Consumer Federation of America
Fund Democracy, Inc.
Consumer Action
Consumers Union
Public Citizen

March 10, 2004

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

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

Dear Secretary Katz:

We are writing on behalf of Consumer Federation of America,[1] Fund Democracy,[2] Consumer Action,[3] Consumers Union[4] and Public Citizen[5] to express our strong support for the proposed rule amendments to enhance the independence and effectiveness of mutual fund boards of directors. Improving fund governance is an essential component of a comprehensive mutual fund reform agenda. The proposed rule does an excellent job of identifying the key changes

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 national, state, and local consumer groups, which in turn represent approximately 50 million Americans. CFA was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Fund Democracy is a nonprofit advocacy group for mutual fund shareholders. It was founded in 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments.

[3] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national

needed to accomplish that goal, within the limits of existing Commission authority. Supplemented by legislation to eliminate loopholes in the current definition used to determine who can serve as an independent director and to clarify and extend the fiduciary duty of directors, these rules should significantly improve the quality of oversight provided by fund boards. **We urge that this rule be adopted without weakening amendments.**

Executive Summary

The proposed rule recognizes and respects the distinct roles played by fund managers, in conducting day-to-day operations of the fund, and fund directors, in overseeing those operations and policing conflicts of interest. By requiring that three-quarters of board members, including the chairman, be independent, the proposed rule helps to ensure that this oversight function will be controlled by those individuals whose sole obligation is to ensure that shareholders' interests are protected.

In addition to enhancing the independence of the board, the proposed rule gives independent directors key tools they need to fulfill their responsibilities more effectively. Requiring that independent directors meet at least quarterly in separate sessions should ensure that these directors regularly discuss key issues without undue influence of fund managers. Permitting independent directors to hire staff should ensure that they have access to the expertise they need to fulfill their responsibilities effectively. And requiring annual self-assessments should provide a useful mechanism for evaluating the effectiveness of the board in fulfilling both its general responsibilities and specific functions entrusted to it.

We also strongly support the requirement that boards maintain records of their deliberations in evaluating and approving the advisory contract. This is perhaps the single most important function entrusted to the board, and it is an area where evidence suggests many boards have been less diligent than they ought to be. By making boards more accountable, and by making their deliberations more transparent to both shareholders and regulators, this provision should help to make directors more conscientious in fulfilling this central board responsibility.

Our specific comments on the rule proposal follow.

- **We strongly support the requirement that at least three-quarters of fund directors, including the chairman, be independent.**

The Investment Company Act is designed to ensure that mutual funds are operated in the

For fund boards to have credibility as they fulfill this responsibility, the board must be firmly under the control of those directors whose sole responsibility is to look out for the interests of shareholders. In addition, boards must be free from undue influence by fund managers. While it is theoretically possible that a fund board that is chaired by the chief executive of the fund manager and that has a bare majority of independent directors will provide aggressive and independent oversight of conflicts, the odds are heavily stacked against it.

The current requirement for a bare majority of independent directors does not adequately assure that these directors will dominate the decision-making process. Because of loopholes in the current definition, not all "independent" directors will necessarily be truly independent. In that case, the bare majority quickly becomes a minority, and the intent of the requirement is thwarted. Similarly, if one or more of the independent directors has a mediocre attendance record, the majority may in reality function as a minority. Finally, not all those who meet the legal requirement for independence will actually assert independent judgment in evaluating issues before the board, either because they lack the expertise or personality to feel comfortable challenging the fund adviser. Requiring that at least three-quarters of all directors be independent won't completely solve, but will help to mitigate, these potential problems.

A strong case could be made for limiting fund managers to a single position on fund boards. This would give the board the benefit of the investment adviser's expertise, while sending a clear message that the board serves as the representatives of shareholders, not fund managers, and has as its sole responsibility protecting shareholder interests. That said, we believe the three-quarters requirement in the current proposal, if coupled with a requirement that the board chairman be independent, will adequately serve this purpose.

Simply increasing the number of independent directors is not enough. It is essential that fund boards also have an independent chairman. With the chairmanship comes the power to set the agenda, primary responsibility for determining what information is provided to the board by the fund adviser and other service providers, and the ability to guide board discussion of key issues. Thus, as long as an executive of the fund's investment adviser can serve as chairman, fund managers are highly likely to continue to dominate the operations of the board. In light of the fact that the board's chief responsibility is to police conflicts of interest and ensure that shareholders' interests are protected, it is also symbolically important that the chairman be independent. Putting a representative of the investment adviser in this position creates the appearance, and inevitably in some cases the reality, that the fox is guarding the henhouse.

these individuals make against the independent chairman requirement often provide the clearest evidence of why it is so badly needed.

The alternatives that have been suggested, such as requiring that independent directors appoint a lead director or relying on independent directors to elect an independent chairman, are clearly inadequate. Appointing a lead director does nothing to ensure that independent directors control the agenda, information requests, and terms of board debate. Evidence suggests that, absent a mandate, few independent directors will be willing to wrest chairmanship of the fund board from the investment adviser, particularly since doing so would likely be interpreted in the media as a lack of confidence in the fund manager that could hurt the fund's reputation with potential shareholders.

We would strongly oppose any move to weaken this central reform, without which the overall independent governance proposal would be all but toothless.

We strongly support the provision authorizing independent directors to hire staff.

One of the arguments put forward against an independent chairman mandate is that independent directors lack the expertise necessary to perform this function effectively. Given that the primary responsibility of the board is not to manage the funds themselves, but to police conflicts of interest, this argument is clearly specious. However, authorizing independent directors to hire employees and consultants to help them fulfill their responsibilities should put this argument to rest once and for all. Furthermore, providing independent directors with a source of expertise independent of the fund's investment manager should ensure that fund managers don't continue to dominate fund boards by virtue of their greater expertise.

The potential drawback of this approach is that it would increase shareholder costs, by adding a layer of employees to the fund structure that currently doesn't exist. The rule addresses this problem by authorizing, rather than requiring, independent directors to hire staff. Thus, funds that did not feel the benefits justified the cost would be under no obligation to hire such employees. Others might decide to consult experts for assistance in evaluating specific issues, rather than hiring permanent staff. The decision of whether to do so would rest with those in the best position to make that judgment – the independent directors whose responsibility is to represent shareholders. We therefore do not believe it is necessary or appropriate at this time to make this provision a mandate.

requirement will help to ensure that independent directors have ample opportunity to discuss important issues without being unduly influenced by the fund manager. Requiring boards to conduct annual self-assessments will force them to take a formal reckoning of their effectiveness and how it could be improved. We believe this requirement should require some form of written documentation to help ensure that it is more than an empty exercise.

We strongly support the requirement that fund boards retain documents used by the directors in reviewing and approving the advisory contract.

Reviewing and approving the advisory contract is perhaps the most important function entrusted to the fund board. Among other things, it is primarily through this process that the fund board ensures that fund operating costs are reasonable. Ample evidence suggests that all too many fund boards think they have fulfilled their responsibility in this area as long as their fund fees are not grossly out of line with industry norms. It is our hope that making fund boards more independent, by requiring a super-majority of independent directors and an independent chairman, will make those boards more likely to act as aggressive negotiators on behalf of shareholders when they review and approve the advisory contract.

This additional requirement – that fund boards retain the documents they considered in evaluating the advisory contract – should serve as a useful supplement. Knowing that SEC compliance examiners will be reviewing those documents should make those fund boards who are now shirking their responsibilities more conscientious in their reviews of the advisory contract. We believe having the Mutual Fund Directors Forum develop best practices at the SEC's behest will strongly encourage funds to adopt those practices. When combined with the Commission's separate rule proposal to improve disclosure regarding approval of advisory contracts, this rule should help to raise the quality of deliberations fund boards engage in when reviewing advisory contracts.[6]

Legislation is needed to ensure that the proposed rule achieves its intended result.

The rule suffers from certain limitations, not of intent, but of Commission authority. First, and perhaps most importantly, the Commission does not have the authority to strengthen the definition of independent director. Thus, even if the rule is adopted without weakening amendments, individuals with close family ties, recent work connections to a fund adviser, and current connections to certain fund service providers will still be eligible to serve as independent directors. This could undermine the reforms the rule proposal seeks to achieve. We therefore strongly endorse the Commission's call for legislation to close these loopholes.[7]

Second, because of limits on its authority, the Commission is forced to rely on the indirect method of amending exemptive rules to achieve its goals. The Commission asserts in the rule proposal that virtually all mutual funds must, as a practical matter, rely on one of those rules and thus will be covered by the proposed independent governance requirements. But past experience suggests that this approach may be most likely to fail just when it is needed most – when there is a bona fide confrontation between the independent directors and the fund manager. The risk is that, in the event of such a confrontation, the fund manager will simply cease relying on the exemptive rules, in which case the independence rules will no longer apply.[8] Under such circumstances, the fund manager would be free to reduce the number of independent directors to 40 percent of the board and nominate its own chairman and independent directors.

For this reason, we believe it is essential that these standards be formally codified through legislation as requirements for all mutual funds. Only such an approach ensures that independent directors will retain their authority in the event of a serious confrontation with the fund manager. We therefore support legislation to impose these requirements directly and to give the Commission authority, going forward, to strengthen or adjust those requirements as appropriate. Similarly, we strongly oppose legislation that would undermine the SEC's efforts by imposing weaker governance requirements than those contained in the SEC proposed rule.

Finally, lack of independence, while important, is not the only concern about fund governance. Also problematic is the failure of many mutual fund boards to act as fiduciaries, with broad responsibility to protect shareholder interests. While enhancing board independence offers a partial solution, we believe the scope of directors' fiduciary duty must be both clarified and broadened, and we support legislation to accomplish that goal.

The legislation recently introduced by Senators Peter Fitzgerald (R-IL), Susan Collins (R-ME), and Carl Levin (D-MI) contains the best provisions to date to address these issues. It codifies the requirement that fund boards have three-quarters independent directors along with an independent chairman. It contains a strong definition of independent director and supplements it with an additional requirement that independent directors set director compensation levels. And it expands and clarifies the fiduciary duty of directors. As such, it would serve as an ideal supplement to this rule proposal.

Conclusion

The mutual fund trading scandals uncovered last fall, and since discovered to pervade the industry, are clear evidence of a systemic breakdown in compliance systems in the mutual fund industry. The attention that the scandals have brought to inadequate fund governance standards offers an opportunity to adopt reforms that, given the responsibility of the fund board to police conflicts of interest and protect shareholder interests, should have been incorporated in the Act from the outset.

While the trading scandals afford the opportunity to adopt these reforms, they are not the only, or even the primary, reason that the reforms should be adopted. More important is the failure of fund boards to ensure that fund operating costs are reasonable. This failure has allowed all too many mutual funds to act as Robin Hoods in reverse, syphoning off tens of thousands of dollars from the retirement savings of middle class Americans over the lifetime of those investments in order to make already highly profitable fund managers even more profitable.

As the Commission itself has noted, enhancing the independence of fund boards is key to driving down these costs. Specifically, in repudiating the fee reduction agreements negotiated by New York Attorney General Eliot Spitzer, and in refusing to use its own authority to challenge unreasonable costs, the Commission has argued that independent fund boards and market competition should be relied on to discipline fund costs.

Despite surface appearances, however, the mutual fund market is not truly cost competitive. A major and growing portion of mutual transactions are conducted through employer-sponsored retirement plans, where employees generally have very limited ability to shop around for low-cost funds. Furthermore, one way fund companies compete for this business is by shifting administrative costs onto employees in the form of higher 12b-1 fees. Thus, competition in this market often occurs in ways that drive costs up, not down. Reverse competition – where funds compete to be sold, not bought – is even more evident in the broker-sold fund market. Here, funds compete to be sold by offering generous financial incentives to the fund salespeople. This drives up costs to investors and allows mediocre, high-cost funds to survive and even thrive.

The Commission has offered several very strong proposals to improve mutual fund sales practices. To our great disappointment, however, the Commission has so far failed to propose the kind of innovative operating cost disclosure that might inject real cost competition into the

Absent regulatory intervention and meaningful, industry-wide cost competition, shareholders will have to rely almost exclusively on fund boards to discipline costs. If adopted without weakening amendments, this rule proposal should increase the likelihood that fund boards will act as tough negotiators in setting fund costs. If supplemented by legislation to codify these requirements, strengthen the definition of independent director, and expand and clarify directors' fiduciary duty, shareholders will have real cause for optimism that fund boards will fulfill their statutory obligation. We congratulate the Commission for putting forward this strong independent governance proposal, and we urge you both to adopt it without weakening amendments and to support the supplementary legislation that would allow it to achieve its full potential.

Respectfully submitted,

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