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Fund Democracy
Consumer Federation of America

March 2, 2007

BY ELECTRONIC MAIL

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

Re: File No. S7-03-04 – Investment Company Governance

Dear Secretary Morris:

We are writing in response to the Commission's request for comments on two staff economic papers on the independent chairman proposal. We believe the staff economic papers provide additional support to the Commission's longstanding, consistent and well-grounded conclusions that the independence of fund boards would be improved if fund chairmen were independent and fund boards were at least 75% independent.

Staff Economic Papers

Not surprisingly, the staff economic papers confirmed the Commission's longstanding position that the costs of an independent chairman are greatly outweighed by the benefits that derive from prohibiting irretrievably conflicted fund manager executives from acting as chairmen of the funds they advise or comprising more than 25% of fund boards. The SEC's Chief Economist found that, in summary:

1. "given the degree of randomness in mutual fund returns and the paucity of available fund governance data, standard statistical approaches have low power to identify relatively small return differences";

2. (a) "boards with a greater proportion of independent directors are more likely to negotiate and approve lower fees, merge poorly performing funds more quickly or provide greater investor protection from late-trading and market timing"; and

   (b) "broad cross-sectional analysis reveals little consistent evidence that board composition is related to lower fees and higher returns for fund shareholders."

The only conceivable conclusion one could draw from these findings is that the cost-based arguments against the 75% independent board and independent chairman proposals are utterly groundless. Indeed, if the staff papers suggest anything about the proposals, it is that they will likely have the incidental benefit of placing downward pressure on fund

fees, improving the efficiency of fund mergers, and protecting investors against market timing abuses. We see no need to elaborate on conclusions the import of which is so clear.

The benefits of the 75% independent board and independent chairman proposals remain obvious and unassailable. As demonstrated by the recent BYSIS scandal, the conflict of interest between mutual funds and their managers is inherent and can cause significant harm to investors. A fund's reliance on the exemptive rules that will trigger the governance requirements presents precisely the situation in which the independence of the board is crucial to protecting fund shareholders' interests. These exemptions relieve funds and their affiliates of prohibitions that Congress chose to impose and are contingent on the Commission's deciding that the exemption is in the best interests of shareholders. It is truly remarkable that exemptions that are legally a matter of Commission discretion somehow have become, once granted, a matter of right for industry members to be modified or withheld only after extensive litigation and delays.

In view of the staff's resounding conclusions, it is not clear what the purpose of the papers could have been unless the Commission moves to adopt the proposals. We hope that the Commission will act promptly so that America's fund shareholders can soon begin to enjoy the benefits of truly independent fund oversight.

Critical Independent Chairman Functions

We have, however, noted reports suggesting that some members of the Commission may be considering abandoning the independent chairman proposal in favor of requiring that key board functions be placed under the exclusive authority of an independent director. While we strongly disagree with the view that assigning an independent director the functions of a board chairman is preferable to an independent chairman (which we had understood to have been a conclusion already reached pursuant to the lawful exercise of the Commission's authority), we acknowledge that ultimately it is the independent exercise of authority, and not a merely titular distinction, that will make a real difference in protecting mutual fund shareholders against the kinds of abuses that have recently plagued the fund industry.

If this approach is adopted, we believe it is critical that at least two key responsibilities be assigned to a director who is independent of the fund manager to protect against self-dealing by the fund manager. The foremost of these is the exclusive authority to oversee the board's relationship with the fund's Chief Compliance Officer ("CCO"). As we have noted previously, the Commission's adoption of the CCO rule would be an empty gesture if the CCO were to report to and communicate with the board through an executive of the entity most likely to engage in self-dealing at the fund's expense. At the heart of the abuses involved in the recent market timing scandal and the current BYSIS scandal have been fund managers seeking to profit at shareholders'

expense.[1] The absurdity of permitting the fund CCO to report fund manager abuses to a fund manager executive is self-evident, yet this is precisely what current rules allow. The CCO should report directly to an independent fund director who should be primarily responsible for coordinating all fund compliance matters or other matters that involve a potential conflict of interest with the fund manager, principal underwriter or significant service provider. It is untenable to argue for a reporting structure under which fund manager trading abuses such as those that occurred at Fidelity Investments could be reported to the fund's board through the fund manager's CEO.[2]

Second, the independent directors must be able to ensure that all appropriate matters are presented and discussed at board meetings. As a practical matter, this means that the authority to set the agendas and conduct the meetings must reside with an independent director. Such plenary authority is necessary because the overwhelming majority of matters addressed at board meetings involve compliance and fund manager conflicts. Affiliates of the fund manager should not be relied upon to ensure that compliance issues and other matters that involve fund manager conflicts of interest are adequately addressed by the board. As the BYSIS scandal illustrates, even matters that may appear not to raise fund manager conflicts, such as the evaluation of an unaffiliated third party service provider, can be and have been exploited by fund managers for their own benefit. Fund managers often have an interest in sweeping compliance and conflicts issues under the rug. An independent board member must oversee the setting of the agenda and the conduct of the meeting to ensure that the board can effectively counter the influence of fund affiliates.

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[1] For example, Rule 38a-1(a)(4)(iii) would be satisfied if the fund CCO provided the annual compliance report to fund manager's CEO in his or her capacity as fund chairman and the CEO promised that it would be shared with the rest of the board.

[2] *See* NASD Fines Four Fidelity Broker-Dealers $3.75 Million, Reuters (Feb. 5, 2007) *at* http://today.reuters.com/news/articleinvesting.aspx?type=governmentFilingsNews&storyID=2007-02-05T181211Z_01_N05457298_RTRIDST_0_FIDELITY-NASD-UPDATE-1.XML.

We encourage the Commission to adopt its fund governance proposals and not to abandon ship in the face of chimerical, cost-based arguments that have repeatedly, and now definitively, collapsed before rigorous, empirical study. We look forward to prompt, final action on the proposals and appreciate your further consideration of our comments.

Respectfully submitted,

Mercer Bullard
President and Founder
Fund Democracy

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc (U.S. mail only):
The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Kathleen L. Casey
The Honorable Annette L. Nazareth
Andrew Donohue, Director, Division of Investment Management
Robert Plaze, Associate Director, Division of Investment Management