Independent Directors Council
Promoting Excellence in Fund Governance

Submission to Senate Republican Capital Markets Task Force, February 2008

Statement of the Investment Company Institute

On the Review of the U.S. Financial Markets and Global Markets Competitiveness

Submitted to the Senate Republican Capital Markets Task Force U.S. Senate

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Introduction

The Investment Company Institute ("ICI" or "Institute"), the national association of U.S. investment companies,[1] commends the Senate Republican Capital Markets Task Force, under the leadership of Senator Mike Crapo (ID), for its examination of the competitiveness of the U.S. financial markets. The challenges facing our financial markets in a time of increasing global competitiveness are significant, and our markets' response to these challenges will be critical to the U.S. economy as a whole. As Senator Crapo recognized in introducing the "Crapo-Schumer Global Competitiveness Amendment" to S. 761, "the U.S. financial sector acts as a catalyst for all other sectors in the U.S. economy." [2] While this submission is in response to the Task Force's request for recommendations on ways to improve the competitiveness of the U.S. financial markets, [3] we hope that both political parties will work together to implement the reforms necessary to ensure our markets' continued success.

The Institute strongly supports Congress' efforts to ensure the continued strength of the U.S. financial markets. Last year, the Institute co-signed two letters endorsing efforts by Congress and the Administration to eliminate barriers that U.S. financial services firms face in foreign markets that directly harm the competitiveness of this vital sector of the economy. [4] The letters also urged financial services regulators, both domestically and globally, to coordinate so as to not impose unwarranted regulations that may have an adverse effect on innovation, or that have costs that exceed expected benefits. [5]

With total assets approaching $13 trillion and almost 90 million shareholders, funds are among the nation's most important financial intermediaries. The continued success and competitiveness of America's fund industry, 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 recommendations to the Task Force on ways to improve the regulation of our financial markets.

Background

Funds 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, funds 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 funds 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.

Several recent studies examining the competitiveness of the U.S. financial markets have identified critical areas that must be addressed to ensure that our markets remain competitive, and have made accompanying recommendations to achieve changes in these areas. [6] These include the complexity of the U.S. financial regulatory system, the lack of regulatory coordination, and certain tax policies.

The recommendations set forth below follow from several basic principles that should govern reforms of our regulatory structure to assure that the U.S. capital markets remain robustly competitive in the service of investors and issuers alike: 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 third, our traditional regulatory organization and approach, especially for purposes of securities regulation, must be reformed in light of changed market realities. In the discussion that follows, we elaborate on these principles with respect to the industry we know best – the fund industry – but we also believe that they have broad applicability to the financial services industry as a whole. [7]

Summary of Recommendations

Preserve the regulatory efficiencies Congress intended in passing the "National Securities Markets Improvement Act of 1996" ("NSMIA") by ensuring that registered funds offered and sold in a national market are subject to a coherent scheme of national regulation

- Congress should direct the U.S. Securities and Exchange Commission ("SEC") to assert its authority under NSMIA as the sole regulatory standard setter for registered funds, to implement the pre-emptive purpose of that statute and secure the regulatory efficiencies Congress intended.
- Develop an additional form of U.S. registered fund to compete in the global marketplace
- Congress and the Administration—in consultation with the SEC, all elements of the fund industry (including fund directors), and other interested parties—should develop legislation to authorize an additional form of U.S. registered fund that would be a competitive, attractive investment option for the global marketplace.
- Ensure that regulatory costs are proportionate to their benefits

- The SEC should reorganize its rulemaking process, and the role within that process of its Office of Economic Analysis, to institutionalize a rigorous, timely and informed process for analyzing the costs and benefits of all regulatory proposals.
- Congress by law, or the SEC by rule, 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.
- Adopt a more prudential model of regulation
- The SEC should modify its regulatory processes and procedures 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.
- Reform our traditional regulatory organization and approach, especially for purposes of securities regulation, in light of changed market realities
- Reorganize the SEC to improve oversight and rulemaking
- The SEC should realign its organizational structure to more accurately reflect the contours of the current capital markets.
- Restructure the SEC's inspection and examination functions
- Responsibility for the SEC's inspection and examination functions should be returned to the SEC's operating divisions.
- All SEC inspections of a firm 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 so-called "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.

Discussion

I. Preserve the regulatory efficiencies Congress intended in passing the "National Securities Markets Improvement Act of 1996" ("NSMIA") by ensuring that registered funds offered and sold in a national market are subject to a coherent scheme of national regulation

Historically, registered funds had to comply with the unique securities regimes of all 50 states as well as the SEC when publicly offering their shares. Just over a decade ago, Congress passed the "National Securities Markets Improvement Act of 1996" ("NSMIA") [8] to eliminate this often duplicative and conflicting regulatory structure. NSMIA represented the judgment of Congress that "the system of dual federal and state securities regulation had resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, is redundant, costly, and ineffective." [9]

Under NSMIA, federal law governs all substantive regulation of funds, and states have concurrent authority to protect against fraud and sales practice abuses. Specifically, 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 fund shares. The Act foreclosed states from exercising any authority - whether by statute or administrative action - over the registration of fund shares, the regulation of fund prospectuses and disclosure documents, or the operations of funds. When signing NSMIA into law, President Clinton noted that the legislation represented a more efficient division of oversight responsibility and would assure that "mutual funds, which are sold nationally, will be regulated nationally." [10]

In recognition that state enforcement powers potentially might be used in a manner tantamount to regulation, Congress directed that the states exercise their retained investigative and enforcement authority in a manner "consistent with" the broad pre-emptive policy of the Act. Congress was clear that the restrictions on states' use of their authority "applied both to direct and indirect State action." [11]

Notwithstanding the lines of authority clearly laid out in NSMIA, in recent years, state authorities repeatedly have sought to regulate funds and fund disclosure requirements through enforcement actions. Three enforcement cases, two of which are still pending, are illustrative of the problem. Each ostensibly has been brought under the antifraud provisions of the states' securities acts. [12] Each alleges that, as a result of the failure to disclose certain information (by a fund in its prospectus or by a broker at point of sale), the funds, 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 funds or broker-dealers.

In addition, effective October 1, 2007, the State of Nevada amended its laws to prohibit any person from conducting transfer agent activities in the state without being registered with the state's securities division. [13] While Nevada's implementation of this provision has excluded fund transfer agents, state law provisions such as this represent yet another avenue through which states may attempt to indirectly regulate the conduct of funds in contravention of the intent and spirit of NSMIA.

Such state actions threaten to wholly undercut the pre-emptive regime established by Congress in NSMIA and to return U.S. funds to the "redundant, costly and ineffective" system of federal-state oversight that Congress rejected over ten years ago. 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 observed, "the setting of disclosure standards for nationally-offered securities such as mutual funds is a function that Congress, through NSMIA, clearly left to the Commission." [14] 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. [15]

Recommendation:

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

II. Develop an additional form of U.S. registered fund to compete in the global marketplace

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. Several of the reports on the competitiveness of the U.S. financial markets note the reduction in the share of worldwide IPO volume attracted by U.S. exchanges. A similar disturbing trend is occurring with respect to the U.S. fund industry.

Recent market data illustrates that the extraordinary rise of fund investing is no longer only a U.S. phenomenon. Global fund assets totaled $26 trillion as of September 2007. [16] Of this total, the share represented by U.S. registered funds has steadily declined from 60 percent at year-end 2001 to 46 percent in September 2007. [17] In contrast, the European fund structure known as "UCITS"[18] has experienced strong growth not only across the European Union but also internationally, particularly for both retail and institutional investors in Asia and Latin America. [19] Ironically, U.S. fund managers that wish to offer investment funds in multiple jurisdictions outside the U.S. have no realistic option other than this European fund structure. As the European Commission has boasted, "UCITS authorisation has won wide global recognition as a guarantee of sound product structuring and effective regulation." [20]

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 the global marketplace. One way to do so is to develop a new form of U.S. registered fund that would be an attractive, competitive investment option for both U.S. and non-U.S. investors alike. An additional form of U.S. registered fund would allow the U.S. fund industry to bring its historical and well-documented successes to investors in jurisdictions outside of the United States. We believe that U.S. funds should be as strong a global "brand" as European-based UCITS – or stronger.

The Investment Company Act of 1940 and related rules, the primary regulation for funds, set forth regulatory schemes for three types of registered funds that are offered to U.S. investors today: mutual funds, closed-end funds, and unit investment trusts. These types of registered funds 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.

Most significantly, U.S. registered funds offer less advantageous tax treatment to foreign investors than many of their foreign counterparts. Under U.S. tax law, U.S. registered funds are required to make annual distributions to all shareholders of the funds' income and gains. These distributions result in an annual tax liability for foreign investors in their home countries [21] that often will not arise if these individuals invest instead in funds organized outside the U.S. that do not make such distributions. Many European countries, for example, permit funds to retain their income and gains without any current tax liability for the funds or their shareholders. Unless an anti-deferral regime applies in a shareholder's home country, [22] the retained income and gains will be taxed only when the shareholder chooses to redeem fund shares, allowing greater growth of the investments. This tax structure creates an ideal savings vehicle for long-term investors.

If the United States is going to compete effectively internationally, we must be able to offer the same sort of tax treatment. Additionally, while this tax structure would certainly allow U.S. funds to compete on a more equal footing internationally, such a structure also would benefit U.S. investors, i.e., eliminate the current tax burdens for U.S. investors holding funds. [23]

The tax challenges facing U.S. funds have been recognized for years. In 1992, the SEC's Division of Investment Management stated: "Without amendments to United States tax laws, securing greater access for United States funds overseas most probably will not meaningfully increase sales to foreign investors. The Division recommends that the Commission support proposals to eliminate the competitive tax disadvantages for United States investment companies marketing overseas." [24]

The lack of flexibility with regard to a fund's organizational structure also is an impediment to selling U.S. funds globally. U.S. registered funds have a complex structure tailored specifically to U.S. federal and state law, including that the fund 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. Specifically, funds are provided with a choice of organizational structure, such as a corporate, contractual or trust structure. This flexibility provides fund sponsors with the ability to customize their product to their target market and the preferences of regulators in that market.

The idea of creating an additional fund model 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 fund, including a type that is generally modeled on highly successful fund structures found outside the United States. [25] Although they differ in their details, these proposals have 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.

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

- a tax "roll-up" of the fund's income and gains, i.e., this income is taxed only when investors redeem their fund shares
- a straightforward fee structure, such as a single, or unitary, fee from which the fund sponsor would pay virtually all fund expenses and earn a profit
- a more streamlined, market-based structure
- many of the same core Investment Company Act protections that characterize the other forms of U.S. registered funds

The last bulleted point – assurance of strong regulatory protections for investors – is a matter of utmost importance to consider in developing any additional fund model. One of the most significant of these protections is the independent review and monitoring of the fund and its sponsor. The U.S. structure achieves this through having independent directors on a fund's board; other jurisdictions achieve this in many different ways, including through independent directors on the fund manager's board, a depository, a trustee, an enhanced role for the fund auditor, an independent review committee, an independent compliance committee, or a supervisory board of the fund manager. In a recent report intended to establish broad international principles for fund governance, the Technical Committee of the International Organization of Securities Commissions (of which the SEC is a member) examined in detail the fund structures utilized in 18 different jurisdictions. [26] On the issue of independent review and monitoring, the report recognized: "The role and concept of the independent entity or entities responsible for this function assumes different forms among the various fund governance structures, although the aim is to provide an 'outside perspective' to meet the goal of fund governance – the protection of fund investors." [27] How to ensure that any additional fund model reflects the same core Investment Company Act protection of independent review and monitoring thus requires careful consideration by Congress, as it is a key element of investor protection.

The introduction of a global fund model would make the U.S. regulatory framework for registered funds more compatible with the regulatory frameworks for funds in other leading jurisdictions around the world. It also would allow U.S. fund managers to retain talent in the United States, rather than sending those jobs and related infrastructure oversees. Finally, a truly global marketplace for registered funds would result in increased investment choice that would benefit U.S. investors and the U.S. economy as a whole.

Recommendation:

- Congress and the Administration—in consultation with the SEC, all elements of the fund industry (including fund directors), and other interested parties—should develop legislation to authorize an additional form of U.S. registered fund that would be a competitive, attractive investment option for the global marketplace.

III. Ensure that regulatory costs are proportionate to their benefits

As regulators consider future rulemaking for financial institutions, including funds, they must do so with a full understanding of the potential consequences of those rules, including their costs and benefits. When new rules are required, or existing rules are amended, it is critical that regulators 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 products or markets. [28]

Congress understood this in relation to the responsibilities of the SEC - it mandated that the SEC consider, in addition to the protection of investors, whether its rulemaking will promote efficiency, competition, and capital formation. [29] Although not explicitly mandating cost-benefit analysis, this requirement does give guidance to the SEC on how to develop its regulatory process. Federal executive regulatory agencies, as opposed to independent agencies such as the SEC, [30] are under considerably more formal and rigorous requirements to execute a cost-benefit analysis of the rules they promulgate. [31]

While the SEC, as an independent regulatory agency, is not required to conduct a formal cost-benefit analysis when it adopts rules, Congress does require, through the Paperwork Reduction Act, [32] 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.” [33]

Under SEC Chairman Cox’s leadership, and by necessity as a result of recent litigation, the SEC has devoted increased resources to examining the costs and benefits of its proposed and existing rules and regulations. Nonetheless, the SEC’s historic process for conducting a cost-benefit analysis has been inadequate: it failed to produce realistic assessments of regulatory costs and burdens or to appropriately evaluate alternative approaches and, other than in a rather cursory manner, largely ignored Congress’ express requirement to evaluate a rule’s effect on efficiency, competition, and capital formation.

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. 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.

Rules should be evaluated for these purposes as they are developed initially and are adopted, and also reviewed periodically to ensure they are achieving their intended effect at an acceptable cost. Federal executive regulatory agencies are required to evaluate existing regulations through retrospective regulatory reviews. These reviews determine whether (1) the expected outcomes of the regulation have been achieved; (2) the agency should retain, amend, or rescind the regulation; and/or (3) the actual benefits and costs of the implemented regulation correspond with estimates prepared at the time the regulation was issued. [34]

It is important to note that 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. [35]

Recommendations:

- The SEC should reorganize its rulemaking process, and the role within that process of its Office of Economic Analysis, to institutionalize a rigorous, timely and informed process for analyzing the costs and benefits of all regulatory proposals.
- Congress by law, or the SEC by rule, 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. Adopt a more prudential model of regulation

Echoing the sentiment of his predecessor as the first SEC Chairman, Joseph Kennedy, SEC Chairman Christopher Cox has articulated the Commission’s desire to be “partners of honest business.” [36] 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 efficiency, competition, 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." [37] A prudential approach to regulation contemplates 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 former 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. [38]

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 fund 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 funds and investment advisers. As of June 2006, firms representing approximately $1.5 trillion were participating in this pilot program. [39]

Recommendations:

- The SEC should modify its regulatory processes and procedures 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.

V. Reform our traditional regulatory organization and approach, especially for purposes of securities regulation, in light of changed market realities

As both issuers and investors in the U.S. capital markets, funds 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 formation of the SEC, 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.

We agree with the various reports on the competitiveness of the U.S. financial markets 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.

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. 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.

Numerous other divisions and offices within the SEC besides the Division of Investment Management (the division primarily responsible for fund regulation) have responsibility for issues that affect funds, 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 registered funds; (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. [40] 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.

B. Restructure the SEC's inspection and examination functions

The SEC's Office of Compliance Inspections and Examination is charged, in part, with inspecting funds 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 which the staff focuses on a particular issue through visits to numerous funds and advisers.

In carrying out inspections of particular firms, there appears to be little coordination among SEC regional offices. This lack of coordination often results in duplicative examinations and inconsistent interpretations of the SEC's rules and regulations and, in turn, substantial and costly burdens on firms. [41] More troubling is the trend for OCIE staff to engage in de facto rulemaking during an inspection (e.g., telling a fund 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.

So-called "sweep examinations" raise additional concerns. They result in a piecemeal look at a fund's operations, usually without any meaningful feedback to the fund. 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.

SEC Chairman Cox has implemented several reforms to the SEC's inspection and examination programs to address some of these concerns, including requiring OCIE to notify the SEC Chairman and the Commission prior to initiating a sweep examination, requiring OCIE to notify registered entities of the status of an investigation after 120 days and provide formal notification upon completion of the investigation, and making enhancements to the pre-examination process to avoid duplication of examinations. We applaud these efforts but believe more can be done to ensure the efficiency and effectiveness of the SEC's inspection and examination functions.

Recommendations:

- Responsibility for the SEC's inspection and examination functions should be returned to the SEC's operating divisions. 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 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.

ENDNOTES

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.68 trillion and serve almost 90 million shareholders.

[2] S.Amdt.956 to S. 761 ("The America Competes Act"). Introduced Apr. 24, 2007; agreed to in Senate by unanimous consent on Apr. 25, 2007.

[3] Letter from Senate Republican Capital Markets Task Force to Paul Stevens, President and CEO, Investment Company Institute, et al, dated Feb. 5, 2008.

[4] See Letters from American Bankers Association, Business Roundtable, Chamber of Commerce, Financial Services Forum, Futures Industry Association, Investment Company Institute, International Swaps and Derivatives Association, Securities Industry and Financial Markets Association, dated Feb. 14, 2007 (to Senator Mike Crapo) and Apr. 24, 2007 (to Senators Mike Crapo and Charles Schumer).

[5] The letters specifically supported the "sense of the Senate" that recommended that:

(1) Congress, the President, regulators, industry leaders, and other stakeholders should take the necessary steps to reclaim the preeminent position of the United States in the global financial services marketplace;

(2) the Federal and State financial regulatory agencies should, to the maximum extent possible, coordinate activities on significant policy matters, so as not to impose regulations that may have adverse unintended consequences on innovativeness with respect to financial products, instruments, and services, or that impose regulatory costs that are disproportionate to their benefits, and, at the same time, ensure that the regulatory framework overseeing the United States capital markets continues to promote and protect the interests of investors in those markets; and

(3) given the complexity of the financial services marketplace today, Congress should exercise vigorous oversight over Federal regulatory and statutory requirements affecting the financial services industry and consumers, with the goal of eliminating excessive regulation and problematic implementation of existing laws and regulations, while ensuring that necessary investor protections are not compromised.

[6] The Institute has submitted recommendations to several of these studies. See Letter from Paul Schott Stevens, President, Investment Company Institute, to Professor Hal S. Scott, Director, Committee on Capital Markets Regulation, Nov. 20, 2006; 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 21st Century, Jan. 26, 2007 and Feb. 7, 2007; and letter and submission from Paul Schott Stevens, President and CEO, Investment Company Institute, to The Honorable Henry M. Paulson, Jr., Secretary, U.S. Department of the Treasury, Dec. 7, 2007.

[7] In our prior submission to the U.S. Department of the Treasury, supra note 6, we also identified the principle that U.S. regulators should embrace the efficiencies offered by revolutionary information, communications and other technologies; we do not discuss this principle here in light of the Task Force's request that we limit our recommendations to five issues.

[8] Pub. L. No. 104-290.

[9] 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).

[10] See "Statement on Signing the National Securities Markets Improvement Act of 1996," President William J. Clinton, The White House, Oct. 11, 1996.

[11] National Securities Markets Improvement Act of 1996, H.R. Rep. No. 104-622, at 30 (1996).

[12] 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. 4th 627, 65 Cal. Rptr. 3d 130 (Cal. App. 3d Dist. Aug. 24, 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). See also, Brown and American Funds End Litigation (press release issued by California Dept. of Justice—Office of the Attorney General, Feb. 15, 2008). Copies of the press release and the agreement to discontinue litigation are available on the California Attorney General's website.

[13] See Chapter 90 and Section 90 90.310(3), Nevada Revised Statutes, which was enacted as Assembly Bill 25 during the 2007 Regulation Session of the Nevada Legislature. "Transfer Agent" is defined, in relevant part, as "any person who, for a fee, performs the service of register the transfer of securities that do not trade on the New York Stock Exchange or the American Stock Exchange or in the over-the-counter market . . .." According to testimony provided on this provision by the Nevada Secretary of State, who sought enactment of this provision, the State's "ability to license and inspect local transfer agents would get a jump on and prevent fraudulent activity before it occurs as well as intervene in situations of abuse." See May 10, 2007 Minutes of the Nevada Senate Committee on Judiciary on Assembly Bill 25 at p. 6. To our knowledge, Nevada is the first state to attempt to require the registration and regulation of transfer agents. Fund transfer agents are registered with and regulated by the SEC under the Securities Exchange Act of 1934. Their activities also are routinely inspected by the SEC for their compliance with federal law. Such regulation and oversight by the SEC obviates the need for concomitant state oversight. Indeed, such regulation and oversight must occur at a federal level to ensure that duplicative and inconsistent regulation does not develop for this national business that is vital to the operation of all funds.

[14] 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, DC, Apr. 20, 2007.

[15] This was recognized by SEC Commissioner Atkins when he stated that "since 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.

[16] The Investment Company Institute compiles worldwide statistics on behalf of the International Investment Funds Association, an organization of national mutual fund associations. The collection for the third quarter of 2007 contains statistics from 43 countries and aggregates data from ICI, EFAMA, and other national mutual fund associations. See, "Worldwide Mutual Fund Assets and Flows, Third Quarter 2007."

[17] Percentage based on assets denominated in U.S. dollars.

[18] The acronym stands for "Undertakings for Collective Investments in Transferable Securities."

[19] 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."). Significant projected growth of the fund industry is expected in developing markets, particularly in Asia, which may in the near future exceed the flows into the U.S. and Europe combined. See Strategic Insight, Asia Fund Management and Middle East Opportunities; Investing in the Future and accompanying Press Release (Nov. 15, 2007). UCITS are well positioned to capture shares of those markets.

[20] See Commission of the European Communities, White Paper on Enhancing the Single Market Framework for Investment Funds, COM(2006)686, Nov. 15, 2006.

[21] Certain distributions by U.S. funds are subject to U.S. withholding tax when made to foreign shareholders. In many cases, foreign shareholders incur more U.S. withholding tax when investing in a U.S. fund than they would incur by investing instead in a foreign fund investing in identical securities. Some of these tax disparities would be addressed by extending and making permanent the so-called "flow-through" provisions of Internal Revenue Code Section 871(k), which expire during 2008.

[22] Some foreign countries have rules, similar to the passive foreign investment company rules of U.S. tax law, that eliminate the tax deferral benefit of investing in funds that retain income and gains.

[23] Legislation strongly supported by the Institute—the Generate Retirement Ownership Through Long-Term Holding Act of 2007 ("the GROWTH Act")—would in part 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.

[24] Protecting Investors: A Half Century of Investment Company Regulation (report by the Division of Investment Management, U.S. Securities and Exchange Commission, May 1992).

[25] See generally, id at 282-88, 332-45. See also 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 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").

[26] See Examination of Governance for Collective Investment Schemes: Part I, Final Report of the Technical Committee of IOSCO (June 2006).

[27] Id at 11.

[28] 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. 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.

[29] See, e.g., Section 2(c) of the Investment Company Act and Section 2(b) of the Securities Act of 1933 (added by NSMIA).

[30] 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 12,866 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); and Executive Order No. 13,258, 67 F.R. 9385 (Feb. 26, 2002).

[31] For example, the Unfunded Mandates Reform Act requires each federal agency (but not independent agencies) to prepare a "written statement" containing "a qualitative and quantitative assessment of the anticipated costs and benefits of the federal mandate" for any rulemaking likely to result in public or private sector costs exceeding $100 million in a single year. See 2 U.S.C. § 1532(a).

[32] 44 U.S.C. § 3501 et seq.

[33] 44 U.S.C. § 3506(c)(1)(A)(iv).

[34] Section 610 reviews required by the Regulatory Flexibility Act require agencies to consider: (1) the continued need for the rule; (2) the nature of complaints or comments received concerning the rule from the public; (3) the complexity of the rule; (4) the extent to which the rule overlaps, duplicates, or conflicts with other federal rules, and, to the extent feasible, with state and local government rules; and (5) the length of time since the rule has been evaluated or the degree to which technology, economic conditions, or other factors have changed in the area affected by the rule. See 5 U.S.C. § 610(b).

[35] 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 available on a website and in paper or by e-mail 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). This approach has the potential to enhance investor understanding of important fund information, without diminishing the amount of information available to shareholders and other market participants.

[36] 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, DC, Mar. 14, 2007.

[37] 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.

[38] Speech by SEC Commissioner Annette Nazareth, U.S. Securities and Exchange Commission, Remarks Before the SIFMA Compliance and Legal Conference, Phoenix, AZ, Mar. 26, 2007.

[39] See Securities and Exchange Commission, Steps Being Taken to Make Examination Program More Risk-Based and Transparent, GAO-07-1053 (Aug. 2007) at 10.

[40] See Commission on the Regulation of U.S. Capital Markets in the 21st Century (U.S. Chamber of Commerce), Report and Recommendations (Mar. 2007) at 137-38.

[41] The lack of coordination between the SEC and SROs in the context of regulatory examinations also is problematic. Unnecessary inefficiencies often result from uncoordinated or conflicting examination requests to market participants from SEC OCIE staff and staff of the SROs.