

November 20, 2006

Professor Hal S. Scott  
Director  
Committee on Capital Markets Regulation  
125 Mt. Auburn Street  
3<sup>rd</sup> Floor  
Cambridge, MA 02138

Dear Professor Scott:

The Investment Company Institute, the national association of U.S. mutual funds and other investment companies, commends the Committee on Capital Markets Regulation for its examination of the efficiency and competitiveness of U.S. capital markets. The continued strength of our nation's markets is of utmost importance to our members, who hold \$10 trillion in assets on behalf of more than 94 million shareholders and 54 million households.

We understand that the Committee is preparing to issue an interim report that will address, among other things, the effect of regulation on the efficiency of U.S. capital markets, whether the costs and benefits of regulation are properly taken into account when new regulations are issued, and whether regulation may unintentionally be making our markets less competitive in the global economy. These issues are of critical importance to our members, both as issuers of securities and as investors in the global marketplace. As our securities markets continue to evolve, we must ensure that our regulations encourage innovation and growth and promote competition, while protecting investors and avoiding regulatory arbitrage that favors less-regulated markets or products.

This letter sets forth our recommendations for the Committee's consideration as it conducts its analysis. As the Committee further develops its views, we would be pleased to provide additional information on our recommendations.

### **Impact of Regulation on the U.S. Capital Markets**

The rapid pace in which the securities markets continue to evolve has highlighted the need to reexamine the structure of the regulation of U.S. securities markets. It is critical that regulators properly take into account the costs and benefits of regulation and that regulators are cognizant of, and

address, any unnecessary and duplicative regulation. It is equally important that substantially similar products and market participants be regulated in a fair and consistent manner.

### *Regulatory Burdens and Disparities Impacting Mutual Funds*

The mutual fund industry has historically been one that has not been heavily concentrated and has been welcoming of new entrants. In the past, regulations governing mutual funds have not impeded new entrants, particularly smaller size fund firms. While mutual funds have always supported strong and effective regulation to protect the interests of fund investors, the totality of recent regulatory requirements imposed on mutual funds has threatened to reduce the competition, diversity and creativity that new and smaller firms historically have contributed to the fund industry. For example, while all fund firms share the burdens of new regulations, the greatest impact falls on smaller and medium size firms and new entrants.

Regulatory requirements that single out mutual funds versus other financial products exacerbate these concerns. The U.S. regulatory structure that has emerged for mutual funds is, in many respects, highly divergent from the regulatory structure that has developed for substantially similar products. No competing financial product is subject to more comprehensive disclosure, compliance and governance requirements than mutual funds are.

Unfortunately, the regulatory disparities that exist for mutual funds continue to grow and the trend appears to be accelerating. There are numerous examples of these regulatory disparities. Unlike hedge funds, mutual funds must calculate their performance in accordance with a standardized formula. Unlike wrap accounts, they must disclose their after-tax returns. Unlike bank collective investment funds, they must establish the value of their assets on a daily basis. Unlike pension funds, they must disclose the policies and procedures that they use to determine how to vote proxies and disclose their proxy voting records. Unlike any other pooled investment product, they must disclose their portfolio holdings on a quarterly basis and disclose information about their portfolio managers. Unlike the sponsors of competing products, they must comply with strict corporate governance requirements.

While the mutual fund industry accepts the costs associated with suitable and appropriate regulation, it is critical that regulators give due consideration to potential unintended consequences of the burgeoning regulatory requirements that uniquely and solely affect mutual funds. To the extent that these regulations (and the associated costs) discourage investment advisers from entering into or remaining in the fund business, discourage portfolio managers from managing mutual funds versus other investment products, or cause intermediaries to favor less regulated financial products over mutual funds, then the current regulatory regime penalizes mutual funds as well as the millions of average investors that mutual funds serve.

The heavy regulatory burden on mutual funds also may be hurting the competitiveness of U.S. mutual funds internationally. European funds – not U.S. funds – increasingly are becoming the vehicle

of choice in countries that allow for the public sale of foreign funds. One industry observer estimates that fully 40% of new investments in European funds came from *outside* of Europe. U.S. funds stand in stark contrast, with only marginal sales to investors outside the U.S.

Our specific recommendations follow.

***Sarbanes-Oxley Act Reform*** - The Institute supports the Committee's efforts to review requirements under the Sarbanes-Oxley Act to ensure that they serve the objectives of the legislation in a manner that is cost-effective and does not adversely impact the competitiveness of U.S. capital markets. The Sarbanes-Oxley Act was initially intended to address the missteps of corporate issuers, and the impetus for the legislation was entirely unrelated to mutual funds. Nevertheless, in rules implementing the Act's provisions, the SEC chose to subject mutual funds to several new, burdensome requirements.

Among other requirements, mutual funds must provide numerous certifications under the Act. The principal executive officer and principal financial officer of a fund complex must certify in annual and quarterly reports filed with the SEC, on behalf of each individual fund, the accuracy of the fund's shareholder reports. This includes a certification of non-financial information included in those reports, such as a fund's Management's Discussion of Fund Performance ("MDFP") which includes, among other things, narrative disclosure of the factors that materially affected a fund's performance during the reporting period. They also must certify that they have established, implemented and maintain internal controls and procedures designed to ensure that the information contained in shareholder reports is summarized and reported in a timely manner. In addition, they must certify that they have disclosed certain information about the fund's internal controls to the auditor and the fund's audit committee.

These requirements go beyond the intent of the Act in several significant respects and place a significant and unnecessary burden on fund executive officers. For example, scores of funds in a single complex often have staggered fiscal year ends, requiring that certifications be made every month. This greatly increases the time and costs of complying with these requirements, including the amount of senior executive attention demanded by the certification process. The Act's certification provisions also are duplicative of a host of unique compliance requirements already imposed on mutual funds and not on operating companies subject to the Act. For example, new compliance requirements for mutual funds, including rules relating to fund compliance policies and procedures and to the appointment of a chief compliance officer, now focus on and directly address the goals of the Sarbanes-Oxley Act, *i.e.*, improving compliance processes and increasing accountability.

***Recommendations:*** In addition to examining possible reforms of Section 404 of the Act, we recommend that the Committee consider the impact of the Act on mutual funds. Specifically, we recommend that the certifications requirements of the Act applicable to mutual funds be withdrawn. At a minimum, a more reasoned approach to regulation should be adopted. For example, we

recommend that certifications not be required for non-financial information included in shareholder reports, such as the MDFP. These changes would ease the burdens imposed by the current Sarbanes-Oxley requirements without sacrificing investor protections.

**Point of Sale Disclosure** - The SEC has proposed to require brokers to disclose information to investors at the point of sale about the costs and potential conflicts of interest associated with selling mutual funds. The Institute supports the concept of point of sale disclosure, but not as currently proposed by the SEC. The manner in which the SEC has proposed to effectuate this disclosure, and the amount of information that will have to be disclosed, is inconsistent with the manner in which brokers typically sell mutual fund shares (*i.e.*, by phone). In addition, other financial products that brokers sell would not be subject to these requirements. Therefore, to the extent the SEC crafts point of sale disclosure requirements in a manner that exposes brokers to increased liability risks, complicates the process of selling mutual funds, and imposes significant programming and compliance costs, brokers predictably will steer their customers to alternative investments that are not subject to these requirements and do not offer the same level of regulatory protection and other benefits (*e.g.*, diversification, liquidity and professional management) that mutual funds do.

**Recommendations:** We urge the Committee to recommend that, if the SEC determines to adopt some form of point of sale disclosure requirements for mutual funds, it does so in a manner that is consistent with the nature of the brokers' business model and that does not create competitive disadvantages for funds. We also recommend that any point of sale disclosure requirements utilize the internet as the delivery vehicle of information to investors.

**Soft Dollars** – In obtaining research and similar products and services from brokers using client brokerage commissions (so called “soft dollars”), advisers to mutual funds and pension plans under the Employee Retirement Income Security Act (“ERISA”) are subject to Section 28(e) of the Securities Exchange Act of 1934. Section 28(e) provides a safe harbor for advisers who determine in good faith that the amount of commissions paid to a broker is reasonable in relation to the value of the brokerage and research services provided to the adviser. Section 28(e) was adopted in response to concerns that advisers would be in breach of their fiduciary duties if they paid anything but the lowest commission rate to obtain these products and services.

Institutional investors, other than advisers to mutual funds and ERISA pension plans, are not subject to the restrictions of Section 28(e), with the result that they have greater freedom to use soft dollars. When combined with other forces exerting downward pressure on overall commissions, this regulatory disparity may create strong incentives for broker-dealers to favor hedge fund and other types of advisers. For example, broker-dealers provide important benefits to investors in connection with the execution of securities transactions, such as providing access to initial public offerings, access to corporate management and committing the broker-dealer's capital to complete client trades. These valuable benefits may bypass mutual funds and ERISA retirement plans in favor of hedge funds and other accounts whose commission payments are more lucrative to the broker-dealer.

*Recommendations:* The Institute has recommended that the SEC adopt a rule that would prohibit *any* investment adviser from using soft dollars to pay for any products or services that fall outside the Section 28(e) safe harbor. We also have expressed support for a recommendation of a NASD task force that the SEC urge the Department of Labor (with respect to non-ERISA retirement accounts) and the federal banking agencies to require all discretionary investment advisers not subject to the SEC's jurisdiction to comply with the standards of the safe harbor. In light of the very real market consequences of applying Section 28(e) only to certain institutional investors, we urge the Committee to include these recommendations in its report.

***Proxy Voting*** – Mutual funds are required to publicly disclose the manner in which they vote proxies, a responsibility they take very seriously. Mutual funds are the only investors subject to this requirement, which has created unintended consequences for fund firms. Among other things, this regulatory disparity means that only fund firms are singled out for scrutiny and unnecessary criticism for the manner in which they voted, thereby uniquely politicizing mutual fund portfolio management.

From the perspective of issuers of securities, concerns have arisen relating to developments in the voting of proxies by brokers. Recently, a working group established by the New York Stock Exchange to examine proxy voting issues recommended that the election of directors be viewed as a “non-routine” matter on which brokers would not be permitted to vote proxies on behalf of their customers. The NYSE has filed a proposal with the SEC that would implement this recommendation. The Institute believes that the working group's recommendation puts all issuers, including investment companies, “between a rock and a hard place” because shareholders typically do not understand the proxy process, typically choose not to vote, and in most cases, cannot be contacted by the issuers who would urge them to vote. As a result, if brokers are not permitted to vote on uncontested elections of directors, funds and other issuers will have significant difficulties in achieving quorums and getting directors elected.

*Recommendations:* To the extent that disclosure of proxy voting records is considered to achieve important public policy purposes, these requirements should be applied to all institutional investors. In the area of broker voting, brokers should be permitted to continue to vote uninstructed shares on uncontested director elections until certain steps are taken. Specifically, shareholders should be educated about the proxy process and the importance of voting so as to improve shareholder responsiveness to proxies and SEC rules should be revised to permit issuers to contact their shareholders (or their nominees in certain cases). Only after these efforts are undertaken and all constituents, including the NYSE, are satisfied that shareholders will exercise their voting rights should director elections become “non-routine.” Alternatively, we believe the NYSE should permit brokers to exercise “proportional voting” with respect to shares for which voting instructions are not received. We urge the Committee to support these recommendations.

***Tax Efficiency*** - Regulatory tax burdens on mutual funds also contribute to competitive disadvantages for funds, both in the U.S. and in foreign markets. Under present law, mutual funds are required to distribute each year their net capital gains. Investors with taxable accounts are required to pay taxes on these capital gains distributions even though they typically choose to have these distributions automatically reinvested in the fund and take no action to realize these gains. Legislation strongly supported by the Institute -- the Generate Retirement Ownership Through Long-Term Holding Act of 2005 ("the GROWTH Act") -- would address this problem by deferring tax on automatically reinvested capital gain distributions until fund shares are sold. Under the GROWTH Act, the reinvested gains would compound, untaxed, in the fund and tax on the fund's gains would be paid by an investor only when the investor decided to redeem the shares and incur the gain. The GROWTH Act also would help address problems for foreign investors in U.S. funds who incur tax currently in their home countries that would not be incurred if they invested instead in non-U.S. funds. This result occurs, in part, because many European funds "roll-up" (rather than distribute) their income, *i.e.*, this income is taxed only when investors redeem their fund shares.

*Recommendation:* We urge the Committee to support adoption of the GROWTH Act. This important piece of legislation is critical to promote a long-term tax policy for long-term investors.

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We look forward to working with the Committee as it develops its recommendations. If you have any questions or if we can provide any additional information, please contact me at 202-326-5901.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens  
President

cc: Peter McClean  
Chief Operating Officer  
Committee on Capital Markets Regulation

The Honorable Christopher Cox  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos  
The Honorable Annette L. Nazareth  
The Honorable Kathleen L. Casey  
Andrew J. Donohue, Director, Division of Investment Management  
U.S. Securities and Exchange Commission