

**Investment Company Institute**

**Submission to the Department of the Treasury**

**Review of the Regulatory Structure Associated with Financial  
Institutions**

**December 7, 2007**

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#### **Introduction**

The Investment Company Institute (“ICI” or “Institute”), the national association of U.S. investment companies,<sup>1</sup> commends the Department of the Treasury for its continuing efforts to improve the competitiveness of the U.S. capital markets. Treasury’s current review of the regulatory structure associated with U.S. financial institutions<sup>2</sup> is a timely and welcome undertaking and one of great significance to investment companies and their shareholders. With total assets of over \$13 trillion and almost 90 million shareholders, investment companies are among the nation’s most important financial intermediaries. The continued success of America’s investment company sector, like that of other financial institutions, depends upon a regulatory framework that is effective, efficient, and even-handed. We are pleased to have this opportunity to submit our views.

Investment companies have a unique perspective on our regulatory structure, because they are both issuers of securities and investors in domestic and international securities markets and their operations are governed by all of the major federal securities laws. As issuers, investment companies seek broad and efficient markets in which to offer their securities without unnecessary regulatory impediments to innovation. As investors, they seek transparency of information and the effective protections of a regulatory system that ensures that their investments are, in fact, as described in the issuer’s offering materials and that they receive the best price possible for their investments. For the most part, these two roles are aligned – strong capital markets with the even-handed application of investor protection provide investment companies with capital-raising opportunities and the assurance that investments made will be subject to appropriate regulatory oversight and protection.

Our historical experience, as both issuers and investors, confirms that the principles and standards underlying our regulatory structure have, to this point, served our markets, and investors in those markets, well. We share the concerns of many others, however, that our current regulatory structure and approach is ill suited to keep pace with rapid changes and accelerating competitive challenges in a now-global marketplace. As Treasury Secretary Paulson stated in announcing the

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<sup>1</sup> ICI members include mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).

<sup>2</sup> Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions, Department of the Treasury, 72 Fed. Reg. 58939 (Oct. 17, 2007).

Treasury’s review of the current regulatory structure, “[t]o maintain our capital markets’ leadership, we need a modern regulatory structure complemented by market leaders embracing best practices.”<sup>3</sup>

The recommendations set forth below follow from four basic principles that should govern reforms of our regulatory structure to assure that the U.S. capital markets remain robustly competitive: first, products and services offered and sold in a national market demand a coherent scheme of national regulation; second, if U.S. financial institutions are to succeed against global competitors, U.S. regulators must encourage and permit innovation and adopt global standards; third, our traditional regulatory organization and approach, especially for purposes of securities regulation, must be reformed in light of changed market realities; and fourth, for a broad array of purposes, U.S. regulators should embrace the efficiencies offered by revolutionary information, communications and other technologies.<sup>4</sup> In the discussion that follows, we elaborate on these principles with respect to the industry we know best – the investment company industry – but we also believe that they have broad applicability to the financial services industry as a whole.

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<sup>3</sup> “Paulson Announces Next Steps to Bolster U.S. Markets’ Global Competitiveness” (Treasury Press Release, June 27, 2007), available at <http://www.treas.gov/press/releases/hp476.htm>.

<sup>4</sup> Our recommendations follow on Institute submissions on other high-level examinations of the competitiveness of the U.S. capital markets. *See* Letter from Paul Schott Stevens, President, Investment Company Institute, to Professor Hal S. Scott, Director, Committee on Capital Markets Regulation, Nov. 20, 2006, available on the Institute’s website at [http://www.ici.org/statements/cmltr/06\\_ccmr\\_fund\\_issues\\_ltr.html#TopOfPage](http://www.ici.org/statements/cmltr/06_ccmr_fund_issues_ltr.html#TopOfPage); Letter and submissions from Paul Schott Stevens, President, Investment Company Institute, to Michael Ryan, Executive Director, U.S. Chamber of Commerce, Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century, Jan. 26, 2007 and Feb. 7, 2007, available on the Institute’s website at [http://www.ici.org/statements/cmltr/07\\_reg\\_cap\\_mark\\_stmt.html#TopOfPage](http://www.ici.org/statements/cmltr/07_reg_cap_mark_stmt.html#TopOfPage) and [http://www.ici.org/statements/cmltr/07\\_reg\\_cap\\_mark\\_stmt\\_add.html#TopOfPage](http://www.ici.org/statements/cmltr/07_reg_cap_mark_stmt_add.html#TopOfPage).

## Summary of Recommendations

- **Products and services offered and sold in a national market demand a coherent scheme of national regulation**
  - The U.S. Securities and Exchange Commission (“SEC”) should assert its authority under the National Securities Markets Improvement Act of 1996 as the sole regulatory standard setter for registered investment companies, to implement the pre-emptive purpose of that statute and secure the regulatory efficiencies Congress intended.
  
- **If U.S. financial institutions are to succeed against global competitors, U.S. regulators must encourage and permit innovation and adopt global standards**
  - *Develop an alternative form of U.S. registered investment company for the global marketplace*
    - The Administration and Congress, in consultation with the SEC and the investment company industry, should develop legislation to authorize a new form of U.S. registered investment company that would be a competitive, attractive investment option for both U.S. and non-U.S. investors.
  
  - *Converge financial reporting standards and accounting principles*
    - Accounting standard setters must ensure that any converged accounting standards yield high-quality financial reporting that accurately portrays issuers’ operating results and financial positions and does not diminish the reported information on which investors rely to make investment decisions.
    - Convergence in accounting principles should be accompanied by efforts by regulators in differing jurisdictions to develop common, high-quality disclosure requirements for financial information presented outside the financial statements.
    - The convergence process should acknowledge that an industry specific accounting model that recognizes the distinctions between investment companies and general corporate issuers results in more meaningful financial statements. Ideally, the convergence process relating to investment companies should converge toward U.S. Generally Accepted Accounting Principals, which we believe better serve the interest of investment company shareholders.

- **Our traditional regulatory organization and approach, especially for purposes of securities regulation, must be reformed in light of changed market realities**
  - *The SEC should adopt a more prudential model of regulation*
    - Building off its experience with the Consolidated Supervised Entity program and an Office of Compliance Inspections and Examinations (“OCIE”) pilot program, the SEC should modify its supervisory and enforcement approaches and more broadly apply a prudential regulatory approach to all firms, large and small.
    - Congress should ensure that the SEC has adequate resources to fund necessary levels of staffing and training to effectively implement a prudential regulatory program.
  - *Reorganize the SEC to improve oversight and rulemaking*
    - Responsibility for the SEC’s inspection and examination functions should be returned to the SEC’s operating divisions (currently organized as the Division of Investment Management and the Division of Trading and Markets).
    - All SEC inspections of a firm (both routine and sweep examinations) should be centrally coordinated, including the information requested, legal interpretations by the examiners, and the feedback provided to firms.
    - The SEC should limit its use of sweep examinations to unusual situations and be required to provide prompt feedback to a firm following an examination. Such feedback should be both consistent among the various SEC regional offices and SEC headquarters, and be provided in writing upon a firm’s request.
    - The SEC should realign its organizational structure to more accurately reflect the contours of the current capital markets.
  - *Ensure that regulatory costs are proportionate to their benefits*
    - The SEC should reorganize its rulemaking process, and the role within that process of the Office of Economic Analysis, to ensure that it conducts a rigorous, timely and informed analysis of the costs and benefits of all regulatory proposals.
    - The SEC by rule, or Congress by law, should require that all self-regulatory organizations (“SROs”) perform a similar cost-benefit analysis prior to submitting regulatory proposals to the SEC.
    - The SEC as well as SROs should establish a process for reexamining existing rules, or at least those rules that they or industry participants identify as imposing unjustifiable costs or competitive burdens.

- **U.S. regulators should embrace the efficiencies offered by revolutionary information, communications and other technologies**
  - To more efficiently advance regulatory policy objectives and to conduct regulatory oversight, the SEC and other regulators should make more effective and thorough use of information, communications and other technology.

## Discussion

### **I. Products and services offered and sold in a national market demand a coherent scheme of national regulation**

From our own historical experience, we are conscious that regulated entities subject to duplicative and often conflicting federal and state laws incur substantial costs and inefficiencies. In the past, to publicly offer their shares, registered investment companies had to comply with the unique securities regimes of all 50 states as well as the U.S. Securities and Exchange Commission (“SEC or Commission”). Just over a decade ago, however, Congress passed the “National Securities Markets Improvement Act of 1996” (“NSMIA”)<sup>5</sup> to correct this situation. NSMIA represented the judgment of Congress that “the system of dual federal and state securities regulation ha[d] resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, is redundant, costly, and ineffective.”<sup>6</sup>

While pre-empting state authority for other purposes, NSMIA preserved the ability of states “to investigate and bring enforcement actions with respect to fraud and deceit” or “unlawful conduct by a broker or dealer” in connection with the sale of investment company shares. The Act foreclosed states from exercising *any* authority – whether by statute or administrative action – over the registration of investment company shares, the regulation of investment company prospectuses and disclosure documents, or the operations of investment companies.

Given the national character of the market in which investment companies operate and their importance to the U.S. economy, Congress recognized the soundness of a policy for shared federal-state oversight of investment companies. Under this regulatory structure, federal law governs all substantive regulation, and states have concurrent authority to protect against fraud under the federal rules. When signing NSMIA into law, President Clinton noted that the legislation represented a more efficient division of oversight responsibility and would assure that “[m]utual funds, which are sold nationally, will be regulated nationally.”<sup>7</sup>

Significantly, Congress also was aware that state enforcement powers potentially might be used in a manner tantamount to regulation. For this reason, it directed that the states exercise their retained investigative and enforcement authority in a manner “consistent with” the broad pre-emptive policy of

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<sup>5</sup> Pub. L. No. 104-290.

<sup>6</sup> Joint Explanatory Statement of the Committee of Conference, Conference Report – National Securities Markets Improvement Act of 1996, H.R. 3005, H.R. CONF. REP. NO. 104-864 (1996).

<sup>7</sup> See “Statement on Signing the National Securities Markets Improvement Act of 1996,” President William J. Clinton, The White House, Oct. 11, 1996.

the Act. Congress was clear that the restrictions on states' use of their authority "applied both to direct and indirect State action."<sup>8</sup>

Notwithstanding the lines of authority clearly laid out in NSMIA, in recent years, state authorities repeatedly have sought to regulate mutual funds and mutual fund disclosure requirements through enforcement actions. Three pending enforcement cases are illustrative of the problem. Each ostensibly has been brought under the antifraud provisions of the states' securities acts.<sup>9</sup> Each alleges that, as a result of the failure to disclose certain information (by a mutual fund in its prospectus or by a broker at point of sale), the investment companies, their distributors, and/or investment advisers committed "fraud." In each case, the information alleged to have been fraudulently omitted is *not* information that the SEC or the federal securities laws require to be disclosed by investment companies or broker-dealers.

Cases of this kind stand to wholly undercut the pre-emptive regime established by Congress in NSMIA, and threaten to return U.S. investment companies to the "redundant, costly and ineffective" system of federal-state oversight that Congress rejected. We believe that state attorneys general and other state officials, as Congress intended, should be scrupulous in deferring to the SEC's judgments on regulatory policy, including disclosure requirements. As SEC Commissioner Paul Atkins recently observed, "[t]he setting of disclosure standards for nationally-offered securities such as mutual funds is a function that Congress, through NSMIA, clearly left to the Commission."<sup>10</sup> Inexcusably, the SEC, to date, has not intervened to preserve or defend its exclusive jurisdiction under NSMIA nor made any attempt to clarify the division of power between federal and state securities regulators.<sup>11</sup>

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<sup>8</sup> National Securities Markets Improvement Act of 1996, H.R. REP. NO. 104-622, at 30 (1996).

<sup>9</sup> See *The People of California v. Edward D. Jones & Co., L.P.*, No. 04AS05097 (Cal. Super. Ct. Dec. 20, 2004) and *The People of the State of California v. Edward D. Jones & Co.*, 154 Cal. App. 4<sup>th</sup> 627, 65 Cal. Rptr. 3d 130 (Cal. App. 3d Dist. Aug. 24, 2007); *Capital Research and Management Company and American Funds Distributors, Inc. v. Bill Lockyer, Attorney General of the State of California* (Cal. Super. Ct. Nov. 22, 2005), *Capital Research and Management Company v. Edmund G. Brown, Jr., as Attorney General*, 147 Cal. App. 4<sup>th</sup> 58, 53 Cal. Rptr. 3d 770 (Jan. 26, 2007) and *Capital Research and Management Company v. Brown*, 2007 Cal. LEXIS 5149 (May 16, 2007); and *In the Matter of Morgan Keegan & Company, Inc., RMK Select Funds*, State of Illinois, Secretary of State, Securities Department File. No. 0500619 (June 4, 2007) and *In the Matter of Morgan Keegan & Company, Inc., RMK Select Funds*, State of Illinois, Secretary of State, Securities Department File. No. 0500619 (Oct. 23, 2007).

<sup>10</sup> Speech by Commissioner Paul S. Atkins, U.S. Securities and Exchange Commission, "Is Excessive Regulation and Litigation Eroding U.S. Financial Competitiveness?", Conference co-sponsored by the American Enterprise Institute and the Brookings Institution, Washington, D.C., Apr. 20, 2007.

<sup>11</sup> This was recognized by SEC Commissioner Atkins recently when he stated that "[s]ince its passage in 1996, the Commission has not engaged in any serious effort under the National Securities Markets Improvement Act (NSMIA) to engage in "regulatory convergence" among Federal and state securities regulators, especially as it may affect nationally and globally-offered securities." *Id.*

*Recommendation:*

- The SEC should assert its authority under NSMIA as the sole regulatory standard setter for registered investment companies, to implement the pre-emptive purpose of that statute and secure the regulatory efficiencies Congress intended.

**II. If U.S. financial institutions are to succeed against global competitors, U.S. regulators must encourage and permit innovation and adopt global standards**

There is a growing “national conversation” among government officials, business leaders of all industries, scholars and others aimed at identifying and addressing the challenges for American businesses in the new global environment. As the Director of the SEC’s Office of International Affairs recently remarked, “[o]ur markets are now interconnected and viewing them in isolation – as we have for so long – is no longer the best approach to protecting . . . investors, promoting an efficient and transparent U.S. market, or facilitating capital formation for U.S. issuers.”<sup>12</sup>

From the perspective of U.S. investment companies, two issues deserve specific mention in this context: first, the need for the development under U.S. law of a new investment company model that would be a competitive, attractive option for both U.S. and non-U.S. investors, and second, the importance of convergent financial reporting standards and accounting principles for issuers from different countries.

**A. Develop an alternative form of U.S. registered investment company for the global marketplace**

The extraordinary rise of mutual fund investing is not a U.S. phenomenon only. Global fund assets exceeded \$24 trillion as of June 2007. Of this total, the share represented by U.S. registered investment companies has steadily declined from 66 percent in early 1999 to 47 percent in mid-2007.<sup>13</sup> In contrast, the European fund structure known as “UCITS”<sup>14</sup> has experienced strong growth not only across the European Union but also internationally. UCITS have become increasingly popular investment choices for both retail and institutional investors in Asia and Latin America as well.<sup>15</sup>

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<sup>12</sup> Ethiopis Tafara and Robert J. Peterson, *A Blueprint for Cross-Board Access to U.S. Investors: A New International Framework*, 48 HARV. INT’L L.J. 31, 32 (Winter 2007).

<sup>13</sup> Data prepared by Investment Company Institute.

<sup>14</sup> The acronym stands for “Undertakings for Collective Investments in Transferable Securities.”

<sup>15</sup> See, e.g., Steve Johnson, *How UCITS Became a Runaway Success: Despite Their Clumsy Name, the Kitemarked Funds are Now a Force to be Reckoned With Across the World*, FIN. TIMES, Nov. 27, 2006, at 3 (“If you are a U.S. [fund] group and you want to be global, you have to do it from Europe, not the U.S. Europe is seen as a good springboard for selling outside of Europe and UCITS has opened that gateway.”).

Ironically, U.S. fund managers that wish to offer investment funds globally have no option other than this European fund structure. As the European Commission recently boasted, “UCITS authorisation has won wide global recognition as a guarantee of sound product structuring and effective regulation.”<sup>16</sup>

As financial markets become increasingly global, investors will be given more freedom to choose among an expanding array of investment products and services, with less regard to their point of origin. The U.S. fund industry needs to be able to compete effectively in such a global marketplace. One way to do so is to develop a new form of U.S. registered investment company that would be an attractive, competitive investment option for both U.S. and non-U.S. investors alike.

The Investment Company Act of 1940 and related rules set forth regulatory schemes for three types of registered investment companies that are offered to U.S. investors today: mutual funds, closed-end funds, and unit investment trusts. These types of registered investment companies generally have served U.S. investors well, but, for the reasons discussed below, they are not a viable investment product for markets outside the United States.

U.S. registered investment companies offer less advantageous tax treatment to foreign investors than many of their foreign counterparts. Most significantly, under U.S. tax law, U.S. registered investment companies are required to make annual distributions to all shareholders of their income and gains, thus generally causing foreign shareholders to incur annual tax liabilities in the United States and in their home countries. Many European funds, on the other hand, do not distribute their income and gains; shareholders are taxed on these amounts only when they choose to redeem investment company shares, allowing greater growth of their investments.

U.S. registered investment companies also have a complex structure tailored specifically to U.S. law, including that the investment company must be organized as a corporate entity separate and apart from the money manager that sponsors it. In contrast, the laws in many other jurisdictions treat an investment company simply as the mechanism through which a money manager offers its services to investors.

The idea of expanding the reach of the Investment Company Act is not new. On various occasions dating back to at least 1980, the staff of the SEC, industry commentators, and others have considered whether the Investment Company Act should be expanded to permit a fourth type of U.S. registered investment company, including a type that is generally modeled on highly successful fund structures found outside the United States.<sup>17</sup> Although they differ in their details, these proposals have

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<sup>16</sup> See Commission of the European Communities, *White Paper on Enhancing the Single Market Framework for Investment Funds*, COM(2006)686, Nov. 15, 2006.

<sup>17</sup> See generally *Protecting Investors: A Half Century of Investment Company Regulation* (report by the Division of Investment Management, U.S. Securities and Exchange Commission, May 1992) at 282-88, 332-45. See also Peter J. Wallison and Robert E. Litan, *Competitive Equity: A Better Way to Organize Mutual Funds*, AEI Press (April 2007) (proposal for a “managed investment trust”); Stephen K. West, panelist, “Is There a Better Way to Regulate Mutual Funds?” panel discussion at the American Enterprise Institute (Sept. 26, 2005) (proposal for a “unified fee investment company”); Stephen

shared a common overarching objective – that of creating a more streamlined, market-based investment vehicle offering investors both competitive returns and the strong protections that flow from regulation under the Investment Company Act.

A new global investment company model could be designed to offer considerable benefits for investment company shareholders – both inside and outside the United States – and for investment company sponsors. Some of the features that should be considered as part of such a model include:

- a straightforward fee structure, such as a single, or unitary, fee from which the investment company sponsor would pay virtually all fund expenses and earn a profit,
- a tax “roll-up” of the investment company’s income and gains,
- a streamlined investment company structure that reflects the “economic reality” of a collective investment fund (*i.e.*, that the investment company is an investment product established by its investment adviser/sponsor), and
- many of the same core Investment Company Act protections that characterize the other forms of U.S. registered investment companies.

The introduction of a global investment company model would make the U.S. regulatory framework for registered investment companies more compatible with the regulatory frameworks for investment companies in other leading jurisdictions around the world. The creation of a truly global marketplace for registered investment companies also would result in increased investment choice that would benefit U.S. investors.

*Recommendation:*

- The Administration and Congress, in consultation with the SEC and the investment company industry, should develop legislation to authorize a new form of U.S. registered investment company that would be a competitive, attractive investment option for both U.S. and non-U.S. investors.

**B. Converge financial reporting standards and accounting principles**

High quality, reliable financial reporting is essential to investors, including investment companies whose advisers rely upon issuers’ reported financial results to make investment decisions on behalf of the investment companies they manage. The rapid globalization of investing illustrates the need for convergence of financial reporting standards and accounting principles. All investors will benefit when issuers’ financial results are prepared and reported under a common accounting framework.

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K. West, panelist, “Regulation Under the Investment Company Act: Where Are We Now and Where Should We Go,” panel discussion at General Membership Meeting, Investment Company Institute (May 1980) (proposal for a “unitary investment fund”).

Convergence of accounting standards has been underway for many years. A significant step towards convergence of International Financial Reporting Standards (“IFRS”) and U.S. Generally Accepted Accounting Principals (“U.S. GAAP”) occurred in 2002, when an agreement was reached among U.S. and international accounting standard setters to develop high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.<sup>18</sup> In 2005, the SEC staff laid out a “roadmap” for eliminating the requirement for foreign private issuers filing IFRS financial statements with the Commission to provide reconciliation to U.S. GAAP.<sup>19</sup> More recently, the SEC approved rule amendments that would eliminate the U.S. GAAP reconciliation requirement for foreign private issuers that comply with IFRS as issued by the IASB.<sup>20</sup> The SEC also has issued a concept release seeking comment on providing U.S. issuers, including investment companies, with the option to file IFRS financial statements.<sup>21</sup>

While significant progress toward convergence of accounting principles has been made to date, much remains to be done. For example, two studies by SEC staff conclude that both U.S. GAAP and IFRS need further improvement in several key areas.<sup>22</sup>

There also are significant differences in investment company financial statements prepared under U.S. GAAP as compared to those prepared under IFRS. For example, U.S. GAAP provides industry-specific reporting requirements for investment companies, which reflect their unique status as pooled investment vehicles. In contrast, IFRS does not provide guidance or standards specific to

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<sup>18</sup> See Memorandum of Understanding (“MOU”) between the Financial Accounting Standards Board (“FASB”), the designated organization in the private sector for establishing and improving U.S. GAAP, and the International Accounting Standards Board (“IASB”), the independent, privately funded accounting standard setter in London that developed IFRS (Sept. 18, 2002). The MOU is available on the FASB website at <http://www.fasb.org/news/memorandum.pdf>.

<sup>19</sup> See Statement by Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, “A Securities Regulator Looks at Convergence,” *Northwestern University Journal of International Law and Business* (Apr. 2005).

<sup>20</sup> See “SEC Takes Action to Improve Consistency of Disclosure to U.S. Investors in Foreign Companies” (SEC press release, Nov. 15, 2007), available on the SEC’s website at <http://sec.gov/news/press/2007/2007-235.htm>.

<sup>21</sup> See Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards, SEC Release No. 33-8831 (Aug. 7, 2007). The SEC has announced that it will hold roundtable discussions to further explore issues covered in the concept release on December 13 and 17, 2007.

<sup>22</sup> See Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, by Office of the Chief Accountant, Office of Economic Analysis, U.S. Securities and Exchange Commission (July 25, 2003), available on the SEC’s website at <http://sec.gov/news/studies/principlesbasedstand.htm>; Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, by Office of the Chief Accountant, Office of Economic Analysis, and Division of Corporation Finance, U.S. Securities and Exchange Commission (June 15, 2005), available on the SEC’s website at <http://sec.gov/news/studies/soxoffbalancerpt.pdf>.

investment companies. Accordingly, investment companies would follow the same financial reporting standards followed by general corporate entities and their financial statements would appear very similar to those prepared by these entities. As a result, investment company financial statements prepared under IFRS likely would be less meaningful to shareholders relative to those prepared under U.S. GAAP.<sup>23</sup>

*Recommendations:*

- Accounting standard setters must ensure that any converged accounting standards yield high-quality financial reporting that accurately portrays issuers' operating results and financial positions and does not diminish the reported information on which investors rely to make investment decisions.
- Convergence in accounting principles should be accompanied by efforts by regulators in differing jurisdictions to develop common, high-quality disclosure requirements for financial information presented outside the financial statements (*e.g.*, Management Discussion and Analysis, market risk disclosures, and executive compensation).
- The convergence process should acknowledge that an industry specific accounting model that recognizes the distinctions between investment companies and general corporate issuers results in more meaningful financial statements. Ideally, the convergence process relating to investment companies should converge toward U.S. GAAP, which we believe better serves the interest of investment company shareholders.

**III. Our traditional regulatory organization and approach, especially for purposes of securities regulation, must be reformed in light of changed market realities**

As both issuers and investors in the U.S. capital markets, investment companies have a strong interest in the effectiveness of the SEC, as primary regulator not only for our industry but also for other market participants and for the securities markets themselves. Since the historic reforms that gave birth to the SEC in 1934, the Commission as an organization has evolved far less dramatically than have its regulated entities, subject as they are to the rigors of the marketplace and relentless competitive pressures. External forces compel private organizations of all kinds to “re-invent” themselves periodically – a process that can unleash surprising new energy and ideas and uncover different ways of performing key missions more successfully. This process is no less necessary, from time to time, for government departments and agencies.

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<sup>23</sup> See Letter from Gregory M. Smith, Director – Operations/Compliance & Fund Accounting, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, re: Commission Request for Comments on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with IFRS, Nov. 13, 2007, available on the Institute's website at [http://www.ici.org/statements/cmltr/07\\_sec\\_ifrs\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/07_sec_ifrs_com.html#TopOfPage).

We agree with others that the SEC's performance of its key statutory missions – protecting investors and promoting efficiency, competition and capital formation – would benefit from a thorough reconsideration of its current organization and approach in light of vast changes in the domestic and international landscape and the experience of other financial regulators and regulatory jurisdictions. The recommendations that follow highlight some of the issues that we believe deserve close attention in the course of such a review.

Having worked closely with the leadership and staff of the SEC for many years, we have great admiration for their dedication and professionalism, and a very healthy regard for how difficult the agency's job can be. We offer the recommendations below in a constructive spirit and with the conviction that all of us share a desire to create regulations that are both effective and efficient, while at the same time workable in today's global markets.

#### **A. The SEC should adopt a more prudential model of regulation**

Echoing the sentiment of his predecessor as the first SEC Chairman, Joseph Kennedy, Chairman Christopher Cox has articulated the Commission's desire to be "partners of honest business."<sup>24</sup> This might succinctly characterize the prudential model of regulation employed with high success by other regulatory bodies. For the most part, it does not characterize the SEC's approach.

There is, we believe, no reason that the regulatory framework for oversight of our capital markets cannot be flexible enough both to protect investors and to foster competition, efficiency and capital formation. The latter objectives, however, have not loomed nearly as large on the Commission's agenda, and accordingly the agency has paid less attention to the differing risk characteristics, business models and management qualities of its regulated entities, to market developments as they arise, and to the competitive standing of U.S. firms and markets. Historically, the SEC instead has preferred to pursue a highly prescriptive regulatory regime, administered with the blunt trauma of aggressive enforcement sanctions. Regrettably, such an approach has served to keep the SEC and regulated entities at arms' length. It has hampered the ability of the SEC to stay closely informed about issues and activities in even the largest regulated firms, and has provided industry participants far less incentive to engage constructively with the agency.

To address these issues, the SEC should modify its supervisory and enforcement approaches, putting more emphasis on "prudential regulation."<sup>25</sup> A prudential approach to regulation contemplates

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<sup>24</sup> Speech by Chairman Christopher Cox, U.S. Securities and Exchange Commission, "Securing America's Competitiveness," Remarks to the U.S. Chamber of Commerce's First Annual Capital Markets Summit, Washington, D.C., Mar. 14, 2007.

<sup>25</sup> For purposes of this submission, we distinguish prudential regulation from principles-based regulation. We question the feasibility of a substantially more principles-based regime of securities regulation, absent a fundamental shift away from the enforcement mentality that pervades SEC oversight today. If prudential regulation can establish the desired goal of mutual trust between regulators and regulated entities, a movement toward principles-based regulation could be re-examined.

closer, cooperative interaction between regulators and regulated entities to identify and correct problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Under this approach, firms are encouraged to step forward with self-identified problems and proposed resolutions, and the regulator pursues its investor protection responsibilities through various means not always involving enforcement measures. This less adversarial approach to regulation also enables regulators to stay current with market innovation and industry developments. As a result, prudential regulation allows market participants to be more competitive while providing regulators with meaningful and current information to protect investors and the securities markets. As noted by SEC Commissioner Annette Nazareth:

Prudential regulation . . . implies having a clear set of standards with a more flexible implementation approach for meeting those standards. It means permitting regulated entities to meet their obligations in a more customized, as opposed to “one-size-fits-all” manner. It means more efficient regulation, not less effective regulation.<sup>26</sup>

Recently, the SEC implemented a more prudential form of regulation for five of the nation’s largest securities firms. The Consolidated Supervised Entity (“CSE”) program allows the SEC to maintain a dialogue with and monitor for, and act quickly in response to, financial or operational weaknesses that might place regulated entities or the broader financial system at risk. Under the CSE program, firms are required to document their tailored systems of internal rules; the SEC does not mandate particular controls through “cookie cutter” requirements. Rather, the SEC reviews the adequacy of the controls and their implementation, taking into account the unique business of the firm. An important component of the CSE program is the regular interaction of SEC staff with the firms’ senior managers, as well as examinations to test whether the firms are implementing their documented controls. In the investment company area, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) has begun a pilot program that uses dedicated teams of two to four examiners to provide more continuous and in-depth oversight of the largest and most complex groups of affiliated investment companies and investment advisers. As of June 2006, firms representing approximately \$1.5 trillion were participating in this pilot program.<sup>27</sup>

The overall approach to regulation for these programs is similar to the way in which registered investment companies are regulated in the United Kingdom, where there is close cooperation and dialogue between the manager of a U.K. fund, the independent depository to the fund,<sup>28</sup> and the U.K.

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<sup>26</sup> Speech by Commissioner Annette Nazareth, U.S. Securities and Exchange Commission, Remarks Before the SIFMA Compliance and Legal Conference, Phoenix, A.Z., Mar. 26, 2007.

<sup>27</sup> See *Securities and Exchange Commission, Steps Being Taken to Make Examination Program More Risk-Based and Transparent*, GAO-07-1053 (Aug. 2007) at 10.

<sup>28</sup> Depositories for U.K. funds are typically large banking institutions. The depository is required to be independent of the fund manager, and owes a fiduciary duty to fund investors. The depository is responsible for the safekeeping of all fund assets and must take reasonable care to ensure that the fund manager is properly discharging its own duties. See *generally*

Financial Services Authority. Specifically, the depositary typically uses a risk assessment process to determine the appropriate level and nature of oversight that is required with respect to a particular fund manager. The depositary regularly meets with, and has affirmative reporting obligations to, the FSA. This dynamic appears to provide fund managers in the United Kingdom with additional incentives to deal with potential problems and bring them to the FSA’s attention quickly. For its part, the FSA also appears to take a risk-based approach to regulation and to regulate with an eye toward both protecting investors *and* fostering industry competitiveness.<sup>29</sup>

*Recommendations:*

- Building off its experience with the CSE program and OCIE pilot program, the SEC should modify its supervisory and enforcement approaches and more broadly apply a prudential regulatory approach to all firms, large and small. The techniques used to achieve this goal should vary depending on a number of factors, including the perceived risk a firm may pose as demonstrated by its past inspections or its level of assets under management, as well as the overall size and complexity of a firm.
- Congress should ensure that the SEC has adequate resources to fund necessary levels of staffing and training to effectively implement a prudential regulatory program.

**B. Reorganize the SEC to improve oversight and rulemaking**

The current organizational structure of the SEC largely took shape in the early 1970s to reflect the operation of the securities markets of that day. In the almost forty years since then, we have witnessed a sea-change affecting every corner of the Commission’s responsibilities, including the roles of investment advisers, broker-dealers, and other service providers, the products and services they create or promote, and much more. As a result, we agree with others that there is a critical need to re-examine the current organization of the SEC.

**1. Restructure the SEC’s examination and inspection functions**

The SEC’s Office of Compliance Inspections and Examination is charged, in part, with inspecting investment companies and investment advisers for their compliance with the federal securities laws. OCIE, which is structurally separated from the SEC’s operating divisions that promulgate and interpret the rules for which it tests compliance, carries out this responsibility by conducting either routine or “for cause” inspections, and increasingly through “sweep” examinations, in

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*Review of the Governance Arrangements of United Kingdom Authorised Collective Investment Schemes* (report by the U.K. Investment Management Association, Feb. 2005).

<sup>29</sup> See, e.g., *A New Regulator for the New Millennium*, Report by the U.K. Financial Services Authority (Jan. 2000), available at <http://www.fsa.gov.uk/pubs/policy/P29.pdf>.

which the staff focuses on a particular issue through visits to numerous investment companies and investment advisers.

In carrying out inspections of particular firms, there appears to be little coordination among various SEC regional offices. This lack of coordination often results in duplicative examinations and inconsistent interpretations of the SEC's rules and regulations. Examinations of the same firm by more than one regional office can impose substantial and costly burdens on firms by subjecting the same firm to multiple inspections, with different regions requesting voluminous, and often duplicative, information in varied formats. More troubling is the trend for OCIE staff to engage in *de facto* rulemaking during an inspection (*e.g.*, telling an investment company or adviser that it must have specific policies and/or procedures that are not required by statute or rule), or requiring the production of books and records that firms are not required to maintain or even generate.

The separation of OCIE from the relevant policymaking offices in other SEC divisions also can result in a lack of coordination between the staff drafting and interpreting the rules and those charged with examining the rules' compliance. As a result, the divisions, primarily the Divisions of Investment Management and Trading and Markets, are often deprived of ready access to practical information about how firms operate because OCIE conducts its work at a distance from the actual rule makers.

Sweep examinations raise additional concerns. They result in a piecemeal look at investment company operations, usually without any meaningful feedback to the investment company. OCIE's widespread and frequent use of these exams risks inappropriately diverting finite resources at firms to responding to sweep exam requests, when those resources could be better spent on overall compliance efforts.

*Recommendations:*

- Responsibility for the SEC's inspection and examination functions should be returned to the SEC's operating divisions (currently organized as the Division of Investment Management and the Division of Trading and Markets). This structure would provide several benefits: it would bring together the inspection function with the relevant subject matter expertise and help avoid the recurring problem of *de facto* rulemaking by OCIE staff; it could allow the SEC and regulated entities to interact on a more cooperative basis (*i.e.*, promote a prudential model of regulation as discussed above); and it could vastly expand the practical industry knowledge of the policymaking divisions.
- All SEC inspections of a firm (both routine and sweep examinations) should be centrally coordinated, including the information requested, legal interpretations by the examiners, and the feedback provided to firms.
- The SEC should limit its use of sweep examinations to unusual situations and be required to provide prompt feedback to a firm following an examination. Such feedback should be

both consistent among the various SEC regional offices and SEC headquarters, and be provided in writing upon a firm's request.

## **2. Restructure SEC divisions and offices to better focus on today's securities markets**

Numerous other divisions and offices within the SEC besides the Division of Investment Management have responsibility for issues that affect investment companies, both directly and indirectly. These other divisions and offices include OCIE, the Division of Corporation Finance, the Division of Trading and Markets, and the Division of Enforcement. Inadequate coordination and lack of communication between and among these divisions can and does have adverse consequences on regulated entities, including inappropriate or inconsistent application of existing regulatory policy and flawed development of new regulatory standards.

One recent study on the competitiveness of the U.S. capital markets recommended that the SEC reallocate the responsibilities of the divisions of Investment Management and Trading and Markets into three new divisions: (i) the Division of Market Professionals, which would be responsible for the regulation of broker-dealers, investment advisers and investment companies; (ii) the Division of Markets and Exchanges, which would be responsible for the regulation of market structure, including all exchanges and the institutions that facilitate those markets (*e.g.*, SROs); and (iii) the Division of Securities Products, which would be responsible for the regulation of securities products.<sup>30</sup> This option as well as others deserve serious consideration, with the objective of achieving a new staff organization that will more closely reflect the structure and functioning of today's securities markets and facilitate improved SEC oversight and better regulation.

### *Recommendation:*

- The SEC should realign its organizational structure to more accurately reflect the contours of the current capital markets.

## **C. Ensure that regulatory costs are proportionate to their benefits**

As the SEC considers future rulemaking for investment companies, it is important to do so with a full understanding of the potential consequences, including the costs and the benefits. When new regulations are required, or existing regulations are amended, the SEC, like all regulators, needs to thoroughly examine all possible options and choose the alternative that yields effective regulation at minimal cost. Without such an analysis, investors frequently will pay higher costs, have available fewer investment options, and ultimately see diminished protection if they turn to less regulated alternative

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<sup>30</sup> See Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century (U.S. Chamber of Commerce), Report and Recommendations (Mar. 2007) at 137-38.

products or markets.<sup>31</sup> A rigorous cost-benefit analysis does not mean that investors lose important protections. Rather, it challenges regulators to consider alternative proposals and think creatively to achieve appropriate protections in the least burdensome manner possible.<sup>32</sup>

Congress understands this – it *mandated* that the SEC consider, in addition to the protection of investors, whether its rulemaking will promote efficiency, competition, and capital formation.<sup>33</sup> Furthermore, although the SEC, as an independent regulatory agency, is not required to conduct a formal “cost-benefit analysis” when it adopts rules,<sup>34</sup> Congress does require, through the Paperwork Reduction Act,<sup>35</sup> that the SEC conduct an analysis of the time and monetary burdens imposed under a proposed rule that requires a collection of information. Among the considerations that the SEC must weigh for each collection of information is “a specific, objectively supported estimate of the burden imposed.”<sup>36</sup> Regrettably, the SEC’s historic process for conducting a cost-benefit analysis has been inadequate: it has failed to produce realistic assessments of regulatory costs and burdens or to appropriately evaluate alternative approaches and, other than in a rather cursory manner, has largely ignored Congress’ express requirement to evaluate a rule’s effect on efficiency, competition, and capital formation.

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<sup>31</sup> See Speech by Paul Schott Stevens, President, Investment Company Institute, “Finding the Right Balance for Mutual Fund Regulation,” 2006 Securities Law Developments Conference, Dec. 4, 2006, available on the Institute’s website at [http://www.ici.org/statements/remarks/06\\_seclaw\\_stevens\\_spch.html#TopOfPage](http://www.ici.org/statements/remarks/06_seclaw_stevens_spch.html#TopOfPage). See also Statement of Paul Schott Stevens, President, Investment Company Institute, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, “Mutual Funds: A Review of the Regulatory Landscape,” May 10, 2005, available on the Institute’s website at [http://www.ici.org/statements/tmny/05\\_house\\_fund\\_reform\\_tmny.html#TopOfPage](http://www.ici.org/statements/tmny/05_house_fund_reform_tmny.html#TopOfPage).

<sup>32</sup> The SEC recently issued a proposal that demonstrates such a creative approach. In proposing a new “summary” prospectus for mutual funds, the SEC proposed to allow companies to deliver only a short summary of key information to investors, so long as more detailed information is readily available on a website or in paper upon request. See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release Nos. 33-8861 and IC-28064 (Nov. 21, 2007) (“SEC Disclosure Proposal”). This proposal will not diminish the amount of information available to shareholders, but has the potential to save fund companies – and ultimately their investors – substantial amounts from reduced printing and mailing costs.

<sup>33</sup> See, e.g., Section 2(c) of the Investment Company Act; Section 2(b) of the Securities Act of 1933.

<sup>34</sup> President Ronald Reagan issued Executive Orders 12,291 and 12,498 in the 1980s requiring federal agencies to conduct a cost-benefit analysis when making rules. These orders and their subsequent replacements, Executive Orders 12,888 and 13,258, specifically exempted independent regulatory agencies, such as the SEC, Board of Governors of the Federal Reserve Board, the CFTC, the FDIC, and the FTC, from this requirement. See Executive Order No. 12,291, 46 F.R. 13193 (Feb. 17, 1981); Executive Order No. 12,498, 50 F.R. 1036 (Jan. 4, 1985); Executive Order No. 12,866, 58 F.R. 51735 (Sept. 30, 1993); Executive Order No. 13,258, 67 F.R. 9385 (Feb. 26, 2002).

<sup>35</sup> 44 U.S.C. § 3501 *et seq.*

<sup>36</sup> 44 U.S.C. § 3506(c)(1)(A)(iv).

It is imperative that regulators fully appreciate and have the means to understand the costs and benefits of regulation on market participants. This would require, for example, that the SEC abandon proposed rulemakings that do not pass muster from a cost-benefit perspective and reconsider established rules to alleviate undue cost burdens. Similarly, to the extent that regulatory requirements impede companies from doing business in the United States, such requirements should be closely examined to ensure that their benefits outweigh their costs.

Our concerns are not limited to SEC rules and regulations. All self-regulatory organizations (“SROs”) should be explicitly required to evaluate the costs and benefits of their rules and rule proposals. The burdens of their rulemakings have similar effects on the competitiveness of their member firms.

*Recommendations:*

- The SEC should reorganize its rulemaking process, and the role within that process of the Office of Economic Analysis, to ensure that it conducts a rigorous, timely and informed analysis of the costs and benefits of all regulatory proposals.
- The SEC by rule, or Congress by law, should require that all SROs perform a similar cost-benefit analysis prior to submitting regulatory proposals to the SEC.
- The SEC as well as SROs should establish a process for reexamining existing rules, or at least those rules that it or industry participants identify as imposing unjustifiable costs or competitive burdens. This process should be designed to determine whether the rules are working as intended, whether there are satisfactory alternatives of a less burdensome nature, and whether changes should be made. The results of such an analysis should be used to inform future rulemaking efforts.

**IV. U.S. regulators should embrace the efficiencies offered by information, communications and other new technologies.**

Technology is one of the most influential forces driving the economy and our capital markets. When used effectively by regulators and market participants, it can create more efficient markets that are better able to compete in the global marketplace. When used inadequately or ignored, it can create significant competitive disadvantages for both markets and market participants. As SEC Chairman Cox recently stated: “History has a way of wreaking havoc on those who fail to anticipate the full meaning of future technology.”<sup>37</sup>

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<sup>37</sup> Speech by Chairman Christopher Cox, U.S. Securities and Exchange Commission, “Re-Thinking Regulation in the Era of Global Securities Markets,” 34<sup>th</sup> Annual Securities Regulation Institute, Coronado, C.A., Jan. 24, 2007.

Recognizing this principle, market participants have readily embraced technology to keep pace with the constantly evolving marketplace. The U.S. investment company industry has been aggressive in its use of technology to better serve investors, particularly through advances in shareholder communications and disclosure. Fund shareholders routinely access information about their investments on fund-sponsored websites. Many fund websites enable investors to conduct financial and other transactions quickly and conveniently. In addition, fund investors increasingly elect to receive required disclosures, transaction confirmations, and reports from their funds electronically. Technology also is transforming disclosure and the delivery of services in the retirement arena through, among other things, the development of Internet tools such as on-line asset allocation tools and retirement income calculators. Using technology in retirement service programs makes assistance more accessible to participants and reduces service delivery costs.

Technology is being developed to better enable investors and other market participants to retrieve and analyze key mutual fund information and make comparisons among funds. Mutual funds have started, on a voluntary basis, to furnish information contained in the risk/return summary that is included in the front of every mutual fund prospectus in eXtensible Business Reporting Language (XBRL), using a taxonomy developed by the Institute, with assistance from PricewaterhouseCoopers and a working group of interested parties. The risk/return summary includes the information of most importance to investors: the fund's investment objectives, principal investment strategies, principal risks, and historical performance, along with the standardized fund fee table. Using the taxonomy, funds can "tag" information included in the risk/return summary, enabling investors or their advisers to easily search for, retrieve, and compare information on multiple funds, including those from different complexes.

The investment company industry likewise has worked with other market participants to develop and implement a range of automated services to facilitate the transmission of fund orders, settlement of orders, and the exchange of account-level information. For example, the Depository Trust & Clearing Corporation's ("DTCC") mutual fund services facilities have promoted the expansion of fund products, facilitated the dramatic growth of transaction volumes, and allowed funds to process transaction activity for a fraction of the cost as compared to manual processing, saving the industry and fund investors billions of dollars.

To gain efficiencies in regulatory compliance, the mutual fund industry has utilized technology to facilitate the exchange of critical data between funds and intermediaries. For example, in response to the SEC's redemption fee rule, Rule 22c-2 under the Investment Company Act, the industry designed standard records and data exchange protocols to help funds enforce fund policies aimed at preventing abusive short term trading practices. Similarly, we have worked with DTCC to build a national database of information about funds to ensure accurate processing of client transactions and improved compliance with fund prospectus policies. This new automated central source for rules-based processing will continue to evolve to meet future business and regulatory challenges.

Finally, technology has transformed the U.S. capital markets themselves and trading in those markets. Examples include the proliferation of new electronic trading venues, as well as the advent of

sophisticated computer systems and applications to manage securities holdings, order flow, and market data. For investment companies and other institutional investors, these innovations have had a significant impact, resulting in lower costs and better execution of trades for investment companies and in turn, for their shareholders.

These technological advances provide considerable efficiencies and potential cost savings to the fund industry. As new demands arise, technology will remain the focal point to support future industry initiatives. By contrast, however, the regulatory community has been less quick to embrace technology and adapt it to regulatory needs and purposes. As the Vice Chairman of FINRA recently observed, “[w]e have to invest in technology to keep up with new rules, new strategies, new market participants and an ever more complex and interrelated marketplace.”<sup>38</sup>

In certain areas there have been conspicuous successes. The advances in trading discussed above could not have occurred without the blessing of regulators, through appropriate regulation, of the use of technology to facilitate innovation and competition. Possibly the most significant example of this is the SEC’s Regulation NMS,<sup>39</sup> the most comprehensive restructuring of the securities markets in over 30 years. Through Regulation NMS, the SEC recognized the need to adapt to changing technology in the marketplace. Regulation NMS comes on the heels of other important regulatory initiatives that have embraced technology including Regulation ATS,<sup>40</sup> the advent of decimalization,<sup>41</sup> and the SEC’s Order Handling Rules.<sup>42</sup> These rules launched an era of rapid innovation that continues today, opening the door for new entrants to the securities markets to introduce new technology and to compete with “traditional” market participants.

Nevertheless, numerous additional opportunities could be cited for the potential for better utilizing technology, to the benefit of both regulators and regulated industry. One significant example in our industry is the conduct of investment company examinations. SEC staff routinely request that significant amounts of data be converted to non-native formats. Investment companies have established sophisticated records management programs that, among other things, enable them to efficiently identify and produce requested data. Investment companies also routinely receive data in various formats from multiple third party service providers. Converting millions of records to a non-native (*e.g.*, Microsoft Excel) format is labor intensive and does not leverage the efficiencies of the

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<sup>38</sup> Speech by Doug Shulman, Vice Chairman, FINRA, at STA Annual Conference, Oct. 4, 2007.

<sup>39</sup> See Regulation NMS, SEC Release No. 34-51808 (June 9, 2005), 70 Fed. Reg. 37496 (June 29, 2005).

<sup>40</sup> See Regulation of Exchanges and Alternative Trading Systems, SEC Release No. 34-40760 (Dec. 8, 1998), 63 Fed. Reg. 70844 (Dec. 22, 1998).

<sup>41</sup> See Order Directing the Exchanges and NASD To Submit a Decimalization Implementation Plan, SEC Release No. 34-42360 (Jan. 28, 2000), 65 Fed. Reg. 5003 (Feb. 2, 2000).

<sup>42</sup> See Order Execution Obligations, SEC Release No. 34-37619A (Sept. 6, 1996), 61 Fed. Reg. 48290 (Sept. 12, 1996).

records management programs. If the SEC could handle data in these other formats, the time, cost and effort on the part of investment companies, especially smaller investment companies (that may not have a dedicated IT department), as well as regulators, would decrease significantly. Most importantly, more flexible and efficient examination programs would better serve investors because regulators would be able to identify areas of risk sooner and take actions to rectify problems faster. Likewise, we agree it is time for the SEC to engage in a significant overhaul of the investment company industry's recordkeeping requirements by moving away from the "paper and file-drawer focus" of our current rules and moving instead towards "technology-based alternatives."<sup>43</sup>

In recent years, access to the Internet has greatly expanded, to the point where it can appropriately be the primary vehicle for information delivery and a means for regulators to creatively respond to rapidly changing markets.<sup>44</sup> Regulators are making some strides to integrate the Internet into new rules and regulations. Most significantly, technology and the Internet are increasingly being used as vehicles for the disclosure and dissemination of information to investors. The Internet is an effective mechanism that can achieve significant cost savings in disclosing information to investors, their financial advisers and the marketplace at large. In addition, it is well suited to serving a variety of needs and preferences for different levels of information, which is particularly appropriate in the investment company context.

The SEC recently proposed significant reforms to the current mutual fund disclosure system, and the Internet plays a central role in the new disclosure regime.<sup>45</sup> In the proposal, mutual fund investors may receive key information about their funds in the form of a "summary prospectus" and would have access to additional information, including the full prospectus and statement of additional information, on the Internet.<sup>46</sup> A key to the success of the proposal is the SEC's willingness to embrace the Internet as a delivery mechanism for the detailed information that some, but not all, investors want. The proposal, when implemented, should provide investors with a slimmer, more user-friendly

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<sup>43</sup> See Speech by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Keynote Address at the 2007 Mutual Funds and Investment Management Conference, Palm Springs, C.A., Mar. 26, 2007 ("If the Division of Investment Management wants to retain its role as a relevant and respected regulator in the 21st century, then we must seriously consider which of the regulations we administer has outlived its utility or is in need of a 21st century makeover. In the latter category, the investment adviser and investment company books and records rules immediately jump to mind.").

<sup>44</sup> According to Pew Research Center data for early 2007, 71 percent of Americans use the Internet. See The Pew Charitable Trusts' Pew Research Center, Pew Internet & American Life Project. Latest survey information is available for February-March 2007. The demographic profile of fund investors strongly suggests an even higher level of use. Our own survey data show that in 2006, 91 percent of mutual fund shareholders have Internet access. This number has grown considerably in recent years – in 2000, only seven out of 10 mutual fund owners had Internet access (the first year ICI measured shareholders access to the Internet). Data are tabulated from ICI Annual Tracking Surveys.

<sup>45</sup> See SEC Disclosure Proposal, *supra* note 32.

<sup>46</sup> Investors would be able to obtain this information in paper upon request, at no additional charge.

disclosure document designed to communicate more effectively key information. It will make it easier for investors to compare this information across different funds. It also could realize cost savings for mutual funds (and their investors). We commend the SEC for its willingness to think broadly and creatively for the benefit of mutual fund investors. Indeed, we encourage the SEC to consider ways to utilize Internet technology for all required disclosure documents, such as facilitating electronic access to annual and semi-annual shareholder reports.

Furthermore, where funds are currently required to provide the same information in different SEC filings – for example, certain financial information in Form N-SAR and in semi-annual reports - use of Internet technology and data tagging, as discussed above, may present opportunities to eliminate redundancy. Specifically, using this technology, funds can tag information included in various SEC filings only once, enabling the SEC and other interested parties to easily search and retrieve the data.

Technology also can play a critical role for regulators in the dissemination of information in the retirement area. In plans, such as the typical 401(k) plan,<sup>47</sup> in which participants select investments for their own accounts, providing key information to participants about all investment options and offering access to additional information, such as the full mutual fund prospectus, on the Internet, will have significant benefits for participants and plans. Providing this key information more efficiently can help close existing gaps and help participants focus on comparable information about products offered in 401(k) plans, including bank collective funds and insurance separate accounts, as well as mutual funds.<sup>48</sup> It also will reduce plan administrative costs that typically are borne by participants. The Department of Labor has indicated its willingness to use technology to improve retirement plan disclosure and communication.<sup>49</sup> The Department has noted that the new summary prospectus described above could serve as a model for disclosure of 401(k) and similar defined contribution plans.<sup>50</sup>

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<sup>47</sup> In only 26 years of existence, 401(k) plans have grown to become the most common employer-sponsored retirement plan in the United States. 401(k) plans held \$2.7 trillion in assets in 2006, which surpasses the assets held in all private defined benefit plans. In most of these plans, the participants direct the investment of their accounts, choosing from among a diversified menu of investments pre-selected by their employer. The investment company industry has a significant stake in these matters. Today, 55 percent of 401(k) assets and 47 percent of IRA assets are invested in mutual funds. See “The U.S. Retirement Market, 2006,” *Fundamentals*, Vol. 15, No. 5, Investment Company Institute (July 2007) at 4, 8. Seventy-two percent of investment company shareholders report that saving for retirement is their primary financial goal. See *Profile of Mutual Fund Shareholders*, Investment Company Institute (Fall 2004) at 10.

<sup>48</sup> Currently, Department of Labor regulations produce disparate disclosure among 401(k) investment options. Participants receive a full prospectus for securities, such as mutual funds, registered under the Securities Act of 1933. Other products, such as insurance separate accounts and bank collective trusts, are not required to provide key information such as annual fees and historical performance unless a participant requests the information. See 29 C.F.R. § 2550.404c-1.

<sup>49</sup> See Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule, 72 Fed. Reg. 60452, 60458 (Oct. 24, 2007).

<sup>50</sup> See Written Testimony of Assistant Secretary of Labor Before the Committee on Education and Labor (Oct. 4, 2007), available at <http://edworkforce.house.gov/testimony/100407BradfordCampbellTestimony.pdf>. See also Written Testimony of Assistant Secretary of Labor Before the Special Committee on Aging (Oct. 24, 2007), available at <http://www.dol.gov/ebsa/newsroom/ty102407.html>.

In sum, technology is the “fuel” that ultimately drives changes in the market place.<sup>51</sup> Technology likewise should drive changes –and yield increasing efficiencies—in the way we advance regulatory policy objectives and conduct oversight. Assuring that this potent tool is wielded to the best advantage within a sound regulatory structure will promote the competitiveness of the U.S. financial market and financial institutions.

*Recommendation:*

- To more efficiently advance regulatory policy objectives and to conduct regulatory oversight, the SEC and other regulators should make more effective and thorough use of information, communications and other technology.

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<sup>51</sup> See Speech by Commissioner Annette L. Nazareth, U.S. Securities and Exchange Commission, Remarks Before the Brown Spring Forum: Economics, Entrepreneurship & Technology, Brown University, Providence, RI, Apr. 28, 2007.