

AQUILA INVESTMENT MANAGEMENT LLC



A subsidiary of
AQUILA
MANAGEMENT CORPORATION

August 21, 2006

VIA E-MAIL TO: rule-comments@sec.gov

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

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

Dear Ms. Morris:

As Chairman and Founder of Aquila Management Corporation in New York, a twenty-two year old investment management company, I wish to express my strong disagreement with the Independent Chair Rule and the 75% Independent Board Members Rule for Mutual Fund Boards. I believe that if these rules stand, the mutual fund industry will suffer from a decrease in entrepreneurs willing to put their time, effort and money behind the innovation of new worthwhile fund products, due to the increased costs of implementing these rules as well as the fact that they will not be allowed to chair the entities that they create.

The Aquila Group of Fundssm

As an entrepreneur, I founded Aquila Management Corporation and the Aquila Group of Fundssm (collectively, "Aquila") after having been involved several years before that with the creation of one of the earlier money-market funds in the nation. From the outset as well as thereafter, Aquila was funded by me and my family. Over the years, we have spent over \$12 million in capital investment to develop our funds, including reimbursement of fund operating expenses in order to be competitive in the marketplace. Aquila currently consists of 12 funds with approximately \$2.4 billion in long-term assets under management and approximately \$1.9 billion in money market funds. As a result, Aquila would be considered a smaller fund complex. As of May 31, 2006, Aquila ranked 123rd (in terms of total assets under management) out of the 349 fund complexes whose data is tracked by the Investment Company Institute.

The largest segment of Aquila is represented by 7 single-state tax-free municipal bond funds – Hawaii, Arizona, Oregon, Colorado, Kentucky, Rhode Island and Utah. In addition, we have 3 money market funds, 1 regional (Rocky Mountain) equity fund and 1, relatively new, high income corporate bond fund. Each fund generally has its own board consisting of mostly independent trustees. Each of the tax free municipal bond funds rank first, second or third in size in its respective state.

You should be interested in knowing that the Lipper organization named Aquila the Best Bond Fund Group for 2003.

Start-Up Costs

In garnering assets from the retail market with each fund, Aquila and I have had to be prepared to live with whatever market environment existed. For example, from 1994 – 2000, the interest of investors in municipal bond funds was basically flat while it ballooned for equities during this period. Aquila had to support, through paying operating and marketing expenses, and waiving management fees, each fund it created; our Utah and Rhode Island funds have required greater support than our other municipal bond funds due to the fact that their launch dates immediately preceded this flat environment. (Our Utah fund, it is worth mentioning, is the only fund of its type in that state.) Specifically, we had to be prepared to subsidize the operating expenses of these two funds until they reached a critical mass size of approximately \$100 million each. And, despite having achieved over \$100 million in size with both of these funds, we are still waiving management fees in order to be competitive with other similar funds. There has been no quick fix under the prevailing market conditions.

In fact, before the Utah and Rhode Island funds broke even in terms of covering their operating costs, excluding management fees, Aquila paid a combined total of over \$3 million in fund expenses over a period of 11 years. Through June 30, 2006, Aquila has additionally waived management fees totaling nearly \$6 million for both funds. These expenditures and waivers are in addition to the extensive amounts of marketing-related costs we have borne through Aquila Distributors, Inc.

In July 1994, Aquila also created Aquila Rocky Mountain Equity Fund, the only fund of its type specializing in this geographic area. Aquila spent approximately \$750,000 subsidizing operating costs before this fund broke even, with respect to its operating expenses excluding management fees, at an asset size of approximately \$22 million. Also, it should be mentioned that for the benefit of shareholders, Aquila has contractually capped fund expenses, which in turn has increased the level of our subsidization and reduced our management fees since the inception of the fund. Through December 31, 2005, Aquila has waived nearly \$900,000 in management fees. Meanwhile, Aquila Distributors, Inc. has spent substantial amounts of money in marketing-related expenses. (Note: My May 11, 2004 letter to William Donaldson regarding independent chairs of mutual fund boards indicated that this fund had broken even with respect to non-management fee operating expenses at an asset level of

approximately \$13 million. Unfortunately, due to increased trustee fees, legal fees and insurance premiums that were incurred largely due to the proposed rules as detailed below, Aquila was forced to continue to reimburse operating expenses until the fund reached the \$22 million asset level previously cited.)

While not directly related to the proposed rules, there are other areas related to start-up costs and otherwise in which smaller fund groups are being squeezed by increased, and new, expenses. For example, it should be noted that until recently, Aquila had not engaged in paying brokerage firms to gain special treatment to enlarge the asset size of its funds (those cases that do currently exist are disclosed in our registration statements). We were essentially forced to compensate one major firm within the last year (in order to retain assets and protect the interests of that firm's current shareholders in our funds). For a short period of time prior to our agreement to compensate this firm (in order to maintain our "shelf space" on their brokerage platform), this major firm would not allow its current shareholders in our funds to make additional investments into their existing accounts for which that firm served as the broker of record.

Altogether, the start-up expenses of new funds have increased because of the new rules. This primarily comes from having higher fees for the trustees, higher legal fees and increased insurance costs. These expenses on top of other expense pressures are serving to further squeeze small funds and small fund sponsors.

Increased Management Company Operating Costs

There are very real costs associated with both the Independent Chair Rule and the 75% Independent Board Members Rule. Each additional cost on its own may not seem large, but when combined with other costs of the increased regulatory environment, these costs become larger for smaller fund complexes like Aquila.

It appears that the U.S. Securities and Exchange Commission (the "Commission") may not have taken into consideration both the start-up costs and the additional operating costs for smaller fund groups, such as Aquila, in its possible mandating of the Independent Chair Rule and the 75% Independent Board Members Rule.

With the exception of our newest fund, each of the funds within the Aquila Group of Fundssm has elected an independent chair in anticipation of the rule's adoption. Aquila has subsequently had to devote increased staff time to support requests of the independent chairs and independent trustees in view of the fact that they are not involved in the day-to-day operations of the funds and, therefore, must be continually brought up to speed. My own time, previously often devoted to long-term strategic planning, is increasingly spent worrying about manpower requirements and, hence, money necessary to support the independent chairs and independent trustees. Specifically, these additional costs, which are mainly related to staffing, have primarily had to be absorbed by Aquila, thereby decreasing our capacity to compete.

At this point of time, Aquila either cannot pay competitive salaries or cannot hire as many people as we would like. In fact, in large part to help Aquila with the increased regulatory environment, we have specifically had to hire an in-house counsel and also had to increase the compensation of the higher level people of Aquila in line with the increased responsibilities required of the staff. Altogether, these increased management company salaries (excluding supplemental payroll taxes) total approximately \$350,000 annually. This figure does not include the extra cost involved with the compensation of the Chief Compliance Officer, which is an additional \$36,000 annually for the management company.

Hence, large fund complexes may be the only option open to shareholders in the future as other entrepreneurs may decide not to enter the field or to leave fund management entirely. I fear that smaller fund complexes may thus begin to disappear and with them, the shareholder public will lose out as there will be fewer products and less innovation.

Increased Expense Ratios For Funds

It should be pointed out that not only have the expenses of the management company increased, but the expenses, and, in turn, expense ratios, of funds have increased.

For instance,

- Our Rhode Island fund, Narragansett Insured Tax-Free Income Fund, Board was expanded by electing additional trustees in order to comply with the 75% Independent Board Members Rule. Now, with the rule potentially in flux, the board has determined to retire one board member until such time as the 75% Independent Board Members Rule is judged to stand.
- In view of the overall governance rules, the trustees of the Aquila Group of Fundssm increased their own compensation in terms of both retainer and meeting fees.
- The various funds within the Aquila Group of Fundssm now split a combined annual expenditure of \$50,000 for the cost of the Chief Compliance Officer.
- The independent trustees, in particular the independent chairs, have increased their usage of, and reliance on, fund counsel at additional expense, the amount of which is dependent on the size of the individual fund.
- Directors and Officers and Errors and Omissions (D&O/E&O) insurance premiums have increased significantly. In 2006 vs. 2003, the increased cost to the funds was approximately \$107,000. Part of the increased cost consisted of additional coverage as requested by the trustees and part consisted of increased premiums to reflect the increased risk. (Note: our current coverage generally exceeds that of comparable size groups, despite the fact that our funds generally have a lower risk profile.)

In short, there is no doubt in our judgment that in addition to the increased management expenses, the Independent Chair Rule and the 75% Independent Board Members Rule have increased the overall expense ratios of the various funds in the Aquila Group of Fundssm in an amount dependent upon the size of the individual fund.

The Funds' Entrepreneurial Spirit

Entrepreneurial opportunities have always been at the very core of business growth within our nation.

With nearly each of the 7 tax-free bond funds, as well as with Aquila Rocky Mountain Equity Fund, new ground was broken for these types of funds in each state or region. Had we not created these funds, approximately 40,000 investors would not have had the opportunity to benefit from these funds. We strongly believe that shareholders have been distinctly rewarded by our efforts to develop these mutual fund products.

Now, I ask you, if Aquila had not taken the lead to develop these funds, but rather the funds had been developed under the jurisdiction of an independent chair, why would we have spent the time, effort and money to do all this? With the proposed new Independent Chair Rule, the newly mandated chair does not provide new funds with sponsorship or subsidize their operating costs. The Commission is essentially mandating that someone else steer the ship. This could be a strong disincentive for an entrepreneur to either consider entering the industry or developing new funds.

Consequently, I believe that it is critical that the SEC make every effort to ensure that it does not squash the entrepreneurial spirit in the smaller fund complex arena.

Inconsistent Requirement

In comparing investment companies formed under the Investment Company Act of 1940 with regular corporations, we feel that there is a major inconsistency. In our opinion, it is unfair to require an independent chair for mutual fund groups and not have the same requirement for regular corporations. Independent trustees have consistently been charged with making a number of important decisions. Since the 1940 Act was enacted, they have fulfilled such charges admirably without necessarily having an independent chair and without necessarily having 75% independent board members.

Risk of Independent Chair Becoming Interested

Another important matter involves the "independence" of an independent chair. At what point does an independent chair cross the line and essentially become an interested trustee, as that person learns every aspect of what is going on in the mutual fund organization and perhaps even takes on additional liability (for example, if required to

certify financials under Sarbanes Oxley)? Moreover, if there is additional real or perceived liability, such chair will likely insist upon additional compensation and a higher level of insurance coverage. At what point do such demands "jeopardize" one's independence?

In our judgment, increased risk to shareholders is associated with the character of the individual involved, whether or not that person is from the management company or is an independent trustee.

Indeed, concerning shareholder risk, it is worth noting that some of the fund groups that were charged with market timing had independent chairs. These independent chairs failed to detect the market timing.

Aquila's Approach to Independent Trustees

The independent trustees on our boards are by no means "yes" people. Moreover, they never have been. Aquila has always sought to have the right mix of responsible people on its boards, regardless of whether or not they were independent. Each board member has always been encouraged to speak up about any subject that they wished to explore – and I can assure you that they have and continue to do so.

Many of the independent trustees on our boards are from the specific individual states or regions involved. Thus, they are able to provide us with further insight into the nuances of the economy and other pertinent information about their investment region. The portfolio management of each regional fund is also directed out of the region in which the fund invests.

You should be interested to know that since its inception, each of the funds in the Aquila Group of Fundssm has generally had 75% independent trustees and has always had more than a majority of independent trustees. Based on Aquila's experience, we specifically question the need for a 75% Independent Board Members Rule when a super-majority of independent board members accomplishes the same goals.

As new board requirements have increased, the governance rules have already led to additional costs in terms of my time and my employees' time in supporting the independent trustees and, in particular, the independent chairs. This is not to mention the increased time and expense related to the funds' independent legal counsel.

Aquila's Hands-On Approach With Shareholders

Aquila has always been conscious of the fact that it is the shareholders' money invested in our funds. Thus, we seek to act responsibly in all of our activities with each fund.

It is worth noting that from its inception, each of the 7 single-state municipal bond funds has conducted an annual shareholder meeting based in the particular state involved. Shareholders are invited and generally attend in large numbers (over 500 at one meeting alone). At these meetings, trustees are elected and the independent auditor is approved (and, as applicable, other fund matters are addressed by the shareholders.) Following the business part of the meeting, an informational session of up to an hour is then conducted regarding pertinent aspects of the operations of the fund. This provides an opportunity for shareholders to ask unscreened questions.

A Super-Majority of Independent Trustees Should Suffice

Having 75% independent board members as well as an independent chair is superfluous.

With Aquila, independent trustees have always discussed and negotiated fees for each of their respective funds within the fund complex without having the interested chairman present. It is worth noting that each of the funds within the Aquila Group of Fundssm has had management fees, as well as expense ratios, which generally are decidedly on the lower side of similar-type funds in the industry.

With independent legal counsel and independent auditors, as well as an abundance of independent studies, there is adequate information available within the industry to ensure that the independent trustees are provided with fair and unbiased information and material from which to make well-documented decisions concerning fee structure(s) and other matters for the benefit of shareholders.

Consequently, boards which have a super-majority of independent trustees of less than 75% can more than adequately carry out their responsibilities.

The Focus of Boards Has Changed

In the increased regulatory environment that currently exists, our boards have generally become extremely cautious and now constantly turn to independent legal counsel. In part, I suspect that this is for self protection. In turn, these additional discussions with the independent legal counsel have resulted in higher fund expenses from increased legal fees and therefore, have tended to result in higher expense ratios.

The time that the boards spend on watchdog issues has increased such that one wonders whether areas of true concern are being covered in the proper depth. At times, one might wonder if items are added to the board meeting agendas just to indicate to the Commission that an area has been covered. We doubt that this adds better value for shareholders, particularly in light of the quarterly and periodic reports that the Chief Compliance Officer, independent legal counsel

and independent auditors provide to the independent board members as well as to the board as a whole.

In our opinion, Chief Compliance Officers, together with independent legal counsel and independent auditors, should ensure the avoidance of future industry scandals. Boards in general are focusing too much of their time and efforts in the wrong direction and not on how a particular fund's objective and operations can be better served.

The Role of the Chief Compliance Officer Compared With the Independent Chair Rule and the 75% Independent Board Members Rule

We believe the Commission's Chief Compliance Officer Rule should substantially assist in avoiding future scandals in the mutual fund industry. The Commission has largely defined through its rules those practices which it feels are appropriate and worthy of the board's knowledge. The Chief Compliance Officer should report, as ours does, on a quarterly basis to the independent board members on each area of activity that the Commission feels should be appropriately monitored.

Therefore, in our judgment, the idea of an independent chair and 75% independent board members is superfluous, given the existence of the Chief Compliance Officer Rule.

Summary

We wholeheartedly support the Commission's desire to take action to "clean-up" problems in the mutual fund industry. We specifically abhor the fact that 15 - 20 bad apples have tainted the entire barrel of 547 fund groups (as of June 2006 according to Strategic Insight) which make up the mutual fund industry. However, we do not believe that anyone will be served by mandating an independent chair. In fact, we firmly believe that this action would be contrary to the future well being of the industry. Having an entrepreneurial interested chair can make all the difference in the world in terms of having the initiative to create products which are of value to investors. Moreover, there is no proven benefit to having an independent chair – given that some of the funds that had problems also had independent chairs.

Given the lack of any such proven benefit, we believe that it is impossible to justify the increased costs associated with the Independent Chair Rule which are particularly burdensome on smaller fund complexes like ours. Consequently, we firmly believe that the Independent Chair Rule is superfluous.

Finally, we believe that a board that has a super-majority of independent board members is a sufficient number and that having 75% is unnecessary. Mandating that 75% of board members be independent increases direct and indirect costs, especially to the detriment of smaller funds and their sponsors.

Thank You for this Opportunity

Thank you for this opportunity to express my disagreement with the Independent Chair Rule and the 75% Independent Board Members Rule for Mutual Fund Boards. I have devoted a great deal of effort to convey my thoughts to you on these rules because I feel very strongly that they would have a harmful effect on the industry as a whole and especially on smaller fund groups and their respective (and potential) shareholders. As you know, many fund groups do not have an unlimited amount of time and money to cope with increasing regulatory burdens which are not necessary for the protection of shareholders.

Sincerely,



Lacy B. Herrmann
Chairman

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

Andrew J. Donohue, Director
Division of Investment Management