United States Senate

WASHINGTON, DC 20510

S7-03-04

April 7, 2004

The Honorable William H. Donaldson
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Mr. Chairman,

As members of the Senate Banking Committee, we have participated in numerous hearings to review the current state of the mutual fund industry. As Congress questions whether current securities law can be improved, the SEC is taking enforcement and regulatory actions, including proposing several amendments to existing rules regarding the governance of funds, to address recent mutual fund scandals and to ensure that funds are managed to benefit shareholders rather than fund insiders. It is important that the SEC continue to take the necessary steps to restore investor confidence, and we appreciate your leadership as the SEC works to end abuses, such as illegal late-trading.

The principal objective for government action must be to enhance the ability of fund shareholders to make informed choices about competing funds with boards that will provide appropriate oversight of fund advisors. While we support many of the SEC's actions, we also firmly believe that the SEC and Congress should be cautious in their approach to addressing problems within the industry and that any new regulations should be based on empirical evidence that demonstrates a clear benefit to investors. We are particularly concerned about a rule proposed on January 14, 2004, in which the SEC would require that a fund's board be chaired by an independent director.

Current law requires that fund boards must have a majority of independent directors in virtually all cases, and the SEC has proposed to increase a board's level of independence to 75 percent. This supermajority would clearly give the independent directors the leverage to select any individual they deem appropriate as chairperson. Moreover, current law requires that contracts with the fund advisor be approved by the independent directors separately from any management directors who serve on the board, in addition to approval by the full board. As you know, some fund boards have exercised their business judgment to elect independent chairs, while others have selected interested chairs. The mutual fund industry is highly competitive, and fund shareholders are free to choose among the more than 8,100 funds based on their performance, quality, or even governance structure. Mandating that all fund chairs be independent from the fund advisor would be inappropriate, and we urge the SEC to reconsider this proposal.

The proposed rule assumes that shareholder protections would be improved by imposing such a mandate on mutual fund boards; however, no empirical evidence has been presented to the Banking Committee in its nine oversight hearings that supports this assumption or demonstrates that funds with independent chairs perform better or have lower fees. Furthermore, there appears to be no correlation between instances where regulators have identified inappropriate activity and whether the fund at issue had an independent or interested chairperson—indeed, a number of the mutual funds publicly named in recent scandals were headed by independent chairs. Testimony has suggested that an interested chairperson may be better positioned to promote administrative efficiencies and draw upon their experience and expertise in the fund industry, overall providing greater representation for shareholders' interests. Testimony has also highlighted studies demonstrating that public companies with boards headed by interested chairpersons perform better than those with a higher level of independence, including an independent chair. Therefore, fund boards should retain their ability to decide for themselves who chairs the board based on the unique circumstances of the particular fund complex.

Mutual funds are a $7.4 trillion industry with more than 90 million investors, and it is imperative that the SEC and Congress not put form over substance when considering reforms to such a vital component of our economy. Without conclusive evidence, the SEC should not take the radical step of prohibiting the right of a fund board to exercise its discretion in selecting a board chairperson. There are several alternatives that offer substantive solutions to board governance issues: increasing the percentage of independent directors to a supermajority; electing a lead independent director and allowing them to nominate their successors; appointing independent counsel; allowing independent directors to set their compensation and the board agenda by separate vote; and requiring the full board and independent directors by separate vote to elect the chairperson annually.

The SEC is moving ahead on many proposals that will make improvements to the mutual fund industry, and we support the SEC's efforts to increase transparency and strengthen regulation for the benefit of American shareholders. However, we believe the proposal to prohibit an interested person from chairing a mutual fund's board of directors does not provide any real benefit or significant protection for shareholders. Rather, it merely gives investors a false sense of security that such a change would eliminate many of the problems we have seen with mutual funds, when in reality it would not. We ask that you carefully consider these concerns before moving ahead on this proposal.

Sincerely,

John E. Sununu
United States Senator

Mike Crapo
United States Senator

Jim Bunning
United States Senator

Mike Enzi
United States Senator

Chuck Hagel
United States Senator

cc: The Honorable Richard Shelby