



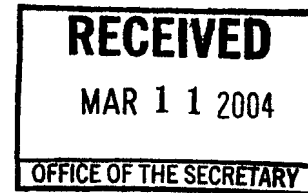
# DIRECTORS' COMMITTEE

INVESTMENT COMPANY INSTITUTE

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March 10, 2004

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609



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

Dear Mr. Katz:

The Directors' Committee of the Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the rule amendments proposed by the Securities and Exchange Commission addressing fund governance generally and the role of independent fund directors specifically.<sup>2</sup> The Committee supports the objectives of the amendments to enhance the independence and effectiveness of fund boards, thus empowering them to better perform their oversight responsibilities. The Committee offers comments on issues presented in the Proposing Release below.

## General Comments

As a preliminary matter, the Committee members have some general observations about the premise of the Proposing Release. Language in the release seems to suggest that recent problems facing the investment company industry have been a result of failures in fund governance. While we applaud efforts to strengthen fund governance, we strongly object to the proposition that directors were "asleep at the switch" and failed to protect fund shareholders.<sup>3</sup>

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<sup>1</sup> The Directors' Committee is a standing committee of the Investment Company Institute. The Committee currently consists of 18 independent directors and 2 interested directors. In addition, 8 independent directors serving on the Institute's Board of Governors participate on the Committee. Collectively, the Committee members are associated with 24 separate fund groups.

<sup>2</sup> Investment Company Act Release No. 26323 (Jan. 15, 2004) ("Proposing Release"). The Directors' Committee shared its preliminary views on the concepts presented in the Proposing Release by letter from its chairman, James H. Bodurtha, to SEC Chairman Donaldson, dated December 31, 2003. However, given the detailed nature of the proposal and the request for comment on a number of specific issues not addressed in the previous letter, the Committee determined that a formal comment letter was both necessary and appropriate.

<sup>3</sup> See Proposing Release at 3473 ("In some cases, boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers. . .").

The facts do not bear this out and certain of the pending legislative and regulatory proposals intended to address the problems suggest a role for directors that far exceeds their oversight responsibilities.

Furthermore, the Proposing Release suggests that fund governance has been ignored and is long overdue for reform.<sup>4</sup> This is simply not true. The role of directors and fund boards was thoroughly examined quite recently beginning with the Commission's Roundtable on Fund Governance in February 1999, the Report of the Advisory Group on Best Practices for Fund Directors in June 1999 ("Advisory Group Report")<sup>5</sup> and the SEC's comprehensive package of rule amendments on governance issues in 2001.<sup>6</sup> The result was a host of required operational changes and additional disclosures and recommendations of best practices applicable to most boards.<sup>7</sup> Each of these efforts has done much to enhance their effectiveness and independence. Indeed, many of the best practices recommended in the Advisory Group Report have been or are now being codified, and reforms adopted from 1999 through 2001 have served as a model for reforms to the corporate governance regime.<sup>8</sup>

We do believe that opportunities to strengthen fund governance exist and support periodic re-examination of the governance system. We are distressed that management representatives of certain fund companies have failed to act consistently with the best interests of their shareholders and believe certain

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<sup>4</sup> The Proposing Release described the comprehensive rule amendments in 2001 relating to fund governance as "modest." Directors on the Committee would respectfully disagree. Not only was extensive new disclosure required but many boards were forced to add members and others had to retain new counsel.

<sup>5</sup> Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 1999).

<sup>6</sup> Investment Company Act Release No. 24816 (Jan. 2, 2001).

<sup>7</sup> The current rule proposals, as in the 2001 rule amendments, would apply to funds that rely on certain exemptive rules. The ten exemptive rules included in this proposal are: Rule 10f-3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1 (permitting use of fund assets to pay distribution expenses); Rule 15a-4(b)(2) (permitting fund boards to approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract); Rule 17a-7 (permitting securities transactions between a fund and another client of the investment adviser); Rule 17a-8 (permitting mergers between certain affiliated funds); Rule 17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies); Rule 17e-1 (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j) (permitting funds to maintain joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of voting stock); and Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors) (the "Exemptive Rules"). The Commission also proposes to amend Rule 31a-2 under the Investment Company Act to require that funds retain copies of written materials considered by the board in connection with approval of the advisory contract.

<sup>8</sup> The Proposing Release suggests that the proposed rules, if adopted, would serve to bring funds up to the corporate governance standard for operating companies. In fact, many of the rules recently adopted for operating companies have been required of funds for some time (e.g., have a majority of independent directors and an independent nominating committee).

changes should be made to address deficiencies. However, this examination should be approached as part of an on-going obligation of both regulators and boards themselves to better serve shareholders – not as part of a wholesale condemnation of a system that has served millions of American families well as they save for college and their retirement. We agree with a statement in the Proposing Release to the effect that efforts to promote a culture of independence and to empower directors will inure to the benefit of all fund shareholders.

The Directors' Committee urges the Commission, as it evaluates the comments submitted on the Proposing Release and all proposed reforms, to focus on the proper role of fund directors. Most importantly, fund directors are not part of "management." The role of the director is one of oversight and decisions are made through a collective board process. Directors exercise due diligence and their "business judgment" during this process. Day-to-day operations and compliance, on the other hand, are the responsibility of management, and supervision of these activities is, in many instances, most appropriately placed with management executives, not with the board of a fund. Additional regulation of and/or legislation addressing mutual funds should be directed at the entity where the problem occurs and where solutions can be effectively implemented.

### **Composition of the Board**

The proposed amendments would require that the independent directors of a board that relies on the Exemptive Rules constitute at least 75% of the board. According to the Proposing Release, this requirement is intended to strengthen the presence of independent directors and improve their ability to negotiate effectively on behalf of shareholders, especially with respect to the advisory fee.

The Committee does not oppose the increase in independent board members to 75%. The Advisory Group Report recommended an increase in the percentage to 66 2/3% and we believe that an increased percentage, either to 66 2/3% or 75%, will help enhance the authority of the independent directors. It is possible that maintaining the higher percentage could present timing issues for boards, for example, if a director becomes ill or dies, so we encourage the Commission to incorporate language that would allow boards a reasonable time to fill vacancies.<sup>9</sup>

In the Proposing Release, the Commission asked whether stating the board composition requirement in terms of a percentage is the best option. We

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<sup>9</sup> In 2001, when the Commission adopted the requirement of a majority of independent directors for boards of funds that rely on certain enumerated exemptive rules, it adopted Rule 10e-1 to permit the board time to fill unanticipated vacancies. The Commission might consider incorporating this rule into the super-majority mandate.

believe that it is because the number of independent directors needed to meet the super-majority requirement will vary, depending on the total number of directors on the board. The release also inquired as to the method by which boards that do not already have 75% independent directors might attain that percentage. While it is our expectation that most funds would reach this percentage by asking an interested director to step down from the board, there are some boards that will do so by adding an independent director.

### **Independent Chairman**

The SEC's proposal would require the board to select a chairman that is an independent director. The reason cited for this requirement is that the chairman typically controls the agenda and has a strong influence on board deliberations. He or she would be in a position to promote a board culture that is conducive to decisions favoring the long-term interests of fund shareholders.

We believe that it is in the best interests of our shareholders to strengthen the tools available to independent directors to further assure control of the information and processes essential to the oversight responsibilities of fund directors. We do not, however, believe that there is necessarily a single best way to accomplish this objective. Some boards have designated a lead director as recommended in the Advisory Group Report. Others have tasked the audit committee chair with the responsibility for the agenda. Still others have appointed an independent chairperson. Independent directors with a super-majority of board seats have the absolute power to choose the governance structure that best suits their board culture. We believe directors should determine the best way to manage their workload.

Some Committee members expressed concern that use of the "chair" designation would extend the responsibilities of the independent director with that title to day-to-day management and compliance. If the "chair" designation creates this type of additional substantive responsibility and liability, the role is inconsistent with directors' oversight responsibilities under the Investment Company Act and threatens to blur the line between what is properly the role of fund directors and that of management. We urge the Commission to proceed with caution here so that final rules do not create an operational responsibility for a board member that can only effectively be fulfilled through an on-site, daily in-person presence at the fund company. Many Committee members expressed concern that such an in depth role would, in fact, cause the chair to become de facto part of management.

Moreover, in the context of the other changes found in the Proposing Release, we believe requiring an independent chair is unnecessary. The super-majority mandate, separate meetings of the independent directors, and other proposed amendments ensure that the independent directors will have a firm

grasp on the agenda and boardroom activities, and yet reserve to the independent directors the option to choose the leadership structure that is best-suited for a particular fund or funds.

The Committee would support a requirement that committee chairs be independent. In fact, under current rules the chairs of the audit and nominating committees of most boards must be independent. Independent director oversight of the remaining committees may advance the goals of the Commission of ensuring independent director control of the business of the board. Another tool to consider is requiring that the agenda for all in-person meetings be approved in advance or at the commencement of any such meeting by the independent directors or by one or more independent directors designated to perform that function by the independent directors. However, the requirement that the independent chair of the board or committees, if put in place, be elected annually seems neither necessary nor productive. A board is in the best position to determine the processes it needs to function effectively and its members should decide when an election is necessary.

### **Annual Self-Assessment**

Under the proposal, directors would be required to assess the effectiveness of the board and its committees at least once a year. This process would allow directors to review their performance and consider improvements to their governance practices. The amendment would permit boards to develop their own assessments to evaluate both the substantive and procedural aspects of board operations, but it would require that the assessments include consideration of the board's committee structure and the number of funds on whose boards the directors serve.

We support the requirement of an annual assessment by all fund directors. The Advisory Group Report recommended periodic evaluations of board effectiveness as a best practice in 1999. Since that time, many boards have conducted assessments and benefited from the exercise. We believe that this is an effective way to address the issue of service on boards overseeing multiple funds.<sup>10</sup> An annual evaluation will enable directors to determine whether they are appropriately managing their workload and to take any necessary remedial steps, including the use of board committees, to oversee certain matters. However, we caution the Commission about mandating the total content of the assessment. We believe the individual directors on each board are in the best position to tailor the assessment to their individual needs and to address fund or fund complex issues that are unique to their experience. Prescription of extensive assessment requirements is ill-advised and is likely to lead to a focus on process rather than substance.

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<sup>10</sup> The Commission noted that this practice in and of itself would not render a director "interested" under the Investment Company Act. See Investment Company Act Release No. 24083 at p. 14 (Oct. 14, 1999).

We do not believe that the assessments must be in writing to be effective. In fact, a requirement that assessments be written would likely have a chilling effect on the self-evaluation process. Directors have expressed concern that identifying areas for improvement in a written document, even in the absence of material weaknesses or failures, may expose a board to unwarranted liability.

### ***Service on Boards Overseeing Multiple Funds***

The Proposing Release questions whether multiple fund board service should be limited in some way. There are a number of reasons we believe this would be counterproductive to the Commission's goal of improving fund governance. First, many matters with which fund directors deal are not fund-specific, but complex-wide. These include monitoring activities of the custodian and of the dividend and transfer agent, oversight of compliance matters, supervision of shareholder servicing, oversight of disaster contingency plans, meetings with third-party providers (particularly with independent accountants) and with independent counsel, monitoring systems to control portfolio risk and to address recent issues such as market timing, late day trading, directed brokerage, soft dollar policies and revenue sharing. In fact, the matters that should be addressed on a complex-wide basis vastly exceed the fund-specific issues.<sup>11</sup> The most effective way to address complex-wide issues is through a consolidated approach of one board overseeing a number of funds.

Second, we advocate no restrictions on multiple fund board membership because there is great strength imparted to a board when management knows their participation in fund governance impacts materially management's operating results. This strength is diminished as the assets represented decline. Management may well be less responsive to a large number of individual boards that represent smaller asset pools. We do not believe this model serves shareholders well.

Third, restricting board service to a defined number of funds will increase the number of boards with which management of fund companies must work. It is vital that boards work with management at the highest executive levels: with the key decision makers. Senior executives at many large fund complexes already spend a substantial portion of their time attending to their shareholder representatives on fund boards. Asking them to double or triple this time is not practical, with the result that board contact will be relegated to junior executives. This is the exact opposite of what we should be doing and is adverse to shareholder interests.

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<sup>11</sup> We do not intend to minimize the importance of fund-specific matters, such as the renewal of the advisory contract, merely to point out that most board matters are not fund-specific.

Finally, some have argued that service on boards overseeing multiple funds and the compensation received for that service could compromise the independence of the board. In our opinion, this position ignores two vital facts of the board process: independent directors set their own compensation and are nominated and selected by the independent directors. Management has no control over this process. Board compensation is set based on a number of factors, including cumulative workload and the number of meetings attended.

For these reasons, we encourage the Commission to promote service on boards that oversee multiple funds.

### **Separate Meetings of Independent Directors**

Pursuant to the proposal, the independent directors on each board would be required to meet in separate sessions at least once a quarter. This meeting is intended to provide independent directors the opportunity to conduct candid discussions about the management's performance. Furthermore, if executive sessions are mandated, no negative inference will be drawn from the calling of such a meeting.

Practices among funds vary with respect to separate sessions of the independent directors. Some boards conduct executive sessions each time they meet in person, others when there are specific issues to be discussed. Indeed, conducting executive sessions of the independent directors is one of the recommendations in the Advisory Group Report. Because many other proposals in this release would strengthen the ability of the board to exercise its judgment, we support leaving the frequency of executive sessions to the determination of the board.

### **Independent Director Staff**

The proposed rule would expressly authorize directors to hire employees and others to assist them in the performance of their duties. According to the Proposing Release, this would help independent directors who find they need outside assistance on a matter.

Committee members support a provision that would clarify that independent directors have the authority to retain staff as needed. Most of us have felt that we have had this authority for some time. In fact, independent counsel is now accepted practice. The Advisory Group Report recommended that directors "should be able to obtain expert advice from independent accountants or other third parties whenever particular problems or initiatives may call for special expertise. Use of independent consultants may be necessary if the directors are to be effective on matters that are beyond their expertise and the expertise of their counsel." Whether or not a board hires experts should be

left to its discretion. This position does not differ with respect to hiring experts for committees. The Committee believes that hiring experts could present a substantial cost issue for smaller funds and, for that additional reason, should not be mandated.

### **Preserving Documents Directors Use to Determine the Reasonableness of Fees**

We support the proposal to amend Rule 31a-2 to require that documentation considered by the board in connection with its approval of the advisory contract be maintained by the fund for SEC inspection, with one recommended clarification noted below. Pursuant to SEC governance rules adopted in 2001, each fund must disclose the board's basis for approving the advisory contract. Each board requests and reviews a wealth of information, but the specific documents or reports and the process of review may differ. This rule would allow SEC compliance examiners to review the sufficiency of materials requested and reviewed in connection with the boards' advisory contract renewal.

As a practical matter, most funds do not have employees. Another person or entity must take physical responsibility for documents considered by the board in connection with its approval of the advisory contract. Fund counsel may not be the best alternative as the records may not be readily accessible to SEC examiners. We recommend that the SEC consider requiring the compliance officer or secretary of each fund to maintain the records or, in the alternative, allowing the board to delegate this function to an appropriate officer of the adviser.

We believe that retention costs should be minimal and should not be a consideration in the implementation of this proposal. Requiring retention, in our opinion, will not change practices in terms of the volume of information requested by directors in connection with their review of the advisory contract. Here, we must point out that, for many boards, assessment of the quality of the adviser's performance and of the quality of the services delivered to fund shareholders is an ongoing process. Consequently, while intense scrutiny is focused on the annual renewal of the advisory contract, the total record of evaluation is building throughout the year. For example, part of the assessment process may include review of disaster contingency planning by the adviser, but this review may not take place at the time of contract renewal. Because practices in this regard vary and the use of the term "considered" in the proposed rule might lead to some confusion as to what documents must be retained, we recommend that the SEC clarify that the documents to be retained for inspection pursuant to amended Rule 31a-2 would be those provided in response to a request from the board pursuant to Section 15(c) of the Investment Company Act.



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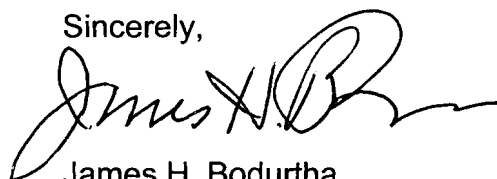
**Other**

As part of this proposal to give boards the tools they need to perform their oversight responsibility, the Directors' Committee supports a strong, well-funded SEC. We encourage adequate staffing to perform more frequent examinations of funds and we believe that a meeting with the independent directors should be a part of the examination process. The SEC, with a staff of experienced examiners, is in the best position to identify deficiencies early. In cooperation with fund boards, the Commission can protect the interests of fund shareholders.

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We appreciate the opportunity to comment on this proposal and offer the support of the Directors' Committee to your efforts to strengthen fund boards.

Sincerely,



James H. Bodurtha  
Chair, Directors' Committee

cc: The Honorable William H. Donaldson  
The Honorable Cynthia A. Glassman  
The Honorable Harvey J. Goldschmid  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos

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