MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

March 20, 2008

The Honorable Henry M. Paulson, Jr.
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Treasury Review of the Regulatory Structure Associated with Financial Institutions

Dear Secretary Paulson:

The Mutual Fund Directors Forum, a membership organization composed of independent directors and trustees of United States investment companies,[1] is vitally interested in efforts to improve the regulation of the financial services industry and maintain the global competitiveness of United States capital markets. U.S. mutual funds are a remarkably efficient means of effectively deploying the savings of ordinary Americans in the capital markets and ensuring that those savings are invested in a way that increases the strength and improves the competitiveness of the United States economy.

Any discussion of the broader functioning of capital markets would be incomplete without considering the role of regulation in assuring a successful and vibrant fund industry. As the Department of Treasury's request for comment on the regulatory structure of financial institutions did not specifically ask about mutual funds, we appreciate the recent efforts of the Investment Company Institute ("ICI"), the trade organization for the mutual fund industry, to highlight the importance of mutual fund regulation on capital markets.[2] We are now writing to provide our own recommendations on how the future of mutual fund regulation should be approached.

First, we join with the ICI in encouraging legislative changes that would permit fund investors to roll over the capital gains and dividends they earn in their funds into additional shares, and not be taxed on those gains until they redeem their fund shares. Such a system would more fairly tax fund shareholders. Taxation of gains would be triggered not by the investment manager's decisions on how to manage investors' funds, but rather by each individual investor's decision to redeem his or her shares to use the money invested in the fund for a different purpose. This tax change would place investors in mutual funds on the same footing as investors in individual stocks and would clearly make funds more attractive investments. More investors

[1] The Forum's current membership includes five hundred seventy-five independent directors, representing seventy-nine independent director groups.

[2] The comment letter of the Investment Company Institute was dated December 7, 2007.

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would thus choose to use them, thereby leading to more assets being effectively and efficiently invested in the growth of our economy.

We also join in recognizing the benefits of a flexible system of fund regulation rooted more in standards than in detailed, prescriptive rules and regulations. Successfully implemented, such a system offers the possibility of increasing investor protection and improving the effectiveness of the regulation while at the same time reducing the regulatory burdens borne by the fund industry and fund shareholders. Fortunately, the manner in which funds are regulated already provides a solid foundation for this approach.

In the United States, funds are generally overseen at two levels. Pursuant to the Investment Company Act of 1940, the Securities and Exchange Commission oversees and regulates the activities of funds. But most funds also have a second layer of oversight – an independent board of directors (or trustees) ("independent directors") that oversees the management of each fund within a fund complex and seeks to ensure that the fund is managed in the best interests of its shareholders.[3] As fiduciaries charged with these responsibilities, independent directors represent a coming together of a fund's investors to collectively supervise their investment.[4]

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[3] The Investment Company Act of 1940 was enacted to address a concern that "the national public interest and the interest of investors are adversely affected" when, among other things, "investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, ... rather than in the interest of all classes of such companies' securities holders." 15 U.S.C. § 80a-1(b)(2).

As the Investment Company Institute notes in its investor education booklet *A Guide to Understanding Mutual Funds*:

> A mutual fund is governed by a board of directors, which works to ensure that the fund management executes its business affairs in the best interests of fund shareholders.... The bottom line is that independent fund directors serve as watchdogs for shareholder interests and oversee a fund's investment adviser and others closely affiliated with the fund.

See Investment Company Institute, *A Guide to Understanding Mutual Funds* at 28 (2006). (Available at http://www.ici.org/pdf/bro_understanding_mfs_p.pdf.)

The staff of the SEC has described the rationale for independent directors as follows:

> The task of providing such protection is a difficult one. Investment companies are unique in that they are organized and operated by people whose primary loyalty and pecuniary interest lie outside the enterprise. Consequently, conflicts of interest are inherent in the structure of companies, creating great potential for abuse.... [The Act] imposes requirements that assume the standard equipment of corporate democracy: a board of directors ... whose function is to oversee the operations of the investment company and police conflicts of interest; and shareholder voting to, among other things, elect board members....

See Division of Investment Management, United States Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* at 251, 252 (1992)

[4] While directors have numerous duties arising under state law and the Investment Company Act, their most important duties are approving the fees paid by a fund to the adviser that manages the fund's assets, approving the contracts between the fund and its other service providers and otherwise acting to protect the interests of fund shareholders. In addition, when the SEC grants a fund an exemption from one of the prohibitions of the Act, it often assigns independent directors a central role in overseeing how the exemption is implemented and used by the fund.

This investor protection structure offers a number of key benefits:

- First, it is a highly cost-effective system of regulation. Rather than depending on an army of government regulators and inspectors (as is the case, for example, under the system for regulating banks in the United States), fund directors are paid by their funds' investors – the persons who most directly benefit from the activities of their directors.
- Second, the system is very efficient. Fewer than 3,000 directors oversee all U.S. fund assets.[5] Nonetheless, based on their deep involvement in and familiarity with the specific funds they oversee, fund directors can quickly identify the issues faced by their funds and respond to protect the interests of their funds' shareholders.
- Third, the system is extremely flexible. Although funds and directors must comply with specific regulations, in many cases, the regulatory system defers to the business judgment of directors to protect the interests of fund shareholders. Because each fund has its own board, directors are able to respond flexibly to the unique circumstances faced by that fund. This flexibility is highly preferable to the "one size fits all" approach to regulation that would have to be adopted if the government were the sole regulator of mutual funds.
- Finally, this type of regulatory framework enables a significantly more flexible approach to regulation than is possible with other types of entities. An independent board of directors that owes its sole duty to its shareholders is uniquely positioned to effectively rely on standards and principles and still achieve a high degree of investor protection – a result that produces significant benefits for those that invest in funds and allows the fund industry to build upon its numerous successes.

Independent directors have thus been, in many ways, one of the critical linchpins of the highly successful regulatory system under which the fund industry in the United States has thrived. Investors have generally had a high degree of confidence in the United States fund industry, and funds in the United States hold approximately $12 trillion in assets – a truly remarkable total.[6]

Of course, the successes of the existing regulatory system should not and cannot stand in the way of beneficial regulatory change. Indeed, we embrace regulatory change that would improve the functioning and competitiveness of the United States fund industry or that would increase the number and type of appropriately regulated investment products available to U.S. investors.

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5 A 2007 study by Management Practice, Inc. stated that 2,650 fund independent directors oversaw $10.1 trillion in fund assets. *See* Management Practice, Inc., *Survey of Mutual Fund Trustee Compensation and Governance Practices*, Second Edition, July 2007 at 39.

6 As of January 2008, U.S. mutual funds had $11.7 trillion in assets. *See* Investment Company Institute, *Trends in Mutual Fund Investing*, January 2008. (Available at http://www.ici.org/home/trends_01_08.html#TopOfPage.)

We are, however, concerned about any recommendation to amend the Investment Company Act to permit introduction in the United States, of new types of pooled investment vehicles, whether based on the European UCITs model or otherwise, that would not be incorporated or otherwise organized in a manner separate from their sponsors and advisers. As we outline below, investment vehicles of this type do not necessarily allow for fund investors to jointly protect their interests, as they are currently able to do through their fund's board of directors, and we are skeptical that the United States asset management industry has global competitive issues that this proposal would resolve.

Investor Protection Issues -- Mutual funds and similar pooled investment vehicles are organized in different ways in different jurisdictions. Most serious commentators on the global fund industry have recognized that, irrespective of the form organization, these entities require independent oversight to protect fund investors from the conflicts of interest that are inherent in fund management. For example, as a recent IOSCO Technical Committee[7] noted:

> The purpose of a [fund] is to successfully invest the pooled assets for the primary benefit of [fund] investors. As a consequence, a robust [fund] [G]overnance framework should seek to protect, through oversight and review, the [fund] assets from loss due to malfeasance or negligence on the part of those that organize or operate the [fund].... The TC believes that the operation of [funds] potentially entails conflicts between the interests of those who invest in [funds] and those who organize and operate the [funds].... A robust [fund] governance framework should, therefore, seek to minimize or otherwise address conflicts of interest and to ensure that the interests of well-informed investors in [funds] are well protected and managed in the best conditions.[8]

As the IOSCO report goes on to recognize, virtually all jurisdictions' regulatory systems, therefore, have a mechanism whereby funds are subject to some form of independent oversight. We therefore have great confidence that no new type of investment vehicle would be permitted without some type of protection intended to ensure that the vehicle is managed in the best interests of its investors. However, we doubt that any alternative investor protection approach adopted would have the same flexibility and responsiveness as a system that relies on independent directors.

Even more important would be the potential impact of regulatory change on the costs paid by fund investors. Perhaps the most significant difference between the oversight of funds in the United States, as provided by independent directors, and that which occurs elsewhere, is the right and obligation of the directors to review their fund's advisory contract on a yearly basis. This gives the directors the ability to review whether the price paid by fund investors for professional asset management and other related services is fair, and to renegotiate the price with the fund's adviser if necessary. Recent research suggests that investors in U.S.-based funds pay

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7 IOSCO, the International Organization of Securities Commissions, was established in 1983. Today, IOSCO's membership includes representatives from more than 100 jurisdictions.

8 Technical Committee of the International Organization of Securities Commissions, *Examination of Governance for Collective Investment Schemes Final Report Part I*, June 2006 at 4. (Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD219.pdf.)

lower costs than almost anywhere else in the world.[9] These savings are of critical importance to the millions of Americans who invest and save through mutual funds.

Proponents of alternate types of funds should, therefore, demonstrate that the approach they recommend will provide benefits to fund investors at least equal to those under the current system – that is, that it will be as effective in protecting fund investors' best interests and that it will continue to assure that investors will pay a fair and reasonable price for the asset management services they receive. We remain open to the possibility that another regulatory approach might achieve these goals, including one that does not rely on independent directors as the key advocates of the interests of fund shareholders. But, critics of the role of independent directors have yet to demonstrate that these benefits can be obtained in some other manner.

Global Competitiveness of the United States Asset Management Industry – We see no evidence that the existing regulatory system, which requires that most funds be overseen by directors, hinders the ability of the United States asset management industry to compete globally. In particular, we do not understand how the growth of the fund management business in other countries somehow demonstrates that the U.S. mutual fund industry has become less competitive, that our regulatory structure injures our fund management industry's ability to compete internationally or that our system somehow produces inferior results for American investors. It should come as no surprise that as capital markets have developed in the rest of the world, individual investors in other countries have increasingly turned to pooled investment vehicles to save for their futures. Since the United States is a more mature market for asset management, the proportion of pooled assets worldwide represented by U.S. funds has – unsurprisingly – decreased.

Moreover, asset managers – both U.S. and foreign-based – do compete globally. Just as foreign-owned advisers have been able to introduce fund products in the United States, U.S.-owned advisers have introduced appropriate investment management products in other countries. In each market, all competing asset managers, no matter where they are based, must – and effectively do – comply with local regulatory schemes. We are thus skeptical that permitting a new type of investment vehicle in the United States is needed to address the global competitive aspirations of asset managers based in the United States.[10]

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9 *See* Henri Servaes, Ajay Khorana, and Peter Tufano, "Mutual Funds Fees Around the World" (July 23, 2007). HBS Finance Working Paper No. 901023. (Available at SSRN: http://ssrn.com/abstract=901023.) We believe that research like this effectively refutes the criticism of commentators such as Peter Wallison and Bruce Litan who have argued that the requirements of independent directors and annual review of the advisory contract has somehow resulted in a fund industry that is uncompetitive and where U.S. investors pay fees higher than would otherwise be the case. See Peter Wallsion & Bruce Litan, *Competitive Equity* (2007).

10 The competitiveness of the U.S. fund industry might be understood not in terms of the ability of United States asset manager to compete in foreign markets, but rather in terms of the willingness of foreign investors to entrust their money to U.S. registered and regulated funds, However, the extent to which funds incorporated in the United States have had trouble attracting foreign investors likely has more to do with the inefficiencies inherent in how such investments are taxed by the United States than it does with the manner in which funds incorporated here are governed. This problem could thus be fully solved by enacting the tax changes outlined above and in the ICI's letter.

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At the end of the day, diminishing or eliminating the role of independent fund directors would ultimately risk harming the millions of Americans (and others) who have invested – and will in the future invest – in U.S. mutual funds without improving the global competitive position of United States asset managers. As we have outlined above, independent directors are effective and efficient overseers of mutual funds and are often better positioned than government regulators to respond to specific issues and problems and ensure that the fund's adviser manages the fund in the best interests of shareholders. Independent directors play a fundamental role in allowing investors in U.S. funds to obtain high quality professional asset management at a reasonable cost. Changing this system would risk reducing investor confidence in U.S. mutual funds, which clearly would be detrimental to our economy and to our capital markets. That other regulators in other jurisdictions, presumably for their own reasons, do not choose to extend this level of protection to their investors is no reason for the United States to follow suit.

In sum, the approach to regulating mutual funds in the United States, especially our reliance on independent directors to oversee mutual funds and to act on behalf of fund investors, has produced uniquely beneficial results for investors. While we support a re-examination and improvement of the manner in which U.S. capital markets are regulated, we remain firm in our belief that the benefits provided by independent fund directors cannot be duplicated through any other approach.

We would welcome the opportunity to discuss with the Treasury Department these or any other issues addressed in this letter. Please feel free to contact Susan Wyderko, the Executive Director of the Forum, at 202-521-6754 at any time.

Sincerely,

David S. Ruder
Chairman of the Board