MEMO# 20872

February 21, 2007

Draft ICI Comments on SEC Staff Economic Papers Relating to Fund Governance

[20872]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-07
SEC RULES COMMITTEE No. 17-07
SMALL FUNDS COMMITTEE No. 6-07 RE: DRAFT ICI COMMENTS ON SEC STAFF ECONOMIC PAPERS RELATING TO FUND GOVERNANCE

Late last year, the Securities and Exchange Commission reopened the comment period on rule amendments requiring that funds relying on certain exemptive rules under the Investment Company Act of 1940 have (1) an independent chair and (2) a board with no less than 75% independent directors. [1] The Commission did so to permit public comment on two studies prepared by its Office of Economic Analysis (OEA) relating to mutual fund board independence. [2]

The Institute has prepared the attached draft paper analyzing and commenting on the OEA studies and a draft letter to accompany the paper. The draft letter and paper are attached and summarized below.

Comments on the OEA studies are due to the SEC by March 2, 2007. The Institute will hold a conference call at 2 p.m. EasternTime on Monday, February 26th to discuss the draft ICI letter and paper. The dial in number is 888-396-9185 and the pass code is 37405. Please email Barbara Watkins at bwatkins@ici.org to let us know if you plan to participate on the call. If you cannot participate on the call, please provide any comments to Frances Stadler

(202/326-5822 or frances@ici.org) or Sean Collins (202/326-5882 or scollins@ici.org) before the call.

Draft Letter

The draft letter indicates that while the studies provide useful background on the staff's economic analysis, they do not justify a regulatory mandate that fund boards have an independent chair. Similarly, they do not provide any compelling evidence that a requirement that 75 percent of a fund's board be independent would further the SEC's objectives more than the two-thirds requirement supported by the Institute.

The letter notes that publication of the papers is the latest step in a rulemaking proceeding with an unusually long and tumultuous history. It states that in response to legal challenges, a federal appeals court has twice found deficiencies in the SEC's rulemaking process.

The letter mentions that following the latest court decision, the Commission announced plans to undertake a "top to bottom" review of its process for complying with legal obligations to analyze the economic impact of proposed rules. It expresses hope that this initiative will lead to improvements in the rulemaking process, in particular by highlighting the need for timely and thorough consideration of the economic consequences of proposed rules. To help address this need, the letter recommends that the OEA staff regularly perform economic analysis of significant rule proposals and do so early in the rulemaking process.

The letter strongly encourages the Commission to publicly release the staff's economic analysis as a matter of routine in the future, and to do so much earlier in the rulemaking process. It says that making the staff's economic analysis available at the time new rules are first proposed would be far more productive, and more consistent with the D.C. Circuit Court of Appeals's interpretation of the Commission's statutory obligations.

The letter states that the Institute is troubled by reports that proponents of the independent chair and 75 percent board independence requirements may have prevented the dissemination of the OEA studies within the Commission and their release to the public at an earlier stage because of concerns that the studies cast doubt on the need for or efficacy of the requirements. It commends the Commission for making the studies available now, and expresses hope that the Commission's "top-to-bottom" review will address how to avoid the possibility that this situation could re-occur.

The draft letter then lists the key conclusions in the Institute's paper. The letter states that, based on our analysis, the Institute does not believe there is a sound basis for mandating that virtually all fund boards have an independent chair. It recommends that the Commission refrain from further efforts to impose such a requirement. In addition, the letter notes that the OEA studies do not change the Institute's previous position regarding the required percentage of independent directors on fund boards.

Draft Paper

The draft paper discusses the two OEA studies [3] within the framework that regulators generally use when analyzing the economic rationale of a rule. As explained in the paper, this framework involves first identifying the need for a rule (in economic terms, the market imperfection or market failure that the rule seeks to address), then identifying the benefits associated with the rule, and finally, weighing those benefits against the costs of the rule.

Market Imperfections Described in the Literature Review

The draft paper discusses the three main groups of market imperfections that the Literature Review examines, all of which involve potential conflicts between the interests of fund advisers and those of fund shareholders. The draft paper points out that, as the Literature Review indicates, it is unclear whether these putative conflicts always, or even mostly, work to the detriment of fund shareholders. The paper expresses agreement with the Literature Review both that there is little conclusive evidence that such conflicts are economically meaningful, and that many SEC rules already seek to address them.

The draft paper states that in the Institute's opinion, to the extent the conflicts are economically meaningful, market forces can and do help to mitigate them. Finally, the paper notes that if these conflicts do have a meaningful influence on advisers' behavior that is not addressed by current rules and market forces, it remains unclear how greater board independence or an independent chair would address them.

Market Forces That Help to Align the Interests of Advisers and Shareholders

The draft paper then discusses more generally how market forces help to align the interests of fund advisers and fund shareholders. The paper expresses the Institute's belief that the Literature Review understates the extent to which market forces spur competition in the fund industry. It argues that it is less costly for investors to search among funds, and that shareholders are more willing and able to move among funds, than the Literature Review suggests. The draft paper emphasizes the competitive pressures that result from the strong demand among fund shareholders for low-cost funds. It also discusses academic research suggesting that a fund adviser has a strong incentive to protect its reputation.

Benefits Associated with the Requirements

The draft paper notes that the Literature Review concluded that academic studies provide no consistent evidence that an independent chair improves the governance of a mutual fund, and limited, and at times contradictory, evidence that more independent boards are beneficial to funds and their shareholders. It expresses concurrence with these broad findings and summarizes the relevant academic research.

The draft paper examines the analysis in the Power Study concerning possible reasons for the lack of statistical evidence to conclude that requiring an independent chair would benefit fund shareholders, either through better fund performance or lower fund expenses. It disagrees with the Power Study's finding that the lack of statistical evidence of benefits may be attributable to the limitations of statistics and data. The draft paper states that the available statistical data and statistical tests are sufficient to have uncovered substantial, or even relatively modest, benefits of an independent chair, if such benefits existed. It interprets this as indicating that there is no economic or business reason to conclude that one governance approach is preferable to another.

Costs of Implementing the Requirements

The draft paper briefly discusses the costs of the independent chair and 75 percent board independence requirements, reiterating the Institute's concern that they will have a disproportionate impact on small fund advisers.

Frances M. Stadler
Deputy Senior Counsel

Attachment

endnotes

[1] See Memorandum to Closed-End Investment Company Members No. 62-06, SEC Rules Members No. 108-06 and Small Funds Members No. 86-06 [20698], dated December 18, 2006.

[2] See Memorandum to Closed-End Investment Company Members No. 3-07, SEC Rules Members No. 3-07 and Small Funds Members No. 3-07 [20761], dated January 5, 2007.

[3] As noted in the draft paper, one study (the "Literature Review") provides a summary of recent academic research related to mutual fund governance. The other study (the "Power Study") discusses the strength of the statistical tests used in many of the academic papers cited in the Literature Review.
