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Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-03-04: Investment Company Governance

Dear Mr. Katz:

The Committee on Investment Management Regulation of the Association of the Bar of the City of New York (the "Committee") is composed of lawyers with diverse perspectives on investment management issues, including members of law firms, and counsel to financial services firms, investment company complexes and investment advisers. A list of our current members is enclosed.

This letter responds to the request of the Securities and Exchange Commission (the "Commission") for comment on rule amendments contained in Release No. IC-26323 ("Proposing Release"). The proposed amendments would require that registered investment companies ("investment companies") that rely on certain exemptive rules under the Investment Company Act of 1940 ("Investment Company Act") adopt certain governance practices.

The members of the Committee are acutely conscious of the developments in the investment company industry that led the Commission to publish the Proposing Release. By consensus, the Committee will address only one of the proposals: a requirement that the board of directors of an investment company have as chairman a "disinterested" director (the "disinterested chairman proposal").

The Committee believes that this proposed amendment disregards the careful balance between state and federal law reflected in the Investment Company Act. The Committee also believes that this proposed amendment conflicts with the basic approach of the Commission to entrust certain important matters to an investment company's disinterested directors.

I. The Proposed Amendment Conflicts with the Investment Company Act's Deference to State Corporate Law

While the Commission's goal of strengthening the voice of investment company boards of directors in compliance matters is understandable, we do not believe that it is appropriate to do this by using the Commission's rulemaking power to fill perceived gaps in state corporate law. Such an approach is inconsistent with the careful balance between state and federal law incorporated into the Investment Company Act.

As a general matter, the Investment Company Act entrusts corporate governance matters of investment companies to well-developed state corporate law. Indeed, as the Commission itself has recognized, the Investment Company Act is predicated upon investment companies being organized as corporations.[1] In taking this approach, Congress generally left matters relating to the organization of the investment company to state law. As the Supreme Court stated, in addressing the interplay between the Investment Company Act and state law:

> Mutual funds, like other corporations, are incorporated pursuant to state, not federal, law. . . . The [Investment Company Act] does not purport to be the source of authority for managerial power; rather the Act functions primarily to "impos[e] *controls and restrictions on the internal management of investment companies.*" [citations omitted]
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> The [Investment Company Act] and the [Investment Advisers Act], therefore, do not require that federal law displace state laws governing the powers of directors unless the state laws permit action prohibited by the Act, or unless "their application would be inconsistent with the federal policy underlying the cause of action . . ." [citations omitted]

Burks v. Lasker, 441 U.S. 471, 478-479 (1969). *See also Cort v. Ash*, 422 U.S. 66, 84 (1975)("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.")

The selection of a chairman of a board of directors clearly is one of the core issues affecting the internal affairs of a corporation. Nothing in the Investment Company Act suggests that mandating who the chairman should be is a matter of federal interest. The disinterested chairman proposal would constitute an unprecedented intrusion on the internal processes of boards of directors and upset the careful balance between state corporate law and federal law reflected in the Investment Company Act.

Perhaps in an effort to establish that the disinterested chairman proposal does not intrude on state law, the Proposing Release states that "[t]he Investment Company Act and state law are

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[1] *See, e.g.* Investment Company Directors and Voting, Investment Company Act Rel. No. 12888 (Dec. 10, 1982).

silent on who will fill this important role on fund boards." This "silence," however, does not represent any limitation on the authority of boards of directors or a gap in their decision-making process. As the Commission itself recognizes, the authority of boards to select a chairman is provided by state law.[2] Moreover, the fact that relevant law does not mandate who should, or should not, be selected to fill this position does not mean that this matter is left for the Commission to determine. It is equally true that the qualifications of other officers of a corporation are not specified by the state corporation laws. As a result, perceived silence should not be viewed as an invitation for the Commission to impose its own requirements. The Commission should be reluctant to federalize matters related to corporate governance – to adopt rules that "overlap and quite possibly interfere with state corporate law" – in the absence of a clear indication of Congressional intent.[3]

The Commission should be even more reluctant to go down this path in the face of the recent Congressional determination that an independent chairman should not be mandated. In connection with the passage of the Sarbanes-Oxley Act of 2002, Congress exhaustively considered the extent to which certain matters traditionally left to state corporate law should be addressed at the federal level. Neither Congress nor the national securities exchanges require that public companies, even in light of the substantial breakdown in corporate governance in a number of public issuers, have an independent director serve as chairman of the board of directors. This same outcome should also obtain for investment companies and the Commission should not act on its own.

II. The Proposed Amendment Undermines the Authority of Independent Directors

The disinterested chairman proposal has the effect of circumscribing the authority of a board of directors to select its own chairman. This approach appears to be in conflict with provisions of the Investment Company Act and Commission rules that impose significant responsibilities on disinterested directors. The Investment Company Act and certain Commission rules vest in a majority of the disinterested directors the authority to make a number of important decisions with respect to various matters, including the approval of investment advisory contracts, underwriting agreements and determinations under various rules that address conflicts of interest.

The Proposing Release does not appear to recognize the inconsistency of taking the discretion to elect the board chairman out of the hands of the disinterested directors, particularly when a majority (or, if the proposed amendments are adopted, three quarters) of the board will consist of disinterested directors. Rather, there appears to be an assumption that on this one issue the disinterested directors should be powerless to exercise their judgment and discretion. In view of the fact that there are investment companies that have disinterested directors who serve as

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[2] *See* Proposing Release at Section V.B. (addressing costs of requiring an independent chairman). The Proposing Release also notes that the state laws generally do not require a chairman at all.

[3] *See Santa Fe Industries v. Green*, 430 U.S. 462, 479 (1977)

This analysis may also suggest that it is inadvisable for the Commission to federalize other aspects of board governance – for example, requiring executive sessions of independent directors – as other proposed amendments would do. As noted above, however, the Committee is not commenting on this or other proposals.

chairman, this concern seems unwarranted and the disinterested chairman proposal appears to be unnecessary.

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For the foregoing reasons, the Committee does not believe the Commission should adopt the disinterested chairman proposal. The Committee is mindful, however, of the legitimate policy concerns that underlie the proposed amendments, particularly the concern that independent directors should have a meaningful role in formulating board and committee meeting agendas. The Commission may wish to consider a rule amendment that would require the independent directors or their designee to be consulted on (or consent to) meeting agendas. The Committee would be pleased to meet with the Commission or its staff to discuss or amplify the comments in this letter.

Very truly yours,

Stuart H. Coleman, Chair

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