

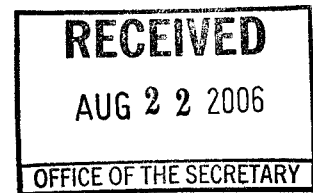
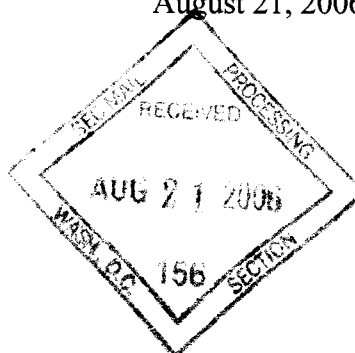


**American Federation of State, County and Municipal Employees**  
**1625 L Street, N.W. Washington, D.C. 20036**  
**EMPLOYEES PENSION PLAN**

**Pension Committee**

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August 21, 2006



Nancy Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: File No. S7-03-04

Dear Ms. Morris:

The American Federation of State, County and Municipal Employees ("AFSCME") is the nation's largest public service employees' union representing more than 1.4 million members. Most of our members are plan beneficiaries in over 150 public pension systems whose assets total \$1.5 trillion as well as being individual investors with billions of dollars invested in mutual funds through 401(a) type plans. We write in response to your request for additional comments on rules governing mutual fund independence entitled "Investment Company Governance" (the "Rules").

We urge the Securities and Exchange Commission (SEC) to leave intact the Rules that require mutual fund boards to be made up of 75 percent independent directors and to be chaired by independent director. These standards of independence are needed because they address the fundamental problem inherent in having funds run by non-independent chairmen: a fund chairman who also works for the management company may believe she is representing investor interests, but investor interests naturally conflict with the management company's financial interest in preserving its role and maximizing its own profit.

The Investment Company Act requires that mutual funds be managed in the interests of their shareholders. Moreover, the Investment Company Act gives oversight responsibilities to the board, including approval of the fund's contract with the investment adviser, the management company's advisory fee and monitoring against conflicts of interest. Requiring independent directors and chairmen will help ensure this safeguard is in place.

Following the mutual fund timing scandals, the SEC wisely acted to ensure more independence for mutual fund boards. Fund directors are now expected to ask more questions, have

resources to independently measure the performance of the management company and challenge fund management when it raises proposals that might run counter to the best interests of shareholders.

Indeed, numerous studies support independent boards as being in shareholders' best interests. A study by AFSCME and the Corporate Library, "Enablers of Excess: Mutual Funds and the Overpaid CEO", which we released on March 28, shows that mutual funds in general are enabling executive compensation excesses through their proxy votes.<sup>1</sup> Mutual funds, which hold about one-quarter of all U.S. companies, have a key role to play in restraining CEO compensation. Mutual fund boards are responsible for delegating the funds' proxy voting responsibilities, whereby votes must be cast in the best interests of mutual fund shareholders. And shareholders have a strong financial motivation for constraining executive compensation, as compensation to the five highest-paid CEOs of public companies accounted for 9.8 percent of their aggregate earnings in the period from 2001 to 2003, up from just 5 percent of aggregate earnings from 1993 to 1995.<sup>2</sup> Reflecting shareholder discontent with the inexorable rise in executive pay, a recent survey found that 90 percent of institutional investors are dissatisfied with current executive pay practices.<sup>3</sup>

Yet, in spite of executive pay's ever-growing take of earnings and widespread institutional support for constraining pay, the AFSCME/Corporate Library report found that mutual funds' proxy votes on executive compensation most often provide a rubber stamp for management's pay. Mutual funds supported over three-quarters of all management pay proposals, while supporting shareholder proposals calling for CEO pay reform little more than one-quarter of the time. Notwithstanding their duty to vote proxies in the interests of their shareholders, fund insiders may have potential conflicts of interest in selling 401(k) services to companies where they also vote proxies on behalf of mutual fund investors. The AFSCME/Corporate Library findings show that an independent mutual fund board run by an independent chairman is needed to stand up to fund insiders, because mutual funds proxy votes are not being used to protect shareholder wealth.

Another study by Professors Ding and Wermers finds a direct correlation between the 75 percent independence standard and replacement of underperforming managers. The study, presented at the American Finance Association 2006 Boston Meeting, found that when underperforming managers are replaced, the replacement manager substantially improves the performance of the fund. Mutual fund boards that were larger in size and had more outside directors were the most likely to replace underperforming directors. Ding and Wermers also found that when non-interested directors are below a 75 percent threshold, an increase in outside directors leads to a higher probability of manager replacement in the case of underperforming manager.<sup>4</sup>

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<sup>1</sup> American Federation of State, County and Municipal Employees and the Corporate Library, "Enablers of Excess: Mutual Funds and the Overpaid American CEO," March, 2006. The study examined votes cast by 18 of the largest 25 mutual funds at 1,642 shareholder meetings from July 2004 to June 2005.

<sup>2</sup> Lucian Bebchuk and Yaniv Grinstein, "The Growth in Executive Pay," 21 *Oxford Rev. Econ. Policy* 283, 2005.

<sup>3</sup> "Institutional Investors Dissatisfied with U.S. Executive Pay System, Watson Wyatt Study Finds," Watson Wyatt, 12/13/05. 55 institutions managing \$800 billion in assets were surveyed.

<sup>4</sup> Ding, Bill and Russell Wermers, "Mutual Fund Performance and Governance Structure: The Role of Portfolio Managers and Boards of Directors," 8/1/05, pgs. 4 - 5, 24 - 25.

The Tufano and Sevick study on board structure and fees found that shareholder fees are lower when fund boards are smaller and have a greater fraction of independent directors.<sup>5</sup> A University of Oregon study looking at governance and board structure of closed-end funds came to the same conclusion, finding specifically that funds with relatively lower expense ratios have smaller boards and a higher proportion of independent directors. Moreover, the Oregon study also found reasonably strong evidence of association between board decisions in shareholders' interests and greater overall independence.<sup>6</sup>

A review of mutual funds' influence on proxy voting on M&A activity also reinforces the need for the independence rule. A study by Lily Qiu of Brown University on the impact of institutional investors upon M&A activity found that mutual funds appeared to be the least likely monitors among all types of institutions. The study also supported a negative correlation between mutual fund ownership and M&A stock performance in the long-run, which was consistent with a trend that mutual fund ownership presence encourages value-reducing activity by company management.<sup>7</sup> These studies make a strong argument that independent directors are needed to stand up to perfunctory money managers.

In conclusion, we urge the SEC to support the Rule requiring an independent chairman on mutual fund boards comprised of 75 percent independent directors. We appreciate the opportunity to make our views known to the Commission on this reform of major importance to shareholders of mutual funds.

Sincerely,



GERALD W. McENTEE  
International President

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<sup>5</sup> Tufano, Peter and Matthew Sevick, "Board Structure and Fee-Setting in the U.S. Mutual Fund Industry," Journal of Financial Economics, December 1997, pgs. 321 – 357.

<sup>6</sup> Del Guercio, Diane, Larry Dann, and M. Megan Partch, "Governance and Boards of Directors in Closed-end Investment Companies," May 2002, pgs. 3 & 30.

<sup>7</sup> Qui, Lily, "Which Institutional Investors Monitor? Evidence from Acquisition Activity," June 2006, p. 26.