

MEMO# 20257

August 8, 2006

Draft Comment Letter on SEC Fund Governance Rules on Behalf of the Small Funds Committee; Conference Call August 10th

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20257] August 8, 2006 TO: SMALL FUNDS COMMITTEE No. 18-06 RE: DRAFT COMMENT LETTER ON SEC FUND GOVERNANCE RULES ON BEHALF OF THE SMALL FUNDS COMMITTEE; CONFERENCE CALL AUGUST 10TH As we indicated previously, the Securities and Exchange Commission has requested additional comments on requirements that investment companies relying on certain exemptive rules have a board with (1) an independent director as chair and (2) no less than 75 percent independent directors.¹ In addition to the Institute's comment letter, a draft of which you received on July 31, 2006, ² we have prepared a letter to be submitted on behalf of the Small Funds Committee. A draft of that letter is attached and summarized below. PLEASE NOTE that the current draft letter includes a list of members of the Small Funds Committee in Appendix A. If you object to having your name included in the letter, please respond to Peter Salmon at salmon@ici.org or 202/326-5869. The Institute will hold a conference call on Thursday, August 10th at 1:00 pm Eastern Time to discuss the draft letter. The dial-in number for the call is 888-390-3404 and the passcode is 22503. Please email Peter Salmon at salmon@ici.org to let us know if you plan to participate on the call. If you cannot participate on the call, please provide any comments on the draft letter to Mara Shreck at mshreck@ici.org or 202/326-5923 before the call. In addition, we encourage all members of the Small Funds Committee to submit their own comment letters. A series of points to consider in drafting such a letter is also attached to this memo. ¹ See Memorandum to Small Funds Committee No. 15-06 [20107], dated June 15, 2006. ² See Memorandum to Small Funds Committee No. 17-06 [20224], dated July 31, 2006. ² Summary of Draft Letter The draft letter begins by expressing support for the Institute's comment letter, which opposes the independent chair requirement and recommends that the Commission require that two thirds of a board's members be independent, rather than 75 percent. The draft letter then provides background about small funds. It describes their importance to the industry as sources of innovation and providers of specialized investment products. The draft letter next reviews in some detail the market pressures faced by small fund complexes, explaining that the preference for low-cost funds places pressure on small fund advisers to absorb costs that could be charged to the fund, in an effort to keep expense ratios competitive. The draft letter suggests that each additional regulatory cost imposed on a small fund complex makes the business less profitable and less desirable to enter. The

draft letter then discusses the disproportionate impact on small funds of recently imposed regulatory requirements. It explains how legal, audit, and directors' fees have risen substantially as a percentage of total fund expenses in recent years, making the mutual fund advisory business more expensive for small fund advisers. The draft letter then addresses the specific requirements under consideration. With respect to the independent chair requirement, the draft letter examines the SEC's estimates of the cost of implementation, and compares them to actual costs reported to the Institute by Small Funds Committee members who have elected an independent chair. The draft letter concludes that, while in isolation the cost is not prohibitive for all small funds, the cumulative effect of recently imposed fund governance rules is considerable. The draft letter further states that, as set forth in more detail in the Institute's comment letter, independent directors are in the best position to evaluate the costs and benefits specific to their situation and determine the most qualified chairman for their particular board. Finally, the draft letter notes that the proposed requirement creates additional barriers and disincentives for entrepreneurs considering entering the mutual fund industry. Turning to the board composition requirement, the draft letter examines the SEC's cost estimates for compliance with the 75 percent requirement, as well as other studies on director compensation. The draft letter also reviews the number of small fund complexes that already have restructured their boards, and how they did so, evaluating the likely costs of compliance. The draft letter explains that a 75% requirement reduces flexibility for boards following the resignation of an independent director, by making it more likely that the board will need to add an independent director to maintain the appropriate balance. Finally, the draft letter notes that the 75% requirement places a substantial burden on entrepreneurs who wish to start a fund and appoint two interested directors, by requiring them to have six independent directors. The draft letter suggests that the 75% requirement imposes additional burdens, both in dollars and decreased flexibility, without any corresponding benefit compared to the Institute's proposed two-thirds supermajority requirement. 3 Mara Shreck Assistant Counsel Attachment (in .pdf format)