Bogle Financial Markets
Research Center

August 21, 2006

c/o The Vanguard Group
100 Vanguard Boulevard
Malvern, PA 19355

Ms. Nancy M. Morris
Secretary
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Request for Additional Comment: Investment Company Governance:
File Number S7-03-04

Dear Ms. Morris:

I write as a 55-year veteran of the mutual fund industry, founder of Vanguard, and former chief executive of Wellington Management Company (1967-1974) and of Vanguard (1974-1996). I think it's fair to say that few, if any, individuals have both a comparable amount of experience in the industry and a consistent record of working to bring it to its full potential of service to investors. I've given literally hundreds of speeches on the subject of building a better fund industry, and written five books as well, most of which have been best-sellers. (I want to be clear that I'm writing on my own behalf, and do not presume to speak for Vanguard's present management and board of directors.)

I have many concerns about the prevailing levels of conduct and values in today's mutual fund industry. But my over-riding concern is that funds are operated largely in the interests of their management companies, rather than in the interest of their shareholders. To begin to redress that imbalance, *I am strongly in favor of requiring the chairman of the fund board of directors to be independent of the management company*.

I also endorse the requirement that at least 75 percent of the board be independent directors. However, since an executive of an investment advisor who serves as a fund director has a profound and direct conflict of interest that cannot be simply disclosed away, I continue to believe that 100 percent of the board should be independent. The charter that we created for Vanguard in 1975 in fact prohibits representatives of any adviser to a Vanguard fund from serving on the fund's board. (I recognize that it will take time before that change will be acceptable to the industry.)

My reason for endorsing the independent chairman rule begins with this paraphrase of the statutory language of the 1940 Act: Mutual funds must be "organized, operated, and managed . . . in the interests of their shareholders, *rather than* in the interests of advisers, underwriters or others."[1] That principle is simply ignored in today's industry, dominated as it is by giant financial conglomerates and publicly-owned firms, in business, truth told, to earn a return on *their own capital* rather than a return on the capital of their *mutual fund investors*.

The data overwhelmingly show that the more that managers as a group take, the less that fund shareholders as a group make. What was, when I joined this industry in 1951, an investment profession with attributes of a business has become a marketing business with attributes (and too few at that) of a profession. That change has ill-served fund investors.

Redressing this imbalance should be at the very top of the Commission's mutual fund agenda. Requiring an independent chairman is a highly appropriate first step along the long road that must at last place the fund shareholder in the driver's seat of mutual fund governance. This is not a complex or novel governance structure. It is a simple manifestation of the need for the *separation of powers* in any sound governance system.

One need go no further than the wisdom of our nation's Founding Fathers in the writing of our Constitution and their articulation of the reasoning behind its principles as expressed in the Federalist papers to understand that the separation of powers is the key essential of sound government and of sound governance alike.[2] Paraphrasing Madison, "if management company executives were angels, no governance would be necessary."

But it *is* necessary. For in the governance of mutual funds today, there is little if any separation of powers. Power is concentrated in the hands of the management company, subject only to a largely illusory system of checks and balances. While fund boards have the ultimate power to slash advisory fees, terminate contracts with managers and distributors, and refuse to serve on the boards of new funds created to meet the evanescent needs of the investor marketplace, such actions are virtually without precedent. (The formation of Vanguard was a notable exception.) Interestingly, even after the market timing scandals, none of these actions were taken by the boards of the affected funds.

[1] The latter part of the phrase is a direct quotation from the Commission's unanimous opinion in its Vanguard decision (February 28, 1981), which turned the "double negative" in the 1940 Act into a "single positive" that bluntly asserted the Act's underlying principle.

[2] This is actually an issue of good business practice. For example, Kenneth Starr, now representing the Free Enterprise Institute, argues that constitutional principles are violated whenever we ignore the separation of powers. (*Directorship*, July/August 2006)

Even when a management company executive does *not* chair the board (a change that arose, I believe, only when executives of banks and brokers were not permitted to hold the position), the management company remains in the driver's seat. The company performs all of the fund's essential functions (under a unilateral contract drawn before the fund existed and before the directors were even chosen). It typically supplies the fund's officers. It controls the information provided to the fund's directors.

While this system flies directly in the face of the industry's statutory mandate, it will not be an easy system to change. But I know of no better first step than to require that the chairman of the mutual fund board of directors be an independent director, whose fiduciary duty runs, not to two masters (the fund and the management company), but to only one (the fund itself).

Of course, there's no solid statistical evidence that such a change would, in and of itself, make a difference. *But sometimes common sense tells us what statistics cannot*. For example, when the Commission tried to bar public accounting firms from providing consulting services to their attestation clients in 1998, no one could point to a "smoking gun" that clearly evidenced the existence of a problem. So the necessary reforms failed to be adopted. But then, of course, came Enron, followed by other similar cases, and we had—too late—our smoking gun, followed by public outcry and ultimately by the Sarbanes-Oxley Act.

Similarly, in the mutual fund market-timing and late trading scandals, no smoking gun was found that clearly linked the misbehavior to funds without independent chairmen. (In some instances, the problems occurred under independent chairmen; in others the chairman was a management company representative.) The smoking gun, as it were, was the obvious fact that funds were being operated with the interests of managers and distributors taking precedence over the interests of fund shareholders. It is high time we begin the process over reversing this baneful situation.

Of course, Fidelity management—which has its own interests to serve—has produced a study purporting to show that funds with independent chairman actually provide lower returns to shareholders.[3] The study is badly flawed.

- It includes only close A shares of funds, ignoring initial sales loads and the 12b-1 deferred sales loads on the B, C, etc. shares. As a result, the average fund does not rank, as it should, in the 50th percentile. It ranks in the 58th percentile, our industry's own Lake Wobegon.

[3] Defining his position, Edward C. Johnson, III, chairman both of Fidelity and the Fidelity funds, has stated that "when there are icebergs in the area, I don't want to be on a ship without two captains." Myopically, he fails to understand that there are in fact *two* ships involved—the fund and the management company—and each must pursue its own distinct course.

- Some of the poorer performing fund groups are counted as having independent chairmen when they adopted this structure very late in the ten-year period (1993-2003) covered by the study. Properly placed in the affiliated chairman slot, the study would look quite different.

- What the study did clearly show is that funds run by banks, brokerages, and financial conglomerates (49th percentile, well below that peculiar 58th percentile norm) delivered distinctly poorer returns than funds that were managed by private companies (70th percentile). These giant marketing companies are the embodiment of the conflict of interest that exists when the name of the game is gathering enormous asset bases, which generate huge profits to the managers, all the while disadvantaging shareholders.

With a proposal that's generated so much controversy regarding cost, value, and economic impact, I make so bold as to offer a compromise solution that I hope the Commission will consider: Require an independent chairman solely for giant complexes overseeing scores of funds (let's call them "business" enterprises). Exempt from the rule small fund groups offering a limited range of funds (let's call them "professional" enterprises). Where to draw the line? Of course it will be arbitrary. But perhaps the latter would include management firms that are (a) privately-held, without either public or conglomerate ownership; (b) managing less than, say, $50 billion in assets; and (c) overseeing fewer than 12 individual funds.[4] If that policy failed to mitigate the conflicts of interest that exist in mutual fund management today, we could revisit the issue based on experience.

The fund industry urgently needs to refocus its activities on management, not marketing; on profits to fund shareholders, not profits to fund managers. That is what a plain reading of the Investment Company Act of 1940 requires, and separation of the powers of governance among fund owners, fund investors, and fund managers should be the goal of public policy. I urge the Commission to press on with the adoption of an independent chairman rule, either in its totality, or in the modified form suggested above.

Sincerely,

John C. Bogle

P.S. Please incorporate by reference my earlier comments dated May 25, 2004 File S7.03.04.

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[4] I'm tempted, tongue-in-cheek, to add, (d) any fund complex where a majority of independent directors are unable to name each of the funds he or she serves as director. However, I can't imagine a single director or independent consultant of a major fund complex who could pass this test. *That tells us something important*! By the way, in such cases, I'd also require a separate fund staff to provide objective information to the board.