September 30, 2009

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-08-09, Political Contributions by Certain Investment Advisers

Dear Ms. Murphy,

We are writing to comment on your proposed rule *Political Contributions by Certain Investment Advisers*, File Number S7-08-09. We are finance professors at Rice University, University of Tennessee, and University of Memphis, respectively. These opinions are our own and do not necessarily reflect those of our respective institutions.

Your proposal mentions that it is modeled after rules G-37 and G-38 of the Municipal Securities Rulemaking Board ("MSRB") and is intended to address pay to play practices in investment advising services to state and local governments. We believe that your proposal could be highly effective at meeting its goal and we would like to draw your attention to our recently published research paper (see Alexander W. Butler, Larry Fauver, and Sandra Mortal, 2009, "Corruption, Political Integrity, and Municipal Finance," Review of Financial Studies Vol. 22, No. 7, 2673-2705), where we present evidence consistent with the effectiveness of rules G-37 and G-38 at addressing pay to play practices.

In our paper we examine the effects of a different form of pay to play. Until 1994, it was commonplace for underwriters of municipal securities to make political campaign contributions in order to be considered for underwriting business. This practice was analogous to the type of pay to play currently under consideration by the Commission. Pay to play practices by underwriters stopped abruptly in 1994 when the MSRB adopted rules G-37 and G-38.

We looked at approximately 128,000 tax-exempt municipal bond issues to investigate what impact, if any, did pay to play have in the market, and how effective were rules G-37 and G-38 at curbing its practice. During the pay to play era, before these rules were implemented, when underwriting firms routinely made political campaign contributions to win underwriting business from the state, gross spreads (the fees paid to the underwriting firms) were significantly higher, but only for negotiated bid deals, i.e., those deals that can be allocated on the basis of political favoritism. The effect is statistically significant and economically large – it ranges from 11.8 to 13.8 basis points, depending on the specification. This magnitude is roughly one seventh of the mean gross spread. In contrast, competitive deals, which offer no room for favoritism, have fees that are only negligibly higher (and generally not statistically significant). This result continues to hold when controlling for the identity of the underwriter. That is, on average, for a given underwriter, that underwriter charged abnormally high fees during the pay to play era compared to what the same underwriter charged afterwards. We interpret these higher fees as quid pro quo for political campaign contributions, and as evidence that rules G-37 and G-38 were effective at curbing pay to play practices.

Furthermore, we find some evidence that the pay to play practices by underwriters distorted not only the fees, but which firms were allocated business. The current proposal mentions that pay to play practices may create an uneven playing field among investment advisers by hurting smaller advisers that cannot afford to make political contributions. We find evidence that is consistent with this view. During the pay to play era, municipal bonds were underwritten by investment banks with larger underwriting market shares compared to afterward. One interpretation of this result is that smaller underwriters were passed over in favor of larger underwriters (who presumably had deeper pockets for political contributions).

Our study quantifies the effect of such financial persuasion and corruption in the municipal bond market. We believe that rules such as the one proposed by the Commission are needed to effectively address pay to play practices by investment advisors.

Thank you for the opportunity to comment on this proposed rule.

Sincerely,

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