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March 2, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. S7-03-04; Release No. IC-27600

Dear Ms. Morris:

On behalf of the Chamber of Commerce of the United States of America ("Chamber"), I am submitting this letter in response to the Commission's request for comment on two papers prepared by the Commission's Office of Economic Analysis in connection with the consideration of amendments to the "exemptive rules" under the Investment Company Act. 71 Fed. Reg. 76618 (Dec. 21, 2006).

With substantial membership in each of the fifty states, the Chamber has an underlying membership of more than three million businesses, chambers of commerce, and business and professional organizations of every size and in every industry sector. One of the Chamber's associational purposes is to voice its members' concerns with costly and unnecessary federal regulations. The Chamber has an abiding interest in the Commission's proposed mutual fund "governance" rules and appreciates the opportunity to comment on the papers prepared by the Office of Economic Analysis.[1]

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[1] The Chamber appreciates that the Commission has now made the papers publicly available. It is of interest, however, that the papers are being made available at this particular time. The consideration of empirical data is central to most regulation, particularly in areas governed by the National Securities Market Improvement Act of 1996. Commissioner Atkins has recently stated in a speech posted on the Commission's website that the papers have been in the Commission's possession since the "original rulemaking." Remarks of Commissioner Paul S. Atkins Before the

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A principal point of the Chamber's earlier comments in this rulemaking is that the Commission should not intervene in the financial markets, nor limit investor choice, without compelling evidence of a *need* for further regulation, and without establishing that the regulations proposed would *in fact* deliver the benefits promised. Simply, the burden lies with those who would restrict free markets, constrain investor choice, and— in this instance— bar or otherwise deter a favored investment model within the industry (the management-chaired fund). *See* Comments of the Chamber of Commerce of the United States of America (August 21, 2006). The independent chair and 75 percent independent director provisions, the Chamber has said, fall well short of these requirements and indeed would have significant adverse effects on investors and the mutual fund industry.

Now, with its release of the two papers prepared by the Office of Economic Analysis—the *Literature Review on Independent Mutual Fund Chairs and Directors* ("Literature Review") and *Power Study as Related to Independent Mutual Fund Chairs* ("Power Study")—the Commission has confirmed in crucial respects the views previously expressed by the Chamber. The papers state— and we agree— that it is presumptively wrong to restrict investor choice in free and well-functioning competitive markets. Because the Commission cannot support a finding that the nation's multi-trillion dollar mutual fund industry is not a free and competitive market, regulatory intervention is improper. Additionally, the papers confirm, as the Chamber has argued, that there is no empirical basis to believe that imposing increased independence on mutual fund boards will serve investors' interest or increase efficiency, competition, and capital formation. Generally, the papers characterize the existing body of empirical literature in the area as "small" and "underdeveloped," lacking in both "strong theoretical underpinnings" and "consistent

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SEC Speaks in 2007 (Feb. 9, 2007), http://www.sec.gov/news/speech/2007/spch020907psa.htm (last visited Feb. 27, 2007). If so, the fact that the papers are being made available only now raises additional important questions about the rulemaking's procedures.

The Chamber has submitted a Freedom of Information Act request to better understand the Commission's preparation and release of the papers. The request was denied on February 16, and an appeal has been taken from the denial.

evidence." Literature Review at 3, 23-24. And, the papers show, the empirical evidence that does exist suggests that mandating increased board independence is more likely to decrease fund performance than to increase it. For these and other reasons, the Commission should close the rulemaking record in this matter without imposing any further regulatory requirements.[2]

The comments that follow are divided into four sections:

- Section I discusses a key premise to this and virtually any other rulemaking: the government should not constrain investor choice in a free and competitive market without first identifying a market failure associated with the "problem" it seeks to remedy. Certainly, the Commission has not and cannot establish that the market for mutual funds is not competitive. The evidence is to the contrary. Accordingly, by the reasoning of the Commission's own Office of Economic Analysis, there is no basis for adopting mutual fund governance requirements.

- Section II addresses the specific provisions the Commission is considering and explains that even assuming regulation is warranted—and it is not—there is insufficient evidence to support the independent chair and 75 percent independent director requirements. There are only a handful of studies that directly examine the relationship between increased board independence and fund performance. Those studies fail to establish a consistent relationship between fund performance and the independence of board members and chairs and, indeed, suggest that if anything management-controlled funds perform better. All the other studies discussed in the Literature Review address the matter only indirectly, by looking at the relationship between board independence and items such as fees and fund mergers. Those papers, also, fail to reliably establish a benefit associated with outside directors. The research surveyed in the Literature Review accordingly, *supports* the Chamber's position

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[2] If the Commission nevertheless concludes that some additional regulation is necessary, we continue to recommend that its action be limited to adopting the "disclosure alternative," which would further investor choice while avoiding counterproductive, intrusive regulation.

that the independent chair and 75 percent independent director requirements are unnecessary, unjustified, and counterproductive.

- Section III explains that the two recently-released papers indicate that rules intended to bar or deter management-directed funds are likely to have negative effects on efficiency, competition, and capital formation. We note as an initial matter that the Commission has not examined what effects its regulations would have if the mutual fund market is in fact currently well-functioning. The Commission must examine and account for those effects. In addition, the Literature Review confirms that smaller funds and fund families and new entrants in the mutual fund market are likely to be negatively affected by additional regulation. Increased costs for small funds would likely cause more to shutdown or merge, thereby limiting investor choice, innovation, competition, and capital formation.

- The Literature Review acknowledges that any benefits of greater board independence could vary according to the particular transaction or activity in which the fund is engaged. Section IV explains that without carefully examining the need and value of greater board independence with respect to the activities governed by each of the ten exemptive rules, the Commission risks imposing significant costs without any corresponding benefit.

I. The Commission Should Approach This Proceeding With A Presumption Against Interfering In Well-Functioning Markets; The Power Study And The Literature Review Provide No Basis For Concluding That The Mutual Fund Market Is Not Well-Functioning.

As discussed in the Chamber's earlier comments, a basic principle that must guide the Commission's consideration of further regulation of mutual fund governance is that the burden of justifying a new law or regulation lies with the party proposing constraints on free markets. This presumption of non-interference is particularly strong here because Congress purposely granted investors the option of investing in funds in which the adviser plays a leading role, 15 U.S.C. § 80a-10(a) (requiring only 40 percent of mutual fund directors to be independent), and investors have registered their approval of the current mutual fund governance regime by

investing billions of dollars in funds whose boards have management chairs and a significant number of management directors.

Importantly, the Literature Review endorses the premise that there is no basis to intervene without first establishing a market failure. "[I]f there are no impediments to markets working efficiently," it states, "mutual funds and their shareholders would select governance characteristics—including the presence of an independent chair or the percentage of the board held by independent directors—in an optimal manner." Literature Review at 23. Given that, government intervention and the cost it entails should not occur without first establishing that in fact markets are not functioning efficiently. This is additionally important because of another observation in the literature review: "Due to differing business conditions, *[optimal] board structure may be different for individual mutual funds.*" *Id.* (emphasis added). *Accord id.* at 3 (because "this optimum may prove to be quite different for firms with different characteristics," there will likely be "differences in board composition across firms"). In other words, imposing a particular governance model is mistaken because what model is best may vary by fund and a well-functioning market, unlike the government, has the capacity over time to match a fund with the model that serves it best. The Mutual Fund Directors Forum— which is an association of independent directors and has been regarded as supporting increased independence requirements— has made the same point: "[T]he Forum recognizes that each fund and fund family is unique, that fund directors need to assess whether a particular practice makes sense for a particular fund, and that in some circumstances the independent directors of a fund may reasonably conclude that the recommended governance structure [*i.e.,* independent chair and 75 percent independent directors] may not be in the best interests of their fund's shareholders." Comments of Mutual Fund Directors Forum (August 21, 2006).

While the Commission's Office of Economic Analysis correctly recognizes that in an efficient market "mutual funds and their shareholders would select governance characteristics . . . in an optimal manner," the Commission has not and cannot substantiate a finding that the mutual fund market suffers from significant competitive failures that would deter the exercise of informed investor choice. The evidence is to the contrary. *See* John C. Coates IV & R. Glenn Hubbard, *Competition and Shareholder Fees in the Mutual Fund Industry: Evidence and Implications for Policy* (AEI working paper # 127) (June 2006), *available at* http://www.aei.org/docLib/20060711_Coates_Hubbardwps.pdf (last visited Feb. 14,

2007); *see also* paper by John Coates, filed with comments of Fidelity Management & Research Company (Mar. 2, 2007). The Coates-Hubbard study examined numerous structural and performance characteristics of the mutual fund industry and found that "[c]laims that price competition is absent among equity mutual funds are unfounded." Coates-Hubbard Study at i (Executive Summary). "Investors have thousands of rival, substitutable product choices, and face small transaction costs in moving from one fund to another." *Id.*

In sum, the recently-released papers by Commission staff confirm that there should be a presumption against intervening in competitive markets, particularly because mutual funds and their shareholders reasonably may conclude that different funds are better served by different governance structures. The Commission has not made the findings that would justify further interference in the nation's highly active and competitive mutual fund market. To regulate nonetheless would be to default to the untenable position that— in the words of a former chairman— "there are no empirical studies that are worth much." SEC Open Meeting, 57-58 (June 23, 2004).

II. Even If Some Additional Regulation Is Needed, There Is No Evidence Supporting The Specific Rules Under Consideration.

Even assuming the Commission could find that the mutual fund market is not competitive—and it cannot—there is no basis for concluding that mandating an independent chair or an increased number of independent directors is an appropriate response. Changing the board structures of mutual funds will affect shareholder wealth. While the Literature Review notes that, "to the extent board structures are *not* optimally chosen from the investor perspective, *changes in board structure can create value*," Literature Review at 19 (emphases in original), it fails to note that changes will create value *only* if the board structures they mandate are more efficient. It also omits the corollary: to the extent board structures *are* already optimally chosen from the investor perspective, changes in board structure away from the optimal can *destroy* value. Accordingly, before adopting the provisions under consideration, the Commission must show that mandating an independent chair and greater board independence will actually increase shareholder value, not erode it. The papers prepared by the Office of Economic Analysis do not support this, rather, they suggest the contrary.

Most of the papers discussed in the Literature Review do not directly address the relationship between the proposed regulations and fund performance. Of the ten papers reviewed, only three directly address the question of the impact of the proposed Commission governance rules, and only two of those—the Bobroff-Mack and Meshcke papers—directly examine the relationship between the proposed regulations and performance. Altogether, this literature fails to establish a consistent, positive relationship between board independence and fund performance, whether measured directly or indirectly. And, indeed, the two studies that most directly examine the link between independent chairs and directors and fund performance fail to find a positive relationship between board independence and fund performance and actually suggest that greater board independence leads to *lower* performance:

- One study used a sample of 55 fund families with at least $10 billion in assets to study the relationship between independent chairs and performance. G. Bobroff & T. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*," (submitted with Fidelity Investment's comments for consideration of Investment Company Governance rules (IC-26250), adopted July 2, 2004). The study found that "the relative and absolute Morningstar rankings of funds with independent chairs are significantly lower than the rankings of management-affiliated funds over the past three, five and ten years," that "the average *alpha* for management-chaired funds is higher than for independent-chaired funds," and that there is "no reliable relation between chair independence and expenses." Literature Review at 15.

- A second study found "no evidence of a positive relation between board or chair independence and a variety of measures of fund performance." Literature Review at 18, discussing Felix Meshcke, *An Empirical Examination of Mutual Fund Boards* (working paper at the University of Minnesota) (Feb. 2005). In fact, "for both equity and bond funds," the study found "that greater board independence is generally associated with *lower* returns." *Id.* (emphasis added).[3]

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[3] It is notable that the Literature Review does not address the flaws in the studies that are cited as potentially supporting a requirement for increased board independence. Instead, its criticisms are generally limited to the Bobroff-Mack and Felix Meschke studies. Moreover, even if the Literature Review did identify sound reasons for discounting these studies—and it does not—that would not relieve the Commission of its burden to show that the studies' results are

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Taken together, these two studies establish the likelihood that, even assuming current mutual fund markets are not efficient, increasing board independence is more likely to destroy shareholder value, than to create it. Accordingly, there is no empirical basis for requiring an independent chair or increased independent directors, or for otherwise increasing the costs and burdens of shareholders who choose to invest in management-chaired funds.[4]

The remaining studies discussed by the Literature Review are significantly less relevant because they do not directly examine the relationship between board independence and fund performance. Rather, these studies attempt to assess board effectiveness indirectly, by examining the relationship between an independent chair or independent directors and other variables, such as fees charged. *See* Literature Review at 12-14. As a threshold matter, the Literature Review correctly observes that these studies are of limited value because "[e]ven in the case where board independence is related to board decision-making, it is not generally possible to make a direct connection between those decisions and increased shareholder value." *Id.* at 13. For example, the Literature Review discusses a study that links a higher proportion of independent directors to a greater likelihood of replacing a poorly performing manager. *Id.*, discussing B. Ding & R. Wermers, *Mutual Fund Performance and Governance Structure: The Role of Portfolio Managers and Boards of Directors* (working paper at the University of Maryland, College Park) (2005). But "it is very difficult for researchers to determine whether replacing a manager after poor performance was a

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wrong and that in fact increased independence results in enhanced performance. If existing academic studies do not disprove the Bobroff-Mack and Felix Meschke findings—and they do not—then it is the Commission's obligation to conduct its own study before setting aside what is currently the most relevant available empirical data.

[4] Even the Mutual Fund Directors Forum—an association of independent mutual fund directors that stands to gain from increasing their number, influence, and compensation—recognizes that the proposed governance rules are inappropriate and recommends only that they be encouraged as "best practices." Comments of the Mutual Fund Directors Forum at 1 (August 21, 2006).

Curiously, the Forum's Board of Directors disagrees with the Forum's membership on this point. *Id.* at 1-2 n.3. Perhaps the Forum's Board would be more closely aligned with the interests of its membership if it were not so "independent."

good idea (because the poor performance was due to poor management and the new manager is likely to be better) or a bad one (because the poor performance was due to bad luck, and the new manager is not likely to be any better)," the Literature Review acknowledges. Literature Review at 14. Likewise, studies that evaluate boards' effectiveness solely in terms of the fees they negotiate are not persuasive. Although holding other variables constant, lower fees benefit shareholders, no investor would trade significantly higher performance for slightly lower fees. In addition, and as the Literature Review notes, "higher fund fees may be, at least sometimes, associated with more highly skilled managers and not with poorer governance." *Id.* at 12. That is because advisers "with better ability to choose investments are able to command higher fees." *Id.* at 11. Studies that examine fees without controlling for performance thus cannot make the case for increasing independence requirements on mutual funds, particularly when higher fees may actually correlate with higher performance, and the empirical studies that look at performance directly suggest that, if anything, management-chaired funds are higher performing. Accordingly, the at-best indirect relationship between fund performance and the other variables considered in these studies renders them unpersuasive, particularly in light of the conclusions of the studies that directly examined the relationship between governance structure and fund performance.

Even on their own terms, however, the studies that examine independent mutual fund governance less directly generally support the conclusions to be drawn from the Bobroff-Mack and Meschke studies: increased board independence cannot be presumed to benefit fund shareholders. Two of the papers—Tufano and Sevick, and Del Guerico, Dann and Partch—are unable to draw a consistent relationship between board independence and the level of fees; rather, results vary depending on relatively arbitrary assumptions. The same is true of the paper by Ferris and Yan, where the estimated relationship between independent directors and fund fees was positive or negative depending on the assumptions employed by the authors. Khorana, Tufano, and Wedge also observe inconsistent results in their sample: that a higher proportion of independent directors are associated with higher fees, while an independent chair is associated with lower fees.[5] In sum, what this literature suggests

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[5] The Literature Review also cites the conflicting results reported in the Meshcke paper. For the earlier period studied in that paper greater board independence is associated with *higher* fees,

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is that there is no clear benefit associated with greater board independence and any benefit that does exist is not in the interest of all funds. As the Power Study aptly notes: "Existing empirical studies of the effects of mutual fund governance have failed to consistently document a statistically significant relation between fund governance and performance, particularly with respect to board chair independence." Power Study at 1. This literature confirms both the lack of empirical support for the proposed regulations, and that a one-size-fits-all approach to board governance is mistaken and insupportable. For all of these reasons, the Commission lacks the evidence to responsibly conclude that current governance structures are sub-optimal, and that market intervention in the form of increased independence requirements is necessary. To proceed in the absence of such evidence would be to adopt the "dismissive attitude toward the value of empirical data" that has caused the Commission difficulty twice before. *Chamber of Commerce v. SEC*, 412 F.3d 133, 142 (D.C. Cir. 2005). No additional governance rules should be adopted.

III. The Literature Review And Power Study Confirm That The Governance Rules Likely Will Have A Substantial Negative Effect On Efficiency, Competition, And Capital Formation.

The Commission is required by law to consider the effects that any new requirements would have on efficiency, competition, and capital formation. 15 U.S.C. § 80a-2(c). In analyzing these effects, the Commission must consider not only direct costs, but also non-monetary factors such as the loss of investor choice and of innovation that results from increased competition. *See* Peter J. Wallison, Financial Services Outlook: *Buried Treasure: A Court Rediscovers A Congressional Mandate The SEC Has Ignored* (AEI, Oct. 2005). The Literature Review and Power Study confirm that the earlier proposed independent chair and 75 percent independence requirements would have a substantial, negative effect in all three areas.

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whereas in the later period greater board independence is associated with lower fees. *See* Literature Review at 18.

A. The best available evidence indicates that current board structures are optimal; therefore, mandating greater board independence likely will decrease efficiency and destroy value.

Mandating sub-optimal mutual fund governance structures will destroy shareholder value. *Cf.* Literature Review at 19 (stating the corollary—that moving from sub-optimal to optimal governance structures will enhance value). As Section II explains, the Bobroff-Mack and Felix Meschke studies provide the most direct evidence of whether existing governance structures are optimal. Those studies indicate either that there is no relationship between greater board independence and performance, or that the relationship is negative, *i.e.*, greater board independence leads to lower performance. Accordingly, there is a significant likelihood that regulatory changes which bar or deter management-directed funds will decrease efficiency in the mutual fund market by producing sub-optimal governance structures.

The Commission has not examined what adverse effects would result from rules that mandated inefficient governance structures. Yet the losses could be immense. "At the end of 2005," the Power Study noted, "the mutual fund industry managed approximately 9 trillion dollars." Power Study at 15. "One half of one percent (50 basis points) of 9 trillion dollars," the paper continued, "is *45 billion dollars*." *Id.* (emphasis added). Therefore, even if only a small percentage of the mutual fund market was negatively affected by the proposed rules, the sheer size of the market could create investor losses in the billions. Plainly, as a matter of law and policy the Commission must consider these potential losses before proceeding with any further regulation. It has not done so.

B. The independent chair and 75 percent independence requirements would have a negative effect on competition by driving smaller funds out of business.

The independent chair and 75 percent independent director provisions would have a disproportionate effect on smaller funds, which are vital to competition and innovation. As we explained in our earlier comments, the Commission must analyze the provisions' effects on the competitiveness of smaller fund and fund families. The Commission, analysts, and commentators have all noted that the burdens of implementing and complying with the provisions are likely to be particularly great for smaller funds and fund families. *See, e.g.,* 70 Fed. Reg. at 39,393, 39,395; Amanda

Gerut, *Small Fund Boards Struggle to Comply with 75% Provision*, BOARDIQ, July 12, 2005; Comments of Scott L. Barbee (May 12, 2004) and Joseph Harroz, Jr. (Apr. 2, 2004). The Literature Review and the Power Study confirm that these concerns are well-founded.

A recent study of 2002 requirements imposed by Sarbanes-Oxley and the stock exchanges found that the rules had a "significantly negative [effect] for small firms." Literature Review at 19. This new rules "were not value enhancing in small firms," the study found. *Id.* at 20. The disproportionate negative effect on smaller firms is not surprising— they must absorb similar costs to larger companies, but must do so over a much smaller revenue base. The same is true of mutual funds. Each fund or fund family must bear the costs of recruiting an independent chair and additional independent directors. The smaller the fund, the fewer shareholders there are to absorb the costs. These effects are already being felt. A 2005 study reported that by September of that year, 250 smaller funds had liquidated, compared with 169 smaller fund liquidations for all of 2004. The study attributes these liquidations not to past performance difficulties or enforcement actions, but to the provisions contemplated here. The costs "of maintaining an independent board, including an independent chair person" have been too much for smaller funds, it was reported. Herbert Lash, *Over 250 Mutual Funds Liquidate, Cite Rule Costs*, REUTERS, Sept. 16, 2005. These concerns continue to warrant close consideration by the Commission, as urged by the Chamber previously.

C. The provisions would have a similarly negative effect on capital formation.

Because the two disputed provisions would disproportionately affect smaller funds, they would have a similarly negative effect on capital formation. New funds and fund families often begin as small funds. Increasing the costs associated with small funds therefore will limit the number of new funds created, directly limiting competition, investor choice, and capital formation. Moreover, because the provisions would further separate advisers from the funds they create, the provisions must be expected to lower the incentives for entrepreneurs to create new funds, further deterring capital formation. *See* Comments of Lacy B. Herrmann (May 11, 2004) ("If this proposal is adopted the mutual fund industry will suffer from a decrease in entrepreneurs willing to put their time, effort and money behind innovation of new worthwhile fund products."). Once again, and as previously

argued by the Chamber, this is another serious effect to be thoroughly examined before the independent chair and 75 percent independence requirements are adopted.

IV. The Literature Review And Power Study Confirm That As A Policy Matter— As Well As For Legal Reasons— The Commission Must Analyze Any Additional Requirements As They Relate To Each Exemptive Transaction Being Regulated, Not Mutual Fund Governance In General.

The Commission does not have *carte blanche* to regulate mutual fund governance. Rather, the DC Circuit held, the Commission may use its exemptive authority—on the basis of a proper rulemaking record—as a prophylactic measure to "prevent abuses *of exemptive transactions.*" *Chamber of Commerce*, 412 F.3d at 141 (emphasis added). As explained in the Chamber's earlier comments, this requires that there be a genuine "fit" between any exemptive rule amendment and the particular activities regulated by that specific rule.

The Literature Review confirms that any "governance"-related amendments must be considered with respect to the specific exemptive transactions being regulated, rather than through a broadbrush, indiscriminate assumption that a particular governance model will enhance all fund exemptive rule activities. "The types of events where governance appears to matter most," the Literature Review explains, "may not be representative of all types of decisions with economic consequences made by the board." Literature Review at 3. Therefore, "[i]t may prove *inappropriate to conclude that greater independence benefits all decisions.*" *Id.* (emphasis added). *Accord id.* at 20 (board independence may be desirable only for "a set of specific decisions made by the board").

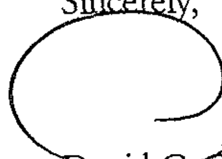
The Commission's method to date of considering further governance regulation commits precisely this mistake: it fails to separately consider the specific activities regulated by the exemptive rules and whether— as to those activities, and for each rule— increased independence requirements are necessary and will enhance shareholder value. The report of the Commission's staff now confirms that this is poor policy, as well as an inappropriate exercise of the Commission's exemptive rule authority.

CONCLUSION

The Commission's recently-released papers confirm what the Chamber has repeatedly stated—there is "no consistent evidence" to support the independent chair and 75 percent independent director requirements, which are unnecessary, counterproductive, and are more likely to destroy investor wealth than to create it. After more than three years of advocacy, the proponents of the provisions remain unable to carry their burden to justify a costly interference with free markets that conflicts with Congress's design and deprives the investing public of a choice preferred by many.

For all of the reasons above, and for the reasons stated in our earlier comments, the Chamber urges the Commission to close the rulemaking record without adopting any further regulatory requirements.

Sincerely,



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