SCHWAB *funds*®

March 2, 2007

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

Re: S7-03-04: Investment Company Governance

Dear Ms. Morris:

I appreciate the opportunity to comment on the Securities and Exchange Commission's proposal regarding mutual fund governance. I am pleased to file this letter, which supplements our comment letter dated August 21, 2006, in response to the Commission's request for additional comment regarding two economic studies prepared by the Commission's Office of Economic Analysis ("OEA") and the economic consequences of the proposed rule.[1]

I welcome the Commission's efforts to enhance investor protection and to conduct more economic analysis before adopting a rule that has potentially serious consequences for promoting efficiency, competition, and capital formation. Requiring mutual fund boards to be composed of at least 75% independent directors[2] will strengthen the integrity of the decision-making processes of boards and will thus promote the goal of protecting investors. However, I remain concerned that the requirement to have an independent chair is inconsistent with the 75% independence requirement. The latter empowers the board; the former takes away a key decision right. It seems contradictory to trust an independent board to make every key decision (i.e., fees, new board members, advisor contracts, etc.) except one, who the board's chair should be.

The two OEA studies provide no justification for a mandatory independent chair rule, and instead support the modified approach outlined in our previous comment letter to the proposed rule, in which we recommended that the Commission retain the 75% independent requirement, but eliminate the independent chair requirement. In the Literature Review, the OEA analyzed a number of economic papers related to mutual fund governance, and drew two main inferences: (1) boards with a greater proportion of independent directors are more likely to negotiate and approve lower fees, merge poorly performing funds more quickly and provide greater protection against market timing and late trading, but the OEA did not find similar support for the hypothesis that independent chairs lead to lower expenses, and (2) there is no consistent evidence

---

[1] See: OEA Literature Review on Independent Mutual Fund Chairs and Directors (December 29, 2006) ("Literature Review"), and OEA Power Study as Related to Independent Mutual Fund Chairs ("Power Study") (collectively, the "OEA studies"); SEC Release No. IC-27600 (December 15, 2006), 71 Fed. Reg. (December 21, 2006).
[2] I use the term "director" to include both mutual fund directors and trustees, regardless of whether the fund is structured as a corporation or a trust.

that chair or board independence is associated with lower fees and/or higher returns for mutual fund shareholders. Literature Review pp. 23-24.[3]

In the Power Study, the OEA concluded that "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, p.1. Although the OEA cautioned that the lack of such evidence may be a result of the limits of standard statistical methods in identifying such a relation, and is not necessarily indicative of the failure of such a relationship to exist, we believe that the costs of a one-size-fits-all approach mandating an independent board chair without regard to the needs of the particular fund far outweighs any theoretical benefit of such an approach.

The OEA's analysis highlights an important negative consequence of mandating an independent chair for every fund group. The Literature Review states that the optimum board structure for a given mutual fund depends on the best trade-off between the positive and negative consequences of increasing the influence of outsiders over the board. On the one hand, according to the OEA, outsiders bring expertise and independence, so that their influence may improve the quality of management decisions and manage conflicts of interest that insiders have, thereby increasing value to the firm. On the other hand, OEA found, outsiders may lack information about the inner workings of the firm and other firm-specific knowledge. The OEA states that the optimum structure of a firm's board depends on the relative importance of the board's expertise or independence versus the benefits of greater access to firm-specific information. OEA concludes that: (1) this optimum may prove to be quite different for different firms with different characteristics; (2) changes in board structure may affect investor value; and (3) the value of outsider expertise and independence, relative to information access, may vary widely among firms. Literature Review, pp. 2-3. The OEA cautions that "*Boards with a suboptimal structure may be associated with reduced investor wealth.*" Literature Review, p. 3 (emphasis in original).

The Commission's proposed mandatory independent chair requirement would deny independent directors the ability to pursue the optimal board structure for their particular fund family, and instead mandate an independent chair even when that approach might be detrimental to the funds' best interests and actually reduce investor value. Such an approach is fundamentally in conflict with the OEA's description of the economic theory of board composition. Before the Commission adopts a rule mandating an independent chair, which potentially imposes significant costs on shareholders, it should seek to determine through economic analysis whether such a rule will in fact promote efficiency, competition, and capital formation. Both OEA's analysis and common sense suggest that a mandatory independent chair requirement will impair competition by foreclosing many fund families from pursuing their optimal governance structure. The result will be that this rule may actually reduce shareholder value, and inhibit capital formation.

---

[3] The OEA acknowledged that the first and second inferences may seem in conflict, but explained that the lack of consistent empirical evidence that board composition leads to better performance may be attributable to several factors, including limitations inherent in statistical research methodology.

Recent media reports suggest that the Commission may be considering alternative compromise solutions to a mandatory independent chair approach.[4] We believe that any alternative solution that the Commission may be considering should start from the premise that independent directors who form a supermajority of the board should have the discretion to elect whomever they deem best suited to chair their board, whether independent or interested, in light of the unique characteristics of their fund family, and in a way that they deem to be in shareholders' best interests.

In 1999, the Investment Company Institute convened a blue ribbon panel of experts to consider mutual fund governance best practices, which recommended that "independent directors designate one <u>or more</u> 'lead' independent directors." <u>See</u> <u>Enhancing a Culture of Independence and Effectiveness</u>, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) at page 25 (emphasis added). This panel recognized that some boards might be better served by dividing lead independent director responsibilities among two or more independent directors, rather than a single lead independent director. We believe that there is no need to impose a single lead independent director requirement in cases such as ours, where four lead independent directors each serve as chair to a committee of the board, which essentially achieves the same benefits as a single lead independent director. Other fund organizations may decide that a single lead independent director is preferable to four lead independent directors. Each board should be able to make that decision based on the circumstances of their particular fund family, especially in light of the OEA's findings that there is wide variation in optimal board governance structures. I respectfully submit that any alternative or compromise solution that the Commission considers in this area should focus on strengthening board independence by creating a supermajority of independent directors and empowering them to determine who should chair their board, based on their careful and deliberate consideration of the best interest of their funds' shareholders.

I appreciate your consideration of my views and request that when deciding on the final rule, the Commission consider whether requiring an independent chair may produce an unintended consequence, that of actually weakening the decision-making latitude of the independent directors to do what they believe is in the best interest of fund shareholders.

Sincerely,

Evelyn Dilsaver

Evelyn Dilsaver
President, Schwab Funds

---

[4] SEC Considers Fund Board Compromise, Wall Street Journal, February 15, 2007, p. C13.