



Consumer Federation of America

Fund Democracy
The Mutual Fund Shareholder's Advocate

October 18, 2006

BY ELECTRONIC AND U.S. MAIL

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Chairman Cox:

We are writing on behalf of Fund Democracy and the Consumer Federation of America to emphasize, at what appears to be the outset of yet another mutual fund scandal, the importance of ensuring the mutual fund chairmen are independent of the fund's manager.

In recent years, the mutual fund industry has been rocked by scandals involving the routine denial of commission discounts to eligible investors and market timing and late trading practices. The most recent scandal, the full scope of which has yet to unfold, involves the payment of kickbacks by BISYS Fund Services, Inc. ("BISYS") to fund managers in return for steering fund business to BISYS.¹ According to the Commission's findings, fund managers recommended that their funds retain BISYS to provide administrative services to the funds in return for BISYS opening accounts for the fund managers that were used to pay for marketing, check fraud losses, seed capital for new mutual funds, settlements for losses due to errors, and settlement of disputes with third parties. These kickbacks exceeded \$230 million and involved 27 fund managers.

As you know, the primary impetus for the independent chairman rule was the market timing and late trading scandals. The Commission specifically found these scandals resulted from "a serious breakdown in management controls" that demonstrated a need to strengthen fund governance. Indeed, the Commission found, after it adopted the governance requirements, that "the level of wrongdoing, and the corresponding investor losses, were in fact significantly greater than was known at the time."

We believe that the level of wrongdoing found in the current kickback scandal exceeds even the level of wrongdoing in the market timing and late trading scandals and accordingly presents an even stronger argument for an independent chairman. Whereas

¹ See In the Matter of BISYS Fund Services, Inc., Inv. Co. Act Rel. No. 27500 (Sep. 26, 2006).

at its worst the market timing scandal involved fund managers' sharing of market timers' profits, the kickback scandal involves fund managers' effective embezzlement of fund assets. For both types of abuses, the presence of a chairman who is an executive of the fund manager creates an insurmountable conflict of interest. As boards are currently structured, a fund chief compliance officer ("CCO") reports to the chairman of the board. It is unreasonable to expect the CCO to take allegations that a fund manager is extracting kickbacks from the fund's administrator *to the fund manager's CEO*. It is similarly unreasonable to expect the fund manager's CEO to bring the kickbacks – for which he will be at least indirectly, if not directly, responsible – to the attention of the board. A compliance model that relies on fund manager executives/fund chairmen to confess their own wrongdoing cannot work.

This is not to say that an independent chairman is a magic bullet that will prevent all such instances of fraud. Indeed, the chairmen of many of the 27 funds whose fund managers have been receiving kickbacks are probably independent (we assume these will be identified in future enforcement actions). Rather, our point is that, all things being equal, it is hard to understand how the fund would not be better off relying on someone other than a fund manager executive to ensure that the fund manager is not defrauding the fund. The Commission has noted the fund "adviser's monopoly over information about the fund and its frequent ability to control the fund's agenda" militates for enhancing the independence of fund directors. When a fund's chairman is an executive of the fund manager, this monopoly *is actually strengthened* and the board is even less likely to receive critical information.

The kickback scandal is yet another reminder of the importance of requiring that a fund chairman be independent of the fund manager if the board is to be an effective watchdog with the respect to the fund manager. We believe that requiring an independent chairman is an important step toward reducing the widespread abuses by fund managers that seem to have become regular occurrences in recent years.

We appreciate your consideration of our comments.

Respectfully submitted,

Mercer Bullard
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Fund Democracy, Inc.

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc: Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Kathleen Casey
Commissioner Annette Nazareth
Andrew Donohue, Director, Division of Investment Management
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