CHARLES W. LUTTER, JR.
Attorney and Counselor at Law
103 Canyon Oaks
San Antonio, Texas 78232
(210) 496-5438

August 11, 2006

Submitted via E-Mail
rule-comments@sec.gov

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

Re: Comments on Investment Company Governance Proposed Rules
File No. S7-03-04

Dear Ms. Morris:

I am an attorney with more than 30 years of investment company and investment adviser experience. A significant portion of my time is devoted to acting as counsel to disinterested directors (or trustees) of investment companies.

Recently, after receipt of a request from the Independent Directors Council ("IDC") concerning the Securities and Exchange Commission's (the "SEC's") request for comments on proposed corporate governance rules, the lead independent trustee of one of my clients requested input from other trustees and counsel in order to formulate the fund's response. The following memorandum was prepared for the trustees' use in response to that request. The memorandum has been provided to other clients for their use.

I am forwarding a copy of the memorandum as my comments on the investment company governance rule proposals. If you have questions or comments, contact me at any time.

Sincerely'

/S/

Charles W. Lutter, Jr.

_______ Funds
Comments for Trustees

My Views

This brief memorandum is in response to your request for my views in connection with your consideration of providing feedback to the IDC on the SEC's request for comments on proposed corporate governance rules.

First, it is always good to provide regulators with feedback on proposed regulations.

Second, on the specific proposals, you need to focus on whether they are necessary to accomplish some goal. The SEC' June 13, 2006 Release refers the reader back to the July 27, 2004 Adopting Release [IC-26520] for its reasons [goals to be accomplished] in adopting the independent chairman and 75% disinterested – that is, independent director provisions. Here is the "Summary" from the 2004 release.

> **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.*

(Emphasis Supplied)

Third, when you consider my views on the proposed rules, keep in mind that the board you currently serve on does not have an independent trustee as chairman, but it satisfies the 75% test. In addition, *in lieu* of an independent chairman, there is a designated "lead independent trustee." It has been my practice (even before the SEC's 2001 corporate governance initiative) to have a majority of the board independent, to have a lead independent trustee, and to have only independent trustees on the audit committee. This structure has provided independent trustees with majority vote on all matters considered by the board, not just the matters where the Investment Company Act gives them veto power.

Fourth, when you consider my views on the proposed rules, keep in mind that the independent directors (or trustees) are vested with veto power over key contracts by various provisions of the Investment Company Act, and veto power over adoption of procedures and plans designed to allow the funds to qualify under exemptive rules adopted by the SEC. Moreover, with respect to the exemptive rules, amendments adopted by the SEC on January 2, 2001, added a condition to relying on the rules requiring that a majority of the directors be independent [using words such as, "A majority of the directors of the investment company are not interested persons of the

company, and those directors select and nominate any other disinterested directors of the company."]. These 2001 provisions were being replaced by Rule 0-1(a)(7) in 2005.

Fifth, here are my views. **First,** the change from requiring that a majority of the board be independent to requiring that 75% of the board be independent would not necessarily *enhance the independence and effectiveness of fund boards and improve their ability to protect the interests of the funds and fund shareholders they serve*. Independence is a question of fact. It is the individual integrity and intelligence of the director that is important. Adding more warm bodies just means there are more individuals to look at when assessing independence. The 2004 adopting release includes the following.

> 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.

(Emphasis Supplied) Based on the highlighted wording, it appears that the SEC is concerned that many boards are "rubber stamps." I do not see how changing from a majority to 75% will change this. The regulatory mechanisms are in place to assess the independence of directors and to bring enforcement actions if independence is not found. Moreover, in 2001 the SEC added Rule 0-1(a)(6), the requirement that there be an "independent counsel" for the independent directors as a condition to relying on exemptive rules. If such counsel believes the board is a "rubber stamp" dominated by management, counsel has a legal/ethical obligation to inform his client and to withdraw from representation if the situation is not fixed. I think the mechanisms are already in place to address the SEC's concerns.

Fifth, here are my views. **Second**, I do not think it makes much difference who has the title "Chairman of the Board." Under state law the conduct of board meetings is the bailiwick of the directors. The majority decides how meetings are to be conducted and what is to be considered. A chairman is only one of many directors and has a duty to follow board decisions. It is troublesome to think that a chairman controls the agenda. All directors need to consider the agenda. Here is our practice. Once an agenda is drafted, it is customary for the Secretary to distribute a notice of the meeting, the proposed agenda, and a request for comments/suggestions. It is the time for suggesting agenda items and requesting data necessary to properly address the agenda items. Independent counsel is customarily involved with meeting preparations. At the meeting, the agenda is typically the road map for the discussion. Independent counsel is generally

present and is used to make sure legal requirements are properly articulated and critical factors are considered during the meeting. It is rare to find boards where discussion is strictly controlled and someone asserts Roberts Rules of Order; and, if you find such an environment, there are issues under the surface that need to be resolved. My only experience with strictly controlled discussion has been with a fund group where the chairman of the board is an independent trustee; where the time required from independent counsel to provide guidance to the independent chairman has been significant; and where there have been issues. The 2004 adopting release includes the following paragraphs on the independent chairman rule.

> 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.* 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. *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, *when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser.*
>
> 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. *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. 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.*

(Emphasis Supplied, Footnotes Omitted) Based on the highlighted wording, it appears that the SEC's decision to mandate an independent chairman is based on its 2004 enforcement activity evidencing *conflicts of interest inherent in the role of an executive of the fund adviser*. This sounds like a "knee jerk" reaction to the enforcement matters. The enforcement problems encountered by the SEC involved fraud and egregious breaches of fiduciary duty – greedy fund managers. Requiring an independent chairman will not prevent fraud. It will not facilitate the detection of fraud. The key in this area is a strong compliance program with direct reports to the board of directors.

My Experience

My experience with investment companies began in 1976 when I joined the SEC's staff in the Atlanta Regional Office. Between 1976 and 1983 I participated in and/or supervised examinations of investment companies. In 1976 we were instructed to focus on the corporate governance matters to make sure the investment companies' boards of directors were not "rubber stamps" for management. At no time in the past 30 years have I heard that the SEC's staff has been told not to focus on governance matters.

As part of the 1976 instruction to focus on corporate governance, upon examination we made sure that the directors were properly qualified and selected/elected; that the required number of disinterested – that is "independent," directors were present at meetings; that the directors – including, in particular, the independent directors, fully considered/discussed issues that required their vote and separate vote; and that there was a separate vote of the independent directors on issues requiring a separate vote (*e.g.*, continuation of advisory, distribution and related party agreements, auditor selection, joint fidelity and E&O/D&O insurance arrangements, procedures for inter-fund transactions, and distribution and expense allocation plans under Rules 12b-1 and 18f-3). As a SEC examiner I knew (and as an attorney providing legal services to investment companies I know) that the independent directors have **veto power** on each of the issues requiring a separate vote; and that it was my job to assess whether they exercised that power to protect fund shareholders.

It has been my experience (and my legal advice) that independent directors understand the power they hold over investment company service providers; and that the independent directors use that power diplomatically to make sure that they have the information necessary to make informed decisions on matters submitted for consideration – all matters, not just the matters calling for a separate vote. It has also been my experience that open and candid dialogue between directors, management and counsel (and accountants) has facilitated the directors' requests for and consideration of information.

In light of my 30 years experience with investment company regulation – including, in particular the role of the board of directors (or trustees), I do not think the proposed independent chairman or 75% rules are necessary.

Statute and Regulations

The SEC is not attempting to change the Investment Company Act of 1940. It is seeking input on two parts of Rule 0-1(a)(7) that were challenged after adoption. Its request for comment relates to the highlighted provisions of Rule 0-1(a)(7) set forth below and to costs related to implementing the proposed rules.

> (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.

The proposed rules need to be considered in light of the regulatory scheme established by the **Investment Company Act of 1940** (the "Act"). Section 10(a) reads:

> No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

Section 15(a)(2) and (b)(2) of the Act provide that investment advisory agreements and principal underwriter agreements, respectively, "Shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors…" Section 15(c) of the Act makes it unlawful "to enter into, renew, or perform any" investment advisory or principal underwriter agreement

> …unless the terms of such contract or agreement and any renewal thereof have been approved by vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval.

This is clear veto power vested in the independent directors. Similarly, Section 31 of the Act [or Section 32, depending on which version you use] vests the independent directors with the power to select the fund's independent public accountant.

Regulations adopted pursuant to the Act also provide the independent directors with veto power. Here are some examples.

Rule 12b-1

(b)(2) Such plan, together with any related agreements, has been approved by a vote of the board of directors of such company, and of the directors who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan, cast in person at a meeting called for the purpose of voting on such plan or agreements;

(3) Such plan or agreement provides, in substance:

(i) That it shall continue in effect for a period of more than one year from the date of its execution or adoption only so long as such continuance is specifically approved at least annually in the manner described in paragraph (b)(2) of this section;

(ii) That any person authorized to direct the disposition of monies paid or payable by such company pursuant to the plan or any related agreement shall provide to the company's board of directors, and the directors shall review, at least quarterly, a written report of the amounts so expended and the purposes for which such expenditures were made; and

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(d) In considering whether a registered open-end management investment company should implement or continue a plan in reliance on paragraph (b) of this section, the directors of such company shall have a duty to request and evaluate, and any person who is a party to any agreement with such company relating to such plan shall have a duty to furnish, such information as may reasonably be necessary to an informed determination of whether such plan should be implemented or continued; in fulfilling their duties under this paragraph the directors should consider and give appropriate weight to all pertinent factors, and minutes describing the factors considered and the basis for the decision to use company assets for distribution must be made and preserved in accordance with paragraph (f) of this section;

(e) A registered open-end management investment company may implement or continue a plan pursuant to paragraph (b) of this section only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties under state law and under sections 36(a) and (b) (15 U.S.C. 80a–35 (a) and (b)) of the Act, that there is a reasonable likelihood that the plan will benefit the company and its shareholders;

Rule 17d-1(d)(7)

(7) Any arrangement regarding liability insurance policies (other than a bond required pursuant to rule 17g–1 (§270.17g–1) under the Act); *Provided,* That

(i) The investment company's participation in the joint liability insurance policy is in the best interests of the investment company;

(ii) The proposed premium for the joint liability insurance policy to be allocated to the investment company, based upon its proportionate share of the sum of the premiums that would have been paid if such insurance coverage were purchased separately by the insured parties, is fair and reasonable to the investment company;

(iii) The joint liability insurance policy does not exclude coverage for bona fide claims made against any director who is not an interested person of the investment company, or against the investment company if it is a co-defendant in the claim with the disinterested director, by another person insured under the joint liability insurance policy;

(iv) The board of directors of the investment company, including a majority of the directors who are not interested persons with respect thereto, determine no less frequently than annually that the standards described in paragraphs (d)(7)(i) and (ii) of this section have been satisfied; and

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