

MEMO# 20924

March 5, 2007

ICI Comments on SEC Staff Economic Papers Relating to Fund Governance

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TO: BOARD OF GOVERNORS No. 9-07

CLOSED-END INVESTMENT COMPANY MEMBERS No. 15-07

SEC RULES MEMBERS No. 28-07

SMALL FUNDS MEMBERS No. 20-07 RE: 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 filed the attached letter with the SEC, along with a paper analyzing and commenting on the OEA studies. [\[3\]](#) In the letter the Institute concludes that, based on our analysis, we do not believe the SEC's studies provide any basis for mandating that virtually all fund boards have an independent chair or for raising the required percentage of independent directors to 75 percent. Our letter ultimately recommends that the SEC conclude this rulemaking proceeding without further action. The letter and paper are summarized below.

Summary of the Letter

The letter notes that publication of the papers is the latest step in a rulemaking proceeding

with an unusually long and tumultuous history that includes legal challenges and court findings of deficiencies in the SEC's rulemaking process.

The letter expresses hope that an initiative announced by the Commission to undertake a "top to bottom" review of its process to analyze the economic impact of proposed rules will lead to improvements in the rulemaking process. 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 also strongly encourages the Commission to publicly release the staff's economic analysis as a routine matter in the future, and to do so much earlier in the rulemaking process.

The letter expresses concern with reports that proponents of the independent chair and 75 percent board independence requirements may have prevented the dissemination of the OEA studies at an earlier stage because the studies may 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.

Summary of the Paper

The paper discusses the two OEA studies [\[4\]](#) 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. [\[5\]](#)

Market Imperfections Described in the Literature Review

The 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 paper points out that, as the Literature Review indicates, it is not clear that these putative conflicts are always economically meaningful, work to the detriment of fund shareholders, or fail to be addressed by existing SEC rules or mitigated by market forces.

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 requiring an independent chair or 75 percent independent board would address them.

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

The paper then discusses more generally how market forces help to align the interests of fund advisers and investors. 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 paper emphasizes the competitive pressures that result from the strong demand between 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 paper notes that the Literature Review found that academic studies offer little support for the view that requiring an independent chair would improve mutual fund governance 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 paper also examines the analysis in the Power Study concerning possible reasons for the lack of statistical evidence that requiring an independent chair would benefit fund shareholders, either through better fund performance or lower expense ratios. [6] It questions the Power Study's suggestion that the lack of statistical evidence of benefits may be attributable to the limitations of statistics and data. It concludes that existing studies have found no benefit to having an independent chair because there is no consistent relationship between board chair status and fund performance or expense ratios. It interprets this lack of proven benefits as indicating that there is no reason to believe that one approach is preferable to another.

Costs of Implementing the Requirements

The 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.

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[Attachment](#)

endnotes

[1] See [Memorandum](#) to Board of Governors No. 32-06, 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 Board of Governors No. 2-07, 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] The paper is available at http://www.ici.org/pdf/ppr_07_oea_study.pdf.

[4] As noted in the 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.

[5] Appendix A to the paper discusses this framework in greater detail.

[6] Appendix B to the paper provides an analysis of power tests.

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