INVESTMENT COMPANY INSTITUTE

MEMO# 20305

August 21, 2006

ICI and Small Funds Comment Letters on SEC Fund Governance Rules

 [20305] August 21, 2006 TO: BOARD OF GOVERNORS No. 24-06 CLOSED-END INVESTMENT COMPANY MEMBERS No. 36-06 SEC RULES MEMBERS No. 72-06 SMALL FUNDS MEMBERS No. 58-06 RE: ICI AND SMALL FUNDS COMMENT LETTERS ON SEC FUND GOVERNANCE RULES Today the Institute filed a comment letter with the Securities and Exchange Commission, urging the Commission 1) not to pursue a requirement that investment companies relying on certain exemptive rules have a board with an independent chair, and 2) to require that two thirds of a board's members be independent, rather than 75 percent.1 Over 35 members of the Institute's Small Funds Committee submitted a second comment letter, addressing the disproportionate impact these requirements would have on small funds, and explaining that the cumulative effect of recently imposed regulatory requirements has made the industry less profitable for small fund advisers and less appealing to entrepreneurs. Both letters are attached and summarized below. The Institute's Letter The Institute's letter recommends that the Commission not pursue the independent chair requirement and that it require two thirds of a board's members to be independent, rather than 75 percent. 1 The letter was filed in response to the Commission's request for additional comment on these requirements. See Investment Company Act Release No. 27395 (June 13, 2006) ("Release"). The Release and a related press release are available on the SEC's website at http://sec.gov/rules/proposed/2006/ic-27395.pdf and http://sec.gov/news/press/2006/2006-95.htm, respectively. 2 Independent Chair The letter asserts that the selection of the best person to serve as chairman rightfully is, and should continue to be, a decision made by the directors themselves. It notes that since the Commission first issued its proposal, many fund boards have chosen an independent director as chair, demonstrating that a legal requirement is not necessary to facilitate this approach. The letter points out that independent directors, because they generally must constitute at least a simple majority of the board, are fully empowered to choose an independent chair if they wish. While recognizing that an independent chair arrangement works well for some boards, the letter states that the Institute does not believe the Commission has adequately demonstrated the benefits of mandating this governance structure for virtually all fund boards. The letter points to the lack of empirical evidence of benefits and discusses developments, including other new rules, that have already addressed the purposes of the independent chair requirement. The letter expresses the Institute's belief that given (1) the lack of empirical evidence of benefits, (2) the other new rules and other factors that have addressed the Commission's goals, and (3) the successful experiences of boards with each structure, the costs of a one-size-fits-all requirement are

not justified. The letter suggests that if the Commission continues to believe that additional measures are needed, it should consider less costly and disruptive alternatives, such as requiring boards that do not have an independent chair to appoint a lead independent director. Board Composition The letter expresses the Institute’s support for requiring a supermajority of independent directors on fund boards. It discusses the costs involved in reaching and maintaining a supermajority of independent directors and provides examples to illustrate that a 75 percent requirement amplifies these costs, most notably in terms of reduced flexibility in board composition.2 The letter urges the Commission to revise its proposal so as to require a two-thirds supermajority instead of 75 percent because the costs of the 75 percent requirement – both in dollars and decreased flexibility – come without any apparent corresponding benefit. The Small Funds’ Letter The Small Funds’ letter supports the Institute’s comment letter, and focuses on the impact of the requirements on small fund complexes. The letter describes small funds’ role in the industry as sources of innovation and providers of specialized investment products. It explains that investors’ preferences for low-cost funds place pressure on small fund advisers, often requiring them to absorb costs that could be charged to the funds in an effort to keep expense ratios competitive. The letter also 2 For example, an eight person board with two interested directors would be in violation of the requirement after a single independent director resigned; under a two-thirds supermajority rule, the same board would not be in violation until three independent directors resigned. 3 highlights the disproportionate impact on small funds of recently imposed regulatory requirements, explaining how legal, audit, and directors’ fees have risen substantially as a percentage of total fund expenses in recent year. The letter emphasizes that each additional regulatory cost imposed on small fund complexes makes the business less profitable and less desirable to enter. Independent Chair The letter examines the SEC’s estimates of the cost of implementing the independent chair requirement, and compares them to actual costs reported to the Institute by Small Funds Committee members who have elected an independent chair. The letter concludes that, while in isolation the cost is not prohibitive for all small funds, the cumulative effects of recently imposed governance rules have been considerable. The letter reinforces the conclusions of the Institute’s letter that 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 letter notes that the proposed requirement creates additional barriers and disincentives for entrepreneurs considering entering the mutual fund industry. Board Composition The letter examines the SEC’s cost estimates for compliance with the 75 percent requirement, as well as other studies on director compensation. It 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 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. It 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 letter contends 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. Elizabeth Krentzman General Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 20305, or call the ICI Library at (202) 326-8304 and request the attachment for memo 20305. Attachment no. 1 (in .pdf format) - ICI Letter Attachment no. 2 (in .pdf format) - Small Funds Committee Letter