MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

March 2, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-9303

RE: Request for Additional Comments on Investment Company Governance, File No. S7-03-04

Dear Ms. Morris:

The Mutual Fund Directors Forum, an independent non-profit membership organization for the independent directors of mutual funds, is dedicated both to educating independent fund directors and representing their interests. The Forum is pleased to have the opportunity to submit further comments on the Commission's ongoing efforts to improve fund governance.[1] This letter, which should be read in conjunction with our prior letters, responds to two papers by staff in the Commission's Office of Economic Analysis on the costs and benefits of various forms of fund governance.[2]

I. Introduction

The two staff papers published by the Commission in December 2006 address, in rigorous fashion, whether it is possible to measure statistically the relationship between particular types of fund governance and fund performance and whether others who have studied this problem have succeeded in identifying any correlation between these things. Taken together, the two staff papers argue that it is difficult, if not impossible, to prove a statistical relationship between any type of mutual fund governance and improved fund performance. The papers nonetheless also note research findings that "more independent

---

1 The Forum has filed a number of letters and materials regarding these proposals. *See, e.g.,* Letter to William Donaldson, Chairman, U.S. Securities and Exchange Commission from the Mutual Fund Directors Forum (February 17, 2005) ["February 2005 Letter"]; Letter to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Aug. 21, 2006) from Allan Mostoff, President, Mutual Fund Directors Forum ["August 2006 Letter"]

2 *See* Memorandum from Chester S. Spatt, Chief Economist, to Investment Company Governance File S7-03-04 (Dec. 29, 2006) ("Power Study as Related to Independent Mutual Fund Shares") [hereinafter "Statistics Paper"] and Memorandum from Chester S. Spatt, Chief Economist, to Investment Company Governance File S7-03-04 (Dec. 29 2006)("Literature Review on Independent Mutual Fund Chairs and Directors") [hereinafter "Literature Review Paper"]. For the sake of convenience, we refer to the two staff memoranda collectively as the "2006 Papers."

boards make value-increasing choices across a spectrum of corporate events"[3] and conclude that "greater board independence may be desirable for a set of specific decisions made by the board, especially when agency conflicts between management and shareholders are of primary concern."[4] Importantly, neither of the staff papers raises fundamental questions about the four critical premises that underlie the Commission's recent proposals to improve fund governance:

- First, that managers of mutual funds are faced with significant conflicts between their interests and the interests of fund shareholders that, if resolved in management's favor, may reduce shareholder wealth in the long term;

- Second, that where a fund is overseen by a board that acts independently of management and as the fiduciary representative of shareholders, conflicts are more likely to be managed and resolved in a manner that is fair to shareholders;

- Third, that a fund board with a supermajority of independent directors and an independent chair is more likely to act independently and as a representative of shareholder interests; and

- Fourth, that the costs of implementing the Commission's proposed governance proposals is extremely low.

Based on these points, the Forum continues to believe that mutual funds should be encouraged, at least as a best practice,[5] to have an independent chair and a board composed of directors at least three-fourths of whom are independent.[6]

II. Analysis

The 2006 Papers are an important contribution to the debate over the Commission's proposals to improve fund governance. In particular, the papers argue, with a high degree of rigor, that it has been and will continue to be very difficult to identify a strict statistical correlation between different approaches to fund governance

---

3 Literature Review Paper, *supra* note 2, at 20.

4 Id.

5 In recommending best practices, the Forum recognizes that each fund and fund family is unique, that fund directors need to assess whether a particular practice makes sense for a particular fund, and that in some circumstances the independent directors of a fund may reasonably conclude that the recommended governance structure may not be in the best interests of their fund's shareholders. For example, we recognize that a number of our members believe that benefits similar to those associated with an independent chair can be obtained if, as an alternative, the independent directors select a lead independent director, and that director is either given or shares with the board chair the responsibilities and authority that the chair would normally possess.

6 Although it is the Forum's recommendation that the Commission endorse these governance enhancements as best practices, the Forum's Board of Directors unanimously recommends that the Commission mandate these governance enhancements. This recommendation of the Forum's Board of Directors does not represent the views of all Forum members in every respect.

and fund performance. This conclusion is not, however, especially surprising. As the 2006 Papers recognize, there are numerous contributors to fund performance – most notably, the skill of the portfolio manager – and it is intuitively obvious that it would be difficult to isolate and compare other contributors to fund performance.

Nonetheless, there is little dispute that fund managers, desiring to maximize their own profits, are faced with numerous conflicts of interest. The Literature Review Paper identifies a number of agency conflicts that can have direct impacts on the performance of a fund.[7] In addition, as the review paper recognizes, management has a conflict with respect to the setting of its advisory fee. Finally, there are numerous other conflicts inherent in fund management, ranging from valuation to fund sales practices to the various types of affiliate transactions permitted under the Commission's rules and orders, each of which, if not resolved appropriately, can harm fund shareholders financially.

The final point is worth emphasizing. The manner in which conflicts are managed and resolved has numerous and potentially significant consequences for fund shareholders. Although outcomes such as the level of the advisory fee are important, they are not the only potential effects. The resolution of conflicts as basic as whether, how and on what terms a fund manager chooses to deal with its own affiliates on behalf of the fund can also have a substantial influence on the long-term financial interests of fund shareholders. Likewise, how a fund and its manager respond to potential compliance issues can also have a significant impact on the long-term financial results of the fund.

It may well not be simple or even possible to isolate and measure the effect of independent fund boards on the resolution of the conflicts, particularly in terms of the impact that the manner in which conflicts are resolved has on fund performance. Independent fund boards are, however, still ideally positioned to oversee and, if necessary, manage the resolution of these conflicts. Fund boards do not have split loyalties; rather, they owe fiduciary duties to fund shareholders and have no other role other than acting on behalf of fund shareholders.[8] In the absence of fund oversight, the only controls that exist on conflict resolution are the good will of the management company, any competitive pressures faced by the management company, and the regulatory structure imposed on the fund industry.

It stands to reason that a fund board that is more independent, and thus more singularly devoted to the interests of fund shareholders, is more likely effectively to oversee the management and resolution of the entire range of conflicts than is a board that itself has divided loyalties – that is, divided loyalties that can arise when members of the Board themselves have competing and potentially contradictory obligations to the

---

7 *See* Literature Review Paper, *supra* note 2, at 4-7.

8 Put another way, just as fund shareholders combine their buying power to obtain the benefits of diversification and professional management, they also combine to purchase the ability and expertise to oversee the investment manager that they would be unlikely to possess individually.

fund and the adviser. The Forum has analyzed these issues in its prior comment letters to the Commission and thus will not repeat them here.[9]

We observe that the Literature Review Paper notes studies that support this conclusion. In particular, in its discussion of the studies of operating company governance, the Commission staff notes that "[t]here is also some empirical evidence to suggest that board independence is associated with lower likelihood of fraud and manipulation."[10] Opportunities for fraud and misconduct in the operating company context bear some similarities to the types of conflicts that fund managers face – in each opportunity, the manager of the company must decide whether to make a decision that maximizes its short-term benefit, or instead make a decision that is in the best long term interests of shareholders.[11] Hence, to the extent that independent boards tend to result in shareholder-friendly outcomes in the operating company context, there is equal reason to assume that independent boards will improve outcomes for shareholders in the mutual fund context.

Finally, we reiterate that these benefits come at a relatively trivial cost. As our prior survey of our membership has shown, the monetary cost of converting to a supermajority of independent directors and/or an independent chair is small.

More specifically, our 2006 survey results indicated that fund complexes that have transitioned to an independent chair and a 75 percent independent board have experienced modest costs in doing so. For those funds with an independent chair, the additional compensation paid to the chair was the primary cost attributed to the transition. The other main category of costs was legal fees to amend governing documents, amend appropriate disclosure, and to review the independent status of the chair. With respect to rebalancing the board to 75 percent independent directors, participating boards identified a variety of different costs.[12] Nonetheless, the overall costs to rebalance the board were very similar both in type and in scope as costs attributable to an independent chair.

---

9 *See, e.g.,* February 2005 Letter, *supra* note 1, at 1-2; August 2006 Letter, *supra* note 1, at 4-6.

10 Literature Review Paper, *supra* note 2, at 20 (text accompanying footnote 76 and sources cited therein).

11 We say "long term" because in the short term, fraud and misconduct can temporarily increase profits.

12 For further details on these costs, see our August 2006 Letter, cited above in footnote 1, at 6-8 and in the associated report of our membership survey. As a general matter, during the last comment period, a number of commenters discussed the costs of compliance with the proposed rules. For example, the Chamber of Commerce submitted a letter asserting that the costs of compliance could increase fund expenses by as many as 400 basis points for fund complexes with assets under management of less than $10 million. *See* Letter re: File No. S7-03-04 from David Chavern, Vice President and Chief of Staff, Chamber of Commerce of the United States of America to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Aug. 21, 2006) at 14. Surveys of our own membership, however, illustrate that although costs may vary significantly based on the size of the fund complex, the overall costs of the provisions are insignificant in relation to a fund's assets.

Moreover, in the context of overall fund assets and fund expenses, board-related costs are insignificant. Compared to total fund assets – or even total fund expenses – the costs related to the board and its activities, which generally appear as a line item in a fund's annual financial reports, represent a tiny percentage. Independent boards, as a general matter, are and continue to be an extremely cost-effective means of overseeing the fund industry and particularly the assets of fund shareholders.[13]

Finally, the 2006 Papers do not indicate that there are any significant indirect costs related to greater board independence, and there are no rigorous demonstrations elsewhere that such costs exist.[14] While better management of conflicts of interest may be overwhelmed by other factors in a statistical analysis of fund performance, better management of these conflicts should, nonetheless, provide better long-term results for fund shareholders.

Given these low costs, it is hard to imagine how criticism of the Commission's governance proposals could be rooted in the proposals' costs – looking at this issue in isolation, the small costs of having a supermajority of independent directors and an independent chair provide no justification for rejecting this approach to fund governance.

III. Conclusion

In sum, the 2006 Papers show how difficult it is to measure with statistical certainty the impact that fund governance has on overall fund returns. However, the 2006 Papers recognize that fund managers inevitably face conflicts of interest, and that the manner in which these conflicts are resolved can have a significant impact on shareholder welfare. The 2006 Papers also recognize that the manner in which funds are governed will have an effect in how these conflicts of interest are resolved.

These conclusions do not provide a basis for rekindling the debate over fund governance. In the vast majority of circumstances, a strongly independent board, composed of a supermajority of independent directors and an independent chair, will make it most likely that the conflicts inherent in fund management will be resolved in the best interests of fund shareholders. Moreover, given its minimal direct costs and lack of demonstrated indirect costs, a strongly independent board represents a highly cost-effective means of approaching and managing the conflicts of interest that always will be inherent in fund management.

---

13 *See, e.g.,* Memorandum re: File S7-03-04 to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission from C. Meyrick Payne, Partner, Management Practice Inc. (July 13, 2006) at 2 (comparing the number of regulators and directors devoted to the mutual fund industry to the number of regulators devoted to the banking industry in the United States).

14 Indeed, the Literature Review Paper points to a number of methodological flaws in the one paper suggesting that there might be a negative correlation between board independence and overall fund performance.

In sum, it is the Forum's view that a fund governance system that includes an independent chair and a board with a supermajority of independent directors can be expected to provide substantial benefits to fund shareholders and to the capital markets generally, at a relatively minimal cost. Because of this balance of costs and benefits, there is good reason for the Commission to encourage further adoption of these enhancements by funds. The Forum therefore recommends that the Commission strongly reiterate, as it has done in the past, the value of these practices, and encourage fund boards to consider adopting these practices as soon as practicable. [15]

Again, we appreciate the opportunity to provide these comments to the Commission to aid it in its continuing consideration of fund governance. We would be happy to address any questions raised by our comments.

Sincerely,

Allan S. Mostoff
President

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Kathleen L. Casey
The Honorable Annette L. Nazareth
Andrew Donohue, Esq.

---

15 The Forum recognizes that for some very small or new funds, these corporate governance enhancements may not be immediately feasible. *Cf.* note 5, *supra*.