

## COMMENT LETTER

August 21, 2006

# ICI Members Comment on Impact of Fund Governance Rules on Small Funds (pdf)

August 21, 2006 Ms. Nancy M. Morris Secretary 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: The undersigned are members of the Small Funds Committee of the Investment Company Institute.<sup>1</sup> We fully support the position set forth in the Institute's comment letter, which opposes the Commission's mandatory requirement that the boards of all funds that rely on certain exemptive rules have an independent chair, and recommends revising the requirement that such boards be comprised of no fewer than 75 percent independent directors to require a two-thirds supermajority of independent directors.<sup>2</sup> This letter is intended to supplement the Institute's comments by addressing the specific impact of these corporate governance requirements on small fund complexes. Small funds represent an important segment of the mutual fund industry. In addition to providing choices for investors and encouraging competition,<sup>3</sup> they have historically been prolific sources of innovation and purveyors of highly specialized investment products.<sup>4</sup> For 1 The Small Funds Committee was created over 25 years ago to bring together management company executives to discuss relevant business, operational, legislative, regulatory and general industry developments. The Institute defines small fund members as fund complexes with less than \$2 billion in non-money market assets. We recognize that the Institute's definition of a small fund is broader than the SEC's which, as set forth in 17 CFR § 270.0-10, defines a small fund as a fund complex with net assets of \$50 million or less. We believe that the SEC's definition is too narrow, inasmuch as it does not adequately capture all of the complexes that are disproportionately affected by the costs of complying with new regulations. More information about small funds and the Committee is included in Appendix A. 2 See Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated Aug. 21, 2006, a copy of which is attached to this letter. The governance requirements under consideration are set forth in Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("Adopting Release"). 3 See, e.g., The Success of America's Mutual Fund Marketplace: Benefiting Fund Investors, Remarks by Paul Schott Stevens, President, Investment Company Institute, at AEI/Brookings Forum, March 15, 2006 (explaining that low concentration in the mutual fund marketplace, as evidenced by the large number of fund complexes, none of which is dominant, is a hallmark of a competitive industry). 4 See, e.g., Statement of Thomas O. Putnam, Founder and Chairman, Fenimore Asset Management, Inc./FAM Funds, Review of Current Investigations and Regulatory Actions Regarding the

Mutual Fund Industry: Fund Costs and Distribution Practices, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 2nd Sess. (March 31, 2004), at 4-7 (describing the important role of small funds in the mutual fund industry, Ms. Nancy M. Morris August 21, 2006 Page 2 example, money market funds, which now hold \$2.2 trillion in assets, were first offered in 1971 by the Reserve Fund, at the time a small fund complex. Small fund complexes also popularized many other common investment products, including socially responsible and leveraged funds. Some specialized products, such as municipal bond funds for particular states, are still only available from small fund advisers. Yet the very nature of their size means that small funds are more costly to operate per dollar of assets under management. To maintain competitive expense ratios, small fund advisers often accept lower margins, absorbing costs that in larger funds would be passed on to shareholders. Not infrequently, small fund advisers even operate one or more funds at a loss for an extended period of time in the hope that they will eventually gather enough assets in those funds to achieve economies of scale and profitability. The cost to implement the fund governance requirements currently under consideration could have a meaningful impact on a small fund complex. Additionally, potential new entrants may be dissuaded from joining our industry, because of both the higher startup and ongoing compliance costs of these and other new regulatory requirements. Moreover, the requirements may create a disincentive for entrepreneurs considering the mutual fund industry. A company founder understandably may have concerns about the requirement that the board chair be an individual who by definition is, at least initially, unfamiliar with the company, and may come from outside the industry. Alternative business opportunities in the field of asset management with lower regulatory burdens, such as hedge funds and separately managed accounts, are therefore becoming increasingly attractive to entrepreneurs. Meanwhile, as discussed in the Institute's comment letter, the benefits of requiring an independent chair and a 75% independent board have not been established. In assessing the rules under consideration, the Commission must take into account their possible effects on competition and capital formation.<sup>5</sup> Because of the potential impact of the costs on small fund complexes, as well as the disincentives created for potential market entrants, we urge that the Commission not require all funds to have an independent chair, but rather leave it to the independent directors to assess the costs and benefits specific to their situation and determine the most appropriate chair for their particular board. We further recommend that the requirement that fund boards be comprised of no fewer than 75 percent independent directors be revised to require a two-thirds supermajority.

Market Pressures on Small Fund Complexes To appreciate the potential impact on small fund complexes of the requirements currently under consideration, it is helpful to understand the constraints imposed on small funds by the competitive nature of the mutual fund industry. including providing choice for investors, fostering competition, developing specialized and niche products and offering shareholders individual service and attention that cannot be matched by large funds). <sup>5</sup> See 15 U.S.C. §80a-2(c). Ms. Nancy M. Morris August 21, 2006 Page 3 Mutual funds face highly competitive pricing pressure in the marketplace. Expense ratios are a fundamental factor for investors and investment professionals when analyzing and comparing funds with similar investment objectives.<sup>6</sup> Shareholders are predominantly invested in mutual funds with low expense ratios. In 2005, nearly 90 percent of stock fund assets were in funds with below-average expense ratios.<sup>7</sup> At the same time, small funds tend to have higher expense ratios, in part because their fixed costs are spread over a smaller asset base.<sup>8</sup> For example, 80 percent of growth-oriented funds have operating expense ratios<sup>9</sup> between 69 basis points and 141 basis points, compared with an average of 136 basis points for growth-oriented funds offered by small fund complexes.<sup>10</sup> Because their expense ratios already tend to be higher than average, small funds have a limited ability to pass higher regulatory costs on to their shareholders. Higher expense ratios are likely to make a fund less

attractive to potential and existing shareholders. Indeed, investors can and do vote with their feet: in any given year, a quarter to a half of all mutual fund firms experience net outflows from long-term funds.<sup>11</sup> To avoid increasing expense ratios, small fund advisers often pay costs out of their own pockets that typically are charged to a fund. Similarly, many small fund advisers enter into expense cap agreements, under which they agree to limit the expenses charged to a fund, paying any excess costs themselves. Advisers may also offer fee waivers; while large and small funds offer fee waivers with similar frequency, the waivers offered by small funds tend to be substantially higher.<sup>12</sup> These practices suggest that, for funds to attract and retain shareholders, there is essentially a market-imposed constraint on their expense ratios.

6 See, e.g., Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064 (March 13, 1998) [63 FR 13916 (March 23, 1998)], at 13924 (describing “the Commission’s strongly held belief in the importance of fees and expenses in a typical investor’s decision to invest in a fund”); Understanding Investor Preferences for Mutual Fund Information, Investment Company Institute (2006).

7 See 2006 Investment Company Fact Book, 46th Edition, [www.icifactbook.org](http://www.icifactbook.org), at 41. Similarly, according to an ICI analysis of confidential data submitted for the monthly Trends in Mutual Fund Activity report, from 2000 to 2005, 97 percent of investors’ net new purchases of stock funds were in funds with below-average expense ratios.

8 See Appendix B for more detail on expense ratios.

9 An operating expense ratio is measured as the total expense ratio net of 12b-1 fees and waivers. 12b-1 fees are excluded because such fees represent the external costs of distributing a fund’s shares, as opposed to the direct costs of operating a fund.

10 Figure based on ICI calculations using expense data by share class for 2005 from Lipper LANA 4.0 database. Small fund expense ratios are consistently well above the asset-weighted average of funds in the same category. See Appendix B for more detail.

11 Figure based on confidential data submitted to ICI for the monthly Trends in Mutual Fund Activity report.

12 See Appendix C for more details on fee waivers.

Ms. Nancy M. Morris August 21, 2006 Page 4

Many small fund advisers appear to have little room to absorb additional fund costs. The median<sup>13</sup> of annual fund expenses paid by funds at small fund complexes, net of 12b-1 fees and waivers, is only \$1.7 million.<sup>14</sup> These fund expenses cover fund costs<sup>15</sup> and management fees paid to the adviser to cover a core set of services, including investment advisory services.<sup>16</sup> From the management fee paid to the adviser, the adviser must pay its own operating expenses as well as any fund expenses it has assumed; the remainder, if any, is the adviser’s pre-tax profit. These small fund advisers do not enjoy the operating margins necessary to absorb an unlimited stream of higher regulatory costs. Eventually, the costs of managing a small mutual fund complex could become prohibitive, and starting one may be substantially less appealing. The Disproportionate Impact of Recently Imposed Regulatory Requirements Because of the fixed costs inherent in many regulations, new rules tend to have a disproportionate impact on small funds. We recognize, of course, that small fund complexes have chosen to offer mutual funds and, consequently, to be regulated by the same rules as other mutual funds. Many rules have clear benefits to fund shareholders and are therefore worth the cost. Nevertheless, the SEC has an obligation to consider the effect of its regulations on small funds,<sup>17</sup> as well as on competition and capital formation.<sup>18</sup> To the extent that new rules raise barriers to entry for potential market participants and pressure margins of existing participants without any discernible benefits, the Commission is doing a disservice to investors and the market. The recent rules comprising the SEC’s fund governance “package”<sup>19</sup> have directly and indirectly increased the operating costs for small funds. For example, according to Lipper data, between 2003 and 2005, small fund complexes saw an overall increase in their legal costs,

13 For figures based on assets under management, the median is used because we believe it is more representative of the typical mutual fund complex than the simple average.

14 Figures based on ICI calculations

using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006. See Appendix D for more detailed information on average and median assets among different segments of the mutual fund industry. 15 Fund costs include directors' fees, legal and audit costs, insurance, registration fees, fund accounting, transfer agency, and shareholder services. 16 Core services often include fund administrative services and fund personnel, such as the CCO and other officers. 17 See 5 U.S.C. §§ 601-612; 17 C.F.R. §270.0-10(a). 18 See 15 U.S.C. §80a-2(c). 19 In its Adopting Release, which included the governance requirements currently under consideration as well as related fund governance rules that have not been challenged, the SEC described the rules as part of a "package" to address concerns about the governance of mutual funds. The unchallenged requirements provide that fund boards must (1) perform annual self-assessments, (2) hold separate meetings of the independent directors at least once each quarter, and (3) have express authority to retain experts and hire staff. The other rules in the fund governance package are listed in Appendix E. Ms. Nancy M. Morris August 21, 2006 Page 5 directors' fees, and audit costs of 25 percent; 20 many consider this cost increase to be an indirect result of the recent governance rules. For the median small fund complex, such costs represented 7 percent of fund expenses in 2005, up from 6-1/4 percent in 2003. Meanwhile, costs for legal, audit, and directors' services relative to fund expenses for the median large fund complex, which has assets of \$10.6 billion, remained around 1-1/2 percent. Several small fund members of the Institute have provided more detailed information on recent cost increases. 21 These firms have experienced sizable increases in their direct and indirect compliance-related expenses. For example, increases in compensation for directors have ranged from approximately 50 percent to over 100 percent. In addition, some firms have experienced substantial increases in legal fees, as well as increased compliance expenditures due primarily to the appointment of a chief compliance officer. Little by little, these added costs make small funds more costly for shareholders and, particularly when advisers choose to absorb some of the costs rather than pass them on to shareholders, make the mutual fund advisory business more expensive for small fund advisers. Rules Under Consideration In its Response to the Remand by the Court of Appeals, the Commission stated that: We find that the costs of the 75 percent condition and of the independent chairman condition are extremely small relative to the fund assets for which fund boards are responsible, and are also small relative to the expected benefits of the two conditions. We expect that the minimal added expense of compliance with these conditions will have little, if any, adverse effect on efficiency, competition and capital formation. 22 While the costs to a fund complex with expenses equal to the industry average of \$91 million may not be significant, we can assure the SEC that the costs of implementing these rules will impact those of us with expenses closer to \$1.7 million (the median for small fund complexes), or even \$4 million (the average for small fund complexes). 23 Further, as set forth 20 Figure based on ICI calculations using expense data by share class from Lipper LANA 4.0 database. Data represents only those funds that reported legal and audit costs and directors' fees separately for both 2003 and 2005. 21 See Appendix F. 22 Investment Company Governance, Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26985 (June 30, 2005) [70 FR 39390 (July 7, 2005)] at 39395 ("Remand Response"). 23 See, e.g., Letter from F.E. James, Ph.D., James Investment Research, Inc., to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 6, 2004 (describing the costs to a small investment company of hiring and compensating an independent chair and noting that this "would cause many small investment companies to reconsider their decision to remain in the investment company business"); Letter from Maurice Schoenwald, Chairperson of New Alternatives Fund, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Feb. 9, 2004 (describing the substantial cost impact of the proposed rules); Letter from Richard F.

Curcio, Chairman, The Valiant Fund, to the Securities and Exchange Commission, dated July 27, 2006 (“[t]he proposed rules will do nothing but add approximately \$100,000 in costs that I as the advisor will have to pay. Since our management fee is capped, these costs cannot be passed on to shareholders.”). Ms. Nancy M. Morris August 21, 2006 Page 6 more fully in the Institute’s comment letter, while an independent chairman or a 75 percent independent board may work well for some fund boards, we do not believe that the benefits of requiring these governance structures have been adequately established, particularly in light of their costs. Independent Chair of the Board In its examination of the costs of the independent chair requirement, the SEC considered a variety of costs, which are set forth in the Remand Response. The Commission acknowledged that fund complexes can comply with the requirement by elevating an existing independent director to the position of chair or recruiting a new independent director to serve as chair. In some cases, a fund complex (even a small fund complex) may need to do both if it has multiple fund boards. These decisions and their associated costs are particularly relevant for small fund complexes, as approximately half of them do not have independent chairs.<sup>24</sup> The least costly alternative is to promote a qualified independent director to the position of chair. The SEC estimated that the cost of this option would range from \$1,147 to \$9,000 per fund, depending on how many funds the board oversees.<sup>25</sup> Confidential data on independent director compensation collected by the Institute and the Independent Directors Council is generally consistent with the SEC estimates.<sup>26</sup> For small fund complexes, the data suggests that the additional compensation is typically in the upper half of the range, as small fund complexes generally have far fewer funds over which to spread the fixed and growing cost of an independent chair. 24 The Institute and the Independent Directors Council collect data on fund board practices and independent director compensation through their Directors’ Practices Study. The most recently completed study collected data covering the year ended December 31, 2005 (the “Study”). It includes information reported by 185 complexes, representing approximately 88% of the industry’s total net assets. These complexes reported information on 1,471 independent directors. One hundred forty-seven of the complexes participating in the Study utilized the unitary board structure (one board overseeing all funds in the complex). Forty-six of these complexes reported total net assets of \$2 billion or less. Fifty percent of the 46 complexes reported having an independent chair. 25 The estimated fees for an independent chair were based on a 2003-04 survey by Management Practice, Inc. (“MPI”) suggesting a median salary of \$12,500 for a director overseeing 1-6 funds. The SEC added a 20 percent premium to account for possible cost increases since the survey (\$15,000), and assumed that a chair would earn 50 percent more than other directors, and added another 20 percent ( $\$15,000 \times 0.5 \times 1.2 = \$9,000$ ) for total compensation of \$24,000, or \$9,000 more than other directors. See Remand Response, *supra* note 22, at 39392- 39395. It should be noted, however, that a more recent comment letter from MPI suggests that the annual average additional cost of compensating an independent chair is approximately \$30,000. See Letter from C. Meyrick Payne, Partner, Management Practice, Inc., to Nancy M. Morris, Secretary, Securities and Exchange Commission, July 13, 2006. 26 Compensation estimates from the 2004 Directors’ Practices Study are consistent with, though moderately higher than, those originally reported by MPI and relied upon by the Commission, likely reflecting differences in timing, sample sizes, and the particular respondents in each of the surveys. Data from the 2005 Study also indicates that compensation for independent directors is increasing. Ms. Nancy M. Morris August 21, 2006 Page 7 Two small fund complexes provided information about the additional costs of electing a lead independent director to the chair position. One complex, whose board elected its lead independent director as chair in 2004, incurred about \$3,500 in additional compensation costs in the first year. The chair’s fees increased another \$6,500 the following year. The second complex has multiple boards, several of which elected lead

independent directors as chairs in 2005. The additional compensation for the independent chairs ranged from \$1,250 to \$13,375, depending on the type of fund overseen. To keep the funds' expense ratios from rising as a result of these costs, the adviser cut its management fees on all of the affected funds, and reduced its management fee to zero for three of them. For those small funds that opt to hire a new independent director to act as chair, the costs are even higher. The Commission's estimates suggest that compensation for an independent chair could be approximately \$24,000 annually for a small fund complex.<sup>27</sup> This estimate is consistent with the 2004 data collected by the Institute and Independent Directors Council. The SEC also estimated that recruiting costs could be equal to the independent chair's first year compensation, for an additional \$24,000. In either case – whether an existing director is promoted or a new director is hired to act as chair – the SEC projected that an independent chair would require more assistance from independent counsel than an interested chair, at an estimated cost of \$15,000. While it is difficult to isolate the increased use of counsel that is directly attributable to an independent chair, as opposed to other recent regulatory requirements, this estimate is consistent with data suggesting increased legal costs in recent years, and with the experience of several Small Fund Committee members.<sup>28</sup> We do not suggest that the direct cost of complying with the independent chair requirement is by itself prohibitive for all small fund complexes. Indeed, some complexes have elected an independent chair in the past year in anticipation of the rule.<sup>29</sup> Even so, when added to the costs of other recent rules, the requirements will considerably increase the cost of doing business for small fund complexes, with virtually no demonstrable benefits.<sup>30</sup> Moreover, independent directors are uniquely positioned to thoroughly evaluate the costs and benefits specific to their situation and determine the most appropriate chair for their particular board. Such an analysis is particularly important in the case of small fund complexes, where the cost could impact the expense ratio, reduce an adviser's profitability, or require the scaling back of other expenditures, such as services provided to shareholders, to keep overall costs down. <sup>27</sup> See *supra* note 25. <sup>28</sup> See *supra* notes 20-21 and accompanying text. <sup>29</sup> The 2004 Directors' Practices Study found that only 38 percent of reporting small fund complexes had an independent chair, compared to 50 percent in 2005. <sup>30</sup> The empirical evidence, discussed more thoroughly in the Institute's comment letter, does not show any demonstrable benefits from mandating an independent chair. See Letter from Elizabeth R. Krentzman, *supra* note 2. Ms. Nancy M. Morris August 21, 2006 Page 8 Finally, the rule creates additional barriers and disincentives to enter the mutual fund industry. Founders of fund advisers often act as chairs of the funds they establish, particularly in the first years when few other people are intimately familiar with the company. Prohibiting this arrangement raises startup costs, both in terms of the expense of recruiting and paying an independent chair and the time and effort required to find a qualified person. In addition, company founders often have invested significant personal capital in the business, not to mention time and effort. Such individuals understandably may have concerns about the requirement that the board chair be an individual who may not have experience in the mutual fund industry and, at least at the outset, may be unfamiliar with the company. These added costs, both tangible and intangible, create disincentives for entrepreneurs in the asset management business to organize mutual funds. Board Composition While we support a supermajority independence requirement for fund boards, we believe that a two-thirds majority requirement is more appropriate than 75 percent. As discussed in the Institute's letter, a 75 percent requirement adds additional costs with no apparent benefit. The 75 percent requirement substantially reduces flexibility in board composition generally and, because small funds tend to have smaller boards,<sup>31</sup> reduces our flexibility even more than the average board. In estimating the costs of implementing this rule, the SEC recognized that boards that do not already meet the 75 percent test may comply either by adding independent directors or reducing

the number of interested directors. To explore what small funds have done in practice, ICI staff reviewed the board composition of the approximately 80 members of the Small Funds Committee.<sup>32</sup> Almost half of these boards met the 75 percent independence requirement in 2003. By 2005, nearly 80 percent met the requirement. Among those boards that restructured, approximately 60 percent only removed an interested director. The remaining 40 percent added independent directors as part of their restructuring.<sup>33</sup> Funds whose boards added directors must pay additional directors' fees. The MPI study relied upon by the SEC found that median annual compensation for an independent director of a small fund complex ranged from \$10,500 to \$28,000. These estimates are consistent with the 2004 data gathered by the Institute and the Independent Directors Council.<sup>34</sup> In adding directors, 31 The average reported board size (both interested and independent directors) for small fund complexes is 5.6, compared to 7.8 for the 101 fund complexes with more than \$2 billion in assets. See *supra* note 24. 32 Funds report information on board composition in their Statements of Additional Information. 33 There are good reasons to keep affiliated directors on the board. As the Advisory Group on Best Practices for Fund Directors explained in its 1999 report, among other things, board membership by representatives of the adviser facilitates more direct accountability on the adviser's part and a better exchange of information with the adviser, and subjects the representatives to the same fiduciary standards as independent directors. See *Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999). 34 See *supra* note 26. Ms. Nancy M. Morris August 21, 2006 Page 9 these funds may also have incurred recruiting and training costs, and possibly the costs of a proxy solicitation to comply with Section 16(a) of the Investment Company Act. Additionally, the SEC estimated that new independent directors would require more assistance from independent counsel, at an estimated cost of \$9,000. Just as with an independent chair, it is difficult to isolate the increased use of counsel that is directly attributable to new independent directors, but this estimate is consistent with data suggesting increased legal costs in recent years, and with the experience of several Small Fund Committee members.<sup>35</sup> Although many boards now meet the 75 percent test, they will have very little flexibility to address board turnover. Under a 75 percent requirement, a single resignation will more often require the board to act quickly to add a new independent director to maintain the appropriate balance, and potentially trigger the need for a proxy solicitation. Even if an election is not necessary, adding a new director consumes time and resources, and diverts the board's and management's attention from its other duties. Meanwhile, there is no evidence that this board structure is more beneficial to shareholders than a two-thirds majority. The costs of the 75 percent requirement may also discourage entrepreneurs considering entering the fund business. Should a board have two interested directors (and therefore not qualify for the small board exception), six independent directors would be required from day one. It is worth noting that, particularly for a new company with an entire slate of new directors, it seems sensible to have at least two individuals on a board who are familiar with the business. As one group of independent directors, who already comprise a two-thirds supermajority (four of six), explained: Meeting a 75% requirement would require the addition of two new independent director positions, at an additional cost to our shareholders exceeding \$20,000 per year. (Because of the small existing Board size and other circumstances, it would not be appropriate for either of the two interested directors to step down to increase the independent director percentage.) One has to wonder what a 75% majority of independent directors could accomplish that the Fund's existing 66- 2/3 % cannot?<sup>36</sup> \* \* \* 35 See *supra* notes 20-21 and accompanying text. 36 See Letter from the Independent Directors of Flaherty & Crumrine Preferred Income Opportunity Fund Inc., to William H. Donaldson, Chairman, Securities and Exchange Commission, dated Feb. 23, 2004. Ms. Nancy M. Morris August 21, 2006 Page 10 We

appreciate your attention to the disproportionate effects of these requirements on small funds, and would be pleased to offer our assistance in any way. Sincerely, /s/ The undersigned members of the Small Funds Committee of the Investment Company Institute: Mark R. Anderson President & COO Integrity Mutual Funds, Inc. B. Reuben Auspitz Executive Vice President Manning & Napier Advisors, Inc. Michael E. Barna Executive Vice President Burnham Asset Management Corp. Lesley Buck Chief Compliance Officer Matthew 25 Fund Inc. Lynne M. Cannon Director – T/A Services Stratton Mutual Funds John Deysher President Bertolet Capital LLC Stephen J. Dodson Chief Operating Officer Parnassus Investments Robert G. Dorsey Managing Director Ultimus Fund Solutions, LLC Cynthia L. Dove Director, Investment Services Homestead Funds, Inc. Allan D. Engel President Activa Asset Management, Inc. Gabriel J. Gibbs Chairman & CEO Volumetric Fund, Inc. Daniel M. Hanrahan Director of Mutual Fund Operations The Catholic Funds Thomas C. Henry General Counsel and Secretary The Ehrenkrantz Trust Diana P. Herrmann\* President & CEO Aquila Investment Management LLC Mark A. Hoopes Chief Compliance Officer Adelante Capital Management LLC Nicholas F. Kaiser President Saturna Capital Corporation Geoffrey Keenan EVP & COO Gateway Investment Advisers, L.P. Brenda T. Koelemay CAO Securities Management and Research, Inc. John S. Larson Managing Director Gardner Lewis Asset Management L.P. Terry Lee President & CEO Lee Financial Group Jill W. Maggiore Vice President & CCO Wells Asset Management, Inc. W. Richard Mason General Counsel Mosaic Funds Susan B. McGee President & General Counsel U.S. Global Investors, Inc. David B. McKinney President Reams Asset Management Co., LLC Michael Mulcahy Partner Bridgeway Capital Management, Inc. Joseph Neuberger Senior Vice President U.S. Bancorp Fund Services, LLC Erik Olstein President Olstein & Associates, L.P. \* Chair of the Small Funds Committee. Ms. Nancy M. Morris August 21, 2006 Page 11 Steven J. Paggioli Trustee Professionally Managed Portfolios Thomas O. Putnam Chairman Fenimore Asset Management, Inc. Shannon D. Radke President Viking Fund Management, LLC Paul E. Rasmussen Vice President Sit Investment Associates, Inc. J. Alan Reid, Jr. President & CEO Forward Management LLC Gary S. Saks Chief Operating Officer Ironwood Investment Management LLC Robert C. Schwartz Director of Marketing Schwartz Investment Counsel, Inc. C. Troy Shaver President & CEO Dividend Growth Advisors, LLC Elizabeth A. Watson VP & General Counsel Quantitative Investment Advisors, Inc. Charles M. Weber SVP & Associate General Counsel Robert W. Baird & Co., Inc. Thomas B. Winmill President Midas Management Corporation cc: The Honorable Christopher Cox, Chairman The Honorable Paul S. Atkins The Honorable Roel C. Campos The Honorable Annette L. Nazareth The Honorable Kathleen L. Casey Andrew J. Donohue, Director Robert E. Plaze, Associate Director Division of Investment Management Chester Spatt, Chief Economist and Director Office of Economic Analysis Appendix A The Institute defines small funds as fund groups with less than \$2 billion in non-money market assets. Approximately 113 ICI member complexes meet this definition, or 36 percent all ICI member complexes.<sup>1</sup> The vast majority of them – 89, or 79 percent – hold long-term assets of less than \$1 billion. On average, they hold \$281 million in long-term assets, and their median size is \$143 million. The Small Funds Committee is comprised of 84 members of the Institute. Some member firms represented on the Committee are technically no longer small funds under the Institute’s definition, because they now manage non-money market assets exceeding \$2 billion. Such firms are welcome to remain on the Committee until they determine that they have more issues in common with larger fund complexes than with the Institute’s small fund members. Additionally, members of the Committee include one small fund independent director and certain representatives of service providers who also act as officers for one or more small fund clients. While not all small fund complexes are members of the ICI, our members are representative of small fund complexes generally. The small fund complexes reporting data to Strategic Insight have average total assets of \$374 million, and their median size is \$178



million.<sup>2</sup> See Appendix D for more detailed information. 1 Twenty-one members of the ICI have long-term assets of \$50 million or less. 2 ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006. Under the SEC's definition of small fund complexes (those with assets of \$50 million or less), 113 small fund complexes report to Strategic Insight, comprising 21 percent of all reporting complexes.

Appendix B Operating Expense Ratios<sup>1</sup> for Selected Investment Objectives (2005) (basis points)

Share Classes of Complexes with < \$2 billion	Investment Objective	10th Percentile	Median	90th Percentile	Asset-Weighted Average	Simple Average
Aggressive Growth	84	115	151	76	152	Growth
69	105	141	71	136	Sector	
84	120	167	86	154	Growth & Income	
39	87	128	50	118	Income Equity	
53	92	124	63	141	International Equity	
88	130	175	100	166	Hybrid	
57	98	134	71	136	Taxable Bond	
45	73	104	69	88	Tax-Exempt Bond	
48	64	86	55	80	Money Market	
20	48	75	47	51		

Source: ICI calculations using expense data by share class for 2005 from Lipper LANA 4.0 database. 1. Operating expense ratio is the total expense ratio net of 12b-1 fees and waivers. 2. Total net assets.

Appendix C Fee Waivers of Small and Large Fund Complexes

Complex Total Net Assets > \$2 billion ≤ \$2 billion	Number of fund share classes	Total	14,502	1,403	With a waiver	8,039	826
Percent with a waiver	55%	59%	Fee waivers <sup>1</sup> (basis points)	25th Percentile	1	4	Median
3	15	75th Percentile	6	44	Simple Average	5	43

Source: ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006; includes only those share classes that reported expense data. 1. Among complexes offering fee waivers, waivers are computed by summing total dollars waived on all funds within a complex divided by the total assets of that complex.

Appendix D Assets and Expenses by Size of Complex<sup>1</sup>

Complex Total Net Assets	A All > \$2 billion	< \$2 billion	< \$50 million	2 Number of Complexes	547	182	365	113	Number of Funds Per Complex	Average	13	33	3	1	Median	3	18
2 1 Complex Assets (millions of dollars)	Average	\$15,772	\$46,652	\$374	\$19	Median	\$515	\$10,553	\$178	\$16	Complex Expenses (millions of dollars)	Average	\$91.1	\$264.8	\$4.0	\$0.3	Median
\$5.2	\$78.4	\$1.7	\$0.2														

Source: ICI calculations using data from Strategic Insight Simfund MF 4.0 mutual fund database, updated June 2006; includes only those share classes that reported asset and expense data. 1. Expenses are estimated by taking expense ratios of each share class in a given complex times the assets of that share class and adding across all share classes within a given complex; expenses are measured net of 12b-1 fees and waivers. 2. This group is also included in the \$2 billion or less category.

Appendix E Additional Rules in the SEC's Fund Governance Package

- 1) Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299, 68 FR 74714 (Dec. 24, 2003) (final rule)
- 2) Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26418, 69 FR 22300 (Apr. 23, 2004) (final rule)
- 3) Disclosure of Breakpoint Discounts by Mutual Funds, Release No. 26464, 69 FR 33262 (June 14, 2004) (final rule)
- 4) Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26486, 69 FR 39798 (June 30, 2004) (final rule)
- 5) Investment Adviser Codes of Ethics, Investment Company Act Release No. 26492, 69 FR 41696 (July 9, 2004) (final rule)
- 6) Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591, 69 FR 54728 (Sept. 9, 2004) (final rule)
- 7) Mutual Fund Redemption Fees, Investment Company Act Release No. 26782, 70 FR 13328 (Mar. 18, 2005) (final rule; request for additional comment); see also Investment Company Act Release No. 27255, 71 FR 11351 (Mar. 7, 2006) (proposed amendments)
- 8) Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288, 68 FR 70388 (Dec. 17, 2003) (proposed rule)

Appendix F Detailed Data on Compliance-Related Expenses for Selected Complexes

Complex	A	B	C	D	E	F	G
2005 Directors' Fees	\$1,068,300	\$181,000	\$76,700	\$116,000	\$126,750	\$14,500	\$172,000

% change from 2003	58%	110%	121%	55%	44%	164%	77%	2005 Legal Costs	\$862,500
	\$117,300	\$76,400	\$153,500	\$31,700	n.a.	n.a.	% change from 2003	31%	90%
	83%	3%	n.a.	2005 CCO Costs	\$120,500	\$33,000	\$145,000	\$271,000	\$31,350
	n.a.	n.a.	2005 Insurance Costs	\$378,800	\$63,000	\$84,000	\$78,700	\$54,250	n.a.
	n.a.	% change from 2003	33%	31%	69%	18%	158%	n.a.	= not available

1. Percent change calculated from 2004 figures. 2. Compensation per director for each board and committee meeting, plus annual retainer fee. 3. Adviser may pay all or part of fund CCO salary and expenses. 4. Future increases will have to be absorbed by the adviser per funds' boards.

---

Copyright © by the 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.