum, the Commission's response to misconduct in the mutual fund industry was rapid and broad-based. Although the requirements at issue in this proceeding proved difficult to defend on judicial review, the majority of the Commission's important changes remain in place. Those reforms should be given ample time to work before the agency attempts to re-impose the controversial, and costly, requirements at issue here.

II. The Provisions Impose Significant Costs On Mutual Funds That Must Be Assessed Fully By The Commission.

The Commission is obliged to adequately assess and weigh the costs of the two provisions before they may be adopted. When it does, we are confident it will conclude that the provisions' speculative benefits do not justify the costs that ultimately will be borne by shareholders.

A. Direct Costs.

Even in its rush to re-adopt the provisions after their initial invalidation by the court of appeals, the prior Commission acknowledged numerous, significant out-of-pocket costs associated with the two provisions. Each fund board forced to replace its current chair with one who is independent, the Commission estimated, could experience costs of approximately $400,000. *See* 70 Fed. Reg. at 39,390, 39,394-39,395 (July 7, 2005) (estimating per board: $314,639 for additional staff (each year), $66,900 for increased compensation (each year), and $15,000 for outside legal counsel (each year)).[7] According to the Commission's calculations at that time (*id.* at 39,404), complying with the 75 percent independence requirement could cost the same board as much as an additional $650,000, for a total of nearly $1 million in the first year. *See id.* at 39,391-39,394 (estimating per board: $111,500 for recruiting each of the three new independent directors (every 5 years), $111,500 for compensating each of the independent directors (each year), $9,000 for outside legal counsel (each year)). Over 5 years, a board could spend approximately $4 million to comply with the two provisions, according to the Commission's own earlier estimates. Moreover, during the second litigation, the Commission

[7] Cost of independent chair provision over 5 years: ($314,639 (staff) + $66,900 (increased compensation) + $15,000 (legal counsel)) x 5 = $1,907,770; Cost of 75 percent independent director provision over 5 years: $334,500 (recruiting) + (($334,500 (compensation) + 9,000 (legal counsel)) x 5) = $2,052,000.

placed heavy reliance on an August 2005 study by the Mutual Fund Directors Forum. *See* http://www.sec. gov/news/press/ 2004-101.htm (last visited Nov. 2, 2005). That study in fact suggests that the costs to some funds would be severe. For example, respondents to the study identified increased compensation costs of up to $500,000, and one group reported over $500,000 of recurring legal fees.

The estimated costs of the two provisions are likely only to increase as the Commission conducts the more rigorous examination ordered by the court of appeals. (Ultimately it is the Commission's obligation—not commenters'—to calculate reliable cost estimates for the regulations that it proposes.) Further, the Commission must consider the wisdom of this sizable financial burden in light of the specific mutual fund activities being regulated and the potential misconduct to be averted. The activities regulated by the exemptive rules are typically discrete, non-controversial acts that are performed infrequently and have not been the subject of significant enforcement activity. For example, and as discussed above, the Commission is considering amending Exemptive Rule 17g-1(j), which permits a fund to maintain a joint insured bond with a management investment company and one or more parties. 17 C.F.R. § 270.17g-1(j). This act is typically performed just once a year, and under the existing rule already requires approval by a majority of the board's independent directors. Proponents of the independent chair and 75 percent independence requirements have never explained why this often once-a-year activity threatens losses to investors that warrant incurring costs that could approach $1 million. Similarly, there has yet to be meaningful discussion by the amendments' proponents of Exemptive Rule 17d-1(d)(7), which permits a fund and its affiliates to purchase joint liability insurance. 17 C.F.R. § 270.17d-1(d)(7). For these rules—and the eight others the Commission has considered amending—a final rule would require addressing whether, and how, misconduct in the activities to be regulated is expected to cause investor losses that, discounted for risk, exceed the $1 million it could take to comply. That is not likely to be the case. But if it is to take action, the Commission must consider these probabilities, assess them in view of the heavy burden the provisions' proponents must carry, and address the questions necessary to determine whether the provisions' costs are warranted by their uncertain benefit. For example, what is the likelihood under the existing rules that a majority of independent directors will permit an improvident joint insured bond or improper joint liability insurance? If that occurred, what would be the cost to shareholders? How does that cost—discounted by risk—compare to the $1 million in administrative costs potentially imposed by the two new requirements? Is it in fact possible that, for these and other exemptive rules, the Commission's "solution" will cost more in dollars than the (supposed) exemptive rule problem being addressed? And how do these costs and benefits compare to alternatives that could be adopted instead, including the disclosure requirement discussed below or simply requiring an independent chair and 75 percent independent directors when authorizing the specific transactions regulated by the exemptive rules? These are fundamental questions that suggest the provisions under consideration would cost investors far more than they can expect to gain.[8]

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[8] The Commission has suggested at times that independent directors cannot be expected to speak up and take positions contrary to management unless they are greatly superior in number and hold the chairmanship of the board. That is a highly speculative argument and

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B. Informational And Experiential Costs.

In addition to direct monetary costs, the provisions will impose informational and experiential costs as independent directors replace management directors. A management director often has expertise, experience, and knowledge that an independent director lacks. Further, the pool of disinterested individuals qualified to be directors is limited, so the Commission would be increasing the likelihood that funds hire individuals with less or no experience in the industry. (Alternatively, a fund might reduce board size to achieve the necessary proportion, thereby departing from what had been determined to be the optimal board size.) Plainly, someone with less experience and expertise would have a harder time performing the role of fund director.[9]

The provisions' informational and experiential costs become clear when the functions of a fund board are considered. "[I]ndependent directors must pass judgment on a variety of legally complex, controversial practices—their jobs, if taken seriously, are extremely difficult." Stephen Tate, *The Role of Independent Directors In Mutual Fund Governance* (April 26, 2000) (unpublished), *available at* http://cyber.law.harvard.edu/rfi/papers/Role.PDF (last visited August 4, 2006). Fund directors are responsible for many actions that affect fund performance, including approving trading practices and fund expenses and electing officers. Further, a board engages each year in a detailed review of fund practices in deciding whether to retain the current

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should be buttressed by more than unsubstantiated assertion before it is made a building block of onerous regulatory requirements.

9 The Commission itself has recognized the extensive education that would be necessary for independent directors to effectively perform their jobs. *See* http://www.sec.gov/news/studies/feestudy.htm#item18 (last visited August 7, 2006) ("[Independent] [f]und directors also can strengthen their hand by educating themselves about issues concerning mutual fund fees and expenses. In particular, we recommend that fund directors focus further on the costs of providing investment management services and, in particular, on whether the funds that they oversee experience any economies of scale. . . . Conclusions as to why economies of scale would be experienced in this way, however, cannot be drawn without knowing what the costs of supplying particular services were to the investment advisory firms.") ("[F]und directors can use this information to evaluate whether the funds that they oversee are experiencing any economies of scale and to assist them in ensuring that fund shareholders share in the benefits of any reduced costs. Whether increases in assets of a fund or fund family produce economies of scale is a factor that may influence fund directors' views on, among other things, the amount of fees that the fund should pay for advisory and other services and whether a rule 12b-1 plan for the fund is appropriate.") ("[F]und directors would benefit from learning about the types of information that they can review when making their decisions, including information that would enable them to determine whether their funds are experiencing any economies of scale. We believe that fund directors also would benefit from knowing about other sources of data and information that would enable them to compare the costs of investment management of the funds that they oversee with those of other funds.").

adviser, examining each of the funds in the family and how they compare to industry averages. The ability to determine if an investment compares favorably to others in the same class managed by other funds, or if an investment adheres to an investing strategy, requires genuine knowledge of the industry. If, due to a lack of knowledge or experience, an independent director does not recognize the value or appropriateness of certain trading practices, or the value of certain expensive assets (for instance, hiring a highly qualified fund manager), it is more likely that a decision by a board member would compromise the performance of the fund.

III. The Provisions Would Have A Significant Adverse Effect On Efficiency, Competition, And Capital Formation.

The Commission is required by law to consider the effects the independent chair and 75 percent independence requirements would have on efficiency, competition, and capital formation. 15 U.S.C. § 80a-2(c). In analyzing these effects, the Commission must consider not only direct costs, but also non-monetary factors such as loss of investor choice and the innovation that results from increased competition. *See* Peter J. Wallison, Financial Services Outlook: *Buried Treasure: A Court Rediscovers A Congressional Mandate The SEC Has Ignored* (AEI, Oct. 2005). A thorough examination of these factors will further demonstrate that the adverse effects of the two provisions greatly outweigh their quite speculative benefits.

As an initial matter, if it goes forward with this proceeding the Commission must analyze the provisions' effects on the efficiency and competitiveness of smaller funds and new entrants in the market, and whether stifling smaller funds and new entrants would reduce competition and capital formation in the industry as a whole. There is ample evidence these would indeed be the consequences. The costs of implementing and complying with the provisions are likely to be particularly great for smaller fund "families," in part because these complexes have fewer funds over which to spread the costs. (A single board often oversees multiple funds within one family.) Indeed, the Commission already has acknowledged that the cost burden for smaller funds is potentially greater. *See, e.g.*, 70 Fed. Reg. at 39,393, 39,395 (small fund families are able to spread board costs over fewer funds). *And see* Amanda Gerut, *Small Fund Boards Struggle to Comply with 75% Provision*, BOARDIQ, July 12, 2005 (because of fewer resources, smaller funds will have a difficult time recruiting experienced individuals to serve as independent directors). Commenters repeatedly have voiced concerns with the consequent effects for small funds and the industry as a whole. "We fear the regulatory burden will be much more intense and time consuming for smaller firms . . . .," one commenter stated. "*Industry consolidation and a reduction in investor choice are likely to be fall-outs of this destabilizing cost-structure* increase across the industry." Comments of Scott L. Barbee (May 12, 2004) (emphasis added); *see also* Comments of Joseph Harroz, Jr. (Apr. 2, 2004) (warning of ill effects for smaller funds).

The available data confirms these concerns. Changes in the financial performance of mutual funds are commonly expressed in "basis points," with each point equaling one hundredth of a percent, or 0.0001. (One hundred basis points thus equals one percent.) Generally, a change in yield of less than one percent can be significant for investment decisions. A profile of mutual fund families by the Investment Company Institute shows that as of June 2005, 47 fund complexes (out of a total of 360) had assets under management of less than $50 million. (The list is available to members at http://members.ici.org/.) If each of these 47 funds is assumed to have a single board of directors and the Commission's estimated incremental costs per board are applied, the average fund in this group would experience increased expenses of at least 83 basis points per year—and a corresponding decrease in performance. (This estimate assumes the hiring of three new board members, which the Commission estimates would cost approximately $415,000 annually, or .83% of $50 million.)[10] The effect would be even more severe for the 14 fund complexes with assets under management of less than $10 million—for these, the change in costs would be at least 4 percentage points, or 400 basis points per year. To put this in perspective, the average total expense ratio for equity mutual funds is approximately 1.1 percent when weighted by assets. Thus, for the 47 funds with less than $50 million in assets, these expenses would represent a more than 75 percent increase in the total expense ratio (calculated by dividing total expenses by total assets under management).[11]

Effects of this magnitude should be expected to have devastating consequences. And indeed, a study from 2005 reports that by September of that year 250 smaller mutual funds had liquidated, compared with 69 smaller fund liquidations for all of 2004. The study attributes these liquidations not to past performance difficulties or enforcement actions, but to the provisions under challenge here. The costs "of maintaining an independent board, including an independent chair person" have been too much for smaller funds, it was reported. *See* Herbert Lash, *Over 250 Mutual Funds Liquidate, Cite Rule Costs*, REUTERS, Sept. 14, 2005. These effects should come as no surprise—the independent chair and 75 percent independence requirements "treat[ ] mutual funds as companies when the economic reality is that they are products," Harvey Pitt, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15, so that, for example, funds that previously had no staff would now hire as many as two full-time personnel. *See* 70 Fed. Reg. at 39,394. Becoming an employer is a serious undertaking for any enterprise—let alone a smaller enterprise—and warrants the Commission's careful attention, particularly given its earlier acknowledgment that excessive costs on smaller funds could destabilize competition in the industry as a whole. *See Chamber II*, SEC Brief at 59.

The provisions' disproportionate effect on smaller funds will also translate to higher costs for new entrants to the mutual fund industry, since new fund complexes typically start out with smaller funds. (Analysis of market entry is, of course, fundamental to determining the competitive consequences of changes in market conditions. For an example of the sophisticated examination the Commission should conduct of effects of reduced entry on competition and capital formation before it were to adopt any regulation, see the guidelines used by two other

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[10] According to prior Commission estimates, the addition of three independent directors would cost smaller fund families approximately $65,000 in additional annual expenses (including legal and recruiting costs) per board. Further, an independent chair of a small fund family (7 to 19 funds) would need legal, analyst, and administrative services which cost approximately $350,000 per year according to Commission estimates, for total incremental annual costs of $415,000 per board. Note that this is lower than the $1 million cited above, which would apply to larger fund families.

[11] *See* http://www.vanguard.com/ bogle_site/sp20050524.htm, at n.2 (last visited July 25, 2006).

federal agencies to analyze mergers. Horizontal Merger Guidelines, pt. 1.0, U.S. Dep't of Justice and Federal Trade Comm'n, http://www.usdoj.gov/atr/public/guidelines/horiz_ book/10.html (last visited July 25, 2006).) Beyond the effect on small funds, a potentially even more important disincentive for new entrants will be advisers' loss of the ability to direct the entities that *they* establish through their own investment of human and financial capital. Mutual fund advisers "organize[ ]" and "provide seed money for" mutual funds. *Chamber I*, SEC Brief at 18-19. By purposely severing advisers from the vehicles they create, the two provisions must be expected to decrease entrepreneurs' incentive to start mutual funds in the first place. The implications for competition and capital formation are plain, and must thoroughly be addressed by the Commission before the provisions could be readopted.[12]

Given the effects the provisions would have on small funds and new entrants, it would be incumbent on the Commission to assess the implications for competition in the industry as a whole before it could adopt the provisions. Several studies establish grounds for concern. First is a study showing that funds with fees that are significantly below average tend to have larger market shares, whereas funds with higher-than-average fees—which typically are smaller funds—tend to have lower market shares.[13] In addition, the study found, when funds with higher-than-average fees increase fees further, their likelihood of asset growth is reduced. This is further evidence that the provisions' incremental board costs are likely to disproportionately affect smaller funds and smaller fund families, causing the funds to stagnate, lose assets, or merge out of existence.[14]

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[12] Commenters have previously warned of these effects. "[I]f this proposal is adopted," one commenter stated, "the mutual fund industry will suffer from a decrease in entrepreneurs willing to put their time, effort and money behind innovation of new worthwhile fund products." Comments of Lacy B. Herrmann (May 11, 2004).

In the past, the Commission has failed to consider the provisions' effects on investor returns and, in turn, what impact that would have on investment decisions, including the decision to seek alternatives to mutual funds. These factors plainly should be considered when analyzing effects on capital formation and competition.

[13] Ajay Khorana & Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* (July 2004) (unpublished), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 240596 (last visited July 27, 2006).

[14] Studies demonstrating that funds with higher fees are more likely to experience capital outflow or even cease to exist include: Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 JOURNAL OF FINANCE 1589-1622 (October 1998); Vikram Nanda, Z. Jay Wang & Lu Zheng, *Family Values and the Star Phenomenon: Strategies of Mutual Fund Complexes*, 17 REVIEW OF FINANCIAL STUDIES 667-98 (2004); Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 JOURNAL OF BUSINESS 2095-2121 (Nov. 2005); Steven J. Brown & William N. Goetzmann, *Performance Persistence*, JOURNAL OF FINANCE (1995), Richard A. Ippolito,

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Second, a study comparing the mutual fund industries in the United States and Europe tied the relative efficiency of the U.S. market to its relatively lower level of concentration: In the U.S. market, smaller funds still account for a significant portion of assets under management, whereas the less efficient European markets—despite a large total number of small funds—are dominated by a relative handful of larger funds.[15] As shown above, the new provisions will erode this strength of the U.S. market.

Third, another recent study examined relative fund "persistence" in UK markets, that is, the duration of above-average returns for specific funds, which the study identified as a potential indicator of a less competitive market. This "persistence" is positively correlated with concentration among UK mutual funds, the study found, further suggesting the competitive value of smaller mutual funds in a vibrant market.[16]

Together, these studies suggest that small funds are vital to mutual fund competition, and that the provisions' potentially staggering effects on small funds bear serious implications for the industry—and, more importantly, for the investing public. Effects of this nature are not mere academic minutiae. Instead, for the nation's principal regulator of financial markets, such factors should be central considerations in discharging a statutory mandate to consider the consequences of government action for efficiency, competition, and capital formation.

IV. Benefits Of Management Chairs And Investor Choice.

In addition to the costs the provisions would impose on mutual funds and their shareholders, management chairs provide benefits that the provisions would eliminate. The Commission's adoption of regulation that places more authority with independent directors reflects a number of "[r]ecent reform efforts that place a relentless emphasis" on director independence. *See* John F. Olson & Michael T. Adams, *Composing A Balanced And Effective Board To Meet New Governance Mandates*, 59 BUS. LAW. 421, 422, 431 (Feb. 2004). That emphasis is often misplaced, however, as management directors have a more extensive understanding of a company and its business and—many authorities believe—are better suited to engage in honest dialogue and provide constructive criticism. *See id.* at 422, 430-31, 445-47.

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Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry, 35 JOURNAL OF LAW AND ECONOMICS 45-70 (1992); Jennifer N. Carpenter & Anthony W. Lynch, *Survivorship Bias and Attrition Effects in Measures of Performance Persistence*, 54 JOURNAL OF FINANCIAL ECONOMICS 337-74 (1999); and Edwin J. Elton, Martin J. Gruber & Christopher R. Blake, *Survivorship Bias and Mutual Fund Performance*, 9 REVIEW OF FINANCIAL STUDIES 1097-1120 (1996).

[15] Rogér Otten & Mark Schweitzer, *A Comparison Between the European and the U.S. Mutual Fund Industry*, 28 MANAGERIAL FINANCE 14, 21 (2002).

[16] Aneel Keswani & David Stolin, *Mutual Fund Performance Persistence and Competition: A Cross-Sector Analysis*, 29 JOURNAL OF FINANCIAL RESEARCH 349-66 (2006).

At least one study indicates that management-chaired funds deliver important benefits to investors. During the initial comment period on the independent chair and 75 percent independence requirements, a 20-page empirical study was submitted that compared the performance of mutual funds that have independent chairs to the performance of mutual funds with management chairs. Management-chaired funds were found to have superior performance:

> *On each of several historical performance measures, independent chair funds have not performed as well as those having management chairs.* For example, using Morningstar's fund rankings within style-based peer groups, independent chair funds on average rank in the 53rd percentile (100=best) over the past three years, while management chair funds on average rank in the 58th percentile. Over ten years the ranking difference is more pronounced, with the independent chair funds averaging in the 48th percentile versus the 59th percentile for the management chair funds. *For these and other performance comparisons included in this study, the differences were statistically significant.*

Geoffrey H. Bobroff & Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*, Mar. 10, 2004, at 9, *available at* http://www.sec.gov/rules/proposed/s70304/fidelity031004.htm ("Bobroff Study") (emphases added) (last visited July 31, 2006).

The Commission should undertake a serious review of the Bobroff Study. During the first proceeding, the study was effectively ignored because, the Commission stated, there are other, "more general[ ]" benefits associated with independent chairs. 69 Fed. Reg. at 46,384. (The foregoing discussion has shown those benefits to be entirely illusory.) As to the findings of the 20-page study, they were dismissed in a brief footnote in which the Commission said that other commenters viewed the study's data differently than the study's authors—the Commission did not undertake to determine which commenters had the better view of the data. *Id.* at 46,383 n.52.

These earlier criticisms of the Bobroff Study are unpersuasive. The prior Commission discounted the study because at one point the study's authors noted that the strong performance of management-chaired funds could be due to other "important differences" besides the identity of the chair. *Id.* The Commission neglected to mention that the authors then proceeded to consider what other explanatory factors might exist, and identified none. Further, one of the two comments cited by the Commission to dismiss the Bobroff Study reached different results partly by declining to classify the Vanguard funds as management-chaired funds, even though Vanguard's management model indisputably includes an interested chairman. *Id.* (citing Remarks by John C. Bogle (May 5, 2004)). This comment also created a separate category for "bank-managed funds with an independent chairman," but the Bobroff Study itself had accounted for differences between these funds and other independent-chaired funds. The other comment cited by the Commission suggested that the Bobroff Study's results were statistically flawed because "less than 1% of funds have independent chairs." *Id.* (citing Letter from John A. Hill to William H. Donaldson (May 12, 2004)). But the Commission's own data at the time indicated that approximately 20 percent of funds had independent chairs, and 14 of the 57 mutual fund families reviewed in the Bobroff Study were chaired by independent directors. *See* Chamber I, Chamber Reply Br. at 23-24 n.8.

The Bobroff Study presents empirical evidence that there are benefits associated with management chairs and that management-chaired funds outperform independent chaired funds. The Commission should seriously consider this study and the other studies that bear on the important question of the benefits associated with management-chaired funds. In full, it is plain that the existing literature does not establish that the benefits of independent chairs and directors are so great that what currently is the dominant governance model in the industry—and what for many investors is a preferred investment product—should effectively and permanently be removed from the market by government intervention.

V. The Disclosure Alternative.

If the Commission were to adopt any amendments to the exemptive rules—and the Chamber believes *no* amendments are necessary—then it should adopt the so-called "disclosure alternative" under which "each fund [would] be required prominently to disclose whether it has an inside or an independent chairman and thereby allow investors to make an informed choice." *Chamber I*, 412 F.3d at 144.

The Commission's previous rejection of this disclosure alternative was flawed. First, the Commission majority at the time asserted that disclosure would be insufficient to address the conflicts governed by the exemptive rules, but failed actually to analyze disclosure in light of those rules. For example, the Commission failed to analyze whether if the disclosure alternative were adopted there would remain risks with joint insured bonds, which already require action by an independent director majority and are typically voted on only once a year. The Commission placed great weight on the "dialogue" an independent chair would promote, but surely the purchase of a joint bond once a year, for instance, is not such a momentous matter that it warrants establishing a new, perennial bureaucracy for the other 364 days on the calendar. Second, the Commission failed to consider the effectiveness of the disclosure alternative in combination with other mutual fund changes, including the 75 percent independence requirement. The Commission had not, it claimed, "adopt[ed] the independent chairman provision in isolation," but rather "as part of a larger package of regulatory reforms." 70 Fed. Reg. at 39,397. Yet it failed to appraise the disclosure requirement as part of that same, larger package. Finally, the Commission gave no consideration at all to the public's interest in having management-chaired funds, an interest that the disclosure provision preserves but that the provisions effectively preclude.

Plainly, the Commission's prior consideration of the disclosure alternative "cannot be said to embody the expertise and best judgment of the Commission." 70 Fed. Reg. at 39,407-39,408. If the Commission still believes that any added regulation is necessary, it should adopt the disclosure alternative exclusively. The disclosure alternative empowers rather than limits investors, while avoiding harmful, costly, and intrusive regulation.

CONCLUSION

The two provisions at issue here depart from Congress's design in crafting the Investment Company Act, which purposely permitted management directors to play a dominant role on fund boards. There is no evidence that market timing or late trading was attributable to management-dominated boards, or that imposing independent-led boards would avert these or other abuses.

Since the Commission first initiated this proceeding, moreover, there have been other, more solidly-grounded regulatory changes that should be given time to work. The two provisions at issue here, for their part, will produce more costs than benefits for mutual funds and their investors, and will have serious effects on efficiency, competition, and capital formation in the industry as a whole. In short, after nearly three years of advocacy, the proponents of the provisions remain unable to carry their burden to justify a costly interference with free markets that conflicts with Congress's design and deprives the investing public of a choice that many consider preferable.

For all of the reasons above, the Chamber urges the Commission to close the rulemaking record without adopting any further regulatory requirements. If a new requirement is to be adopted, the Chamber urges that the disclosure alternative be adopted exclusively.

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