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MUTUAL FUND DIRECTORS FORUM
The FORUM *for* FUND INDEPENDENT DIRECTORS

May 2, 2008

Andrew J. Donohue
Director, Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Mr. Donohue:

Over the past eighteen months, you have attended numerous mutual fund board meetings to observe directly how independent directors represent fund shareholders and help ensure that mutual funds remain an effective, efficient and attractive investment vehicle. As the independent organization consisting of and dedicated to independent fund directors, the Mutual Fund Directors Forum commends you for this effort to reach out to the director community.

Today's mutual fund industry is both vibrant and successful. Mutual funds currently hold approximately $12 trillion in assets – assets that represent the savings and the hopes and dreams of millions of Americans. Undoubtedly, our regulatory scheme – the Investment Company Act, the rules issued under it, and the daily administration of the Act and rules by the Commission and its staff – has played a critical role in effectively balancing the needs of fund managers and investors, encouraging innovation and sustaining investor confidence in the fund industry. As we know you are aware, independent directors play a fundamental role in the success of this regulatory scheme. In particular:

- Independent directors not only have ultimate responsibility for the funds they oversee, but also act solely on behalf of fund shareholders. Independent directors are thus essential to achieving the investor protection goals of the Act.

- Independent directors, who have detailed knowledge of the specific funds that they oversee, are able to respond flexibly and quickly to the specific issues faced by their funds. Independent directors thus allow for a flexible approach that stands in stark contrast to a "one size fits all" regulatory regime.

- Independent directors are also an extremely cost-effective and efficient means of overseeing the fund industry, especially compared to the high number of inspectors and other regulators used to oversee other financial services entities such as banks.

Given the importance of independent directors, it is critical that they have the correct tools and the necessary support to perform their duties as effectively as possible. This is why your willingness to meet with and listen to independent directors, as well as your openness to considering regulatory change as a way of improving director effectiveness, is so important.

Based on our discussions with our members whose board meetings you attended, we also note that your effort to spend time with directors has been greatly appreciated by our membership and has been a very affirming experience for the director community as a whole. Your visits have succeeded in reminding directors how crucial they are to the regulatory system and ultimately to the effective oversight of the trillions of dollars that American investors have entrusted to mutual funds. On behalf of our members, we are very grateful for your recognizing, at such a personal level, the key role played by independent directors.

As your series of board visits draws to a close, we are writing to summarize the perspective of a number of our members on steps you, your staff and ultimately the Commission should consider to enhance the effectiveness of independent fund directors by streamlining the regulatory system. Their suggestions are outlined below.

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Fund boards serve shareholders most fundamentally by monitoring fund performance, by approving the fees paid for advisory and other services necessary for fund operations, and by protecting fund shareholders from the conflicts of interest that are inherent in money management. Along with these broad, fundamental responsibilities, directors are also subject to numerous specific obligations that require them to focus on the particular details of fund management. While these areas are often important, the level of detail involved in directly overseeing them risks distracting directors from their central obligation of ensuring that funds are managed in the best interests of shareholders. Some of these more detailed-oriented responsibilities include:

- Quarterly review of amounts expended under Rule 12b-1 plans;
- Detailed responsibility for the mechanics of making fair value determinations;
- Specific determination of eligible money market fund investments;
- Compliance with codes of ethics under Sarbanes-Oxley and approval and review of a fund's anti-money laundering program;
- Compliance with Sections 406 and 407 of Sarbanes-Oxley;
- Monitoring of compliance with privacy procedures under Regulation S-P; and
- Review of routine transactions involving certain affiliates (e.g., many of the exemptive rules issued under section 17).

There are two potential ways to address the potential detrimental effects of the level of oversight required by these provisions and thus facilitate increased board effectiveness. The first is to reduce the board's responsibility through regulatory change. The second, which we believe is most likely to increase the effectiveness of fund boards, is to clarify that boards have considerable scope to use their power of delegation to determine how to oversee the full range of fund activities for which they are responsible.

We do encourage the Commission and its staff to consider regulatory change. In particular, the Commission should analyze whether eliminating or scaling back the regulatory provisions associated with the above list would enable directors to better serve the interests of shareholders.[1] The Commission's recent proposal to eliminate certain obligations imposed on boards of funds that wish to invest in exchange traded funds ("ETFs") is a welcome example of the elimination of unnecessary duties. But there are also risks involved in enacting changes designed to reduce or eliminate specific board responsibilities. First, the fact that specific board action is mandated often imposes a beneficial discipline on fund management and others involved in daily fund operations. A specific requirement of board oversight often necessitates the adoption of practices and procedures and the preparation of reports that enable oversight. Regulatory provisions that require directors to address specific issues thus ensure that the management company's attention is directed at issues that Congress and the Commission have previously determined present a risk for fund shareholders. This, by itself, may serve to reduce those risks. Hence, regulatory change adopted simply to enable boards to streamline their operations can inadvertently reduce investor protection.

Moreover, mandated oversight can provide great benefits to boards themselves. Independent directors enable a regulatory system that is more flexible than would otherwise be the case because the combination of their duties to shareholders, and their detailed familiarity with the specific funds they oversee, permits them to react quickly and effectively to any issues that arise. While this work can sometimes seem unnecessary, it provides directors with the experience and depth of understanding that ultimately allows them to take appropriate action when issues do arise. The Commission should therefore avoid regulatory changes that would decrease directors' level of familiarity with their funds and thereby risk undermining the basis of a remarkably flexible regulatory system.

In contrast, clarifying that directors have significant discretion to determine how to oversee each of these areas has great potential to improve the effectiveness of boards. Directors already often play a significant role in structuring their workflow, deciding what fund activities need to be overseen, and, even more importantly, in deciding how to more effectively oversee those activities. Boards, for example, regularly consider how they can use their committee structure to more effectively perform their duties. Likewise, boards regularly review their activities to determine which are required, which are beneficial, and which are merely done out of habit, out of a fear of being exposed to litigation, or for other less meritorious reasons. Boards also review the amount of time they devote to particular oversight activities to ensure that they are, in fact, overseeing the

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1 For example, we believe that the quarterly review of expenditures under a fund's 12b-1 plan by directors serves little purpose, particularly since directors can have little impact in the first place on 12b-1 costs incurred by funds. While we recognize that the Commission and your staff are currently engaged in a broader review of rule 12b-1, we nonetheless encourage the Commission, at a minimum, to eliminate the requirement for quarterly reviews.

activity in question and not micromanaging it or second-guessing decisions legitimately within management's discretion.[2]

More, however, should be done to give boards the flexibility to manage their own operations and focus on those areas and activities they believe provide the most benefits to their shareholders. In particular, boards should be able to focus more extensively on delegation. While boards today can and do delegate, they do so in varying degrees and with varying degrees of confidence with respect to the Commission's and staff's views of delegation. This uncertainty may limit the ability and willingness of boards to take steps that they otherwise believe would benefit their funds and shareholders. The Commission and staff should, therefore, focus on clarifying their views on this important issue, and thereby provide directors with more leeway to delegate oversight activities to appropriate persons. Doing so would enable directors to use their time as productively as possible.

Obviously, even when they do delegate, directors retain responsibility for all matters related to the fund. The ability to delegate permits a board to determine the optimum level of oversight to give specific areas of activity while still maintaining ultimate responsibility for the fund and its operations. Authorizing greater delegation would also give each individual board the flexibility to manage its time in a manner responsive to the funds it oversees. Eliminating a specific board duty effectively would imply that no board need prioritize that activity; in contrast, authorizing delegation enables a board to determine the level of attention the specific situation of its fund or its complex requires the activity to be given. Hence, as an alternative to wholesale regulatory change, we recommend that the Commission and its staff consider giving directors clear authority to delegate routine functions to other persons in the fund's organization, in management's, or who are otherwise responsible to the board.

We recognize that the Commission and the staff have traditionally been reluctant clearly to delineate their own view of delegation.[3] However, we believe that there are a number of reasons to reconsider this:

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2 Given the time constraints imposed on boards, a number of our members have made us aware of new initiatives designed to allocate their time most efficiently. We are aware, for example, that a number of our members have made increasing use of consent agendas to separate the procedural from their more substantive oversight responsibilities. It is our understanding, however, that neither counsel nor the individual boards has a clear understanding of the Commission's views on initiatives of the type, and that the pace of change in board practices has likely been slower than might otherwise have been the case.

3 We note, for example, that in a speech before the Forum's Directors Institute on January 15, 2008, you stated that:

> Directors also suggested that they should be able to delegate to others (the chief compliance officer was most often mentioned) certain of their duties in order to free up their time to devote more attention to substantive issues. I am particularly interested in this latter point and my staff is analyzing whether it makes sense for you to delegate certain duties, and if so, to whom and to what extent, in order to create better efficiencies. As we approach this exercise, my staff is focused on the fact that directors are overseers — not executives who are involved in the day-to-day details of running a business.

- The fund business has become considerably more complex in recent years. Requiring directors to spend time on items that they believe are, in the context of their funds, of little importance, directs significant resources away from activities that are of critical importance.

- Giving directors greater leeway to delegate is consistent with a board's responsibility to manage its own time and workflow in a manner that maximizes its effectiveness.

- Delegation is a highly flexible form of regulation – it permits each board to determine, in the context of the funds it manages, what oversight responsibilities are most important and are most likely to be responsive to issues the funds have.

- Recent regulatory changes – particularly the requirement that every fund have a chief compliance officer ("CCO") who reports directly to the board – have made it more likely that boards can delegate certain functions without materially increasing the risk borne by shareholders.

We also understand that certain conditions should be met before directors are permitted to delegate any of their responsibilities. While we do not believe that these conditions can be laid out with great specificity without harming each individual board's ability to delegate as it sees fit in the context of the unique circumstances it faces, we would nonetheless suggest that the following points guide directors' analysis of the extent to which delegation is appropriate:[4]

- Directors should be more reluctant to delegate "core" responsibilities, such as oversight tasks directly associated with the annual review of the advisory contract. In general, responsibilities that are most suitable for delegation are the review of data-intensive fund activities (particularly for purposes of identifying and reporting to the board outliers) and review of routine relationships between the fund and specific service providers (other than the fund's adviser and its affiliates).

- The board should determine that the person or persons to whom it is delegating (such as the fund's CCO) is sufficiently independent to carry out the responsibility, is free of conflicts and will both be solely responsible to the board and will report to the board regularly.

- The board should also determine that it has sufficient familiarity with the type of activity in question that its ability to oversee the fund and protect fund shareholders from conflicts will not be harmed by the delegation.

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4 *Compare, e.g.,* Rule 17f-5(b).

Rule 17e-1 provides a simple example of this. The Rule requires that boards review quarterly reports of brokerage transactions with affiliated broker-dealers. For the most part, this is a data-intensive task that requires identifying and analyzing specific transactions that are inconsistent either with the rule or with the policies and procedures that the board has adopted to implement the rule. There is little reason why, in appropriate circumstances, the board cannot delegate virtually all of this data-intensive work to its CCO (or to other appropriate personnel), and then receive reports on especially problematic transactions or trends.

Rule 17e-1 is just one of many possible examples. Ultimately, permitting directors, in the exercise of their business judgment, to delegate responsibilities pursuant to these guidelines will give boards the flexibility they need to focus on the issues they believe will most benefit shareholders. As in other areas, directors' decisions regarding delegation will be driven not by a rigid, one-size-fits-all regulatory approach, but rather by the specific circumstances they face with respect to the funds and complexes they oversee. The success of regulation under the Investment Company Act over the years is certainly due, at least in part, to the ability that directors, as opposed to regulators, have to respond to unique situations as they arise. It is time to extend this flexibility to boards' management of their time and their responsibilities.

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Again, both the Forum and its members very much appreciate the effort you have put into meeting with individual boards and the great support you have given independent directors. Your efforts have reinforced the importance of directors and provided them with needed reassurance that the Commission and its staff stands behind their efforts to work on behalf of the tens of millions of Americans who have chosen to entrust their savings to mutual funds.

We would welcome the opportunity to discuss these recommendations with you in greater detail.

Sincerely,

David B. Smith, Jr.
Executive Vice President

cc: Mark Berman
Senior Special Counsel
Division of Investment Management