MEMO# 20297

August 16, 2006

Comment Letter from Representatives of Small Funds on SEC Fund Governance Rules

 [20297] August 16, 2006 TO: SMALL FUNDS COMMITTEE No. 19-06 RE: COMMENT LETTER FROM REPRESENTATIVES OF SMALL FUNDS ON SEC FUND GOVERNANCE RULES As we indicated previously, the Institute has prepared two comment letters in response to a request by the Securities and Exchange Commission for 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 then 75 percent independent directors.1 In addition to the Institute's comment letter, we have prepared a letter that addresses the specific impact of the requirements on small funds. We initially proposed to submit this letter on behalf of the Small Funds Committee. We have now decided instead to invite all Committee members to sign the letter, and to submit it on behalf of those who choose to do so. A draft of the letter is attached and summarized below. If you would like to sign the letter and have not already notified us, please contact Mara Shreck at mshreck@ici.org or 202/326-5923 no later than Friday, August 18th. 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 1 See Memorandum to Small Funds Committee No. 18-06 [20257], dated August 8, 2006. 2 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. Mara Shreck Assistant Counsel Attachment (in .pdf format) 3
