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The Honorable Mary L. Schapiro
Chairman
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman ~~Schapiro~~: *Mary*

Congratulations once again on your confirmation as Chairman of the Securities and Exchange Commission. We look forward to working with you, your fellow Commissioners, and the Commission staff.

We believe that the ongoing financial crisis offers an important opportunity for a frank and robust public dialogue about what works and what needs fixing in our system of financial regulation. It should enable you and other policymakers to take the bold steps necessary to modernize and strengthen regulatory oversight of the financial services industry. Your long experience as a regulator will serve you, and indeed all of us, well in the context of this debate.

The SEC and all our members—registered investment companies, their directors, advisers, and distributors—share a common objective of assuring that average Americans have at their disposal a vibrant, competitive and cost-effective way to access the securities markets and realize their long-term financial goals. To this end, a strong and capable SEC is indispensable. We have devoted considerable effort to identifying those reforms that will help assure the SEC can continue to perform its vital role most effectively. I enclose an outline of areas that we believe merit your consideration, ranging from suggestions to improve the Commission to our recommendations for action on specific initiatives.

Underlying these recommendations are several themes that we have emphasized in recent years. One is that regulation of investment products should be driven by the imperatives of the capital markets: investor protection, fair and orderly markets, and the promotion of efficiency, competition, and capital formation.

The Honorable Mary L. Shapiro

February 18, 2009

Page 2

A second is that there is a compelling need for the Commission to inform itself better about the economic consequences of its regulations and to avoid regulatory approaches that could have the effect of making mutual funds less competitive, less innovative, less attractive to talented investment firms and professionals, and less available to investors.

We look forward to a healthy and robust dialogue with the Commission on these and other issues. In that regard, we continue to hope that you will be able to speak at our annual General Membership Meeting here in Washington on May 8. The senior executives from fund companies in attendance would, without doubt, find your remarks to be of great interest. In addition, I hope to be able to schedule an early courtesy call for the Institute's Chairman John Murphy and myself, and I will be contacting your office in that regard.

In the meantime, please be assured that we stand ready to assist in any way we can as you begin your tenure as Chairman.

With my warmest personal regards.

Sincerely,



Paul Schott Stevens
President & CEO

cc: The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner

Andrew J. Donohue, Director, Division of Investment Management
Eric R. Sirri, Director, Division of Trading and Markets

Recommendations for Securities and Exchange Commission Priorities

SUGGESTIONS TO IMPROVE THE COMMISSION

Possible Merger of the SEC and the CFTC. There is general agreement that the existing structure of financial services regulation in the United States is outmoded, fragmented, and unnecessarily complex. For historical reasons, securities and futures are subject to separate regulatory regimes under different federal regulators. In today's marketplace, with the increasing convergence of securities and futures products, markets, and market participants, this approach makes little sense and has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. Many argue that a consolidated regulator would provide more effective and efficient regulation of these industry sectors.

We will stress several themes as Congress and other policymakers debate possible ways to address these issues. We believe it is imperative that any consolidated regulator that encompasses the combined functions of the SEC and CFTC be established by Congress as an independent agency, with an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission. A critical part of that mission should be for the new agency to maintain a sharp focus on investor protection and law enforcement. And, Congress should ensure that the agency is given the resources it needs to fulfill its mission.

The process of creating a consolidated regulator will be lengthy, complex, and have the potential to disrupt the functioning of the SEC, CFTC, and their regulated industries. We accordingly suggest that, in anticipation, the SEC and CFTC undertake detailed consultation on all relevant issues and take all steps possible toward greater harmonization of the agencies. This work could be facilitated by the Memorandum of Understanding signed last March between the two agencies.

Focus on the Management of the SEC. A thorough examination and revamping of the SEC's management, organization, staffing and internal processes is necessary to modernize the agency and enable it to more effectively achieve its mission. We have several recommendations in this regard.

First, we encourage you to improve the SEC's organizational structure. The inspections and examinations functions should be aligned with the policymaking divisions in order to keep staff in the policymaking divisions updated on current market and industry developments and preclude *de facto* rulemaking by the inspections staff. Mechanisms also should be developed to facilitate (and perhaps even require) coordination among divisions that have overlapping or intersecting regulatory responsibilities. This would help to ensure that the SEC "speaks with one voice."

Second, we encourage you to focus, at a high level, on the management of the Commission. One approach to consider in this regard would be the designation of a Chief Operating Officer. We

note that this was one of a number of recommendations relating to the management of the Commission recently made by Jonathan Katz, a respected former SEC official.¹

Third, we recommend that the Commission implement a comprehensive process for setting regulatory priorities and assessing progress. The agency's recent history is replete with examples of its devoting uncommon energy and attention to regulatory issues of far less significance than those left unattended, to the detriment of the investing public. It may be helpful to draw upon the experience of the United Kingdom's Financial Services Authority, which seeks to follow a methodical approach that includes developing a detailed annual business plan establishing agency priorities and then reporting annually the agency's progress in meeting prescribed benchmarks.

Fourth, we strongly encourage you to promote open and effective lines of communication among the Commissioners and between Commissioners' offices and the SEC's staff. As you know, that type of open communication is critical to fostering awareness of issues as they arise and increasing the likelihood that the SEC will be able to act promptly and effectively.

And finally, we would encourage you to seek sufficient resources and establish incentives for the agency to attract personnel with the necessary private sector experience to fully grasp the complexities of today's global marketplace. Finding ways to bring a broader mix of disciplines and perspectives to bear on regulatory challenges would be of great benefit. Along these lines, as noted above, we will encourage Congress to ensure that the agency is given the resources it needs to fulfill its mission, including through hiring additional experienced staff.

Enhance the Role of Economic Analysis at the Commission. We urge you to greatly enhance the contribution of economic analysis to various aspects of the agency's work, including rulemaking, examination and enforcement. Building strong economic research and analytical capabilities is an important way to enhance the mix of disciplines that will inform the SEC's activities. From helping it look at broad trends that shed light on how markets or individual firms are operating, to enabling it to demonstrate that specific policy initiatives are well-grounded, developing the SEC's capability to conduct economic analysis will be well worth the long-term effort required. The SEC should consider having economists resident in each division to bring additional, important perspectives to bear on regulatory challenges.

Economic analysis must play an integral role in the rulemaking process, because many regulatory costs ultimately are borne by investors. When new regulations are required, or existing regulations are amended, the SEC should thoroughly examine all possible options and choose the alternative that reflects the best trade-off between costs to, and benefits for, investors. Effective cost-benefit analysis does not mean compromising protections for investors or the capital markets. Rather, it challenges the SEC to consider alternative proposals and think creatively to achieve appropriate

¹ Jonathan G. Katz, "Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission," Report to the Center for Capital Markets Competitiveness, February 2009, available at http://www.uschamber.com/assets/ccmc/090211ccmc_sec_speed.pdf.

protections while minimizing regulatory burdens, or to demonstrate that a proposal's costs and burdens are justified in light of the nature and extent of the benefits that will be achieved.

Enhance the SEC's Dialogue with Regulated Industry. A healthy ongoing dialogue between the SEC and industry pays many dividends. It helps in assessing the practical and economic impact of rulemaking or Commission policies, as discussed above. It can help industry better understand regulatory expectations and develop best practices that can be shared broadly with market participants. And it can help the Commission take a more preventative approach in pursuing its investor protection responsibilities, identifying and resolving problems or concerns before they escalate into industry-wide or system issues. This type of approach may also have the benefit of encouraging firms to step forward with self-identified problems and proposed resolutions. Of course, this depends upon firms concluding that the benefits of self-reporting outweigh the risks that reporting will lead to unwarranted enforcement actions.

Maintain the Commission's Leading Role Internationally. We strongly encourage the SEC to maintain its leading role in IOSCO and other international organizations. We believe that successful regulatory reform in the U.S. will require an understanding of foreign regulatory approaches and, in many cases, coordination with foreign authorities. It is therefore imperative that the SEC maintain and strengthen its work with foreign regulators.

RECOMMENDATIONS RELATING TO SPECIFIC RULEMAKING INITIATIVES

Money Market Funds. Andrew Donohue, Director of the Division of Investment Management, recently indicated that the Division would undertake a "wholesale review of the money market fund model, its attributes and the regulatory requirements applicable to it" in 2009. This is vitally important work. Events of the past year have brought into sharp focus the significance of money market mutual funds and the critical role they play as a low cost funding vehicle for the American economy. The regulatory regime established by Rule 2a-7 has proven to be flexible and resilient; lessons have been learned from recent events, however, necessitating a thorough examination of how the money market can function better, and how all funds operating in that market should be regulated.

We have formed a working group of fund industry leaders tasked with a broad mandate to develop recommendations to improve the functioning of the money market and the operation and regulation of funds investing in that market. The group will identify needed improvements in market and industry practices and regulatory reforms, including improvements to SEC rules governing money market mutual funds. We and the Chair of our working group, Jack Brennan, hope to meet with you soon to discuss our findings, conclusions and recommendations. The working group will report its recommendations by the end of this calendar quarter.

Investment Adviser and Broker-Dealer Regulation. Many commentators, from both within the Commission and outside of it, have identified the statutory divide between the supervision of broker-dealers under the Securities Exchange Act of 1934 and that of investment advisers under the Investment Advisers Act of 1940 as a regulatory gap that ought to be addressed. We agree. This system

has its roots in real distinctions in the businesses of advisers and broker-dealers at the time the relevant statutes were developed; those distinctions have become almost indiscernible over time, making it imperative that the Commission (and likely Congress) take steps to rationalize the regulatory systems for financial intermediaries who perform similar roles but are subject to differing legal standards. These intermediaries and their customers and clients deserve a coherent regulatory structure that provides adequate investor protections—including, in particular, a consistent standard of care—without overlapping or unnecessary regulation. Further, in devising a consistent standard, investor protection should guide the final result, with the higher fiduciary principle of the *Capital Gains Research Bureau* case governing intermediary conduct.²

A thoughtful and deliberate approach to rationalizing this regulatory regime is also important to lay the foundation for appropriate reforms to Rule 12b-1, which deals with the use of fund assets to compensate intermediaries, and point of sale disclosure initiatives that are product-neutral. As it has evolved over time, Rule 12b-1 has come to play an important part in the structure through which brokers and advisers are compensated for a variety of services they perform for fund investors – including offering ongoing advice, effecting discrete transactions and performing administrative support of different kinds. Recognizing these important contributions to the vitality of mutual funds, we continue to support retaining the basic framework of Rule 12b-1 and limiting regulatory changes to those that refine or enhance the rule, such as changes that would clarify the role of the board and provide better disclosure of 12b-1 fees. Nevertheless, we see Rule 12b-1 reform as a horse that is out in front of its cart. It would seem the status of, and attendant limitations on, advisers and brokers ought to be resolved first, and the operation of Rule 12b-1 then tailored accordingly.

Further, the thought process that goes into developing this regulatory regime may inform the Commission’s work on another important investor protection initiative that should be developed in conjunction with the Commission’s work on investment adviser/broker-dealer harmonization and Rule 12b-1 reform—effective and concise point of sale disclosure. The Institute has long supported enhanced point of sale disclosure to help investors assess and evaluate a broker’s recommendations. We have been, however, deeply concerned that the SEC might effectuate the disclosure by requiring it only in connection with the sale of mutual fund shares, which could incentivize brokers to recommend other investment products not subject to the same requirements at the point of sale. Accordingly, we strongly believe that any point of sale disclosure obligation should be product-neutral; this type of disclosure is equally important for investors to consider with respect to *any* investment offered by the intermediary, not just mutual funds. We also believe any point of sale disclosure requirement should be fully consistent with the industry’s existing customer service model and should seek to find the best way to provide investors with timely and convenient access to the required information without imposing inappropriate costs and burdens on brokers.

² *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S. Ct. 275 (1963) (holding that Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers by operation of law).

Continuing Disclosure Reform. Earlier this year, the SEC published major amendments to the registration and disclosure rules and forms used by mutual funds and other open-end management investment companies. Among other things, the amendments permit a fund to satisfy its prospectus delivery obligation by providing investors with a “summary prospectus” containing key information, and making additional information, including the statutory prospectus, available on the Internet and in paper upon request.

We worked with the Commission for almost fifteen years to promote the development of an effective short-form prospectus, and we applaud the SEC for completing its important work on the summary prospectus initiative. It represents an historic milestone in the ongoing quest to provide investors with information they need in a format they can use, something that is especially important in the current troubled markets. It also represents a model of rulemaking that should be followed in the future, where a wide range of issues was considered in light of a substantial amount of SEC and industry research.

We encourage the Commission to continue to consider the types of information investors find most useful and how they obtain it, the information required by the Commission and how it is provided, and whether there are any gaps in information, unnecessary requirements, or redundancies.³ With that thorough evaluation in hand, the Commission can properly consider how the provision of information may be improved through the application of modern technology and practices. We understand from communications with the Commission staff that this process is underway with respect to the information contained in mutual fund annual and semi-annual reports to shareholders. We fully support this effort and have offered our assistance to the staff.

The Commission has also pursued initiatives in recent years related to the use of interactive or structured data, such as the rule amendments adopted by the Commission last month requiring mutual funds to file the risk/return summary section of their prospectuses in interactive data format, using eXtensible Business Reporting Language or “XBRL.” While structured data has obvious benefits in the context of certain financial or other quantitative information, its application to narrative text is more challenging and the benefits more speculative. As the Commission continues work on modernizing its disclosure system, we urge it to carefully consider the full range of technological possibilities, rather than singling out one, such as XBRL, to apply to disparate types of disclosures. More appropriate options may be available with different technology.

We would be happy to assist the Commission in exploring these issues. For example, were the Commission to form an advisory committee composed of investors, issuers and other market

³ We particularly encourage the Commission, as part of any disclosure modernization efforts, to eliminate requirements for disclosure of information that is not used either by investors or the Commission and to seek to eliminate duplicative disclosure requirements. For example, it is our understanding that Form N-SAR, which funds file with the Commission twice each year, has had limited utility and contains some information that is disclosed elsewhere. The SEC staff has begun to identify those redundancies, and we urge the staff to move forward with a proposal to rationalize the disclosure requirements of Form N-SAR and other Commission filings.

representatives to consider and make recommendations on further enhancements to the disclosure system, as recently recommended in an SEC staff report,⁴ the Institute and its members would be very pleased to participate.

Short Selling. In an effort to ensure fair and orderly markets and address sudden and excessive fluctuations of securities prices, the SEC recently adopted several interim final rules relating to short sale activity. We strongly support regulatory reform designed to enhance investor confidence and to combat market manipulation and abuses related to short selling. Such reform, however, must be appropriately tailored to balance the regulatory interests of the SEC with the trading and cost concerns of market participants.

One of the interim final rules requires institutional investment managers to report to the SEC short sales and short positions in certain securities. It is essential that the SEC adequately protect the confidentiality of this information. Public disclosure of this information has the potential to facilitate the frontrunning of a fund's security positions, increase downward selling pressure on stocks, and confuse investors and other market participants about an investment manager's intentions relating to short sale activity. We strongly support the current nonpublic classification of this information in the interim final rules and encourage the SEC to maintain such confidentiality. If a public disclosure regime is to be established, we believe this is best achieved by the SEC requiring disclosure of the short position only for each stock on a periodic, but sufficiently delayed, basis (*e.g.*, a delay of 45 days after the end of a quarter in which a transaction occurred, similar to the current Form 13F requirements). The SEC also must clarify its authority to maintain the confidentiality of the reported information under FOIA and its intent to exercise that authority.

We also encourage the SEC to thoroughly consider and evaluate calls for other reforms to address concerns relating to short sales including reinstating a form of the short sale "tick-test" and implementing certain types of circuit breakers. The SEC should continue to play an active role in global efforts in the area of short sale regulation. As regulation in this area evolves, it will be critical that the regulatory oversight of short selling involves a consistent and sensible global response.

Municipal Securities Market Reform. Investors must have timely access to relevant, complete, and reliable information about municipal securities offerings. Currently, municipal investors do not enjoy this type of disclosure, unlike investors in many other areas of the U.S. capital market. Legislative action regarding the Tower Amendment will be necessary to develop a truly adequate disclosure regime for municipal securities. Currently, the Tower Amendment prohibits the SEC (and the Municipal Securities Rulemaking Board) from directly or indirectly requiring issuers of municipal securities to file documents with them before the securities are sold. Because of these restrictions, the disclosure regime for municipal securities is woefully inadequate and the regulatory framework is insufficient for investors in today's complex marketplace. Most significantly, the disclosure is limited,

⁴ *Toward Greater Transparency: Modernizing the Securities and Exchange Commission's Disclosure System*, avail. at <http://www.sec.gov/spotlight/disclosureinitiative.shtml>.

non-standardized, and often stale, and the disparities from the corporate issuer disclosure regime are numerous. Consequently, we believe that changes to the municipal securities marketplace necessitate that certain disclosure requirements be imposed directly on municipal issuers to ensure the long-term stability of this market. To this end, we urge the SEC to support efforts to amend or repeal the Tower Amendment. We also urge the SEC to use the full range of its current authority to rectify deficiencies in this area by taking steps to improve the content and timing of disclosure regarding municipal securities to assist funds and other investors.

Credit Rating Agency Reform. The current financial crisis has underscored the need for tighter regulation of credit rating agencies. ICI has long supported increased regulatory oversight, disclosure, and transparency requirements for credit rating agencies. Recently adopted SEC rule amendments requiring greater transparency and disclosure, combined with reforms implemented by the credit rating agencies themselves, are steps in the right direction. Consideration must still be given, however, to whether any further action is needed to address gaps in this area, *e.g.*, the lack of information that is provided directly to investors. The SEC also has a pending proposal to remove references to ratings in SEC rules, including Rule 2a-7 under the Investment Company Act (the rule governing money market mutual funds). We strongly urge the SEC to withdraw this portion of its proposal as we believe it is unnecessary to address the SEC's stated policy concerns, would dramatically weaken the investor protections embedded in Rule 2a-7, and may create the potential to harm investor and market confidence in the entire money market fund industry. Finally, we encourage the SEC to continue to examine other reforms in this area and to stay actively involved in global efforts to reform the regulation of credit rating agencies.

ETF Rulemaking. After fifteen years of issuing individual exemptive orders to exchange traded funds (ETFs), the SEC in 2008 proposed Rule 6c-11 under the Investment Company Act to allow index-based and fully transparent, actively managed ETFs to begin operating without obtaining exemptive relief from the Commission. We strongly supported the proposal. We recognize that the staff or the Commission may wish to better understand the experience of ETFs during recent market events, and we have offered our assistance in this process. We continue to believe that adopting Rule 6c-11 and the other elements of the ETF rulemaking is in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of Investment Company Act. We encourage the Commission to complete this rulemaking as soon as possible.

Books and Records Reform. Director Donohue has noted that reform of the existing books and records requirements, first for investment advisers and then for investment companies, is a high priority. He has been candid in stating that a comprehensive review of these rules will be a long process, and that his Division of Investment Management staff is under instructions to "take the time necessary to understand current practices and technologies that investment advisers and funds are using to maintain and produce their records."

We applaud both the initiative and the desire to craft recordkeeping requirements that are realistic and appropriate in light of modern technology. We also particularly appreciate the staff's

willingness to move deliberately and thoughtfully with this project, and to consider the practical implications of any new recordkeeping rules. These rules will have a significant impact on day-to-day business operations, and need to be carefully tailored to serve the interests of the Commission while minimizing unnecessary costs that are ultimately borne by investment advisory clients and investment company shareholders.

In a related vein, the Director of the Office of Compliance Inspections and Examinations, Lori Richards, recently outlined her thoughts on a new mutual fund surveillance program.⁵ She was critical of the utility of current mutual fund regulatory filings for the SEC's surveillance purposes, and argued that the SEC needed access to far more detailed and real-time information about funds and the portfolio securities they hold. She noted that to make such a program real would ultimately require SEC rulemaking and possibly legislation, but that multiple offices and divisions within the Commission have "a keen interest" in pursuing it.

We fully support the notion that our capital markets regulators should have access to the kinds of data needed to identify developing dangers and help assure the orderly functioning of markets. We have pledged to work with the staff to this end. But we are concerned that the Commission is singling out mutual funds —despite, or perhaps because of, the fact they are the most highly regulated and transparent institutional investors in the United States, the proverbial low hanging fruit. The Commission would be better served to evaluate its surveillance program in a broader context. Consider, for example, that investors *other than* registered investment companies, such as hedge funds and pension funds, manage 73% of all U.S. equities, 88% of all U.S. corporate bonds, and 90% of outstanding U.S. Treasury and agency securities. In order to meaningfully monitor the markets, the SEC needs access to information about the activities of these other investors as well.

Efforts to Streamline Director Responsibilities. Since 2007, the staff of the Division of Investment Management has been working on a Director Outreach Initiative intended to thoroughly examine fund directors' regulatory responsibilities in an effort to enhance fund boards' effectiveness. This is important work, and we encourage the Commission to support the Division's efforts. The responsibilities of fund boards and the complexity of their agendas have increased substantially over time as the industry has grown and evolved, leading to director involvement in a number of routine, nondiscretionary items. At the same time, the fund compliance programs rule, which requires a fund to have a chief compliance officer (CCO) who administers the fund's compliance program and reports directly to the board, has significantly enhanced the oversight structure of funds. In many instances, matters required to be taken up by directors are already being well handled by the fund CCO, and board-level review has become an unnecessary and duplicative layer on a well-functioning system. In light of these developments, we agree with the Division staff that it is appropriate and timely to take a comprehensive look at fund board responsibilities and consider modifications that would enhance fund board effectiveness and thereby benefit fund shareholders.

⁵ *The Role That Surveillance Might Play in the Risk-Based Oversight of Mutual Funds*, speech by Lori A. Richards to the ICI's 2008 Securities Law Developments Conference, December 16, 2008.

Hedge Funds. The Commission should address the regulatory gaps that exist with respect to its oversight over hedge funds and other unregulated products, at a minimum with respect to their potential impact on the capital markets. One approach to consider in this regard would be to mandate the nonpublic reporting of information such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants.

No less critical is the need to ensure that interests in hedge funds (and other private investment pools) are sold only through private offerings to financially sophisticated investors able to bear the economic risk of their investment. In this regard, ICI continues to support the Commission's 2006 proposal to raise the eligibility threshold for natural persons wishing to invest in private pools organized under Section 3(c)(1) of the Investment Company Act. We further believe that all accredited investor standards should be immediately adjusted to correct for the substantial erosion in those standards since their adoption in 1982, and then regularly adjusted every five years to prevent future erosion.⁶

⁶ For a detailed discussion of the Institute's views on these issues, *see* Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated Oct. 9, 2007, available at <http://www.sec.gov/comments/s7-18-07/s71807-37.pdf>.