STATE BOARD OF ADMINISTRATION OF FLORIDA

1801 HERMITAGE BOULEVARD
TALLAHASSEE, FLORIDA 32308
(850) 488-4406

POST OFFICE BOX 13300
32317-3300

VIA EMAIL: rule-comments@sec.gov

August 21, 2006

Ms. Nancy M. Morris
Secretary
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Investment Company Governance – File Number S7-03-04

Dear Ms. Morris:

I am writing on behalf of the State Board of Administration (SBA) of Florida to provide comment on the proposal to require an independent chair and a supermajority proportion of independent directors for mutual fund boards of trustees. The SBA believes the proposed amendment to the rules represents an important step toward ensuring better corporate governance for investment companies and that the independence provisions will enhance the ability of boards to monitor fund operations on behalf of fund investors. Like shareholders of publicly-held corporations, shareholders of mutual funds are allowed a voice in their funds' governance. Voting the SBA's mutual fund proxies is an integral component of the SBA's corporate governance program.

The SBA manages the Florida Retirement System (FRS), the fourth largest public pension system in the United States, with approximately 920,000 beneficiaries and retirees and assets totaling approximately $120 billion. The defined contribution component of the FRS, the Investment Plan, includes 18 investment options (10 options represented by mutual funds) on behalf of more than 75,000 participants with total plan assets over $2.3 billion.

SBA Supports the Proposed Rules Intended to Protect Funds and Fund Shareowners

The framework for director oversight, as with any governance mechanism, needs to be reexamined periodically. On June 29, 2005, following a legal challenge by the U.S. Chamber of Commerce, the SEC re-approved a significant set of governance rules covering the mutual fund industry. The proposed rules would require that mutual funds' boards (or board of trustees if the fund is organized as a trust) consist of at least a 75 percent supermajority of independent directors, as well as identify an independent chairperson of the board. Under the proposal, the independent chairperson would be unaffiliated with any company managing the fund's portfolio to avoid potential conflicts of interest. According to the Investment Company Institute (ICI), 78 percent of fund directors are independent and 43 percent of funds indicate having an independent chair. Other empirical data indicate a clear trend of increasing independence levels among mutual fund boards as well as the selection of independent chairpersons.[1]

[1] "2006 Survey of Mutual Fund Directors", Management Practice, Inc. (a mutual fund board consultancy). Survey indicated that approximately 80 percent of fund directors are independent and 89 percent of funds comply with a 75 percent super-majority independence requirement. Survey also finds that independent chairpersons were in place at 50 percent of funds, which represents an increase of 8 percent over last year's 42 percent classification.

<u>The Need for Independent Chairs</u>

Mutual fund governance structures are similar to those in the public equity space, but differ in several key aspects. Funds' day-to-day operations—including investment management, accounting and general administration—are the responsibility of a separate company referred to as its adviser. The marketing of funds is normally handled by another separate company that may be affiliated with the fund's adviser. These unique organizational structures present a governance challenge for boards to balance their responsibilities to act on behalf of a fund's shareowners while at the same time managing the fund and providing oversight of its external adviser.

Since a fund's board is charged with acting in the best interests of the shareowners, the SBA believes that a management company executive who serves the interests of an affiliated company is not an ideal candidate for board chair. Fund directors have the authority to negotiate the adviser's contract, which potentially includes renegotiating the manager's contract (covering the manager's fees) or possibly terminating the adviser if agreeable terms can not be reached. Within this context, it is reasonable to view a non-independent chair as a conflicted and deficient governance structure that is not in shareholders' best interest. We do not believe affiliated chairpersons can fulfill their duties and provide adequate oversight of the fund's adviser, particularly on an arms-length basis.

The SEC request for additional comment focuses on the cost implications of the added reforms. In August of 2005, the Mutual Fund Directors Forum ("MFDF") released a cost survey of its members to determine the impact of the new SEC rules. MFDF members include independent directors at over 70 fund firms, both large and small in asset base. The MFDF survey found that costs per fund were likely to be less than $50,000 and that such costs could be marginal (due to economies of scale) for those funds comprising the larger fund family complexes such as Fidelity and Vanguard. Now, as well as at the time of the original SEC rule proposal in 2004, many fund companies' boards are chaired by independent directors or trustees. The MFDF survey found that out of the 45 fund companies responding, over 90 percent were in compliance with the new supermajority independence requirements and approximately 80 percent already had independent board chairs (neither Fidelity nor Vanguard were a part of these complying groups). Given this supportive data, the SBA does not believe the proposed requirements represent a material burden to the minority of funds not already in compliance.[2]

Some fund companies have adopted independent chairs simply by naming an existing independent director (individuals usually already serving as "lead" directors) as the chairperson. The SBA believes the role of an independent chair is to assure that the independent directors control board meeting agendas, the tone and tempo of meetings, the discussion and ordering of topics, and the amount of time spent on each topic. Opponents of the independent chair proposal often state that the discretion of the board to select any director as chair would be impaired by such a "procrustean" requirement. We could not disagree more. Proponents of an independent chair do not see any obstacles for the independent directors to select an independent chair among their group—the only restriction would be to remove affiliated directors with real conflicts of interest from the candidate pool.

In its earlier comment letter to the SEC in 2004, the MFDF stated, "It is the board's responsibility to retain the investment adviser, monitor its activities and consider the terms of the advisory

---

[2] Management Practice, Inc. estimates the marginal cost increase to compensate an independent chair to be $30,000. Other fund complexes, such as Calamos Funds, have stated there would be zero costs associated with an independent chair requirement—their funds would pay an independent chair the same retainer fees currently in place for their lead independent trustee.

contract renewal. Although the independent directors must separately deal with these issues, if they are to be truly empowered to evaluate and approve contracts on behalf of the fund and to monitor objectively the performance of the investment adviser and all other fund service providers, the independent directors should not be led in that function by an employee of the investment adviser or other service providers." We concur with these conclusions and believe the proposal will promote efficiency, competition, and capital formation.

Empirical Support for Broader Independence Levels and Independent Chairs

Based on industry and academic research, there appears to be a link between sound mutual fund governance with both lower investment expenses and superior fund performance for shareholders. An updated study done by John Bogle—using ten years of historical data originally analyzed by Fidelity—found that mutually-owned and non-bank funds having independent chair positions had both lower investment costs for their shareholders as well as improved performance when compared to funds without non-independent chairs.[3] Another academic study found that funds whose boards had a larger fraction of independent directors charged investors lower fees—for every 10 percent increase in the percentage of board independence, the fund's fees declined by about 6 percent from the mean fund's fee level.[4] The study's authors state, "…certain board characteristics, such as the size of the board and the percentage of outsiders, are observable features that can affect a board's independence, its skill at deliberation and decision making, and ultimately its effectiveness as a fiduciary."

Fund data from Morningstar, which produces fund "Stewardship" grades, shows that funds with the highest stewardship ratings also have higher average fund ratings, by almost one full star increment between the highest and lowest rated funds by stewardship score.[5] Another academic study has found that funds receiving higher Stewardship grades outperformed funds with poor grades by a substantial margin over several years.[6] This same study found that a board quality variable had the most explanatory power over the fund's performance, and the authors concluded that a mutual fund's board of directors can have a significant effect on the performance of the fund.

These studies and others support the positive relationship between funds' governance structures and higher operating performance. In sum, if a mutual fund has a non-independent chair, the fund is not adhering to what many organizations view as a best practice in mutual fund corporate governance. We believe an independent chair would be better able to provide oversight on behalf of funds' shareholders.

---

[3] John Bogle, "Mutual Funds in the Coming Century…While We're At It, Let's Build A Better World", remarks before the Mutual Fund Regulation and Compliance Conference, Washington, DC, May 5, 2004.

[4] Peter Tufano & Matthew Sevick, "Board structure and fee-setting in the U.S. mutual fund industry", Journal of Financial Economics (1997)

[5] Morningstar's five "star" rating system evaluates a fund's investment expenses, performance, risk and other fund attributes. Morningstar also provides a Stewardship rating, which evaluates a fund's corporate governance characteristics on a scale of A (best) to F (worst), as well as grades in five governance categories including Board Quality, Regulatory Issues, Manager Incentives, Fees, and Corporate Culture. Both the independence of a fund's chairperson as well as the aggregate percentage of independent directors on a fund board are positive factors that raise a fund's Stewardship score.

[6] Jay Wellman & Jian Zhou, "Corporate governance and mutual fund performance: A first look at the Morningstar Stewardship Grades", (2005). Authors find that funds receiving good grades outperformed funds with bad grades by 23 basis points per month over the time period analyzed.

SBA Supports Additional Protections for Funds and Fund Shareowners

In addition to the cost impact discussed above, the request provides for additional comment addressing any other issues related to the underlying purpose of the proposals, which is the protection of funds and fund shareowners. We suggest the following areas for the SEC to consider as further reforms:

- Strengthen how independence is defined—the SBA supports a vigorous definition of independence applied to mutual fund directors. At a minimum, the standards should utilize thresholds currently in place at the New York Stock Exchange (NYSE) or the NASDAQ stock market. Ideally, the standard should stipulate that any tie to the mutual fund organization other than the directorship itself should impair a director's independence.

- Mutual funds should hold annual elections for each of their boards—the SBA views annual elections (whereby all directors are nominated and elected each year) as the optimal governance process for such investment vehicles. Without a consistent approach, funds' shareowners are not allowed to approve their elected representatives on a timely basis and can not voice concerns in the interim periods.

- Mutual funds should have disclosure standards similar to listed companies—mutual fund proxy statements should parallel the information found in corporate proxies about directors, meeting attendance, director and manager compensation, and other key governance policy structures.

We appreciate the opportunity to comment on this most recent set of governance reform proposals. If you have any questions, please contact Michael McCauley, Director of Investment Services and Communications, or me.

Sincerely,

Coleman Stipanovich

Coleman Stipanovich
Executive Director

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth