



**TESTIMONY OF PAUL SCHOTT STEVENS**

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**INVESTMENT COMPANY INSTITUTE**

**BEFORE THE**

**SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED  
ENTERPRISES**

**COMMITTEE ON FINANCIAL SERVICES  
UNITED STATES HOUSE OF REPRESENTATIVES**

**ON**

**“OVERSIGHT OF THE MUTUAL FUND INDUSTRY: ENSURING MARKET STABILITY  
AND INVESTOR CONFIDENCE”**

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## Executive Summary

Today, U.S. registered investment companies – including mutual funds, exchange-traded funds (“ETFs”), closed-end funds, and unit investment trusts (“UITs”) (collectively, “funds”) – help over 91 million investors achieve both long- and short-term financial goals. These millions of investors have entrusted funds with more than \$13 trillion in assets, giving funds a significant role as institutional investors in the U.S. economy and world financial markets.

In serving the interests of its investors, the fund industry has proven innovative, competitive, and, most importantly, accountable. It operates under a remarkably comprehensive framework of regulation, including the Investment Company Act of 1940, which emerged out of the last great financial crisis. That framework has been enhanced over the years by Congress and the Securities Exchange Commission (“SEC”). Its major features – strict limits on leverage, daily mark-to-market valuation, exceptional transparency, and strong governance, among others – again proved their worth by protecting fund investors through the turmoil of recent years.

Taking stock of the state of industry regulation in mid-2011, in the wake of the financial crisis and in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), three important issues present themselves: first, regulatory reforms of money funds; second, uncertainties about the application to funds and their investment advisers of the extraordinary regulatory powers over “systemically important financial institutions” (“SIFIs”) granted under the Dodd-Frank Act; and third, the burdens and potential for conflicts posed by the multiplicity of regulatory regimes to which funds are now subject.

**Money Market Funds.** For thirty years, money market funds have served as a unique and highly effective cash management tool for investors. They also have been an indispensable source of short-term funding for American corporations, municipalities and other issuers, helping to finance payrolls and inventories and build communities.

Since fall 2008, the ICI and its members have dedicated enormous effort, in collaboration with regulators, to preserving the benefits that money market funds provide to the economy and to investors, while making them more resilient in the face of severe market stress such as that which followed the collapse of Lehman Brothers. During this period, both the SEC and the money market fund industry have made a great deal of progress toward this objective. Importantly, all money market funds now manage interest rate, credit and liquidity risks under stricter new SEC standards. In the event a money market fund proves unable to maintain a stable \$1.00 net asset value (“NAV”) per share, the fund’s board is able to take prompt action to assure an orderly liquidation of the fund and equitable treatment for all shareholders.

Notwithstanding the importance of these and other reforms to date, however, both regulators and the industry have continued to weigh additional measures to make money market funds even better prepared to weather the worst conditions, including ways to enhance liquidity available to prime money market funds investing in the commercial paper market and to minimize the risks of a fund being unable to maintain a stable NAV.

We remain committed to working with regulators on these and other policy options. We submit that this process should be guided by two principles. First, we should preserve those features of money market funds (including the stable \$1.00 per share NAV) that have proven so valuable and attractive to investors. Second, we should avoid imposing costs of a nature that will undercut the willingness or ability of large numbers of investment advisers to continue to sponsor these funds. Otherwise, we will put at risk the enormous benefits that money market funds provide to the economy.

***SIFI Designation.*** The Dodd-Frank Act gives the new Financial Stability Oversight Council (“FSOC”) the authority to designate systemically important nonbank financial companies, or “SIFIs,” for heightened prudential regulation and consolidated supervision by the Federal Reserve Board. This is an extraordinarily potent legal authority, and one that, in our judgment, should be exercised only in exceptional circumstances. Registered investment companies and their advisers do not present risks to the financial system remotely justifying the application of such regulatory controls.

Congress intended SIFI designation only for those nonbank financial companies that could pose a threat to U.S. financial stability, either because of material financial distress at the company or because of the “nature, scope, scale, size, concentration, interconnectedness or mix” of its activities. Funds are among the most comprehensively regulated and transparent financial institutions in the United States—and they simply do not pose such threats. Accordingly, neither individual funds nor fund complexes warrant SIFI designation, nor do asset management firms in their capacity as advisers to funds.

Some have suggested that money market funds should be designated as SIFIs. We strongly disagree. In our judgment, it simply makes no sense to designate each of the 642 money market funds or even the 237 prime money funds offered in the U.S. market today as a SIFI, thereby subjecting each to ongoing prudential supervision by the Federal Reserve Board and discrete capital requirements. Nor does it make sense to pick and choose among money market funds or fund complexes for this purpose. Quite apart from SIFI designation, there is ample regulatory authority to craft further reforms if deemed necessary for these funds. This includes both the wide-ranging authority accorded the SEC under the securities laws as well as other powers entrusted to the FSOC under the Dodd-Frank Act.

***Dealing with Multiple Regulators and the Potential for Regulatory Conflict.*** A third broad area of concern to funds is the potential for regulatory conflict and the

compliance burdens posed by the multiplicity of regulators to which they are subject. Increasingly, funds face regulation, or the potential for regulation, from multiple agencies. At its worst, this dynamic could result in irreconcilable regulatory conflicts, where funds are subject to rules imposed by different regulators that simply are at odds with one another. More frequently, the result is a regulatory hodgepodge – when one agency pursues its perceived regulatory mandate without regard to closely related actions underway at another agency or to the implications of divergent standards; or when an agency addresses regulatory policy concerns only with respect to a specific product without regard to the way in which identical concerns arise with respect to other, competing products. Four recent examples highlight these problems:

- The proposed amendments to CFTC Rule 4.5, which if adopted would subject funds (or their advisers) to directly conflicting requirements by the CFTC and SEC;
- The ongoing debates over fiduciary duties at the Department of Labor (DOL) and the SEC, which are proceeding on completely separate tracks;
- Disclosure initiatives at the SEC and FINRA relating to potential broker conflicts, where one agency (FINRA) has acted before another (the SEC) with a narrow rule applicable only to the sale of mutual funds; and
- Multiple areas in the international arena, where regulators increasingly are adopting regulations that may conflict with or reduplicate those that global firms face in the United States.

In the written testimony that follows, we address other current regulatory issues of concern to funds. Some of these issues primarily affect **funds as issuers of securities**. These include, for example, the proposed repeal of Rule 12b-1 governing the use of fund assets to pay for distribution expenses; substantial U.S. tax impediments to foreign investment in U.S. funds; the SEC’s moratorium on product applications for certain new ETFs; the need for further improvements in disclosure and greater flexibility to use electronic media for required disclosures; the vexing issue of how to apply antiquated rules on recordkeeping to the dynamic new use of social media; and the potential for investor confusion with less regulated alternatives to funds, such as exchange-traded notes.

Others issues primarily affect **funds as investors in the markets**. These include the implementation of Title VII of the Dodd Frank Act, establishing a new regulatory framework for the swaps markets and their participants; trading and market structure issues, such as the need for increased transparency of market information and the role of liquidity providers and high frequency trading; municipal securities market reform;

housing finance reform; and the need for across-the-board proxy voting disclosure by institutional investors.

Appropriate resolution of these issues is important to funds and their investors. So, too, is the **effective functioning of the SEC**, our primary regulator. Funds and their shareholders stand to benefit if the SEC is both well resourced and well managed. We continue to urge intensive, high-level, and sustained attention to improving the agency's internal operations, including its ability to conduct empirical research to inform its rulemaking and oversight activities. Effective cost-benefit analysis is not just a good idea—it is a statutory mandate. Several recent rulemaking efforts have been found to be seriously deficient in this regard.

## Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”) (collectively, “funds”).<sup>1</sup> Members of ICI manage total assets of \$13.41 trillion and serve over 90 million shareholders.

I very much appreciate the opportunity to appear before this Subcommittee and offer our perspectives on the state of the fund industry. As both issuers of securities (fund shares) to investors and purchasers of securities in the market, funds have a strong interest in the ongoing consideration by policymakers and other stakeholders of how to improve the functioning of our capital markets and strengthen our financial regulatory system, both generally and specifically with respect to the regulation of funds.

The fund industry is a vibrant, innovative, and competitive industry that helps millions of American investors meet their long-term financial goals. As of April 2011, more than 91 million investors have entrusted funds with more than \$13.8 trillion of their investment dollars. As a result, funds are among the largest investors in U.S. companies—they hold, for example, about 27 percent of those companies’ outstanding stock, approximately 45 percent of U.S. commercial paper (an important source of short-term funding for corporate America), and about 33 percent of tax-exempt debt issued by U.S. municipalities. The fund marketplace is also fiercely competitive, with nearly 700 fund families offering more than 7,000 funds to investors.

Taking stock of the state of industry regulation in mid-2011, in the wake of the financial crisis and in light of the Dodd-Frank Act,<sup>2</sup> three important issues present themselves: first, regulatory reforms of money funds; second, uncertainties about the application to funds and their investment advisers of the extraordinary regulatory powers over “systemically important financial institutions” (“SIFIs”) granted under the Dodd-Frank Act; and third, the burdens and potential for conflicts posed by the multiplicity of regulatory regimes to which funds are now subject.

We discuss these and other issues below in detail. Section 1 describes the state of the industry from an economic perspective and outlines some of the major trends we are seeing. Section 2 describes the three principal regulatory issues facing the industry mentioned above. Section 3 describes a number of other regulatory issues of concern to

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<sup>1</sup> Throughout this testimony, references to “funds” and the “fund industry” refer only to those funds registered with the SEC. Many of our statistics relate specifically to mutual funds, which are by far the most prevalent type of fund in the U.S.

<sup>2</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) (the “Dodd-Frank Act”).

the industry, some that affect funds as issuers of securities and some that affect funds as investors in the markets. Section 4 comments on our experiences with oversight by the Securities and Exchange Commission (“SEC”), the primary regulator for the industry.

## Section 1: State of the Industry

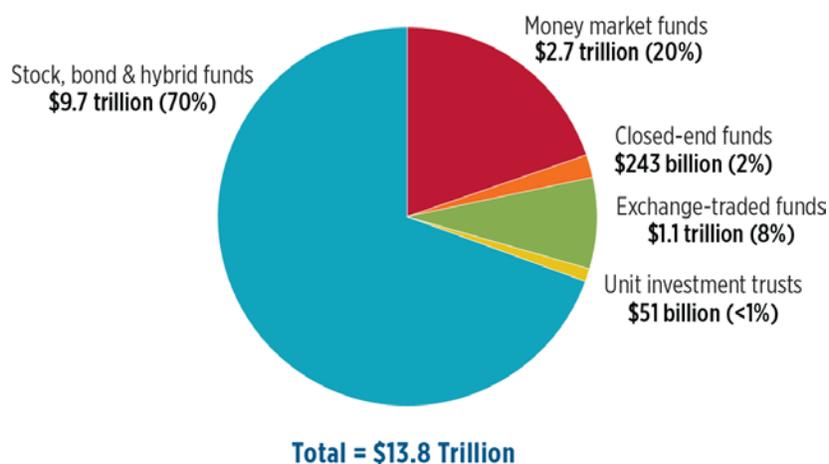
The fund industry is a vibrant, innovative, and competitive industry that helps millions of American investors meet their short- and long-term financial goals. These millions of investors have entrusted funds with more than \$13 trillion in assets, giving funds a significant role as institutional investors in the U.S. economy and world financial markets. This section of the testimony provides an economic overview of the fund industry, including a look at some of the major trends shaping it. More specific details and a comprehensive review of the trends and activity in the fund industry are contained in ICI’s 2011 Investment Company Fact Book.<sup>3</sup>

### A. Overview of U.S. Funds

As of April 2011, U.S. funds managed \$13.8 trillion in assets for over 91 million U.S. investors. Long-term mutual funds (stock, bond and hybrid funds) accounted for 70 percent of investment company total net assets (Figure 1). Money market funds made up 20 percent of assets and exchange-traded funds comprised 8 percent.

**Figure 1**

#### Over Two-Thirds of Investment Company Assets in Long-Term Mutual Funds\*



*\*Data for long-term funds, money market funds, and exchange-traded funds are for April 2011. Data for closed-end funds are for March 2011. Data for unit investment trusts are for December 2010.*

<sup>3</sup> 2011 Investment Company Fact Book (51<sup>st</sup> Edition), available at <http://www.icifactbook.org> (“ICI Fact Book”).

Total net assets of U.S. mutual funds were \$12.5 trillion as of April 2011. Equity mutual funds accounted for \$6.2 trillion or half of U.S. mutual fund assets. Domestic equity funds (those that invest primarily in shares of U.S. corporations) held \$4.6 trillion or 37 percent of total mutual fund assets. World equity funds (those that invest primarily in foreign corporations) accounted for \$1.6 trillion or 13 percent. Bond mutual funds accounted for \$2.7 trillion or 22 percent of total mutual fund assets. Money market funds (\$2.7 trillion or 22 percent of total assets) and hybrid funds (\$816 billion or 7 percent of total assets) held the remainder of total U.S. mutual fund assets.

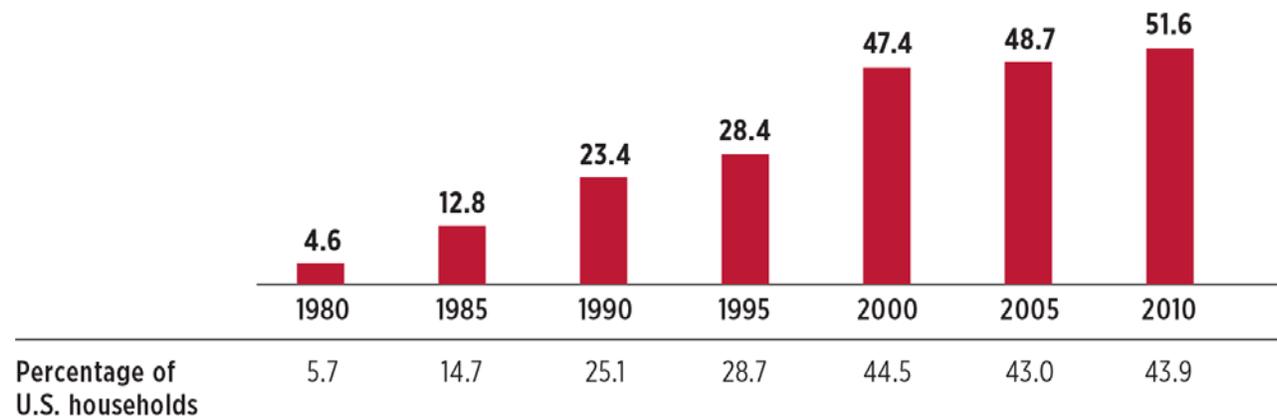
## B. Fund Shareholders

In 2010, an estimated 90 million individual investors owned mutual funds and held 87 percent of total mutual fund assets at year-end. Altogether, 51.6 million households, or 44 percent of all U.S. households, owned mutual funds (Figure 2).

**Figure 2**

### 44 Percent of U.S. Households Owned Mutual Funds in 2010

*Millions and percentage of U.S. households owning mutual funds, selected years*



*Sources: Investment Company Institute and U.S. Census Bureau. See ICI Fundamentals, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010."*

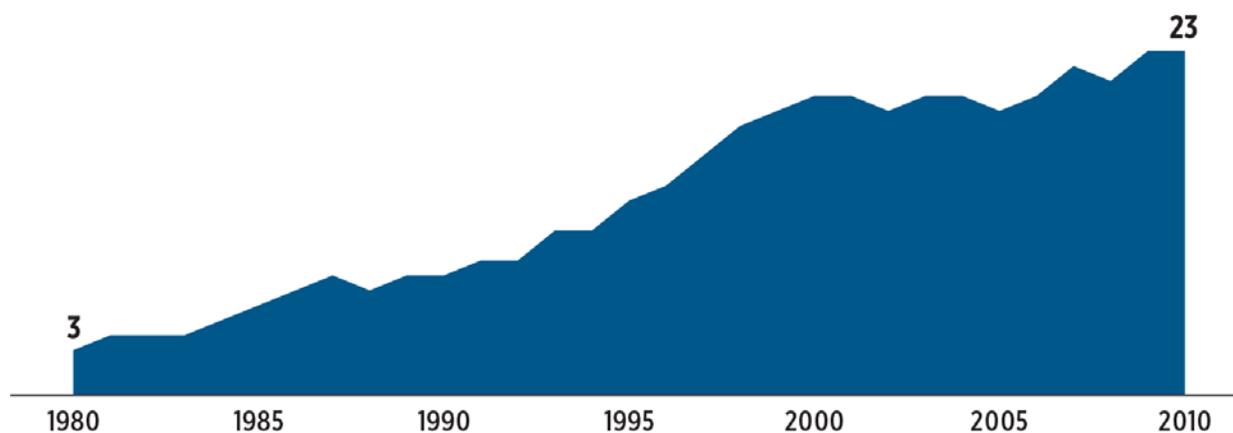
Mutual funds represented a significant component of many U.S. households' financial holdings in 2010. Among households owning mutual funds, the median amount invested in mutual funds was \$100,000. One-quarter of mutual fund-owning households had household incomes of less than \$50,000; 20 percent had household incomes between \$50,000 and \$74,999; 19 percent had incomes between \$75,000 and \$99,999; and the remaining 36 percent had incomes of \$100,000 or more. The median household income of mutual fund-owning households was \$80,000.

Households are the largest group of investors in funds, and funds managed 23 percent of households' financial assets at year-end 2010, up from only 3 percent in 1980 (Figure 3).

**Figure 3**

**Share of Household Financial Assets Held in Investment Companies**

*Percent, year-end, 1980–2010*



*Note: Household financial assets held in registered investment companies include household holdings of ETFs, closed-end funds, and mutual funds. Mutual funds held in employer-sponsored DC plans, IRAs, and variable annuities are included.*

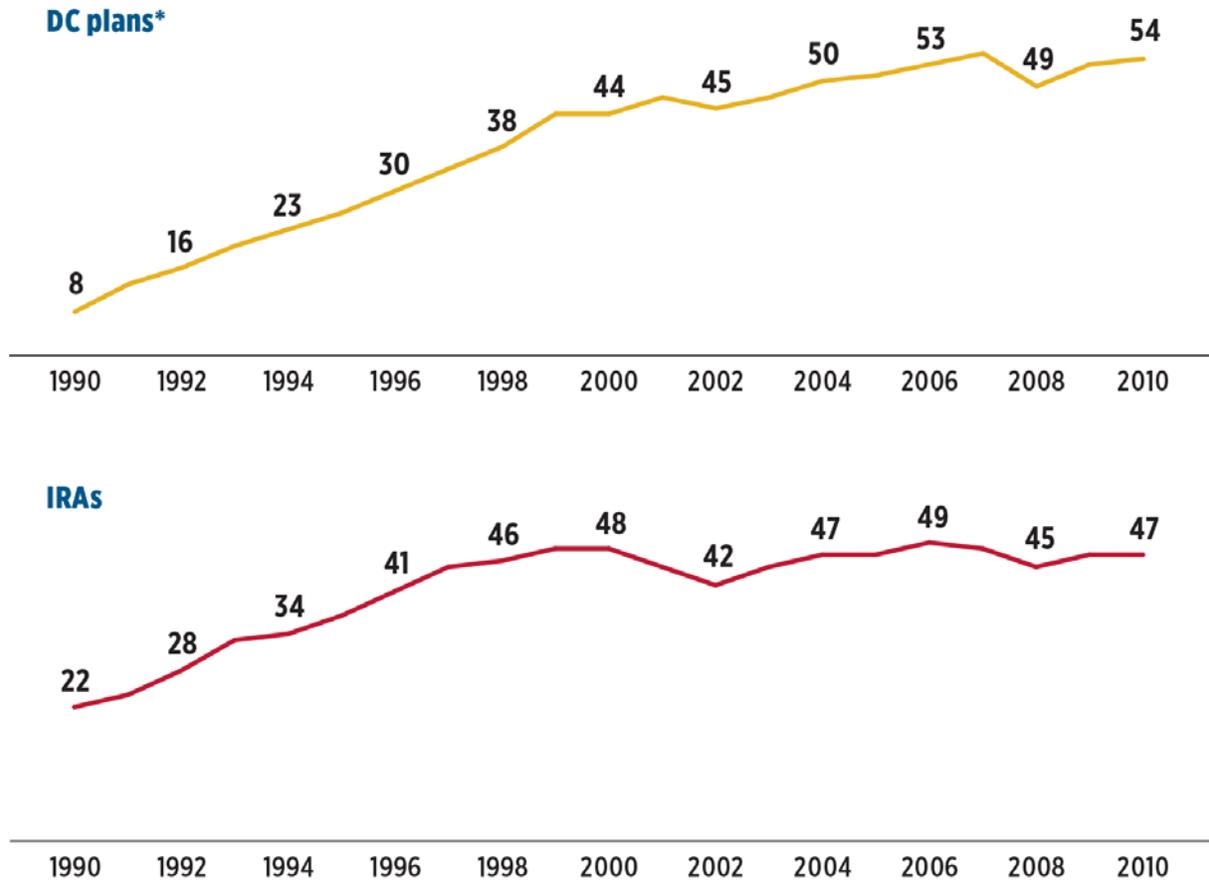
*Sources: Investment Company Institute and Federal Reserve Board*

The growth of individual retirement accounts (IRAs) and defined contribution (DC) plans, particularly 401(k) plans, in conjunction with the important role that mutual funds play in these plans explains some of households' increased reliance on funds during the past two decades. At year-end 2010, 9 percent of household financial assets were invested in 401(k) and other DC retirement plans, up from 6 percent in 1990. Mutual funds managed 54 percent of the assets in these plans in 2010, up from 8 percent in 1990 (Figure 4). IRAs made up 10 percent of household financial assets, and mutual funds managed 47 percent of IRA assets in 2010. Additionally, outside of retirement accounts, mutual funds are investment options in \$1 trillion in variable annuities, which have tax-deferred status.

Figure 4

**Mutual Funds in Household Retirement Accounts**

Mutual fund percentage of retirement assets by type of retirement vehicle, 1990–2010



\*DC plans include 403(b) plans, 457 plans, and private employer-sponsored DC plans (including 401(k) plans).  
Sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

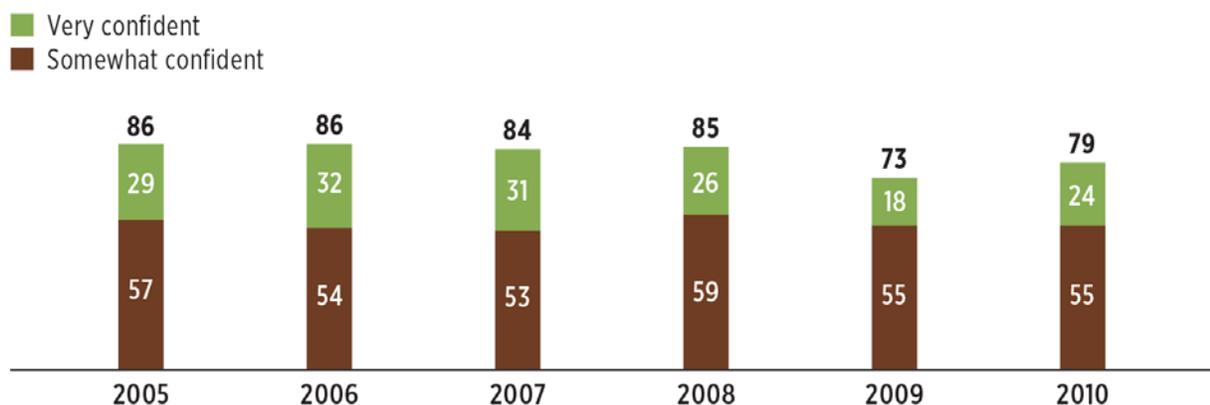
Investors' confidence that mutual funds are helping them reach their financial goals declined a bit in the wake of the financial market crisis. In 2009, 73 percent of fund shareholders said they were confident in mutual funds' ability to help them achieve their financial goals, compared to 85 percent in 2008 (Figure 5). In 2010, confidence rose: 79 percent of all fund shareholders said they were confident in mutual funds' ability to help them achieve their financial goals. Indeed, nearly one-quarter of fund investors in 2010 were "very" confident that mutual funds could help them meet their financial goals.

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**Figure 5**

**Shareholder Confidence Rose in 2010**

Percentage of all mutual fund shareholders by level of confidence that mutual funds can help them meet their investment goals, 2005–2010



Note: This question was not included in the survey prior to 2005. The question has four choices; the other two possible responses are “not very confident” and “not at all confident.”

Source: ICI Fundamentals, “Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010”

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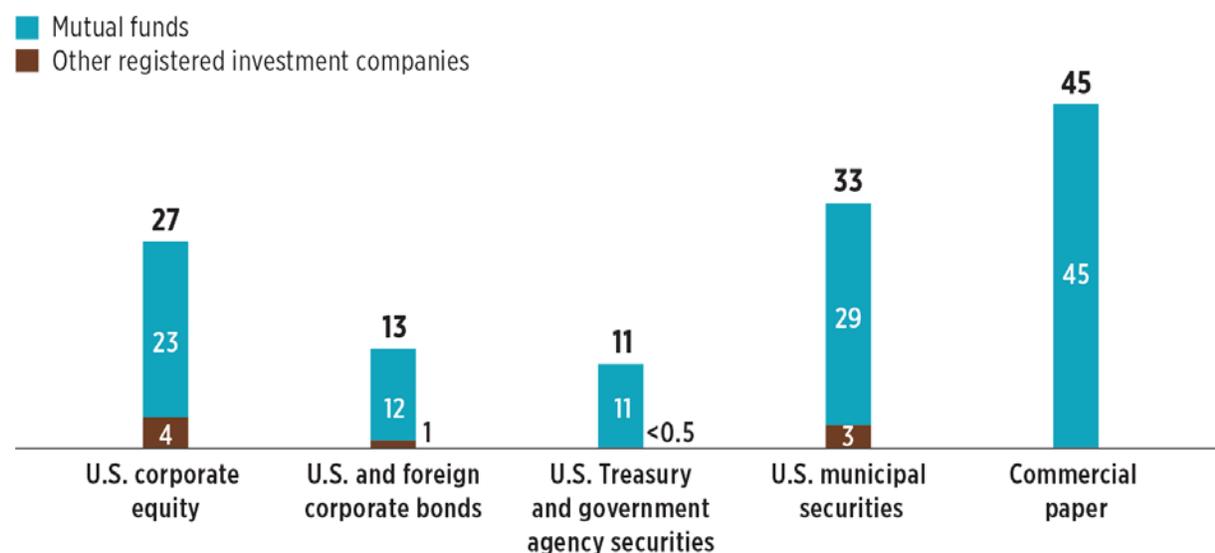
**C. Funds as Investors**

Funds have been among the largest investors in the domestic financial markets for much of the past 20 years and held a significant portion of the outstanding shares of U.S.-issued stocks, bonds, and money market securities at year-end 2010 (Figure 6). Funds as a whole were one of the largest group of investors in U.S. companies, holding 27 percent of their outstanding stock at year-end 2010. Funds continued to be the largest investor in the commercial paper market—an important source of short-term funding for major U.S. and foreign corporations—and held 45 percent of outstanding commercial paper. At year-end 2010, funds held 33 percent of tax-exempt debt issued by municipalities. Funds’ share of the tax-exempt market has remained fairly stable in the past several years despite changes in the demand for tax-exempt funds and the overall supply of tax-exempt debt. Funds held 11 percent of U.S. Treasury and government agency securities and 13 percent of U.S. corporate and foreign bonds.

**Figure 6**

**Investment Companies Channel Investment to Stock, Bond, and Money Markets**

*Percentage of total market securities held by investment companies, year-end 2010*



*Note: components may not add to the total because of rounding.*

*Sources: Investment Company Institute, Federal Reserve Board, and World Federation of Exchanges*

#### D. Competition in the Fund Industry

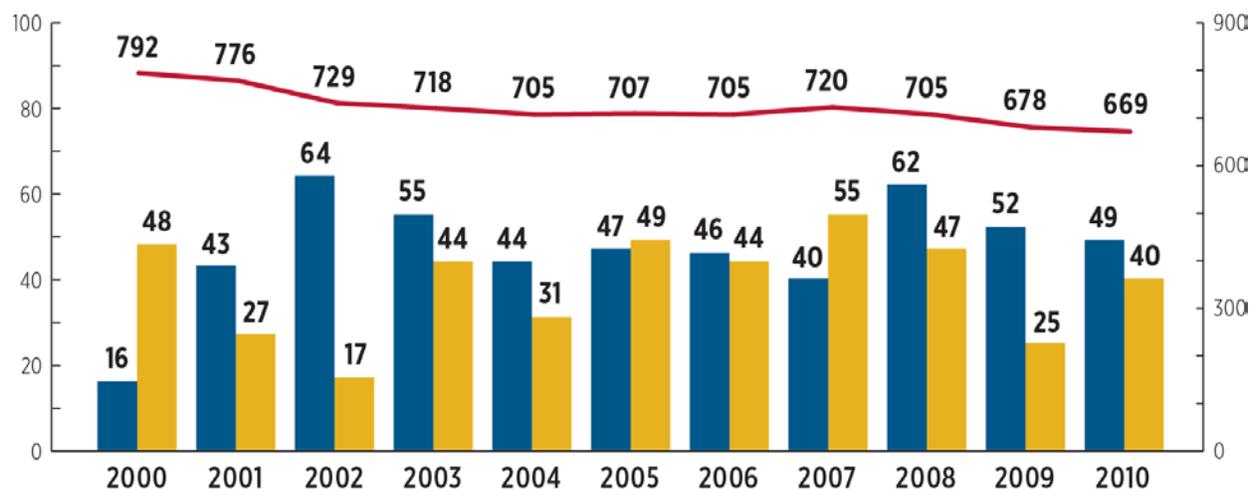
In 2010, there were 669 financial firms that competed in the U.S. market to provide investment management services to fund investors. Historically, low barriers to entry have attracted a large number of fund sponsors to the fund marketplace in the United States. These low barriers to entry led to a rapid increase in the number of fund sponsors in the 1980s and 1990s. However, competition among these sponsors and pressure from other financial products reversed this trend over the past decade. From year-end 2000 to year-end 2010, 502 fund sponsors left the fund business (Figure 7). In the same time, 379 new firms entered. The overall effect has been a net reduction of 16 percent in the number of industry firms serving investors. The decrease in the number of advisers has occurred with larger fund sponsors acquiring smaller fund families and with some fund sponsors liquidating funds and leaving the business. In addition, several other large sponsors of funds sold their fund advisory businesses.

**Figure 7**

**Number of Fund Sponsors**

2000–2010

- Total number of fund sponsors at year-end (right axis)
- Fund sponsors exiting (left axis)
- Fund sponsors entering (left axis)



Source: Investment Company Institute

Competitive dynamics have prevented any single firm or group of firms from dominating the market. For example, of the largest 25 fund complexes in 1985, 13 remained in this top group in 2010. Another measure of market concentration is the Herfindahl-Hirschman Index, which weighs both the number and relative size of firms in the industry. Index numbers below 1,000 indicate that an industry is unconcentrated. The mutual fund industry had a Herfindahl-Hirschman Index number of 465 as of December 2010.

In this past decade, however, the percentage of industry assets at larger mutual fund complexes has increased (Figure 8). The share of assets managed by the largest 25 firms increased to 74 percent by 2010 from 68 percent in 2000. In addition, the share of assets managed by the largest 10 firms in 2010 was 53 percent, up from the 44 percent share managed by the 10 largest firms in 2000.

**Figure 8**

**Share of Assets at the Largest Mutual Fund Complexes**

*Percentage of industry total net assets, year-end, selected years*

	1985	1990	1995	2000	2005	2009	2010
<b>Top 5 complexes</b>	37	34	34	32	37	39	40
<b>Top 10 complexes</b>	54	53	48	44	48	53	53
<b>Top 25 complexes</b>	78	76	71	68	70	74	74

*Source: Investment Company Institute*

Several factors likely contributed to this development. One factor is the acquisition of smaller fund complexes by larger ones. Second, total returns on U.S. stocks averaged only a little over 1 percent annually from year-end 1999 to year-end 2010 and likely held down assets managed by fund complexes that concentrate their offerings primarily in domestic equity funds—many of which tend to be smaller fund complexes. Third, in contrast, total returns on bonds averaged 6 percent annually in the past 11 years. Strong inflows over the decade to bond mutual funds, which are fewer in number and have fewer fund sponsors than equity mutual funds, helped boost the share of assets managed by those large fund complexes that offer bond funds.

**E. Trends in Mutual Fund Fees and Expenses**

Investing in funds involves two primary types of fees and expenses: sales loads and ongoing expenses. Sales loads are one-time fees—paid directly by investors either at the time of share purchase (front-end loads) or, in some cases, when shares are redeemed (back-end loads). Ongoing expenses are paid from fund assets, and thus investors pay them indirectly. A fund's expense ratio reflects all of its annual ongoing expenses, expressed as a percentage of fund assets. Ongoing fund expenses can cover portfolio management, fund administration, daily fund accounting and pricing, shareholder services (such as call centers and websites), distribution charges known as 12b-1 fees, and other miscellaneous costs of operating the fund.

ICI studies trends in fund fees and expenses by adding a fund's annual expense ratio to an estimate of the annualized cost that investors pay for one-time sales loads. This measure is reported as an asset-weighted average, which gives more weight to those funds that have more assets.

Mutual fund fees and expenses that investors pay have trended downward since 1990 (Figure 9). In 1990, investors in stock funds, on average, paid fees and expenses of 2 percent of fund assets. By 2010, that figure had fallen by more than half to 0.95 percent. Fees and expenses paid on bond funds declined by 61 percent from 1.85 percent of fund assets to 0.72 percent over the same time period.

There are a number of reasons for the dramatic drop in fees and expenses incurred by mutual fund investors. First, in general, investors pay much less in sales loads than they did in 1990. For stock funds, for example, the average front-end sales load actually paid fell from 3.9 percent in 1990 to 1.0 percent in 2010. A key factor contributing to the steep decline in loads paid has been the growth of mutual fund sales through employer-sponsored retirement plans. Sales charges are often waived for purchases of fund shares through such retirement plans.

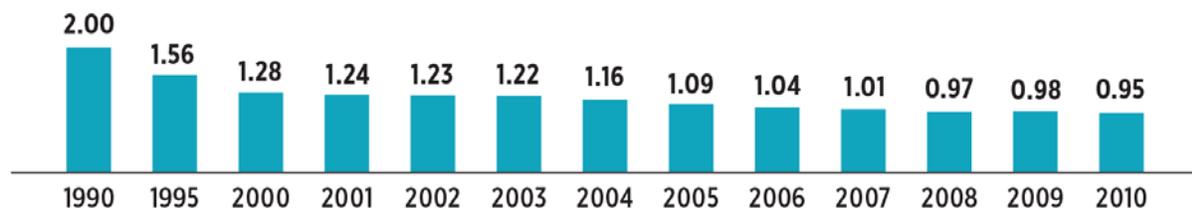
Another reason for the decline in fees and expenses has been growth in the sales of no-load funds. Much of the increase in sales of no-load funds has occurred through the employer-sponsored retirement plan market. In addition, sales of no-load funds have also expanded through mutual fund supermarkets, discount brokers, and full-service brokerage platforms that compensate financial advisers with asset-based fees paid outside of funds.

**Figure 9**

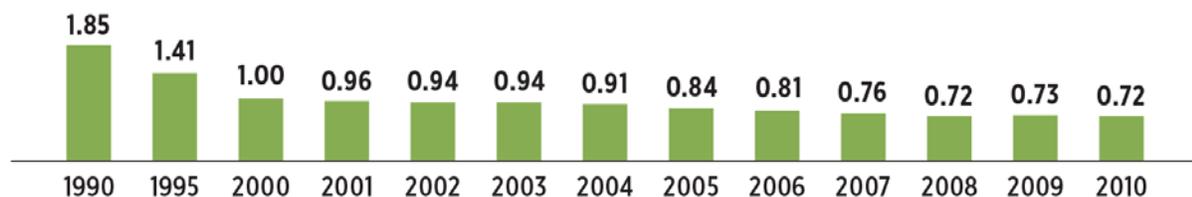
**Fees and Expenses Incurred by Stock and Bond Mutual Fund Investors Have Declined by More Than Half Since 1990**

*Percent, selected years*

**Stock funds<sup>1,2</sup>**



**Bond funds<sup>1</sup>**



<sup>1</sup>Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds. Figure reports year-end asset-weighted average of annual expense ratios and annualized loads for individual funds.

<sup>2</sup>Stock funds include equity and hybrid funds.

Sources: Investment Company Institute and Lipper

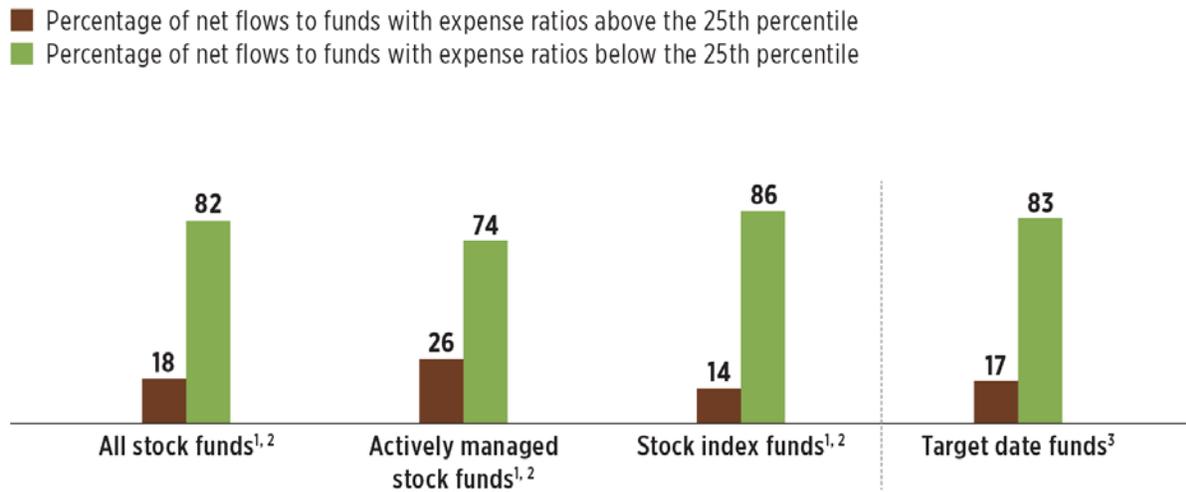
Mutual fund fees also have been pushed down by economies of scale and competition within the mutual fund industry. For example, the number of households owning mutual funds has more than doubled since 1990, going from 23.4 million in 1990 to 51.6 million in 2010. Over the same period, the number of shareholder accounts rose from 61.9 million to over 290 million. Ordinarily, such a sharp increase in demand, coupled with an increased demand for services, could tend to raise fund expense ratios. Any such effect, however, was more than offset by the downward pressure on fund expense ratios from competition among existing fund sponsors, economies of scale from the growth in fund assets, and shareholder movement to lower-cost funds.

Finally, all else equal, ICI research shows that mutual fund shareholders invest predominantly in lower expense ratio funds. During the 11-year period 2000 to 2010, stock funds with expense ratios in the lowest quartile received 82 percent of all net new cash flow, while the remaining 75 percent of funds received only 18 percent of net new cash flow (Figure 10). This pattern holds for actively managed stock funds, stock index funds, and target date funds.

**Figure 10**

**Least Costly Stock Funds Attract Most of the Net New Cash**

*Percent, 2000–2010*



<sup>1</sup>Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

<sup>2</sup>Stock funds include equity and hybrid funds.

<sup>3</sup>Target date fund data are for 2005–2010; includes target date funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

## Section 2: Principal Regulatory Issues Facing the Industry

In the wake of the financial crisis and in light of the Dodd-Frank Act, three important issues face the fund industry: first, regulatory reforms of money funds; second, uncertainties about the application to funds and their investment advisers of the extraordinary regulatory powers over SIFIs granted under the Dodd-Frank Act; and third, the burdens and potential for conflicts posed by the multiplicity of regulatory regimes to which funds are now subject. This section of the testimony describes each of these issues in detail.

### A. Money Market Funds

#### 1. Overview

Money market funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool for investors, and as an indispensable source of short-term financing for the U.S. economy. ICI and its members are committed to working with policymakers to bolster money market funds’ resilience to severe market stress so as to assure their continued ability to serve these purposes.

In September 2008, the failure of Lehman Brothers, coupled with the government’s rescue of Fannie Mae, Freddie Mac, and AIG, prompted mounting concerns about the viability of financial and nonfinancial businesses alike. The result was a liquidity and credit crisis that threatened the global economy. This sequence of events affected virtually every part of the financial system, including all issuers, investors, and intermediaries in the money market. The failure of Reserve Primary Fund to maintain its \$1.00 net asset value (“NAV”) and the subsequent redemption pressures on other money market funds, however, focused much of the attention on these funds.

This section of ICI’s testimony provides a discussion of the money market itself, including its structure and participants; key characteristics of money market funds; and the development and growth of these funds. It then describes how money market funds are regulated, including important SEC amendments to the rule governing these funds that make them more resilient to extreme market stresses. Finally, it discusses ongoing efforts by both the industry and regulators for further strengthening these funds. In particular, we explain why requiring that money market funds “float” their share price (*i.e.*, have an NAV that fluctuates based on the current market prices of portfolio instruments, rather than maintain a stable \$1.00 NAV through the use of the amortized cost valuation method) would be unlikely to reduce systemic risk and may, in fact, increase it.

#### 2. The U.S. Money Market

The money market is a huge, complex, and significant part of the nation's financial system, and one in which many different participants interact each business day. This section describes: the structure of the market; the different vehicles through which investors can access money market instruments (many of which compete directly with money market funds); the unique characteristics of money market funds; and the role and growth of money market funds as financial intermediaries in the money market.

a. Structure of the U.S. Money Market

In the United States, the market for debt securities with a maturity of one year or less is generally referred to as “the money market.”<sup>4</sup> The money market is an effective and lower cost mechanism for helping borrowers finance short-term mismatches between payments and receipts. For example, a corporation might borrow in the money market if it needs to make its payroll in 10 days, but will not have sufficient cash on hand from its accounts receivable for 45 days.

The main borrowers in the U.S. money market are the U.S. Treasury, U.S. government agencies, state and local governments, financial institutions (primarily banks, finance companies, and broker-dealers), and nonfinancial corporations. Borrowers in the money market are known as “issuers” because they issue short-term debt securities.

Reasons for borrowing vary across the types of issuers. Governments may issue securities to temporarily finance expenditures in anticipation of tax receipts. Mortgage-related U.S. government agencies borrow in the money market to help manage interest-rate risk and rebalance their portfolios. Banks and finance companies often use the money market to finance their holdings of assets that are relatively short-term in nature, such as business loans, credit card receivables, auto loans, or other consumer loans.

Corporations typically access the money market to meet short-term operating needs, such as accounts payable and payroll. At times, corporations may use the money market as a source of bridge financing for mergers or acquisitions until they can arrange or complete longer-term funding. In addition, all types of borrowers may seek to reduce interest costs by borrowing in the money market when short-term interest rates are below long-term interest rates.

Borrowers use a range of money market securities to help meet their funding needs. The U.S. Treasury issues short-term debt known as Treasury bills. Government sponsored agencies such as Fannie Mae and Freddie Mac issue

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<sup>4</sup> Securities that have final maturities of more than one year but whose yields are reset weekly, monthly, or quarterly also are generally considered part of the money market.

Benchmark and Reference bills, discount notes, and floating rate notes (agency securities). Municipalities issue cash-flow notes to provide short-term funding for operations, and bond anticipation notes and commercial paper to fund the initial stages of infrastructure projects prior to issuing long-term debt. They also issue variable rate demand notes to gain access to the short end of the yield curve. Banks and other depositories issue large certificates of deposits (“CDs”) and Eurodollar deposits.<sup>5</sup> Banks and broker-dealers also use repurchase agreements, a form of collateralized lending, as a source of short-term funding.

Corporations, banks, finance companies, and broker-dealers also can meet their funding needs by issuing commercial paper, which is usually sold at a discount from face value, and carries repayment dates that typically range from overnight to up to 270 days. Commercial paper can be sold as unsecured or asset backed.<sup>6</sup> One alternative to issuing commercial paper is to obtain a bank line of credit, but that option is generally more expensive.<sup>7</sup>

Although the size of the U.S. money market is difficult to gauge precisely (because it depends on how “money market” instruments are defined and how they are measured), it is clear that a well-functioning money market is important to the well-being of the macro-economy. We estimate that the outstanding values of the types of short-term instruments typically held by taxable money market funds and other pooled investment vehicles (as discussed below)—such as commercial paper, large CDs, Treasury and agency securities, repurchase agreements, and Eurodollar deposits—total roughly \$11 trillion.

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<sup>5</sup> In addition, U.S. banks (including branches of foreign banks in the United States) can lend to each other in the federal funds market. Banks keep reserves at Federal Reserve Banks to meet their reserve requirements and to clear financial transactions. Transactions in the federal funds market enable depository institutions with reserve balances in excess of reserve requirements to lend to institutions with reserve deficiencies. These loans are usually made overnight at the prevailing federal funds rate. Also, banks worldwide can provide funding to each other via the interbank lending market for maturities ranging from overnight to one year at the prevailing London Interbank Offered Rate.

<sup>6</sup> Unsecured commercial paper is a promissory note backed only by a borrower’s promise to pay the face amount on the maturity date specified on the note. Firms with high quality credit ratings are often able to issue unsecured commercial paper at interest rates that are less than bank loans. Asset-backed commercial paper (“ABCP”) is secured by a pool of underlying eligible assets. Examples of eligible assets include trade receivables, residential and commercial mortgage loans, mortgage-backed securities, auto loans, credit card receivables, and similar financial assets.

<sup>7</sup> The expense of these credit lines is expected to increase, and their availability may decrease, as the Basel Committee on Banking Supervision’s endorsement of capital and liquidity reforms for banks (known as “Basel III”) are implemented and banks are required to include credit commitments in their liquidity, net stable funding, and other calculations. See *Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 4* (Basel Committee on Banking Supervision, December 2010).

While these money market instruments fulfill a critical need of the issuers, they also are vitally important for investors seeking both liquidity and preservation of capital. Major investors in money market securities include money market funds, banks, businesses, public and private pension funds, insurance companies, state and local governments, broker-dealers, individual households, and nonprofit organizations.

#### b. Financial Intermediaries for Money Market Instruments

Investors can purchase money market instruments either directly or indirectly through a variety of intermediaries. In addition to money market funds, these include bank sweep accounts, investment portals, and short-term investment pools, such as enhanced cash funds, and ultra-short bond funds.<sup>8</sup> Investors also can purchase money market instruments through offshore money funds. Offshore money funds are investment pools domiciled and authorized outside the United States. There is no global definition of a “money fund,” and many non-U.S. money funds do not maintain a stable NAV.<sup>9</sup> European money funds historically were not bound by Rule 2a-7-like restrictions; however, CESR<sup>10</sup> issued guidelines in May 2010 with criteria for European money funds to operate as either of two types of funds, depending on their risk tolerance. Europe also has an established and strong market of stable NAV money funds, including a large number of dollar-denominated money funds.<sup>11</sup>

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<sup>8</sup> A description of these financial intermediaries is available at *Report of the Money Market Working Group*, Investment Company Institute (March 17, 2009) (“MMWG Report”) at 16-17, available at [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf).

<sup>9</sup> In Europe, floating NAV money funds may use amortized cost accounting for securities up to 90 days in remaining maturity as long as there is no material difference between the amortized cost value and the market value. See Committee of European Securities Regulators (“CESR”), *Guidelines on a Common Definition of European Money Market Funds* (CESR/10-049), May 19, 2010, paragraph 21(valuation), available at <http://www.cesr.eu/popup2.php?id=6638>; CESR, *A Consultation Paper: A Common Definition of European Money Market Funds* (CESR/09-850), October 20, 2009, paragraph 8 (valuation), available at [http://www.cesr-eu.org/data/document/09\\_850.pdf](http://www.cesr-eu.org/data/document/09_850.pdf). See also CESR, *Guidelines Concerning Eligible Assets for Investment by UCITS*, CESR/07-044, March 2007, at 8 (article reference 4(2), amortization and valuation of money market instrument), available at <http://www.cesr-eu.org/popup2.php?id=4421>. In addition, while U.S. mutual funds must annually distribute their income and capital gains, many offshore funds tend to roll-up their income and capital gains. Offshore funds with this “roll-up” treatment therefore provide two advantages over investments in comparable U.S. funds: (1) tax deferral, and (2) conversion of ordinary income into capital gains, which are taxed at a lower rate.

<sup>10</sup> On January 1, 2011, CESR became the European Securities and Markets Authority.

<sup>11</sup> The dollar-denominated stable NAV money funds are used by multinational institutions and others seeking dollar-denominated money funds. The principal providers of these money funds formed a trade association, the Institutional Money Market Fund Association (“IMMFA”). IMMFA members adopted a Code of Practice in February 2003 that aims to ensure that members offer a high quality product and service to investors. All IMMFA funds are triple-A rated by one or more of the credit rating agencies. IMMFA funds also operate under the regulatory requirements of each fund’s domicile. According to IMMFA, the

### c. Characteristics of Money Market Funds

Investors expect to purchase and redeem shares of money market funds at a stable NAV, typically \$1.00 per share. Investors view a stable \$1.00 NAV as a crucial feature of money market funds, because it provides great convenience and simplicity in terms of its tax, accounting, and recordkeeping treatment. Investment returns are paid out entirely as dividends, with no capital gains or losses to track. This simplicity and convenience are crucial to the viability of money market funds because, in contrast with other mutual funds, they are used primarily as a cash management tool. In money market funds that allow check-writing, the \$1.00 NAV gives investors assurance that they know their balance before they draw funds. Without a stable \$1.00 NAV, many, if not most, investors would likely migrate to other available cash management products that offer a stable \$1.00 NAV, such as those listed above, as they seek to minimize tax, accounting, and recordkeeping burdens.

In addition to a stable \$1.00 NAV, money market funds seek to offer investors three primary features: return of principal; liquidity; and a market-based rate of return. Other important characteristics of money market funds include: high-quality assets; investment in a mutual fund; diversification; professional asset management; and economies of scale.

As of April 2011, 642 money market funds had a combined \$2.7 trillion in total net assets under management, up from \$180 billion as of year-end 1983, the year the SEC adopted Rule 2a-7 under the Investment Company Act of 1940 (the “Investment Company Act”).

By investing across a spectrum of money market instruments, money market funds provide a vast pool of liquidity to the U.S. money market. As of February 2011, money market funds held \$2.2 trillion of repurchase agreements, CDs, U.S. Treasury and agency securities, commercial paper, and Eurodollar deposits. Taxable money market funds invest primarily in these short-term instruments<sup>12</sup> and their holdings represent about 20 percent of the total outstanding amount of such money market instruments, underscoring the current importance of money market funds as an intermediary of short-term credit. In comparison, we estimate that money market funds held less than 10 percent of these same instruments in 1983.

Money market funds also are major participants within individual categories of taxable money market instruments. As of February 2011, these funds held 37 percent

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market for the European triple-A rated stable NAV money funds has grown from less than \$1 billion in 1995 to approximately \$675 billion as of June 3, 2011, with approximately \$308 billion of those assets in dollar-denominated money funds (both prime and government money funds).

<sup>12</sup> As of February 2011, approximately 90 percent of all taxable money market funds’ total net assets were invested in these instruments. The remaining 10 percent of assets were invested in bank and corporate notes, bankers’ acceptances, cash reserves less any liabilities, and other miscellaneous assets.

of outstanding short-term U.S. agency securities, 37 percent of commercial paper, 12 percent of short-term Treasury securities, 18 percent of repurchase agreements, 24 percent of large CDs, and 7 percent of Eurodollar deposits.

Tax-exempt money market funds are a significant source of funding to state and local governments for public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. As of May 2010, tax-exempt money market funds had \$352 billion under management and accounted for an estimated 56 percent of outstanding short-term municipal debt.

For nearly 40 years, financial intermediation has developed outside of banks—a phenomenon that has benefited the economy by providing households and businesses more access to financing at a lower cost. Growth in money market fund assets has helped to deepen the commercial paper market for financial and nonfinancial issuers. Many major nonfinancial corporations have come to rely heavily on the commercial paper market for short-term funding of their day-to-day operations at interest rates that are typically less than rates on bank loans. The need for financial issuers to comply with Basel III, such as the new short-term liquidity ratio, will make the ready availability of money market funds to supply liquidity more necessary than ever.

In 1983, the year the SEC adopted Rule 2a-7, the commercial paper market had only about \$185 billion outstanding—about one-fifth of the \$990 billion in non-mortgage loans then on the books of banks and finance companies. At its peak in mid-2007, prior to the start of the financial crisis, the commercial paper market provided a total of \$2.1 trillion in financing—equivalent to over half of the \$3.6 trillion in on-balance sheet non-mortgage bank and finance company loans.

In August 2007, outstanding commercial paper, particularly ABCP, began to contract as reports of defaults in commercial paper issued by structured investment vehicles (“SIVs”) started to surface. While money market funds shied away from buying additional paper issued by SIVs, they continued to supply credit to other financial and nonfinancial corporations in the commercial paper market. Over the next two years, even as the commercial paper market as a whole contracted, money market funds’ share of financing in this market grew steadily, reaching a peak of 46 percent (\$520 billion out of a total of \$1.1 trillion) at the end of 2009. As of April 2011, money market funds held \$414 billion (36 percent of the market) in outstanding commercial paper.

### 3. Regulation of Money Market Funds

Money market funds, like all mutual funds, are subject to a comprehensive regulatory scheme under the federal securities laws that has worked extremely well for over 70 years. Their operations are subject to all four of the major federal securities laws administered by the SEC, including the Securities Act of 1933, the Securities Exchange

Act of 1934, the Investment Advisers Act of 1940, and, most importantly, the Investment Company Act.<sup>13</sup>

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) provide for a high degree of oversight and accountability; (2) ensure that investors receive sufficient information about the fund, including its fees and expenses, and that the information is accurate and not misleading; (3) protect the physical integrity of the fund's assets by having explicit rules concerning the custody of portfolio securities; (4) prohibit or restrict affiliated transactions and other forms of self-dealing; (5) prohibit unfair and unsound capital structures (by, for example, placing constraints on the use of leverage); and (6) ensure the fairness of transactions in fund shares.

One defining feature of money market funds is that, in contrast to other mutual funds, they seek to maintain a stable NAV or share price, typically \$1.00 per share. As a result, money market funds must comply with an additional set of regulatory requirements in Rule 2a-7 under the Investment Company Act. Rule 2a-7 exempts money market funds from the valuation provisions generally applicable to all mutual funds and permits them to determine their NAV using the amortized cost method of valuation,<sup>14</sup> which facilitates money market funds' ability to maintain a stable NAV. The basic premises underlying money market funds' use of the amortized cost method of valuation are these: (1) high-quality, short-term debt securities held until maturity will return to their amortized cost value, regardless of any temporary disparity between the amortized cost value and market value; and (2) while held by a money market fund, the market value of such securities ordinarily will not deviate significantly from their amortized cost value. Thus, Rule 2a-7 permits money market funds to value portfolio securities at their amortized cost so long as the deviation between the amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current NAV per share of the fund. In practice these risk-limiting conditions generally keep deviations between money market funds' per share market value and amortized costs small.<sup>15</sup> Data from a sample of taxable money market funds covering

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<sup>13</sup> Mutual funds also are subject to most of the requirements that apply to U.S. corporate issuers under the Sarbanes-Oxley Act of 2002.

<sup>14</sup> Under this method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount.

<sup>15</sup> See *Pricing of U.S. Money Market Funds*, Investment Company Institute (January 2011), available at [http://www.ici.org/pdf/ppr\\_11\\_mmf\\_pricing.pdf](http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf) ("*Pricing of U.S. Money Market Funds*").

one-quarter of U.S. taxable money market fund assets show that the average per-share market values varied between \$1.002 and \$0.998 during the decade from 2000 to 2010.<sup>16</sup>

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, Rule 2a-7 contains a number of conditions designed to limit the fund's exposure to certain risks by governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments.<sup>17</sup> These risk-limiting conditions include requirements that money market funds:

- only invest in high-quality securities that mature in 13 months or less (with exceptions for certain types of securities including variable and floating rate securities that have an interest rate reset of no more than 397 days or a demand feature), which a fund's board of directors (or its delegate) determines present minimal credit risks, and a requirement that at least 97 percent of a fund's assets be invested in securities held in government obligations or other securities that either received the highest short-term rating or are of comparable quality;
- maintain a sufficient degree of portfolio liquidity necessary to meet reasonably foreseeable redemption requests, including a requirement that all taxable funds maintain at least 10 percent of assets in cash, Treasury securities, or securities that convert into cash within one day ("daily liquid assets"), and that all funds maintain at least 30 percent of assets in cash, Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week ("weekly liquid assets");
- maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk; and
- maintain a diversified portfolio designed to limit a fund's exposure to the credit risk of any single issuer.

In addition, Rule 2a-7 includes certain procedural requirements overseen by the money market fund's board of directors. One of the most important is the requirement that the fund periodically compare the amortized cost NAV of the fund's portfolio with

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<sup>16</sup> *Id.* at 26.

<sup>17</sup> Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.

the mark-to-market NAV of the portfolio.<sup>18</sup> If there is a difference of more than ½ of 1 percent (or \$0.005 per share), the fund’s board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) \$1.00 per share, an event colloquially known as “breaking the dollar.” Regardless of the extent of the deviation, Rule 2a-7 also imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Moreover, all funds must dispose of a defaulted or distressed security (e.g., one that no longer presents minimal credit risks) “as soon as practicable,” unless the fund’s board of directors specifically finds that disposal would not be in the best interests of the fund.

Money market funds also must prominently disclose on the first page of their prospectus that “an investment in the [f]und is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the [f]und seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the [f]und.”

Building upon the lessons of the financial crisis, the SEC’s 2010 rule amendments raised credit standards and shortened the maturity of money market funds’ portfolios—further reducing credit and interest rate risk.<sup>19</sup> For example, the reduction in funds’ weighted average maturity (“WAM”) from 90 days to 60 days lowered the average maturity of taxable money market funds (Figure 11). It also reduced “tail risk” by preventing funds from holding a portfolio with a WAM in excess of 60 days; this is seen in Figure 14 as a “lopping off” of the right-hand tail of the distribution of WAMs across taxable money market funds. Reducing money market funds’ WAM so that a higher percentage of their assets mature sooner than was the case before the onset of the financial crisis, makes them more resilient to changes in interest rates that may be accompanied by other market shocks, and puts money market funds in a better position to meet shareholder redemptions.

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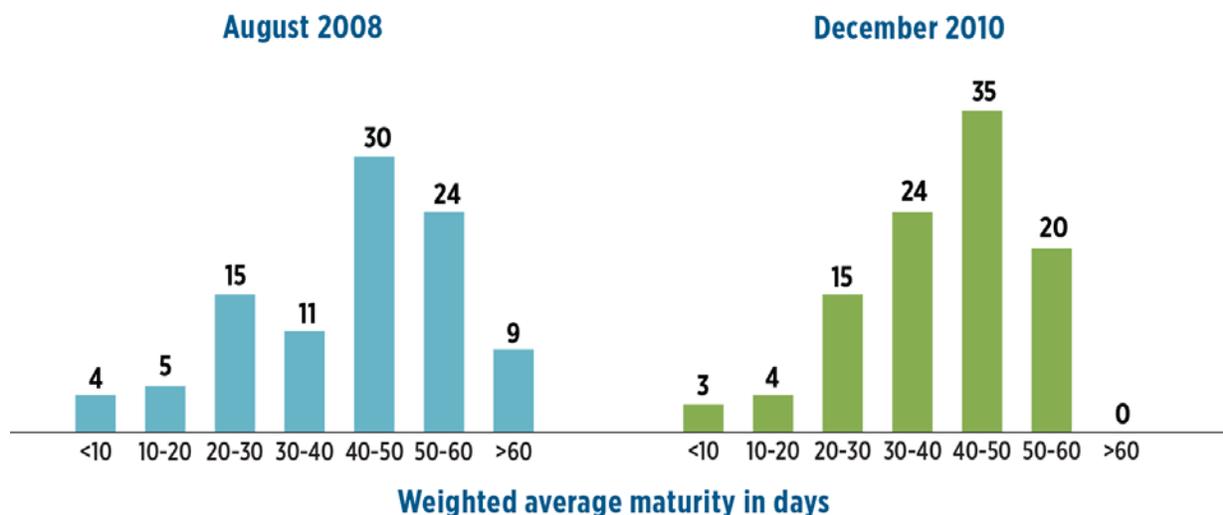
<sup>18</sup> Indeed, as a result of Rule 2a-7’s risk-limiting conditions, money market funds’ underlying per-share market price deviates by only a few basis points from \$1.00 in all but the most extreme market conditions. For example, the SEC’s decision to reduce the maximum allowable weighted average maturity of money market funds’ portfolios significantly reduces volatility in per-share market prices arising from changes in interest rates. See *Pricing of U.S. Money Market Funds*, *supra* note 16.

<sup>19</sup> See SEC Release No. IC-29132 (February 23, 2010) (“SEC 2010 amendments”). A chart comparing money market fund regulations before and after the recent amendments is available on ICI’s website at [http://www.ici.org/policy/regulation/products/money\\_market/11\\_mmf\\_reg\\_summ](http://www.ici.org/policy/regulation/products/money_market/11_mmf_reg_summ).

**Figure 11**

**WAMs for Taxable Money Market Funds**

*Percent of funds*



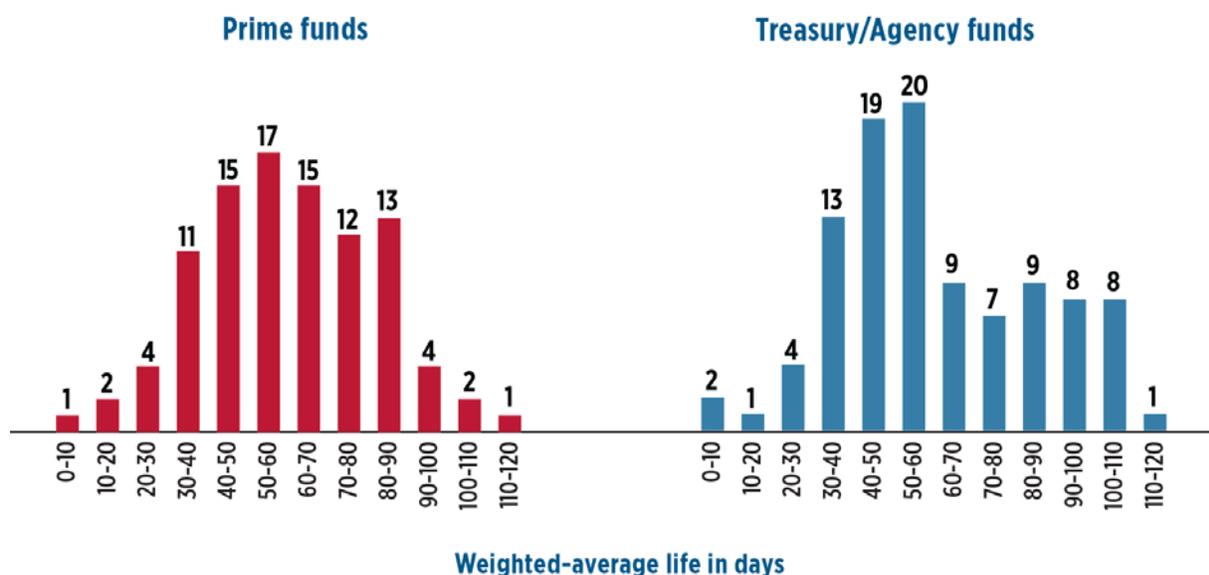
*Source: Investment Company Institute*

The introduction of a limit on money market funds' weighted average life ("WAL") also has strengthened the ability of money market funds to meet redemption pressures. Unlike a fund's WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although publicly available data on WALs do not exist before November 2010, the available data since then suggest that the new WAL requirement likely will bolster funds' ability to absorb market shocks. Figure 12 depicts the distribution of WALs for taxable money market funds as of December 2010. According to Figure 12, a very small proportion of funds have WALs in excess of 100 days. Indeed, the great majority of funds have WALs ranging from 30 to 90 days, in part reflecting the fact that money market securities (including Treasury and agency securities) are issued with maturities in essentially the same range.

Figure 12

**WALs for Taxable Money Market Funds**

Percent of funds, December 2010



Note: Excludes money market funds that invest primarily in other money market funds (e.g., master/feeder structure).

Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website

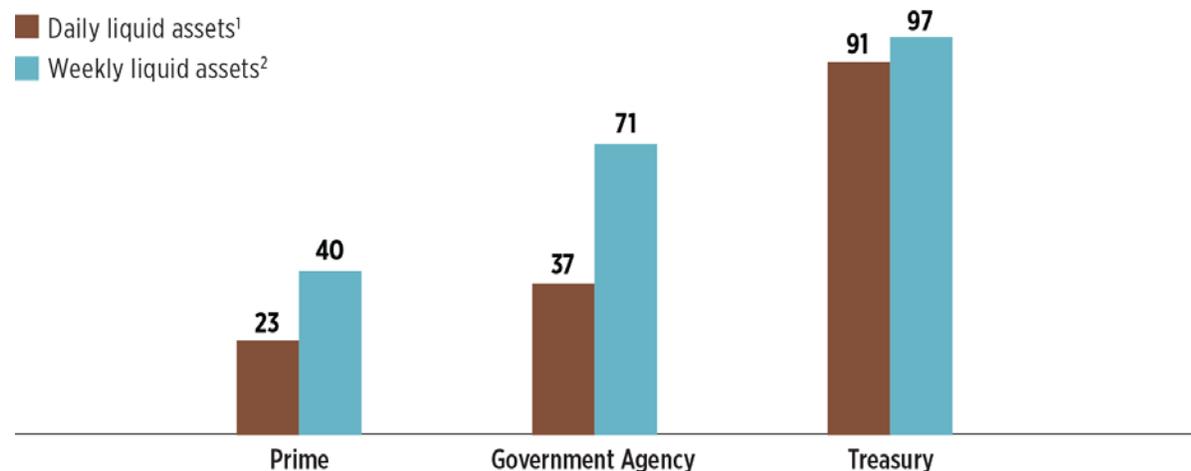
In addition, the SEC 2010 amendments directly addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. The amendments further require funds to have “know your investor” procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly. As Figure 13 shows, as of December 2010, funds’ assets exceeded the minimum daily and weekly liquidity requirements by a fair margin; 23 percent of the assets of taxable money market funds were in daily liquid assets and 40 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated \$1.4 trillion in highly liquid assets, which includes \$660 billion held by prime money market funds.<sup>20</sup> In comparison, during the business week of Monday, September 15 to Friday, September 19, 2008 (the week Lehman Brothers failed), prime money market funds experienced estimated outflows of \$370 billion.

<sup>20</sup> “Prime” money market funds are funds that may invest in high-quality, short-term money market instruments including Treasury and government obligations, CDs, repurchase agreements, commercial paper, and other money market securities. They do not include tax-exempt, government, or Treasury money market funds.

**Figure 13**

**Liquid Assets for Taxable Money Market Funds**

*Percent of total assets, December 2010*



<sup>1</sup>Daily liquid assets include securities with a remaining maturity of one business day, Treasury securities of any maturity, and securities with a demand feature that is exercisable within one business day. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for daily liquid assets.

<sup>2</sup>Weekly liquid assets include securities with a remaining maturity of five business days, Treasury securities of any maturity, government agency securities with a remaining maturity of 60 days or less (regardless of whether those securities were initially issued at a discount), and securities with a demand feature that is exercisable within five business days. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for weekly liquid assets.

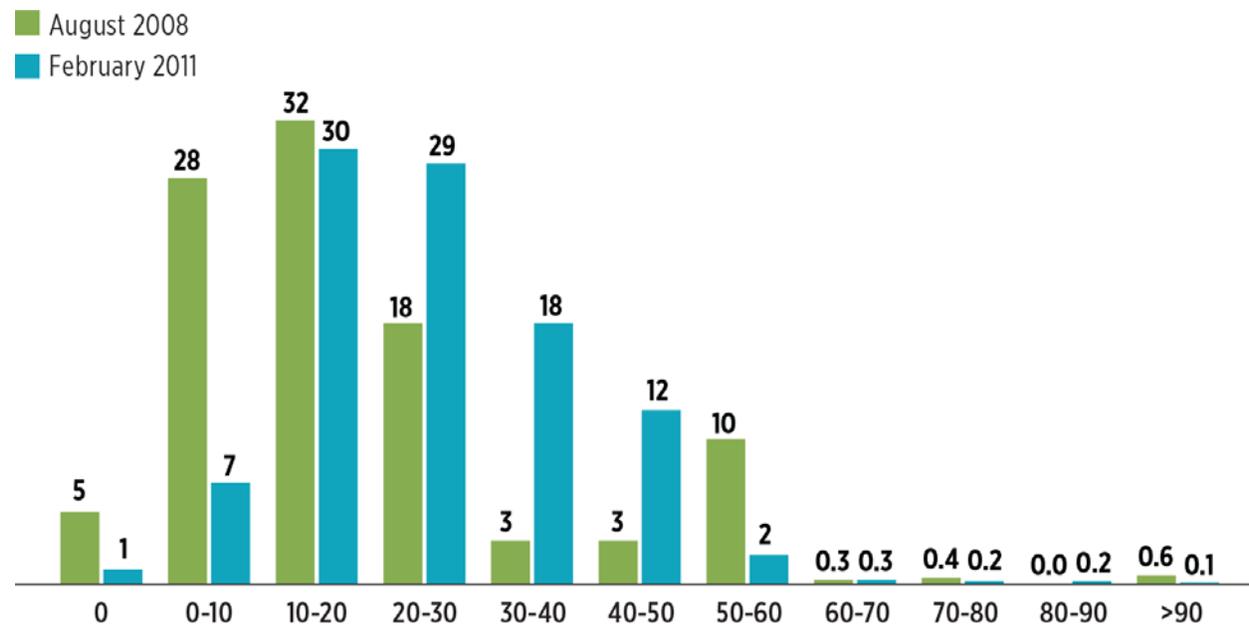
Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website, and Bloomberg

Prime money market funds appear, in part, to be meeting the minimum liquidity requirements by altering their portfolio holdings toward repurchase agreements and Treasury and agency securities. Figure 14 compares the concentration of prime money market funds' holdings of these securities in August 2008 to February 2011. From August 2008 to February 2011, the distribution shifts right, indicating that more prime money market fund assets are now in repurchase agreements and Treasury and agency securities. Indeed, money market funds often use one or seven day repurchase agreements to maintain liquidity to meet redemptions. Under Rule 2a-7 (as amended in 2010), Treasury securities automatically satisfy the daily and weekly liquidity requirements, while certain agency securities automatically satisfy the weekly liquidity requirement.

**Figure 14**

**Concentration of Prime Money Market Funds Assets by Holdings of Repo, Treasury, and Agency Securities**

*Percent of prime fund assets*



*Source: Investment Company Institute*

The rule changes also require more frequent disclosure of money market funds' holdings, so both regulators and investors will better understand funds' portfolios. In addition, the SEC took an important step to help bolster money market funds' resilience to severe market stress and redemption pressures. The SEC gave money market fund boards of directors, upon a determination of the board, including a majority of members who are independent of fund management, the ability to suspend redemptions if a fund

has broken or is about to “break the dollar”—a powerful tool to assure equitable treatment for all of the fund’s shareholders, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund. Indeed, this capability, which is available only if the board has determined to liquidate the fund, protects shareholders under extreme circumstances by ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

#### 4. Making Money Market Funds Even More Resilient

Since September 2008, both the SEC and the fund industry have made a great deal of progress toward making money market funds more resilient under extreme market conditions. In March 2009, ICI issued the *Report of the Money Market Working Group*, an industry study of the money market, of money market funds and other participants in that market, and of recent market circumstances.<sup>21</sup> The MMWG Report included wide-ranging proposals to address weaknesses in money market fund regulation. When that report was issued, ICI’s members pledged to adopt those recommendations voluntarily.

As previously described, early last year, the SEC approved far-reaching rule amendments that enhance its already-strict regime of money market fund regulation.<sup>22</sup> The SEC indicated that the amendments are designed to strengthen money market funds against certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable NAV per share.<sup>23</sup>

The search for ways to make money market funds even more secure under the most adverse market conditions did not stop, however, with the adoption of the SEC’s reforms. For example, ICI and several of its members are actively engaged in a task force sponsored by the Federal Reserve Bank of New York to strengthen the underpinnings of a vital portion of the money market—tri-party repurchase agreements. These reforms are significant not only to money market funds, which provide about one-fifth of the lending in the repurchase agreement market, but to all participants in that market.

Regulators also are actively evaluating other proposals to make money market funds less susceptible to market stresses. In a June 2009 Treasury Department paper on financial regulatory reform,<sup>24</sup> the Treasury recommended that the President’s Working Group on Financial Markets (“PWG”) prepare a report assessing whether more

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<sup>21</sup> See MMWG Report, *supra* note 8.

<sup>22</sup> See SEC 2010 amendments, *supra* note 19.

<sup>23</sup> *Id.* at 10060.

<sup>24</sup> See *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf) (“Treasury paper”).

fundamental changes were necessary to supplement SEC money market fund reforms.<sup>25</sup> The paper called for, among other things, exploring measures to require money market funds “to obtain access to reliable emergency liquidity facilities from private sources.”<sup>26</sup> In response, ICI and its members have developed a detailed framework for such a facility, including how it could be structured, capitalized, governed, and operated.

Last October, the PWG issued its report discussing several options for further reform of money market funds and recommending that the FSOC examine those options.<sup>27</sup> These options range from measures that could be implemented by the SEC under current statutory authorities to broader changes that would require new legislation, coordination by multiple government agencies, and the creation of private facilities, including a private emergency liquidity facility for money market funds as mentioned in the Treasury paper. In response to a request for comments on the report,<sup>28</sup> ICI, along with more than 90 other commenters, provided its views on the reform options outlined in the report.<sup>29</sup> There we described how an industry-sponsored emergency liquidity facility for prime money market funds<sup>30</sup> could address policymakers’ remaining concerns by serving as a liquidity backstop for those funds during times of unusual market stress. In contrast, we explained how the other options presented in PWG’s report, including forcing money market funds to abandon their objective of maintaining a stable \$1.00 share price, would not solve the problem at hand, could increase rather than decrease systemic risk, would adversely impact the market, or would result in some combination of the foregoing. In many cases, transitioning to a new approach in and of itself would have systemic risk implications.

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<sup>25</sup> Notably, the Treasury paper urged caution in this effort. In particular, it recommended that the PWG carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as investor flight from these funds into unregulated or less regulated money market investment vehicles.

<sup>26</sup> Treasury paper, *supra* note 24, at 38.

<sup>27</sup> The PWG’s report is available on the Treasury Department’s website at <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>.

<sup>28</sup> See SEC Release No. IC-29497 (November 3, 2010), available at <http://www.sec.gov/rules/other/2010/ic-29497.pdf>. More recently on May 10, 2011, the SEC hosted a roundtable on money market funds and systemic risk that consisted of SEC officials, representatives of the FSOC, and participants from academia, the business community, the fund industry, and state and local governments. Information about this roundtable is available on the SEC’s website at <http://sec.gov/news/otherwebcasts.shtml>.

<sup>29</sup> See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011), available on ICI’s website at [http://www.ici.org/pdf/11\\_sec\\_pwg\\_com.pdf](http://www.ici.org/pdf/11_sec_pwg_com.pdf).

<sup>30</sup> Based on our study of money market funds, we strongly believe that any further reforms should be limited to prime funds, as their role in the broader money market can directly affect the commercial paper market. We do not believe that other types of money market funds pose the same concerns and, in fact, government and Treasury funds saw substantial inflows during the last market crisis.

Nevertheless, the fund industry remains open to exploring additional forums that will strengthen money market funds even further against adverse market conditions and enable them to meet extraordinarily high levels of redemption requests. Given the tremendous benefits money market funds provide to investors and the economy, however, it is imperative that any additional money market fund reform measures preserve this product's essential characteristics.

#### 5. Requiring Money Market Funds to “Float” Their NAVs

Some commentators have suggested that the incentive for investors to exit money market funds rapidly during market stress would be eliminated if money market funds were forced to “float” their NAVs. Indeed, at various times, the SEC has requested public comments on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation. Out of more than 200 comment letters filed with the SEC during those comment periods, the ones that favored floating NAVs could be counted on one hand. By contrast, scores of letters opposed this idea.<sup>31</sup> Also included among those letters were many from individual investors who strongly opposed changing the fundamental nature of money market funds. Indeed, the SEC's own Investor Advisory Committee has before it a resolution that calls upon the SEC to preserve the stable NAV as a core feature of money market funds.<sup>32</sup> We are highly skeptical that such a requirement would reduce risks in any meaningful way. There is compelling evidence that a substantial portion of money market fund investors either would be unable or unwilling to use a floating NAV money market fund. As a result, the primary effect of requiring money market funds to float their NAVs would be a major restructuring and reordering of intermediation in the short-term credit markets, which would not reduce—and might well increase—systemic risk.

##### a. Impact of a Floating NAV on Preventing Investor Runs

Those urging that funds float their NAVs believe that doing so will prevent investor runs. Requiring funds to float their NAVs, however, is unlikely to achieve this goal. Under normal conditions, the shadow prices of money market funds' portfolios generally deviate very little from \$1.00. This is simply a reflection of the fact that money

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<sup>31</sup> These letters came from a broad spectrum of businesses, governments, schools, retirement plans, consumer groups, and financial services firms.

<sup>32</sup> The resolution states: “Money market funds should not be required to use a floating NAV. Money market funds play a vital role as cash management vehicles for millions of Americans and as liquidity facilities for short-term borrowers. They have an extraordinary history of stability, with only two instances of failure in three decades of regulation under Rule 2a-7. If the Commission believes that the stability of money market funds can be improved, then it should consider appropriate prudential measures. Mandating a floating NAV, however, would put the continued viability of money market funds at risk and be detrimental to the interests of America's retail investors.” The resolution and corresponding memorandum are available on the SEC's website at <http://sec.gov/spotlight/invadvcomm/iacmemo-mmf.pdf>.

market funds invest in very short-term, high-quality, fixed-income securities and the price of these securities deviates little from their amortized cost value absent a large interest rate movement or credit event.<sup>33</sup> In the event, however, of a severe market crisis brought on or associated with a sharp, unexpected change in interest rates or a major credit event, risk intolerant investors who invest in these funds would typically flee to the safest investments (*i.e.* Treasury securities) and away from other investments, regardless of whether these other investments have fixed or floating NAVs.

Indeed, the money market itself historically is susceptible to liquidity pressures. Lenders in this market typically need ready access to their cash and have a low tolerance for financial risk. Borrowers depend on these markets to meet their immediate funding needs. Rollover issuances are a very high percentage of the outstanding short-term securities. During periods of financial stress, risk intolerant investors can and do move quickly out of the markets, leaving large supply and demand imbalances, which can cause volatility in short-term interest rates. These patterns existed long before money market funds developed in the 1970s.

The combination of these factors results in the money market and money market funds operating for long periods of time in relative tranquility punctuated by stress events. Investors' desire to have exposure to the money market, either directly or through money market funds, declines during these periods of stress. Opponents of stable NAV money market funds argue that floating the NAV would reduce the likelihood of investors wanting to move away from the money market during these events. We disagree.

Assuming, for the sake of argument, that a floating NAV money market fund would attract a substantial base of investors,<sup>34</sup> the same motivations to shift away from certain areas of the market would remain and could lead to investor withdrawals in a future widespread financial crisis. As discussed in the MMWG Report, ultra-short bond funds illustrate how this can occur outside of money market funds. While ultra-short bond funds are not required to follow Rule 2a-7, they do invest in a portfolio of relatively short-dated securities. In contrast with money market funds, however, the NAV of an ultra-short bond fund fluctuates. Beginning in the summer of 2007, the average NAV on these funds began to fall (Figure 15). By the end of 2008, assets of these funds were down more than 60 percent from their peak in mid-2007.

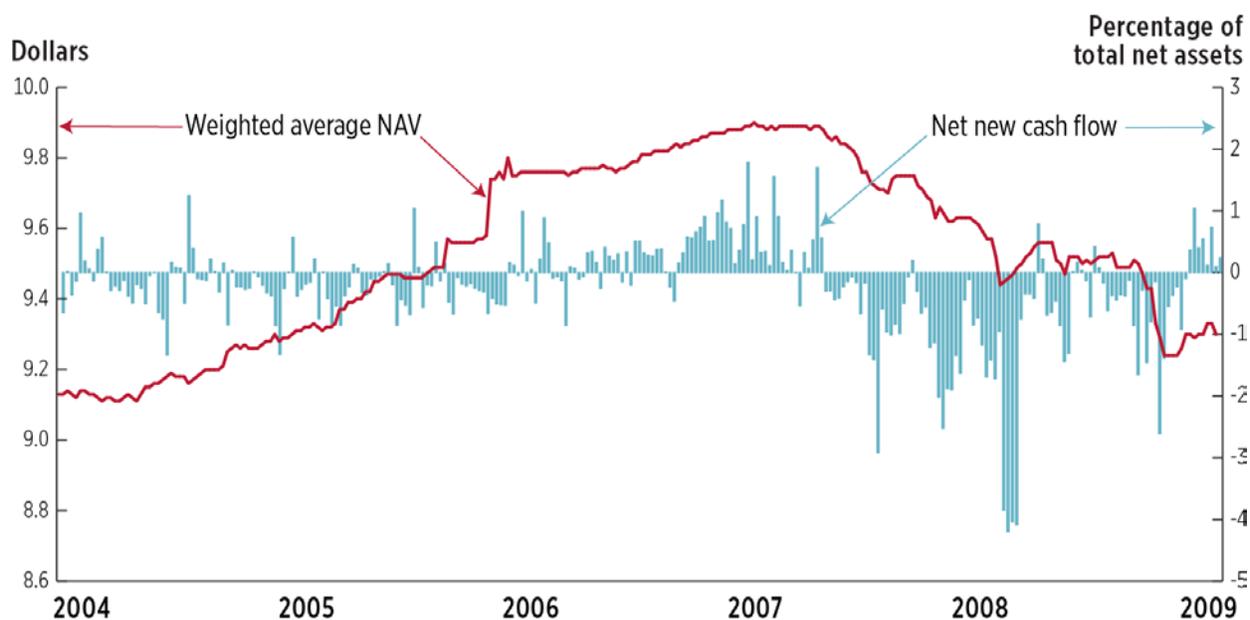
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<sup>33</sup> See *Pricing of U.S. Money Market Funds*, *supra* note 15.

<sup>34</sup> As discussed below, we strongly believe that the vast majority of money market fund investors would reject outright, or substantially reduce their holdings in, a floating-NAV money market fund.

**Figure 15**

**Weighted Average NAV and Net New Cash Flow of Ultra-Short Bond Funds**  
Weekly



Sources: Investment Company Institute and Morningstar

The experience in Europe of certain money funds likewise demonstrates that floating NAV funds also can face strong investor outflows during periods of market turmoil. For example, French floating NAV dynamic money funds (or *trésorerie dynamique* funds), lost about 40 percent of their assets over a three-month time span from July 2007 to September 2007.<sup>35</sup>

For these reasons, we remain doubtful that floating the NAV on money market funds would reduce risks in any meaningful way. Also, as we discuss below, prohibiting money market funds from maintaining a stable NAV would likely lead to the demand for less regulated products that seek to maintain a stable NAV, and would therefore simply shift the risk to a more opaque and less regulated part of the market.

b. Investor Demand for a Stable NAV Fund Would Remain

The elimination of a stable NAV would be a dramatic change for money market funds. One very significant concern is whether investors would continue to use such a product. For a substantial number of investors, the answer is no.

<sup>35</sup> For a more detailed discussion of the experience of certain money and bond funds in Europe, see MMWG Report, *supra* note 8, at 106-107.

Many institutional investors that use money market funds would be unable to use a floating NAV fund. These investors often face legal or other constraints that preclude them from investing their cash balances in pools that do not seek to maintain a stable NAV. For example, corporations may have board-approved policies permitting them to invest operating cash (balances used to meet short-term needs) only in pools that do not fluctuate in value. Indentures and other trust documents may authorize investments in money market funds on the assumption that they seek to maintain a stable NAV. Many state laws and regulations also authorize municipalities, insurance companies, and other state regulated entities to invest in stable NAV funds, sometimes explicitly including funds operating in compliance with Rule 2a-7. Thus, absent a stable NAV, many state and local governments would no longer be able to use money market funds to help manage their cash.<sup>36</sup>

Even those investors who do not face such constraints nevertheless may be unwilling to invest in a floating NAV product. A stable NAV offers significant convenience in terms of tax, accounting, and recordkeeping. For example, all of a money market fund's returns are distributed to shareholders as income. This relieves shareholders of having to track gains and losses, *including* the burden of having to consider the *timing* of sales and purchases of fund shares (*i.e.*, wash sale rule considerations). To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors make fewer purchases and sales from long-term mutual funds and, in any case, many such purchases (or exchanges) are made within tax-advantaged accounts (*e.g.*, 401(k) plans), where such issues do not arise.

A floating NAV also would reduce the value and convenience of money market funds to individual retail investors. For example, brokers and fund sponsors typically offer investors a range of features tied to their money market funds, including checkwriting and ACH and fedwire transfers. These features are generally only provided for stable NAV products. Thus, elimination of the stable NAV for money market funds would likely force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

The current rate environment has proven to be an important test of investor demand for stable NAV funds. Currently, yields on money market funds are 150 basis points below short-duration bond funds, and 300 to 500 basis points below longer term bond funds. Yet, outflows from money market funds have slowed sharply, and since July 2010, assets in money market funds have hovered between \$2.7 trillion and \$2.8 trillion, *greater* than the assets held in money market funds in July 2007, prior to the start of the financial crisis.

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<sup>36</sup> See generally MMWG Report, *supra* note 8, at Appendix D.

Indeed, a diverse range of investors in money market funds previously have communicated their opposition to floating NAVs directly to the SEC. The stable \$1.00 NAV, as the Association of Public and Land-Grant Universities told the SEC in September 2009, provides a “low-cost, convenient, and reliable cash management tool.”<sup>37</sup> Investors, added the American Bankers Association in its comment to the SEC, “understand and appreciate the accounting treatment offered by stable NAV funds.”<sup>38</sup>

The State of Rhode Island’s General Treasurer has told the SEC that “[a] floating NAV will likely reduce investment yields as it increases complexity and drives up administrative costs.”<sup>39</sup> His comment was echoed by a letter to the SEC from the Pennsylvania School District Liquid Asset Fund, which said that a floating NAV would lead to “needless complication of the reporting systems of public schools and local government entities to reflect variations of value that are inconsequential.”<sup>40</sup> Similarly, a floating NAV, in the words of the National Association of State Treasurers, could “potentially destabilize financial markets for both investors and debt issuers.”<sup>41</sup> More recently at the SEC’s May 10, 2011 roundtable on money market funds and systemic risk, Harford County, Maryland’s Treasurer (representing the Government Finance Officers Association) called the stable NAV for money market funds “extremely important” to her department’s mission of maintaining principal for operating cash and noted that “[i]f we have fluctuating NAV, my government won’t be in it.”<sup>42</sup> The Senior Vice President and Treasurer of CVS Caremark echoed this point by stating that she “will not invest in a floating NAV product” and noted that her treasury systems are not equipped to mark assets to market on a day-to-day basis.<sup>43</sup>

Furthermore, surveys of money market fund investors indicate clearly that most investors do not want and would not use a floating NAV product. For example, a survey of institutional cash managers indicated that more than half would decrease *substantially*

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<sup>37</sup> See Letter from Peter McPherson, President, Association of Public and Land-Grant Universities, to Elizabeth M. Murphy, SEC, available at <http://www.sec.gov/comments/s7-11-09/s71109-48.pdf>.

<sup>38</sup> See Letter from Lisa J. Bleier, Vice President and Senior Counsel Center for Securities, Trust and Investments, American Bankers Association, to Elizabeth Mr. Murphy, SEC, available at <http://www.sec.gov/comments/s7-11-09/s71109-107.pdf>.

<sup>39</sup> See Letter from Frank T. Caprio, General Treasurer, State of Rhode Island and Providence Plantations, to Elizabeth M. Murphy, SEC, available at <http://www.sec.gov/comments/s7-11-09/s71109-147.pdf>.

<sup>40</sup> See Letter from Thomas R. Schmuhl, Duane Morris LLP, on behalf of the Board of Trustees of the Pennsylvania School District Liquid Asset Fund, to Elizabeth M. Murphy, SEC, available at <http://www.sec.gov/comments/s7-11-09/s71109-109.pdf>.

<sup>41</sup> See Letter from James B. Lewis, New Mexico State Treasurer and President, National Association of State Treasurers, to Timothy Geithner, Secretary of the Treasury (July 2, 2010).

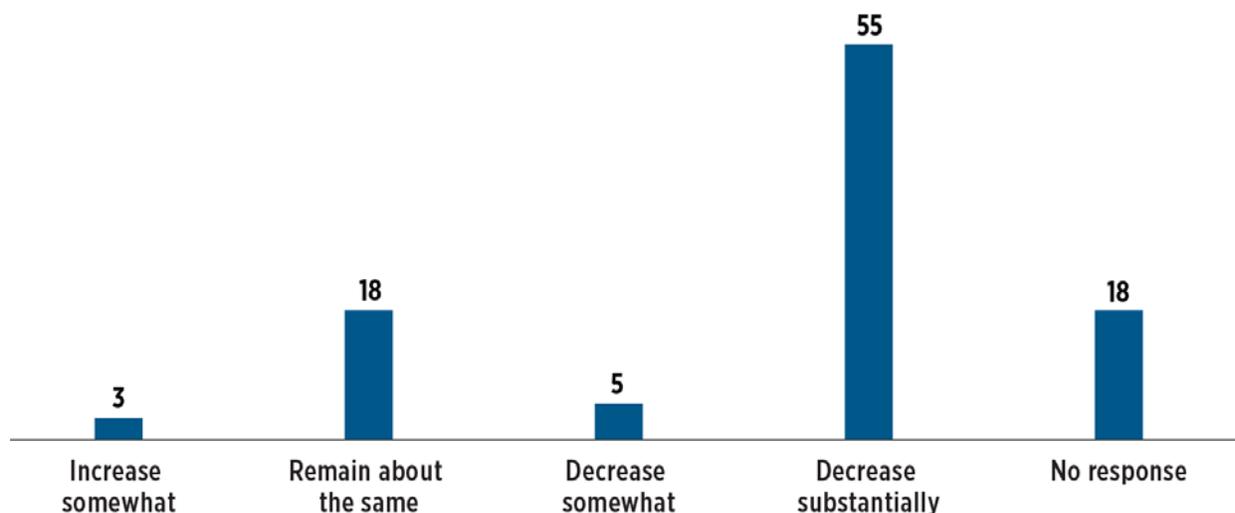
<sup>42</sup> See SEC Roundtable discussion at <http://sec.gov/news/otherwebcasts.shtml>.

<sup>43</sup> *Id.*

their use of money market funds if money market funds are required to have a floating NAV (Figure 16).

**Figure 16**

**Institutional Cash Managers' Expected Usage of Floating NAV Money Market Funds**



*Note: Percentages do not add to 100 percent because of rounding.*

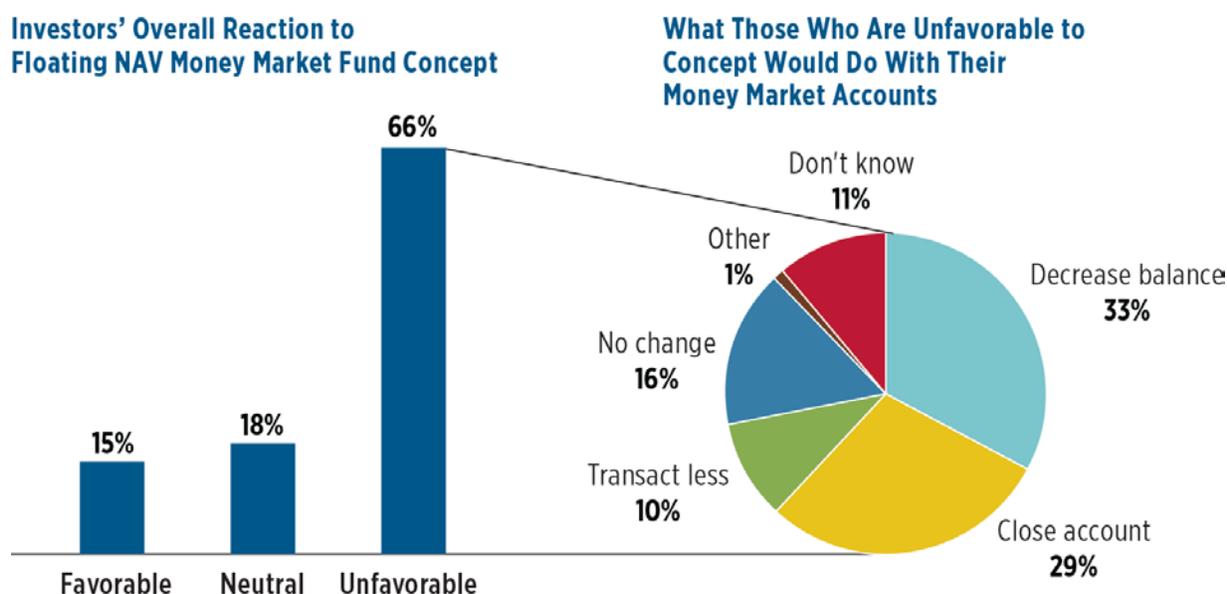
*Source: Treasury Strategies Inc. flash survey of 78 institutional cash managers on January 30, 2009. Of the 78 institutional cash managers, 43 were commercial, 13 were education-related, 13 were private, four were state and local governments, four were financial institutional, and one was unclassified.*

A recent survey of retail money market fund investors commissioned by T. Rowe Price and conducted online by Harris Interactive indicated much the same response (Figure 17).<sup>44</sup>

<sup>44</sup> Based on a study commissioned by T. Rowe Price and conducted online by Harris Interactive from August 31 to September 7, 2010 of 413 adults aged 35-75 who own money market funds outside of a retirement plan, who also own at least one long-term mutual fund, who invest directly with a mutual fund company, do not rely solely on the advice of an investment adviser, and have \$100,000 or more in investable assets. The data are weighted to be representative of the adult population with \$100,000 or more in investable assets. A full methodology is available upon request.

Figure 17

**Retail Investors' Reaction to Floating NAV Money Market Funds**



Source: Harris Interactive / T Rowe Price

Two thirds of retail investors surveyed found the idea of a floating NAV money market fund unfavorable. Among those who found the concept unfavorable, 72 percent indicated that they would use the product less, and that their most likely response would be to close their money market fund accounts (29 percent), decrease their money market fund balances (33 percent), or execute fewer money market fund transactions (10 percent). A third survey, conducted among both retail and institutional shareholders by Fidelity Investments, found much the same result. This survey found that institutional investors overwhelmingly (78 percent) disliked the idea of a floating NAV product and would use money market funds less or not at all (69 percent of 78 percent) if faced with the prospect of a floating NAV. Retail investors also disliked the floating NAV concept. Forty percent of the retail investors surveyed disfavored the floating NAV concept; however, when informed of the adverse tax consequences, the percent disfavoring jumped to over sixty percent.<sup>45</sup> In short, there is good reason, backed by data, to believe that investors do not want and will likely reject a floating NAV money market fund.

<sup>45</sup> The Fidelity survey of retail investors and institutional investors was coordinated by Northstar Research Partners in conjunction with Fidelity Consulting Group in August 2009.

### c. Floating the NAV Would Harm the Market

The primary, and perhaps only, effect that floating the NAV of money market funds would have on the financial system would be a major restructuring and reordering of intermediation in the short-term credit markets. This would not reduce systemic risk and might well increase it.

Assets in money market funds now total \$2.7 trillion. As indicated, money market fund investors of all types are unlikely to use a floating NAV product. Requiring money market funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. This transition, in and of itself, could be systemically risky. It would require money market funds to shed hundreds of billions of dollars of commercial paper, bank CDs, Eurodollar deposits, repurchase agreements, and other assets. Even under the calmest of financial market conditions, this would be a highly tricky process. During a period of stress in the money market, such a transition could well set off the kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs will merely shift credit intermediation from one type of product to others; it will not reduce systemic risk. There are a number of alternative products that money market fund investors could use, including, as listed above, enhanced cash pools, offshore money funds, and other vehicles that seek to maintain a stable unit price but are not regulated under the Investment Company Act. Regulatory changes that push assets from regulated products (*e.g.*, money market funds) to less regulated products arguably would serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.<sup>46</sup>

Indeed, investors have the ability through banks to select among various sweep arrangements that seek to offer a stable unit value, such as money market fund sweeps, repurchase agreement sweeps, commercial paper sweeps, and, importantly, sweeps into offshore (non-money market fund) accounts (*e.g.*, Eurodollar sweeps).<sup>47</sup> If a stable NAV is eliminated for money market funds, investors can migrate to these other kinds of sweep accounts, which in some cases (*e.g.*, Eurodollar sweeps) are largely beyond the jurisdictional reach of domestic regulators.

Such an exodus from money market funds would not reduce systemic risk, but simply transfer it elsewhere and may, in fact, serve to increase systemic risk. Institutional investors that use these money market fund substitutes would likely exit them quickly in a crisis, seeking the safety of Treasury securities. The end result would still be a freeze in the commercial paper, repurchase agreement, or Eurodollar markets.

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<sup>46</sup> See MMWG Report, *supra* note 8, at 62-64.

<sup>47</sup> For a general discussion of overnight sweep arrangements, see MMWG Report, *supra* note 8, at 43-44.

Opponents of stable NAV money market funds suggest that requiring money market funds to float their NAVs could encourage investors to shift their liquid balances to bank deposits. We believe that this effect is overstated, particularly for institutional investors. Corporate cash managers and other institutional investors would not view an undiversified holding in an uninsured (or underinsured) bank account as having the same risk profile as an investment in a diversified short-term money market fund. Such investors would continue to seek out diversified investment pools, which may or may not include bank time deposits.

To the extent that investors would hold deposits in conventional banks, unless these deposits were fully insured, either explicitly or implicitly, institutional investors would likely run during a serious crisis. Insuring these deposits would entail a major increase (perhaps as much as \$2 trillion) in the federal government's potential insurance liability and would result in a vast increase in moral hazard, a development that would simply increase systemic risk. To protect against a run, banks would then need to hold more liquid and higher quality assets in order to meet the requirements of this funding source, especially if institutional investors became concerned about counterparty risk and sought to withdraw their deposits during periods of financial stress. To the extent that banks did not increase their liquidity, systemic risk could increase.

In addition, a shift to traditional banks would result in a significant reduction in the supply of short-term credit to corporate America unless banks raised significant amounts of capital to be able to support their expanded balance sheets. Even if they could raise the capital to support this expansion, the market would be less efficient and the cost of short-term credit would rise. Furthermore, municipalities would lose an important source of financing in the short-term markets because banks cannot pass through tax-exempt income and simply could not replace tax-exempt money market funds.

Not surprisingly, issuers of money market securities have expressed serious concerns about the disruptive effects in the market for their securities should regulatory reforms diminish the role played by money market funds.<sup>48</sup> In sum, investors will

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<sup>48</sup> For example, in its letter to the SEC in September 2009, the National Association of College and University Business Officers has warned the SEC that loss of a stable NAV investment option "could alter both the number of investors and the amount of capital that could be invested in debt issued by colleges and universities, potentially raising the cost of capital for our members." See Letter from John D. Walda, President and CEO, National Association of College and University Business Officers, to Elizabeth M. Murphy, SEC, available at <http://www.sec.gov/comments/s7-11-09/s71109-127.pdf>. More recently, a diverse group of 16 companies that rely on money market funds to support their capital raising and investment needs, as well as six associations, wrote to the SEC to express their view that "American business will lose one of its most important sources of short-term funding if money market funds are forced to abandon their stable per-share value." See Letter from Agilent Technologies, Inc., Air Products & Chemicals, Inc., Association for Financial Professionals, The Boeing Company, Cadence Design Systems, CVS Caremark Corporation, Devon Energy, Dominion Resources, Inc., Eastman Chemical Company, Eli Lilly & Company,

continue to demand a stable NAV money market fund or money market fund-like product. And one way or another, financial markets will find a way to deliver it.

## 6. Money Market Fund Reform—Next Steps

ICI and its members have devoted much effort since fall 2008 to identifying ways to strengthen money market funds against future market shocks. Much progress has been made, including the SEC's extensive amendments to its rules in early 2010. We are committed to continuing to work with regulators as they consider additional ways of achieving this objective. We submit that any such reforms should first, preserve those features of money market funds (including the stable \$1.00 per share NAV) that have proven so attractive and valuable to investors; and second, avoid imposing costs that will undercut the ability or willingness of large numbers of investment advisers to continue to sponsor these funds.<sup>49</sup> Otherwise, we will put at risk the enormous benefits that money market funds provide to the economy.

We, of course, will keep the Subcommittee apprised as the industry and regulators continue to examine issues related to one of our country's most successful financing vehicles.

### B. Systemic Risk Regulation

A second major area of concern to the fund industry relates to systemic risk regulation and the potential that some funds or advisers could be designated as systemically important. Since the beginning of the debate over the shape and scope of financial services regulatory reform, ICI has been a strong proponent of improving the U.S. government's capability to monitor and mitigate risks across our nation's financial system.<sup>50</sup> As both issuers of securities and large investors in U.S. and international

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Financial Executives International's Committee on Corporate Treasury, FMC Corporation, Institutional Cash Distributors, Kentucky Chamber of Commerce, Kraft Foods Global, Inc., National Association of Corporate Treasurers, New Hampshire Business and Industry Association, Nissan North America Inc., Pacific Gas and Electric Company, Safeway Inc., Weatherford International, Ltd., U.S. Chamber of Commerce to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011) (letter in connection with SEC's request for comment on the PWG's report), available at <http://www.sec.gov/comments/4-619/4619-32.pdf>.

<sup>49</sup> The current environment of near-zero short-term interest rates—which stems from the Federal Reserve pursuing a target federal funds rate of 0 to 25 basis points in order to bolster the economy—is already posing a significant financial cost on fund advisers. In this environment, yields on money market funds before fees have been virtually zero. In order to keep fund yields above zero *after* fees, about 90 percent of the share classes of money market funds have recently waived some or all of the funds' operating expenses. These waivers, which are absorbed by funds' advisers, cost advisers an estimated \$3.6 billion in 2009 and another \$4.5 billion in 2010.

<sup>50</sup> See, e.g., Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at [http://www.ici.org/pdf/ppr\\_09\\_reg\\_reform.pdf](http://www.ici.org/pdf/ppr_09_reg_reform.pdf); Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of

financial markets, ICI member funds are keenly interested in policies that promote a well-functioning financial system able to withstand the periodic shocks that are an inevitable part of our complex, global marketplace.

As a starting point, we wish to emphasize that all financial market activities involve some degree of risk. Indeed, the ability of market participants to spread, share, or take on risk through the financial markets is a prime characteristic of vibrant and innovative economies. Thus, the goal of systemic risk regulation should be to eliminate the abuses and excessive risk taking that can endanger the financial system, while at the same time encouraging acceptable levels of the risk taking that are disclosed and necessary for innovation and economic growth.

#### 1. SIFI Designations Should Be Made Deliberatively

The Dodd-Frank Act provides regulators many new tools to address abuses and excessive risk taking by financial market participants. These include tools that will affect financial institutions generally (*e.g.*, comprehensive regulation of the OTC derivatives market, stress tests) and those targeted either to eliminate excessive risk taking in, or to improve regulatory oversight over, specific sectors (*e.g.*, regulation of private fund advisers, swaps push-out rule).

Our financial system and its participants are nothing if not dynamic, however, and the rules set in place today, no matter how well crafted, will not necessarily prevent all of the unforeseen problems of tomorrow. The Dodd-Frank Act therefore gives the new Financial Stability Oversight Council (“FSOC”) the authority to identify gaps in regulation and make recommendations to financial regulators, standard-setting bodies and Congress. Further, the critical monitoring function of the FSOC, with the help of the new Office of Financial Research, is intended to provide the capability to detect new buildups of risk in the financial system, allowing regulators to address changing circumstances before systemic problems develop.

The most well known—and controversial—of the FSOC’s powers is its authority under Section 113 of the Dodd-Frank Act to designate systemically important nonbank financial companies, or “SIFIs,” for heightened prudential regulation and consolidated supervision by the Federal Reserve Board. The FSOC’s ability to determine that an individual company poses potential risk to the entire U.S. financial system—and the additional regulatory scrutiny that would flow from that determination—is an extraordinarily potent legal authority. Accordingly, it is one that should be used with great care. Specifically, ICI believes that the designation of individual companies for heightened supervision should be reserved for those circumstances, presumably quite

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Representatives Committee on Financial Services on “Industry Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals” (July 17, 2009), available at [http://www.ici.org/govaffairs/testimony/09\\_reg\\_reform\\_jul\\_tmny](http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny) (“Stevens July 2009 Testimony”).

limited, when the FSOC has determined that a specific company poses significant risks to the financial system that clearly cannot otherwise be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act.

As discussed more fully in our comments to the FSOC, there are several reasons why ICI believes that SIFI designations should be limited in number.<sup>51</sup> First, it will be very difficult for regulators to determine *in advance* which nonbank institutions are, or may prove to be, systemically significant. Second, the heightened requirements to which SIFIs would become subject largely reflect banking regulation concepts. Even if a nonbank financial company were to present some of the characteristics of being systemically risky, applying prudential standards that are not tailored to the specific risks presented by that company would have little actual value and may even be detrimental to the financial system and macroeconomy.

Third, from a systemic perspective, there is a high level of uncertainty as to how the markets and market participants may react to the designation of a company as systemically significant. Such a designation could signal that the government views the company as unsafe and might increase the company's cost of financing if market participants become reluctant to transact with it. Alternatively, because the designation would result in heightened oversight, this could make the company appear to be a safer bet than its non-designated competitors and provide a competitive advantage in terms of access to lower cost financing. Fourth, the designation could increase moral hazard as it might carry with it a dangerous expectation by market participants that the Federal Reserve Board and the FSOC will be able to mitigate any risks that a designated company may pose to the broader markets.

Finally, there are other potential costs and unintended consequences associated with using this authority too broadly, such as reduced competition and consumer choice. It is also possible that financial companies might be tempted to shift to less regulated jurisdictions and products.

Given these challenges and possible negative consequences, we reiterate our view that the FSOC should reserve this authority for situations that cannot be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act.

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<sup>51</sup> See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010, available at <http://www.ici.org/pdf/24696.pdf> ("November 2010 FSOC Letter").

2. Funds and Their Investment Advisers Do Not Present the Risks That SIFI Designation is Intended to Address

Pursuant to Section 113 of the Dodd-Frank Act, SIFI designation is intended only for a nonbank financial company that could pose a threat to U.S. financial stability, either because of material financial distress at the company or the “nature, scope, scale, size, concentration, interconnectedness or mix” of its activities. For the reasons discussed below, ICI firmly believes that funds simply do not pose such threats, and accordingly, SIFI designation is neither warranted nor appropriate for an individual fund. The same can be said for investment advisers in their capacity as advisers to funds.

Funds are among the most highly regulated and transparent financial companies in the United States. They are subject to all four of the major federal securities laws, including the Investment Company Act. Although that Act was designed to protect shareholders, it also contains strong systemic risk-limiting provisions. These include:

- **Limits on Leverage and Capital Structure:** The Investment Company Act prohibits complex, unfair, or unsound capital structures. Mutual funds are subject to significant limitations on their ability to use leverage. Under the Investment Company Act, the maximum ratio of debt-to-assets allowed by law for a mutual fund is 1-to-3, which translates into a maximum allowable leverage ratio of total assets-to-equity of 1.5 to 1.
- **Disclosure and Transparency:** The Investment Company Act ensures that the market and investors have access to extensive information about each fund, including its strategy and investment risks as well as information on its current activities. In contrast, the marketplace simply does not have access to anything even approaching this degree of transparency about banks and their holdings. In fact, some believe that the opacity of banks’ balance sheets contributed to the spread and severity of the recent financial crisis.<sup>52</sup>
- **Valuation and Liquidity:** Funds provide their investors with liquidity and an objective, market-based valuation of their investments. Mutual fund shares are redeemable on a daily basis at a price that reflects the current market value of the fund’s portfolio securities, which value must be determined in accordance with Investment Company Act requirements. Further, the SEC takes the position that mutual funds should not invest in illiquid securities if doing so would cause the fund to have less than 85 percent of its assets in liquid securities. These requirements are essential to promoting investor and market confidence, and

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<sup>52</sup> See, e.g., *The Financial Crisis of 2008 in Fixed Income Markets*, Gerald P. Dwyer and Paula Tkac, Working Paper 2009-20, Federal Reserve Bank of Atlanta (August 2009).

serve to ensure that investors, counterparties, and others are able to understand easily the actual valuations of funds' portfolios.

- **Transactions with Affiliates:** The Investment Company Act contains detailed prohibitions on transactions between a fund and its insiders or affiliated persons (such as the corporate parent of the fund's adviser). These prohibitions are intended to prevent over-reaching and self-dealing. In so doing, they serve to protect investors and promote investor confidence in funds.
- **Diversification:** Both the Internal Revenue Code and the Investment Company Act provide diversification standards for mutual funds. In contrast, for example, a bank deposit (over any insured amounts) is subject to the single counterparty risk that the bank may fail.
- **Custody of Fund Assets:** The Investment Company Act has specific custody rules requiring strict care of a fund's assets. These provisions protect investors from theft or misappropriation of their investments.

In our view, these characteristics of funds should be a sufficient basis on which to conclude that SIFI designation is not warranted or appropriate for an individual fund. Nevertheless, Section 113 is written broadly and could conceivably be applied to any type of nonbank financial company. For this reason, ICI has provided extensive written comment to the FSOC as it seeks to develop the process by which it will designate certain nonbank financial companies for heightened supervision.

Central to an inquiry under Section 113 are the various criteria that Congress directed the FSOC to consider. In our November 2010 letter to the FSOC, ICI analyzed the criteria in detail, focusing on those we believe to be the greatest indicators of the potential to pose systemic risk.<sup>53</sup> We were pleased that the FSOC, in its release proposing rules under Section 113, described an analytical framework that largely comports with ICI's analysis. This framework—which we have urged the FSOC to incorporate into its final rule—maps each of the specific criteria in Section 113 to one of six broad categories. As the release indicates, the six categories identified by the FSOC (size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) reflect different dimensions of a company's potential to pose risk to the financial system.

Summarized below are ICI's primary observations about the six FSOC categories, with particular emphasis on how they should apply specifically to funds and their investment advisers:

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<sup>53</sup> See November 2010 FSOC Letter, *supra* note 51.

- **Size:** A company's size alone reveals very little about its potential to pose risk to the financial system and, consequently, could be highly misleading if considered in isolation. In assessing a company's size as part of its overall analysis, the FSOC should focus on the size of the company's potential on- and off-balance sheet risks, and the impact on the U.S. financial system of potential losses. In the case of a company that manages assets owned by others, there are several clear reasons why the managed assets should not be attributed to the company. With regard to a fund's investment adviser, these reasons include: (1) the fund is a separate legal entity; (2) shareholder recourse for losses is solely with respect to the fund, absent wrongdoing on the part of the adviser; (3) the adviser cannot pledge the fund's assets to advance its own interests; (4) the adviser does not take on leverage to manage the fund's portfolio; and (5) the adviser must manage the fund's assets as a fiduciary and in accord with the fund's own investment objectives and restrictions.
- **Lack of Substitutes:** Captured within this category is a company's importance as a source of credit (*e.g.*, for households, businesses, and state and local governments). A company is more likely to pose systemic risk if it is a single or primary source of credit for such purposes and no other financial intermediaries can step in as alternate sources of financing. A crucial additional consideration is whether the credit is funded through debt or equity, with the latter posing considerably less risk to the financial system. While funds are significant providers of credit—to state and local governments, U.S. financial and operating companies, the U.S. Treasury, Fannie Mae and Freddie Mac—no one fund is a primary or sole source of credit to any of these markets and the vast majority of this credit is funded by paid-in capital (equity) from fund shareholders.
- **Interconnectedness:** The key issue appears to be whether a financial firm's failure could force a disorderly unwinding of the firm's on- and off-balance sheet positions and spark a cascade of failures among the firm's counterparties that then spread to the counterparties of those firms. Interconnectedness poses the greatest risk when it is coupled with leverage, either of the firm itself or its counterparties. Funds' interactions with shareholders and participation as counterparties in financial transactions pose very modest risks because funds have little or no leverage.
- **Leverage:** As history amply demonstrates, companies that are highly leveraged pose greater potential risk to the financial system. For example, when one highly leveraged firm holds the debt of another highly leveraged firm, losses can mount exponentially and spread quickly. As required by law, most mutual funds operate with little if any leverage and segregate liquid assets (or maintain offsetting positions) in order to meet their obligations in leverage transactions. This has the effect of tightly constraining the risks a fund might pose to the financial markets.

- **Liquidity Risk and Maturity Mismatch:** Generally speaking, financial institutions holding assets that can be sold quickly at a price approximating fundamental value are more resilient to economic shocks. Such assets give those institutions the flexibility to respond quickly to the kinds of rapidly changing economic circumstances that are common during financial crises. By contrast, institutions holding assets that do not trade in deep secondary markets may tend to pose more of a systemic concern. As noted above, in order to maintain liquidity for ordinary redemptions, mutual funds must hold at least 85 percent of their portfolios in “liquid securities,” which are defined as any assets that can be disposed of within seven days at a price approximating market value. As a result, mutual funds can—and do—routinely handle large flows (purchases, exchanges, and redemptions) without perceptible consequences to the broader financial system.
- **Existing Regulatory Scrutiny:** A financial company that already is highly regulated is more likely to have robust internal controls and compliance procedures. Moreover, its primary regulator is the “subject matter expert” regarding the applicable regulatory scheme, and will be knowledgeable about the industry of which the company is a part, industry best practices, areas of regulatory concern, and the markets in which the company operates. These circumstances may militate against the need for imposing additional regulation by the Federal Reserve Board, as is required for any company designated by the FSOC under Section 113. Further, the FSOC should look specifically at the degree to which the regulatory requirements already applicable to that company serve to limit or control risk. As a general matter, a financial company that must already adhere to risk-limiting requirements is less likely to warrant a SIFI designation. As discussed above, funds are subject to comprehensive regulation, including risk-limiting requirements, under the Investment Company Act. Fund investment advisers also are highly regulated.

We understand that the FSOC is continuing to refine its thinking and may seek further comment before adopting final rules under Section 113. We recognize the difficulty inherent in fashioning an appropriate analytical framework to guide the FSOC's decision making in this area and we are hopeful that, with the benefit of additional public input, the FSOC will be able to develop rules that give market participants greater clarity as to how the SIFI designation process is likely to work.

### 3. SIFI Designation is Not Appropriate for Money Market Funds

In comments to the FSOC, some have suggested that certain (presumably larger) money market funds should be designated for heightened supervision pursuant to Section 113. In response, ICI has explained to the FSOC that such designation would *not*

be an appropriate regulatory tool for further strengthening the resilience of money market funds to severe market distress.

The six broad categories identified in the proposed FSOC framework (size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) apply to money market funds in a manner that is similar to mutual funds generally, as outlined above. In fact, money market funds must comply with an additional set of regulatory requirements beyond the comprehensive requirements of the Investment Company Act to which all registered investment companies are subject. These legal requirements include stringent credit quality, liquidity, maturity, and diversification standards. The basic objective of money market fund regulation is to limit a fund's exposure to credit risk, interest rate risk, liquidity risk, and the risk that certain shareholders may act precipitously to seek large redemptions.

As discussed in Section 2.A.3 above, the SEC has adopted significant enhancements to these requirements. Reflecting the lessons learned from the recent financial crisis, these regulatory enhancements are designed to better enable money market funds to withstand certain short-term market risks.

As noted above, ICI and its members are committed to working with regulators to identify an appropriate way to bolster money market funds yet further against severe market stress. Designating each of the 642 money market funds, or even each of the 273 prime money market funds, offered in the U.S. market as a SIFI and subjecting each to ongoing prudential supervision by the Federal Reserve Board is not the way to accomplish this. Nor does it make sense to pick and choose among money market funds or complexes for this purpose, or to designate a fund adviser solely on the basis of its money market fund activities.

Last October, the PWG issued its report discussing several options for further reform of money market funds and recommending that the FSOC examine those options.<sup>54</sup> Nowhere in its detailed and thoughtful analysis of money market funds, however, did the PWG even suggest that the FSOC consider taking a fund-by-fund, complex-by-complex, or adviser-by-adviser approach under Section 113. Indeed, quite apart from SIFI designation, there is ample regulatory authority to craft additional reforms if deemed necessary. This includes both the wide-ranging authority accorded the SEC under the securities laws as well as other powers entrusted to the FSOC under Sections 112 and 120 of the Dodd-Frank Act.<sup>55</sup> To the extent the FSOC has any remaining

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<sup>54</sup> See *supra*, note 27.

<sup>55</sup> Section 112 of the Dodd-Frank Act gives the FSOC the authority to, among other things: (1) facilitate information sharing and coordination among the FSOC member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions; (2) recommend to the member agencies general supervisory priorities and principles; and (3) identify gaps in regulation that could pose risks to the financial stability of

concerns with respect to money market funds, we urge it to evaluate and implement any additional reforms (whether to prime money market funds or money market funds generally) on an industry-wide basis.

### C. Dealing with Multiple Regulators and the Potential for Regulatory Conflict

A third broad area of concern to funds is the potential for regulatory conflict and the compliance burdens posed by the multiplicity of regulators to which they are subject. Increasingly, funds face regulation, or the potential for regulation, from multiple agencies. At its worst, this dynamic could result in irreconcilable regulatory conflicts, where funds are subject to rules imposed by different regulators that simply are at odds with one another. More frequently, the result is a regulatory hodgepodge – when one agency pursues its perceived regulatory mandate without regard to closely related actions underway at another agency or to the implications of divergent standards; or when an agency addresses regulatory policy concerns only with respect to a specific product without regard to the way in which identical concerns arise with respect to other, competing products. Four recent examples highlight these problems:

- The proposed amendments to CFTC Rule 4.5, which if adopted would subject funds (or their advisers) to directly conflicting requirements by the CFTC and SEC;
- The ongoing debates over fiduciary duties at the Department of Labor (DOL) and the SEC, which are proceeding on completely separate tracks;
- Disclosure initiatives at the SEC and FINRA relating to potential broker conflicts, where one agency (FINRA) has acted before another (the SEC) with a narrow rule applicable only to the sale of mutual funds; and
- Multiple areas in the international arena, where regulators increasingly are adopting regulations that may conflict with or reduplicate those that global firms face in the United States.

Each of these is discussed in this section of our testimony.

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the United States. Section 120 provides that the FSOC may issue recommendations to one or more primary financial regulatory agencies to apply “new or heightened standards and safeguards” upon determining that the conduct of a financial activity or practice “could create or increase the risk of significant liquidity, credit, or other problems spreading among back holding companies and nonbank financial companies or the financial markets of the United States.” The primary regulator(s) must impose the recommended standards or similar standards acceptable to the FSOC, or explain in writing why the regulator has determined not to follow the FSOC’s recommendation.

## 1. Proposed Amendments to CFTC Rule 4.5

Rule 4.5 under the Commodity Exchange Act currently excludes certain “otherwise regulated entities,” including funds, from regulation by the CFTC as commodity pool operators (“CPOs”). In late January, the CFTC approved a sweeping proposal to revise Rule 4.5 solely as applied to funds, revise or rescind other exclusionary rules, and adopt new disclosure requirements in an effort to “more effectively oversee its market participants and manage the risks that such participants pose to the markets.”<sup>56</sup> This proposal is not required or even contemplated by the Dodd-Frank Act, although the CFTC attempts to describe it as being “consistent with the tenor” of that Act.<sup>57</sup> For the reasons summarized below, ICI and its members strongly object to the proposal’s narrowing of the Rule 4.5 exclusion. We have provided extensive written comment to the CFTC,<sup>58</sup> and have met with CFTC Commissioners and agency staff, in order to highlight our concerns with the proposal. In addition, our April 12 Letter provided detailed recommendations as to how the Rule 4.5 proposal could be revised consistent with the CFTC’s regulatory goals.

### a. Background

The term CPO is broadly defined in the Commodity Exchange Act and generally includes, among other things, any person engaged in a business that is in the nature of an investment trust who receives funds from others “for the purpose of trading in any commodity for future delivery on or subject to the rules of a contract market or derivatives transaction execution facility.”<sup>59</sup> CFTC Rule 4.5 recognizes the breadth of this definition, and provides an exclusion from CPO registration for certain persons operating “qualifying entities” that are subject to a different regulatory framework, including funds.<sup>60</sup> Prior to 2003, the Rule 4.5 exclusion was conditioned upon the entity satisfying certain conditions relating to its trading in commodity interests and the marketing of shares/participations in the entity.

After lengthy consideration in 2002-03, which included an advance notice of proposed rulemaking and a public roundtable on the regulation of CPOs and commodity trading advisors, the CFTC determined to eliminate the trading and marketing conditions

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<sup>56</sup> See *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 Fed. Reg. 7976 (Feb. 11, 2011) (“Rule 4.5 Proposing Release”).

<sup>57</sup> *Id.* at 7977.

<sup>58</sup> Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated April 12, 2010 (“April 12 Letter”), available at [http://www.ici.org/pdf/11\\_cftc\\_rule4.5\\_exclude.pdf](http://www.ici.org/pdf/11_cftc_rule4.5_exclude.pdf).

<sup>59</sup> Section 1a(5) of the Commodity Exchange Act.

<sup>60</sup> Qualifying entities include funds, insurance company separate accounts, bank trust and custodial accounts, and retirement plans subject to ERISA fiduciary rules.

from Rule 4.5. In so doing, it cited, among other things, the fact that many qualifying entities avoided participation in the markets for commodity futures and commodity options because the Rule 4.5 conditions were “too restrictive for many [of them] to meet.” The CFTC further determined that facilitating participation in the commodity markets by additional collective investment vehicles and their advisers would have “the added benefit to all market participants of increased liquidity.”<sup>61</sup>

#### b. Proposed Amendments

The proposed amendments would condition eligibility for the Rule 4.5 exclusion on a fund’s compliance with certain trading and marketing restrictions that are based upon those in the rule prior to 2003, but in fact are much broader in scope. These restrictions were first proposed in a rulemaking petition filed last summer by the National Futures Association (“NFA”). Although NFA’s petition was prompted by concerns about the marketing practices of three funds offering so-called “managed futures strategies,” it recommended imposing these restrictions (and thus substantially narrowing the Rule 4.5 exclusion) for *all* funds. The CFTC published the NFA petition for public comment and received considerable feedback from individual companies and trade and bar associations. Many of the comment letters, like that filed by ICI, expressed serious concerns about the scope of the NFA’s proposed language, and identified for the CFTC the difficulties that funds would face if they were subject to the overlapping and conflicting requirements of the SEC’s and CFTC’s regulatory regimes.

Regrettably, the CFTC appears to have issued its proposal to amend Rule 4.5 without having fully analyzed the comments it received on the NFA rulemaking petition. The CFTC drew its proposed rule text almost verbatim from the NFA petition, but then proposed to narrow the Rule 4.5 exclusion even further by applying the proposed trading and marketing restrictions to a fund’s positions in swaps. The CFTC’s proposing release contains little explanation for the proposed language, except to describe it as “an appropriate point at which to begin discussions regarding the Commission’s concerns.”<sup>62</sup> The proposing release also fails to address the concerns and difficulties that were identified by commenters, except to the extent it asks for further public comment in the identified areas.

Funds unable to satisfy the proposed trading and marketing restrictions would be subject to regulation and oversight by the CFTC and the NFA. This would impose a second layer of regulation, primarily related to disclosures to investors, on such funds,

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<sup>61</sup>See *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors*, 68 Fed. Reg. 12622, 12626 (March 17, 2003); *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors: Past Performance Issues*, 68 Fed. Reg. 47221 (Aug. 8, 2003).

<sup>62</sup> Rule 4.5 Proposing Release, *supra* note 56, at 7984.

which already must comply with similar comprehensive regulatory requirements under the Investment Company Act and other federal securities laws, administered by the SEC.

### c. ICI Objections to the Proposed Amendments

As noted above, ICI and its members strongly object to the Rule 4.5 proposal in its current form. While we respect the CFTC's authority to "reconsider the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets,"<sup>63</sup> we do not believe the CFTC has demonstrated the need for a second level of regulation on funds. We further believe that the Rule 4.5 proposal is insufficiently developed. It does not appear to reflect thorough consideration by the CFTC of many critical issues raised by the proposal, which are discussed below and in more detail in our April 12 Letter.

The CFTC asserts that the proposed amendments to Rule 4.5 are intended to "stop the practice of registered investment companies offering futures-only investment products without Commission oversight . . ." <sup>64</sup> The agency has failed to explain, however, why the proposed amendments are troublingly broader in reach. Specifically, the sweeping language of the proposed trading and marketing restrictions would implicate a large number of funds that use futures, options and swaps simply as a means to efficiently manage their portfolios, rather than as part of operating a "futures-only" fund. It is particularly difficult to justify this result at a time when the CFTC Chairman has stated that current funding levels for the agency are "simply not sufficient" and has requested substantial additional resources from Congress.<sup>65</sup>

Furthermore, in its proposing release, the CFTC provides no evidence that a "futures-only" fund – not to mention a fund using futures, options or swaps for purposes *other than* providing exposure to the commodities markets, such as risk management – is currently subject to inadequate regulation, or that investors or the commodity markets generally have been harmed by their practices.

In fact, funds are already extensively regulated.<sup>66</sup> In addition to regulating their disclosures to investors, imposing limitations on their use of leverage, and otherwise regulating their daily operations, the federal securities laws subject funds and their

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<sup>63</sup> *Id.* at 7977.

<sup>64</sup> *Id.* at 7984.

<sup>65</sup> *See, e.g.*, Testimony of Gary Gensler, Chairman, CFTC, Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, United States House of Representatives, on the CFTC's budget request for FY2012 (March 17, 2011) (stating that the Commission's current funding level is "simply not sufficient for the CFTC's expanded mission to oversee both the futures and swaps markets").

<sup>66</sup> *See* ICI Fact Book, *supra* note 3, at 191 for a description of how these securities laws apply to funds.

advisers to antifraud standards, and provide the SEC with inspection authority over funds and their investment advisers, principal underwriters, distributing broker-dealers and transfer agents. The Financial Industry Regulatory Authority (FINRA) also has oversight authority with regard to funds' principal underwriters and distributing broker-dealers. As a result, ICI questions why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily regulated entities.<sup>67</sup>

It is not even possible at this time for the fund industry and other stakeholders—or even for the CFTC itself—to assess the full impact of the proposed amendments to Rule 4.5. This is because one of the key restrictions would relate to margin levels on derivative positions held by funds, and the regulators have not yet made critical determinations that relate to swap margin levels. Specifically, the CFTC and SEC have not finalized rules regarding which swaps will be subject to central clearing requirements. In addition, margin requirements have not been established for cleared or uncleared swaps, which could end up varying significantly based on the type of swap. It is our strongly held view that the new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* the CFTC can propose any amendments to Rule 4.5 that implicate the use of swaps.<sup>68</sup>

Nonetheless, the CFTC provides in its proposal a cursory analysis of the costs and benefits of the proposed amendments to Rule 4.5. We believe this analysis is wholly inadequate to justify the costly, duplicative, and burdensome regulation that the amendments would impose on a large portion of the fund industry.<sup>69</sup> We question whether it is possible for the CFTC to conduct an adequate analysis of the costs and benefits of the proposal until the above-mentioned margin issues regarding swaps have been resolved, as the resolution of those issues could vastly impact the number of funds that may be swept into the CFTC's jurisdiction. The CFTC does identify a few costs, which it does not detail or quantify, but it fails to identify many of the major costs the proposal would impose on funds, some of which would inevitably get passed on to shareholders. The CFTC's analysis of benefits is even more abstract and does not appear to be focused on the proposed amendments to Rule 4.5 but instead on other, unrelated, parts of the proposal. Importantly, the CFTC fails to acknowledge in its analysis that any benefits that fund shareholders may receive as a result of the amendments to Rule 4.5 would largely duplicate many protections that shareholders currently enjoy as a result of the Investment Company Act and other federal securities laws. We have deep concerns

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<sup>67</sup> We note that, at a recent hearing before the House Committee on Agriculture, Representative Glenn Thompson asked Chairman Gensler why “your recent 4.5 rule proposal would capture large swaps [sic] of mutual funds and subject them to duplicative and potentially conflicting CFTC regulation, when mutual funds are already highly regulated by the SEC.” Testimony of Gary Gensler, Chairman, CFTC, Before the House Committee on Agriculture (March 31, 2011).

<sup>68</sup> See Section 3.B.1, *infra*.

<sup>69</sup> For our view on the importance of a robust cost-benefit analysis, see Section 4.A.2, *infra*.

whether the CFTC's cost-benefit analysis would satisfy the applicable requirements of the Commodity Exchange Act,<sup>70</sup> and we believe that the agency should not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis.

ICI is not alone in its concerns. This spring, Representative Frank Lucas, Chairman of the House Agriculture Committee, and Representative K. Michael Conaway, Chairman of the Subcommittee on General Farm Commodities and Risk Management, raised very similar concerns in requesting that the CFTC's inspector general undertake an investigation of the adequacy of the Commission's cost-benefit analysis.<sup>71</sup> We particularly agree with their observations that:

The CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . [p]articularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.

The inspector general's report, issued on April 15, concluded that “[a] more robust process is clearly permitted under the [existing] cost-benefit guidance issued by the [CFTC's] Office of General Counsel and the Office of Chief Economist, and we believe a more robust approach would be desirable, with greater input from the Office of Chief Economist.”<sup>72</sup>

Finally, even if the trading and marketing restrictions in the Rule 4.5 proposal are appropriately scaled back, there are likely to be cases in which funds and their advisers would be unable to rely on the amended rule and thus would become subject to regulation by both the CFTC and the SEC. The proposing release specifically

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<sup>70</sup> Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

<sup>71</sup> See Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC, dated Mar. 11, 2011.

<sup>72</sup> See Office of the Inspector General, CFTC, *Report of Investigation: An Investigation Regarding Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act* (April 15, 2011). Even the CFTC's own commissioners have raised concerns about the manner in which the agency conducts its cost-benefit analysis. See Jill E. Sommers, Commissioner, CFTC, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011).

acknowledges that funds may have difficulty complying with some of the CFTC's regulations, yet it does not propose any solutions. As part of our analysis of the CFTC's proposal, ICI and its outside counsel compared the CFTC and SEC regulatory regimes under the Investment Company Act and the Commodity Exchange Act, respectively. This analysis is summarized in a detailed appendix to our April 12 Letter.<sup>73</sup> As this appendix demonstrates, many of the CFTC's requirements would be duplicative of the requirements to which funds and their advisers are already subject under the Investment Company Act or other federal securities laws. Other of the CFTC's requirements would be fundamentally inconsistent with the requirements to which funds and their advisers are subject.

For example, the SEC significantly limits the ability of a fund to include in its prospectus performance information about other funds or accounts managed by the fund's adviser.<sup>74</sup> The CFTC rules, by contrast, *require* disclosure of such information in certain circumstances. A fund could not comply with the CFTC's requirements without likely violating the SEC's (and FINRA's) requirements.

This is just one example of why we believe it is absolutely critical that the CFTC, before imposing an *additional* regulatory requirement on funds, evaluate its regulatory purpose in doing so and consider why a regulation to which funds and their advisers are *already* subject would be insufficient to satisfy that purpose. More broadly, it is essential that the CFTC work closely with the SEC before amending Rule 4.5 in order to reconcile the many duplicative and conflicting regulations to which a fund and its adviser could become subject.

If, after reviewing the public comments on its proposal, the CFTC nevertheless determines to proceed with amending Rule 4.5, ICI believes it is imperative for the agency to develop and issue a new proposal to amend the rule. Such proposal should fully address the issues outlined above, as well as the concerns voiced by other commenters. In particular, any new proposal must outline in detail how funds would be expected to comply with the CFTC's regulations, and how conflicting or inconsistent regulations would be reconciled. To proceed otherwise would deprive funds (and the broader public) of a meaningful opportunity to comment on the new regulatory requirements that would be placed on funds, as is required by the Administrative Procedure Act.<sup>75</sup>

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<sup>73</sup> See *supra* note 58.

<sup>74</sup> FINRA, which has oversight over fund advertising, similarly prohibits funds from advertising the adviser's other fund or account performance.

<sup>75</sup> Section 553 of the APA requires that an agency provide the public with adequate notice of the substance of a proposed rule and an opportunity to provide meaningful comment. If it fails to do so, the resulting rule may be struck down by courts on the basis that it is not a "logical outgrowth" of the agency's proposal. See *Kooritzky v. Reich*, 17 F.3d 1509, 1513 (D.C. Cir. 1994) (court stated that "agencies must include in their notice of proposed rulemaking 'either the terms or substance of the proposed rule or a description of the subjects

## 2. Resolving the Fiduciary Debates at DOL and SEC

Another context in which two regulators are dealing with similar issues is the application of fiduciary duties. Last fall, the DOL proposed a major rewrite of the fiduciary duty rule under the Employee Retirement Income Security Act (ERISA) that could result in fiduciary status for ordinary business interactions, discourage basic educational materials like newsletters that do not provide personalized investment advice, and make it difficult for firms to help workers preserve their savings at job change through an IRA rollover. On a completely separate track, the SEC is contemplating the results of a Dodd-Frank Act mandated study on the standard of care for broker-dealers providing investment advice to retail customers, in which its staff recommended a universal fiduciary duty be applied to broker-dealers and investment advisers.

DOL and SEC proceed from different statutory frameworks. While there are similarities in ERISA and the securities laws about the general obligations that attach to fiduciaries, there are also important differences. For example, an ERISA fiduciary is subject to strict prohibited transaction rules that apply only to ERISA fiduciaries. Because of these rules, compensation arrangements that are common and legal from SEC's perspective could become illegal, absent an exemption, if a person or firm is deemed an ERISA fiduciary.

The separate debates at DOL and SEC do not necessarily pose a regulatory conflict. Indeed, in both contexts, the Institute supports assuring that individual investors are protected by an appropriate legal duty *when receiving personalized investment advice*, as long as that duty is crafted such that investors do not lose access to the investment products and services that meet their needs. Rather, the ongoing debates are an example of the potential for regulatory hodgepodge.

### a. DOL Fiduciary Duty Rulemaking

As noted in Section 1 above, savings held and invested for retirement in defined contribution plans like 401(k)s and IRAs represent an important part of our capital markets. Since 1974, ERISA and the associated excise tax rules in the Internal Revenue Code that govern DC plans and IRAs have provided that persons who provide “investment advice” for a fee are fiduciaries. An ERISA fiduciary not only must act prudently and for the benefit of participants – as virtually all fiduciaries must do – but is subject to unique duties under the prohibited transaction rules, including restrictions on compensation that apply only to ERISA fiduciaries.

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and issues involved’ . . . [a]nd they must give ‘interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.’ The [agency] did neither.” (internal citations omitted)); *Shell Oil Co. v. EPA*, 950 F.2d 741, 751 (D.C. Cir. 1992) (“an unexpressed intention cannot convert a final rule into a “logical outgrowth” that the public should have anticipated. Interested parties cannot be expected to divine the [agency’s] unspoken thoughts.”).

This is relevant to the Subcommittee because ERISA’s regulation of financial service firms that deal with employee benefit plans overlaps with the securities laws administered by the SEC. Congress made clear when it enacted ERISA that it did not intend to disrupt the functioning of the securities markets, prevent employee benefit plans from accessing investments, or turn the “ordinary functions of consultants and advisers” into fiduciary functions.<sup>76</sup> In 1975, DOL released regulations drawing an important legal boundary – *i.e.*, the line between *commonplace financial market interactions* in which plan sponsors and participants of ERISA-governed plans can freely obtain information or suggestions to consider in making their investment decisions, on the one hand, and *advisory relationships* in which those plan sponsors or participants engage providers to act on their behalf in evaluating or making investment decisions, on the other. By restricting application of the ERISA definition of advice and the fiduciary duties it triggers to actual advisory relationships, that 1975 rule gives the clarity to the regulated community necessary for retirement savers to gather a range of market input into their decision making process and for other parties in the marketplace to avoid crossing into fiduciary activities.

Assuring that overlap between the securities laws and ERISA does not cause dysfunction in the securities markets or constrain the ability of retirement savers to get help in their decisions and access products that meet their needs remains critically important. DOL’s rule defining what constitutes investment advice that makes one an ERISA fiduciary is important to mutual funds, and to this Subcommittee, because the clarity of the rule allows firms to offer plans and individuals investments they need and want and to provide financial and investment information to plans and IRA investors.

In October 2010, DOL proposed a major rewrite of the rule that could result in fiduciary status for ordinary business interactions, discourage basic educational materials like newsletters that do not provide personalized investment advice, and make it difficult for firms to help workers preserve their savings at job change through an IRA rollover.<sup>77</sup>

Extensive comments to DOL in letters and during an administrative hearing show the text of the proposal is confusing, its scope is unclear, and its policy implications are controversial. The comments include letters from members of Congress from both

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<sup>76</sup> See ERISA Conference Report, P.L. 93-406, at 323 (“...the ordinary functions of consultants and advisers (other than investment advisers) may not be considered as fiduciary functions...”), *id.* at 309 (some otherwise prohibited transactions “nevertheless should be allowed in order not to disrupt the established business practices of financial institutions” and directing the Secretaries of Labor and Treasury to grant an administrative exemption for brokerage services).

<sup>77</sup> See 75 Fed. Reg. 65263 (Oct. 22, 2010).

parties expressing concern with the proposal and urging DOL to move carefully.<sup>78</sup> Even investor advocates have urged DOL to go “back to the drawing board.”<sup>79</sup>

- The Institute’s comments to DOL<sup>80</sup> emphasized that the proposal should be revised to meet the following principles:
- Persons who deal with plans or IRA investors must know whether or not they are fiduciaries.
- Fiduciary status should attach only to genuine advisory relationships where a position of trust and confidence exists.
- Simply selling an investment product cannot be a fiduciary act.
- The rule should not discourage the assistance that recordkeepers engaged to administer plan accounts provide to help fiduciaries prudently select and monitor plan menu investments.

We provided DOL with specific suggestions for improving the proposal to meet these principles and urged DOL to issue a reproposal of its fiduciary definition rule before moving to a final rule. We made this recommendation because the retirement services and investment industries, plan sponsors, and retirement savers, all have a shared interest in getting this rule right.

#### b. IA-BD Harmonization and the SEC Fiduciary Duty Debate

On a completely separate track from the DOL, the SEC staff recently completed its study, required by Section 913 of the Dodd-Frank Act, on the effectiveness of existing standards of care for providing personalized investment advice to retail customers and

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<sup>78</sup> See, e.g., Letter to Secretary Solis and Chairmen Gensler and Shapiro from Chairmen Bachus, Kline, and Lucas (May 15, 2011); Letter to Secretary Solis from 6 Members of the Blue Dog Coalition (May 10, 2011); Letter to Secretary Solis and Chairmen Gensler and Shapiro from 29 Members of New Democrat Coalition (May 10, 2011); Letter to Secretary Solis from Chairman Rehberg (June 3, 2011). This is only a partial list.

<sup>79</sup> See Mercer Bullard, President and Founder of Fund Democracy, “DOL Fiduciary Proposal Misses the Mark”, Morningstar.com (June 14, 2011), available at <http://news.morningstar.com/articlenet/article.aspx?id=384065>.

<sup>80</sup> See Letters from Mary Podesta, Senior Counsel - Pension Regulation, Investment Company Institute, to Office of Regulations and Interpretations, Employee Benefits Security Administration, Department of Labor (February 3, 2011), available at <http://www.ici.org/pdf/24941.pdf> and (April 12, 2011), available at <http://www.ici.org/pdf/25084.pdf>; Testimony of Paul Stevens before Department of Labor Hearing on Fiduciary Definitions Proposal (March 1, 2011), available at [http://www.ici.org/401k/statements/11\\_dol\\_fiduciary\\_tmny](http://www.ici.org/401k/statements/11_dol_fiduciary_tmny); ICI Letter to The Honorable Phyllis Borzi, Assistant Secretary, Employee Benefits Security Administration, Department of Labor (May 20, 2011), available at <http://www.ici.org/pdf/25210.pdf>.

whether there are gaps, shortcomings, or overlaps in such standards that should be addressed by rule or statute.<sup>81</sup>

The staff recommended establishing a uniform fiduciary standard for advisers and brokers that provide advice about securities to retail customers, consistent with the current standard under the Advisers Act.<sup>82</sup> We agree with this recommendation. For many years, the strong, fiduciary standard that applies to investment advisers has worked well to protect the interests of their customers and clients, and it should be preserved. This standard, which the U.S. Supreme Court articulated in *Capital Gains* nearly half a century ago, puts the interests of advisory clients and customers above those of their advisers. We believe this higher fiduciary standard should be applied to both advisers and brokers when they are providing substantially similar services to retail clients—namely personalized investment advice about securities.

We particularly appreciate that the SEC staff's recommendation would not alter the fiduciary duty articulated by the Supreme Court in *Capital Gains*. That standard has been widely interpreted in court cases and SEC enforcement actions, and a clear body of law has developed that has guided advisory conduct for the protection of investors for many years. We strongly believe that the SEC should not adopt any standard for broker-dealers that would weaken the existing fiduciary duty applicable to advisers.

The staff's report went beyond the issue of fiduciary duties and made a number of other recommendations to rationalize the IA-BD regulatory regime in certain respects. These recommendations are important as well, and should be carefully considered by the SEC. Our current system regulates broker-dealers primarily under the Securities Exchange Act and investment advisers primarily under the Advisers Act. This bifurcation of oversight had its roots in real distinctions in the businesses of broker-dealers and advisers at the time the relevant statutes were developed; those distinctions, in many cases, have become almost indiscernible over time, making it imperative that steps be taken to rationalize the regulatory systems for financial intermediaries who perform similar roles but are subject to differing legal standards. It also is imperative from the perspective of retail investors, who may not appreciate the distinct legal standards applicable to advisers and broker-dealers engaging in activities that are virtually indistinguishable; these investors should not have to peruse lengthy disclosures to

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<sup>81</sup> See U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* (January 21, 2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>82</sup> There is no express fiduciary duty in the Advisers Act. The most commonly cited source of the federal fiduciary duty under the Investment Advisers Act is the Supreme Court's 1963 *Capital Gains* decision. *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 Advisers Act imposes a fiduciary duty on investment advisers by operation of law).

determine where the legal differences may lie.<sup>83</sup> The SEC staff's recommendations aim to create a level regulatory playing field that is functionally related to the financial service provided. This is precisely the type of approach we support.

Overall, we see the SEC's IA-BD rulemaking initiative as important to lay a proper foundation for many other distribution-related initiatives. While we encourage the SEC to move forward with this rulemaking, we also recognize that an overly broad application of a fiduciary duty could chill legitimate business practices. To avoid that result, the SEC should remain cognizant of the differences between investment adviser and broker-dealer business models. For example, broker-dealers may conduct commission-based transactional business that does not involve the provision of personalized advice, execute unsolicited trades, offer the use of financial calculators or similar investment tools or information, or service orphaned accounts. These activities should not be subject to a fiduciary duty standard when they entail no personalized advice or recommendations.

The SEC also clearly should recognize that the uniform fiduciary duty is not unlimited in scope. Both investment advisers and broker-dealers must be able to disclose any material limitations on the range of investment products about which they advise clients, and whether similar products are available outside that range; this disclosure should address concerns by many in the brokerage community about the ability to offer proprietary products. Similarly, both investment advisers and broker-dealers should be permitted to disclose any limitations on the nature and anticipated duration of the relationship with the client/customer.

### 3. Disclosure Initiatives Relating to Potential Broker Conflicts

A third context where multiple regulators are acting on related topics is in the area of disclosures of a broker-dealer's potential conflicts of interest. The SEC is studying new point of sale disclosure rules pursuant to mandates in the Dodd-Frank Act. At the same time, FINRA is seeking to impose new revenue sharing disclosure rules on broker-dealers that sell funds, while also contemplating a broader conflicts disclosure document that brokers could provide customers at the beginning of their relationship. While we strongly support many of these initiatives in concept, we question those that single out mutual funds.

ICI has long supported enhanced disclosure to help investors assess and evaluate a broker's recommendations.<sup>84</sup> Certain compensation structures have the potential to

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<sup>83</sup> See RAND Corporation, "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers" (Jan. 3, 2008), available at [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf) (version finalized Mar. 19, 2008).

<sup>84</sup> See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated May 31, 2011, available at <http://www.ici.org/pdf/25232.pdf>; and Letter from

influence financial intermediaries' recommendations to their clients, such as by creating incentives to inappropriately favor some products over others. To enable investors to assess these incentives and make better informed investment decisions, we believe financial intermediaries should be required to provide relevant disclosure for *all* retail investment products they sell, including variable annuity contracts and separate accounts – not just mutual funds.<sup>85</sup>

We recognize that developing such disclosure is a substantial undertaking, and requires careful consideration of a number of issues. For example, regulators must understand how disclosures could be made most efficiently and with minimal disruptions to the sales process. To the extent that disclosures may be made orally to investors transacting over the telephone, mechanisms for tracking compliance must be considered. And, the appropriate substance of the disclosure, possibly including information about broker compensation and conflicts of interest, must be determined.

We are pleased that the Dodd-Frank Act directs the SEC to consider these issues.<sup>86</sup> We also support the product-neutral approach of Section 919 of the Act, which expressly affirms the SEC's authority to require broker-dealers to provide information to retail investors with respect to *any* product or service the investor may purchase.

We urge Congress to continue to view broker disclosure as a critical need for retail investors across *all* products, and to discourage regulatory initiatives that would single out mutual funds. Requiring prior disclosures only prior for selling mutual funds would create incentives for broker-dealers and other intermediaries to sell products not subject to the same requirement, even when those products are potentially less suitable for and do not offer the same level of regulatory protection and other benefits for investors. Regulators and consumer advocates have expressed concerns about this impact. For example, in discussing earlier point of sale disclosure initiatives, former NASD Chairman

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Karrie McMillan, General Counsel, Investment Company Institute, to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, dated Aug. 3, 2009, available at <http://www.ici.org/pdf/23677.pdf>.

<sup>85</sup> See, e.g., Stevens July 2009 Testimony, *supra* note 50

<sup>86</sup> Section 917 requires the SEC to conduct a study regarding financial literacy among investors, and to identify, among other things: 1) “methods to improve the timing, content, and format of disclosure to investors with respect to financial intermediaries”; 2) “the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors”; and 3) “methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products.” Section 913 required the SEC to study potential harmonization of the obligations of broker-dealers and investment advisers. A report was delivered to Congress in January 2011. The report recommended that the Commission “facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest” and “consider the utility and feasibility of a summary disclosure document containing key information on a firm’s services, fees, and conflicts and the scope of its services.”

Robert Glauber stressed the need to consider this consequence, explaining that “[a]n investor should be sold a security because it’s right for him or her, not because it’s easier to sell than something else.”<sup>87</sup> On a related point, Barbara Roper of the Consumer Federation of America stated that by considering fee disclosures as “a mutual fund issue, instead of a broker compensation issue, sort of more holistically, you run the risk that you make mutual funds less attractive to sell. And I think that would be a very bad thing.”<sup>88</sup>

#### 4. Potential International Regulatory Conflict

Increasingly, harmonizing international regulatory regimes is of large and growing importance for our funds and their advisers, an increasing number of which are global investment fund managers. Cooperation among standard setters is necessary to avoid regulatory arbitrage and to encourage efficiencies as funds pursue an increasing cross-border presence in the interest of their shareholders.

One current example among others of the need for harmonization concerns securities market structure. The issues surrounding the trading of securities by funds and other institutional investors are no longer purely a domestic matter.<sup>89</sup> Many funds utilize intricately linked global trading desks and must be concerned not only about the regulation and structure of the financial markets in the United States but also in other jurisdictions in which they trade.<sup>90</sup> Jurisdictions around the world also are starting to, or are already facing, many of the market structure issues being examined in the United States. As U.S. regulators review their current, and consider further, initiatives relating to the reform of the regulation of the U.S. securities markets, we urge them to work closely with foreign regulators to create consistent and sensible cross-border regulations.<sup>91</sup>

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<sup>87</sup> See Remarks by Robert Glauber, Chairman, NASD, at the Investment Company Institute’s 2006 General Membership Meeting (May 18, 2006), available at <http://www.finra.org/PressRoom/SpeechesTestimony/RobertR.Glauber/poi6642>.

<sup>88</sup> See Remarks by Barbara Roper, Director of Investor Protection, Consumer Federation of America, at the Securities and Exchange Commission 12b-1 Roundtable, Unofficial Transcript, p. 196, available at <http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf>.

<sup>89</sup> For our views on many of the major domestic market structure issues, see Section 3.B.2, *infra*.

<sup>90</sup> See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Directorate General, Internal Market and Services, European Commission, dated February 2, 2011 (Consultation on the Review of the Markets in Financial Instruments Directive (MiFID)), available at <http://www.ici.org/pdf/24946.pdf>.

<sup>91</sup> In particular, we stress the need for U.S. regulators to implement the Dodd-Frank Act in a way that minimizes any negative impacts on the global asset-management operations of U.S.-owned firms. For example, if activities related to the foreign equivalent of a U.S. mutual fund (e.g., highly regulated funds primarily intended for retail investors) are limited by the Volcker Rule, U.S. firms could be placed at a disadvantage to foreign firms.

We also strongly encourage U.S. regulators to recognize the importance of global cooperation and coordination and to commit ample resources (*e.g.*, time and personnel) to the development of regulatory recommendations for financial markets and participants at the international level. Specifically, given the complexity and importance of the issues, the brightest and most knowledgeable that the U.S. has to offer should represent the interests of U.S. mutual funds and their investors in these global discussions.

### **Section 3: Other Regulatory Issues Facing the Industry**

In addition to the principal issues affecting the mutual fund industry described in Section 2, there are a number of other significant regulatory issues that the Subcommittee should note. Some of these, such as the repeal of Rule 12b-1, primarily affect funds as issuers of securities. Others, such as the implementation of Title VII of the Dodd Frank Act, primarily affect funds as investors in the markets. The remainder of our testimony is devoted to these significant issues.

#### **A. Issues Affecting Funds as Issuers of Securities**

##### **1. Repeal of Rule 12b-1**

Last year, the SEC proposed sweeping changes to its rules governing the use of fund assets to pay for distribution expenses. The proposal would repeal Rule 12b-1, the principal rule in this area, and replace it with an entirely new regulatory framework centered around fee caps on distribution fees taken over time.<sup>92</sup> The SEC's proposal attracted more than 2,400 comment letters, the vast majority of which were highly negative.<sup>93</sup>

Rule 12b-1 is an integral part of the structure and strength of the mutual fund industry. The rule and its associated fees allow investors to pay distribution costs over time, to access funds that otherwise might not be available to them, and to compensate financial intermediaries, on whom so many fund investors depend. Accordingly, this rulemaking is of critical importance to the fund industry and its millions of investors.

We recognize that the SEC has legitimate reasons to revisit Rule 12b-1. We too have advocated changes to Rule 12b-1 to provide better disclosure of 12b-1 fees and clarify

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<sup>92</sup> SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010) (the "12b-1 Release").

<sup>93</sup> ICI made two submissions. We filed a lengthy comment letter on November 5 reacting to the substance of the proposal, and a supplemental submission on December 1 providing a full economic analysis of the rulemaking based on a detailed survey of the most affected ICI members. Our comment letters and other materials related to ICI positions on Rule 12b-1 are available at [www.ici.org/rule12b1fees](http://www.ici.org/rule12b1fees).

the role of the fund board under the rule.<sup>94</sup>

In our judgment and that of the overwhelming majority of commenters, however, the SEC's 2010 proposal is unworkable. It would place the agency in the inappropriate role of a ratemaker and be far more extensive and intrusive than necessary. It could fundamentally alter the way intermediaries use funds in various distribution channels, significantly affect the lineup of share class options currently available to investors, necessitate major systems changes, and require the renegotiation of thousands of dealer agreements. As noted earlier in this testimony, ICI performed our own independent economic analysis of the proposal and concluded that the SEC significantly understated the operational and transitional costs on funds and intermediaries of the proposal, which would be reflected in higher expenses borne by shareholders. It also overstated the benefits, which in our view are uncertain and quite possibly illusory. As a result, we urged the SEC to take a further and more careful look at its economic analysis before proceeding with this rulemaking.<sup>95</sup>

We also firmly believe that this Rule 12b-1 reform proposal is the proverbial cart before the horse, given the ongoing debates over the rationalization of the IA-BD regulatory regime discussed above. A thoughtful and deliberate approach to that rulemaking would lay the foundation for appropriate reforms to Rule 12b-1. Moreover, while it is impossible to predict exactly how IA-BD regulatory harmonization or a new fiduciary duty will affect the sale of fund shares, it is fair to suggest that broker-dealers will adjust their business models to suit the new standard, and in so doing may render parts of the SEC's 12b-1 proposal unnecessary or outdated. It makes little sense to fundamentally alter Rule 12b-1 with the virtual certainty that the SEC's new framework would need to be revisited once the new IA-BD regulatory regime is adopted.

Certain elements of the confirmation statement disclosure proposed as part of the 12b-1 rulemaking would require confirms to include the types of information about ongoing fees and expenses found in a fund prospectus. These changes are misplaced and premature, as they would clearly be more appropriate for a point of sale disclosure document.<sup>96</sup> Confirms should serve as a record of a transaction and allow the investor to verify that the transaction was processed correctly and that whatever fees are associated with the transaction were properly assessed. Point of sale disclosure, in contrast, is meant to provide the investor with certain key information that highlights potential conflicts that he or she should consider *before* making the investment decision. As the SEC itself recognizes, confirms cannot do this – “[i]n making this proposal, we are mindful that...customers do not receive confirmations until after completing their purchases of

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<sup>94</sup> See, e.g., letter from Mary S. Podesta, Acting General Counsel, ICI, to Nancy M. Morris, Secretary, SEC (June 19, 2007) (“2007 ICI Roundtable Submission”).

<sup>95</sup> See Section 4.A.2.a, *infra*.

<sup>96</sup> See Section 2.C.3, *supra*.

mutual funds.”<sup>97</sup> The SEC has legitimate concerns over the potential conflicts of interest a broker may have in recommending a particular investment or share class to an investor, but these conflicts are best addressed through the combination of point of sale disclosure and a fiduciary standard. The confirm simply is a belated and inappropriate means to convey this important information.

We also are concerned that the SEC looks to a fund-specific confirm to address potential conflicts that exist with respect to all investments – not just funds. As we noted above, we have repeatedly said that point of sale disclosure must be product-neutral to be effective and Congress appears to have agreed.<sup>98</sup> We are understandably concerned, therefore, that the confirm disclosure requirements proposed by the SEC run the risk of establishing unique disclosure requirements applicable solely to the sale of mutual funds, and not other products. As such, not only are they misplaced, they run counter to the mandate in the Dodd-Frank Act.

## 2. Ability of U.S. Funds to Compete Globally

U.S. fund managers lead the world in offering funds to investors. Forty-eight percent of global mutual fund assets (\$11.8 trillion out of \$24.7 trillion) are held by funds that are organized in the U.S. and managed by firms located here.<sup>99</sup> Several of these U.S. fund managers also are among the largest fund companies in countries (e.g., Luxembourg and Ireland) with globally-sold funds.

Notwithstanding the U.S. fund managers’ preeminent role in the global fund business, our funds are held almost exclusively by U.S. persons. Substantial U.S. tax impediments to foreign investment in U.S. funds are a primary reason why U.S. managers have been forced to go overseas to create foreign funds for distribution outside the United States.

The most significant U.S. tax impediment to foreign investment in U.S. funds involves the effective requirement on our funds to distribute each year essentially all of their income.<sup>100</sup> These distributions can have two negative effects on foreign investors in

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<sup>97</sup> 12b-1 Release at 68.

<sup>98</sup> See Section 2.C.3, *supra*.

<sup>99</sup> See, ICI Fact Book, *supra* note 3, at Table 60. These funds are treated under the Internal Revenue Code as regulated investment companies (“RICs”).

<sup>100</sup> To eliminate an excise tax (under Code section 4982) on “under-distributions,” a RIC must distribute by December 31 an amount equal to the sum of: (1) 98 percent of its ordinary income earned during the calendar year; (2) 98.2 percent of its net capital gain earned during the 12-month period ending on October 31 of the calendar year; and (3) 100 percent of any previously-earned amounts not distributed during the prior calendar year. A tax of 4 percent is imposed on the amount, if any, by which the RIC’s required distribution exceeds the amount actually distributed.

U.S. funds. First, these distributions cause foreign investors to incur tax currently in their home (resident) countries; in contrast, many foreign investors are not taxed in their home countries if they invest instead in a fund that retains, rather than distributes, its income. Second, the favorable tax treatment that most foreign countries provide for capital gains is lost when capital gains realized by U.S. funds are distributed to foreign investors as capital gain dividends. Instead of favorable capital gains treatment, these distributions are taxed in the foreign investors' home countries like any other dividend from a U.S. company. These tax disadvantages play a significant role in forcing U.S. mutual fund managers to go offshore to create funds for foreign investors.

These negative effects would be addressed by legislation supported by the ICI to create the International Regulated Investment Company ("IRIC") for foreign investors.<sup>101</sup> The IRIC would be a U.S. vehicle that invests in a single U.S. fund. The IRIC would not distribute the income it receives from the fund – thus addressing the foreign investors' home-country tax issues. To preserve U.S. tax revenues, however, the IRIC would pay U.S. tax equal to the amount that would be collected from foreigners investing directly in the underlying U.S. fund. The IRIC would improve the international competitiveness of U.S. funds.

Jobs are created in the United States when foreigners invest in a U.S. fund – but not when U.S. managers must go overseas to attract foreign investment. Removing the U.S. tax impediments to foreign investment in U.S. funds will help create jobs in the United States.

### 3. Stifling Innovation in Exchange-Traded Funds

As of March 2011, ETFs registered under the Investment Company Act held \$947 billion in assets under management, comprising 68 percent of the global ETF market. Growth in this market is likely being slowed, however, by the SEC's deferral of certain new product applications.<sup>102</sup> Specifically, in March 2010, the SEC announced the deferral of new applications for ETFs that make significant use of derivatives pending a review of

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To qualify for the tax treatment provided to RICs by Subchapter M of the Internal Revenue Code, a fund must distribute with respect to its taxable year at least 90 percent of its income (other than net capital gain). Any retained income is taxed at regular corporate tax rates. Because a RIC that incurs corporate tax provides a lower return than one that does not incur such tax, RICs generally attempt to distribute all of their income.

<sup>101</sup> International Competitiveness Act of 1991, S. 1748, 102nd Cong. (1991).

<sup>102</sup> Because they operate differently from a traditional mutual fund in certain respects, ETFs must receive exemptive relief from the SEC from specific provisions of the Investment Company Act. This process entails the filing of a detailed application by an ETF's sponsor with the SEC and the granting of an exemptive order that establishes conditions or requirements with which the ETF must comply in exchange for the relief granted.

the use of derivatives by mutual funds, ETFs, and other investment companies.<sup>103</sup> While we support the Commission's review of funds' use of derivatives and have offered our assistance to the SEC staff as they conduct their examination, we believe this protracted moratorium on new ETF applications unfairly disadvantages new entrants to the ETF market, and is unwarranted from a regulatory perspective.

With respect to derivatives use, ETFs registered under the Investment Company Act must comply with the same rigorous regulatory framework as traditional mutual funds. Because mutual funds do not need to undergo the application process in order to launch, however, the SEC's deferral of applications does not apply to them, and therefore innovative products may be created as mutual funds that may not currently be done in the ETF format. Perhaps more importantly, prior to the SEC's announcement certain ETF sponsors received permission to create funds, including new funds, that make significant use of derivatives. This has given some market participants a substantial advantage as new entrants are prohibited, and has even placed an acquisition premium on those sponsors that have obtained such relief.<sup>104</sup> We believe such an unlevel playing field is inappropriate and unnecessary.

We recognize that a number of international regulators and watchdogs have recently expressed concerns about rapid growth and innovation in the ETF market.<sup>105</sup> As detailed in a recent Note by the Financial Stability Board ("FSB"), these concerns largely surround one specific ETF structure – what the Note terms a “synthetic” ETF – one that utilizes a single swap, typically entered into with an affiliated entity, to achieve its investment exposure. The Note acknowledges that this structure by and large does not exist in the United States, and makes reference to the SEC's moratorium. In fact, even absent the moratorium, there would be no synthetic ETFs in our market. As we explained in detail in our comment letter to the FSB, the Investment Company Act, along with its attendant regulations and guidance, establishes a framework under which such a structure could not operate.<sup>106</sup>

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<sup>103</sup> See SEC Press Release: SEC Staff Evaluating the Use of Derivatives by Funds, March 25, 2010, available at <http://www.sec.gov/news/press/2010/2010-45.htm>.

<sup>104</sup> See, e.g., Ignites, “Grail drawing interest from major institutional managers,” Jan. 12, 2011 (“The asset manager that ultimately buys Grail Advisors’ active ETF business is likely more interested in the firm’s expansive regulatory exemptions than in its existing product lineup.”).

<sup>105</sup> See, e.g., Financial Stability Board Note, “Potential financial stability issues arising from recent trends in exchange-traded funds,” April 12, 2011, available at [http://www.financialstabilityboard.org/publications/r\\_110412b.pdf](http://www.financialstabilityboard.org/publications/r_110412b.pdf); Bank for International Settlements Working Paper No. 343, “Market structures and systemic risks of exchange-traded funds,” April 2011, available at <http://www.bis.org/publ/work343.pdf>.

<sup>106</sup> Letter from Karrie McMillan, General Counsel, Investment Company Institute, to the Secretariat of the Financial Stability Board, May 16, 2011, available at <http://www.ici.org/pdf/25189.pdf>. It is unfortunate that

Because its current position creates an unlevel playing field between mutual funds and ETFs as well as among ETFs themselves, and because the Investment Company Act structure offers substantial protections against the risks outlined by international regulators and watchdogs, we believe the SEC should be urged to lift its moratorium on applications for ETFs that may make substantial use of derivatives.

#### 4. Use of Electronic Media to Improve Disclosure

Funds are subject to more extensive disclosure requirements than any other comparable financial product, such as separately managed accounts, collective investment trusts, and private pools. The goal of disclosure should be to provide information that is easily accessible, understandable and useful to investors. ICI research, as well as research by the SEC and consumer groups, finds that providing simplified, streamlined disclosure of essential information results in better-informed investors, because investors are far more likely to read a summary document than lengthy disclosures.<sup>107</sup>

In recent years, the SEC and the DOL—which regulates disclosure to participants in employee benefit plans such as 401(k)s—have made great strides in improving the quality of disclosure to investors, in part by authorizing the use of electronic media for certain disclosure purposes.<sup>108</sup> Indeed, electronic delivery—*e.g.*, using the Internet to

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by and large the media did not grasp this distinction, and unfairly painted all ETFs with the same “systemic risk” brush.

<sup>107</sup> See, *e.g.*, Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders* (Summary of Research Findings) (May 1996), available at [http://www.ici.org/stats/res/arc-rpt/rpt\\_profprspctus3.pdf](http://www.ici.org/stats/res/arc-rpt/rpt_profprspctus3.pdf); Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders* (Volume 1) (May 1996), available at [http://www.ici.org/stats/res/arc-dis/rpt\\_profprspctus.pdf](http://www.ici.org/stats/res/arc-dis/rpt_profprspctus.pdf); Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders* (Volume 2) (May 1996), available at [http://www.ici.org/stats/res/arc-dis/rpt\\_profprspctus2.pdf](http://www.ici.org/stats/res/arc-dis/rpt_profprspctus2.pdf); Investment Company Institute, *Understanding Shareholders' Use of Information and Advisers* (April 1997), available at [http://www.ici.org/stats/res/arc-dis/rpt\\_undstnd\\_share.pdf](http://www.ici.org/stats/res/arc-dis/rpt_undstnd_share.pdf); Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (2006), available at [http://www.ici.org/stats/res/rpt\\_o6\\_inv\\_prefs\\_full.pdf](http://www.ici.org/stats/res/rpt_o6_inv_prefs_full.pdf) (2006 Preferences Study”); ICI Research Fundamentals, “Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010” (September 2010), available at <http://www.ici.org/pdf/fm-vign6.pdf>; see also Barbara Roper and Stephen Brobeck, Consumer Federation of America, *Mutual Fund Purchase Practices* (June 2006), available at [http://www.consumerfed.org/pdfs/mutual\\_fund\\_survey\\_report.pdf](http://www.consumerfed.org/pdfs/mutual_fund_survey_report.pdf).

<sup>108</sup> For example, in 2009 the SEC adopted a rule revising the mutual fund prospectus—the cornerstone of fund disclosure—to require a summary section that contains the key information investors need, and permitting funds to send investors a “summary prospectus” in lieu of the full prospectus, so long as they provide additional information on the Internet and in paper upon request. See SEC Release Nos. 33-8998 and IC-28584 (Jan. 13, 2009), available at <http://www.sec.gov/rules/final/2009/33-8998.pdf>. Similarly, in 2010, DOL adopted new “layered” disclosure regulations to require that key information about all plan investment options be presented concisely and that plans have a website where participants can get more information, such as information about the risks associated with each investment and updated performance

provide disclosure to investors—is uniquely suited to facilitate investor understanding and response to information. It can enhance the effectiveness of communications by highlighting key information, making additional information readily available for those that desire it, and enabling recipients easily to take action on the information.

In the past, regulators have expressed reluctance to rely too heavily on technology that may not be available to some investors.<sup>109</sup> Today, however, Internet access among mutual fund investors is almost universal.<sup>110</sup> Indeed, a recently-released white paper filed with DOL demonstrates that working American families are almost as likely to have Internet access as they are to own a telephone.<sup>111</sup> For these reasons, we urge regulators to place increased emphasis on regulatory initiatives designed to utilize technology to improve delivery and utility of disclosure to investors, including in the areas discussed below.

#### a. Electronic Disclosure by Employee Benefit Plans

DOL recently issued a request for information on whether and how, in light of developments in technology, to revise the rules it adopted in 2002 that constrain e-delivery in employee benefit plans.<sup>112</sup> Given the many advantages electronic delivery can offer—as detailed in our comment letter to DOL—and the favorable statistics regarding working Americans’ access to the Internet, ICI strongly supports amending these rules to allow plans to deliver the required information electronically.<sup>113</sup> We have recommended that DOL exercise leadership by adopting rules that make it easy, not hard, to use electronic delivery mechanisms that Americans are familiar and comfortable with, while preserving the ability of those participants who need or prefer paper to obtain it.

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information. See 75 Fed. Reg. 64910 (Oct. 20, 2010), available at <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24323>.

<sup>109</sup> See, e.g., SEC Release Nos. 33-7856, 34-42728, IC-24426 (April 28, 2000), at notes 100 and 101 and related text, available at [http://www.sec.gov/rules/interp/34-42728.htm#p284\\_83646](http://www.sec.gov/rules/interp/34-42728.htm#p284_83646).

<sup>110</sup> In 2010, approximately nine in ten households owning mutual funds had Internet access. See ICI Research Fundamentals, “Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010,” *supra* note 107.

<sup>111</sup> See Peter P. Swire and Kenesa Ahmad, Delivering ERISA Disclosure for Defined Contribution Plans: Why the Time Has Come to Prefer Electronic Delivery (June 2011), available at [http://www.ici.org/pdf/ppr\\_11\\_disclosure\\_dc.pdf](http://www.ici.org/pdf/ppr_11_disclosure_dc.pdf).

<sup>112</sup> See Request for Information Regarding Electronic Disclosure by Employee Benefit Plans, 76 Fed. Reg. 19285 (Apr. 7, 2011), available at <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24850>.

<sup>113</sup> See, e.g., Letter from Mary S. Podesta, Senior Counsel-Pension Regulation, Investment Company Institute, to Office of Regulations and Interpretations, Employee Benefits Security Administration, dated June 6, 2011, available at <http://www.dol.gov/ebsa/pdf/1210-AB50-041.pdf>.

## b. Shareholder Report Reform

The SEC's summary prospectus initiative, which ICI Strongly supported over many years, has proved to be of enormous benefit to our investors.<sup>114</sup> ICI and SEC research indicates that similar recrafting funds' annual and semi-annual reports to shareholders would do likewise.<sup>115</sup> Also, the information shareholder reports currently must contain (including, for example, various narrative disclosures, financial data, a graphic depiction of portfolio holdings, and a schedule of investments) would seem to lend itself well to a layered disclosure approach.

We urge the SEC to turn its attention to improving fund shareholder reports at the earliest possible opportunity. Given the nearly universal access to the Internet among mutual fund investors, any such reforms should seek to take fullest advantage of the benefits that electronic technology can provide. In this regard, we note that while we supported the requirement that the summary prospectus be delivered in paper (unless an investor consented to electronic delivery), we expressed our expectation that, over time, investors would become accustomed to seeking investment information on the Internet. We recommended that in the future the Commission revisit whether the provision of information solely on the Internet may be sufficient. We believe the evidence is mounting that for many investors electronic delivery may now be superior to paper delivery. For these reasons, we recommend that the SEC continually reexamine the changing technology landscape—including benefits, costs, and risks—as it contemplates future improvements to investor disclosure, such as reform of fund shareholder reports.

## 5. Regulatory Challenges With Social Media

Many members of the fund industry utilize social media, and others are exploring the possibility of doing so.<sup>116</sup> Social media presents funds with an opportunity to communicate with shareholders and the public in a more dynamic way than was previously possible. For example, in the past, a fund typically would publicize a research report by means of a press release and posting on the firm's website. Social media provides the opportunity to additionally post the report on Facebook, tweet about it over Twitter, and have a portfolio manager discuss his or her findings on YouTube. Third parties may seize on this information and disseminate it even more broadly. The benefits

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<sup>114</sup> See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated February 28, 2008, available at <http://www.sec.gov/comments/s7-28-07/s72807-92.pdf>.

<sup>115</sup> See 2006 Preferences Study, *supra* note 107; Mandatory Disclosure Documents Telephone Survey, Submitted to the Securities and Exchange Commission, July 30, 2008, at 78, 80, available at <http://www.sec.gov/pdf/disclosuredocs.pdf>.

<sup>116</sup> See e.g., kasina, *Harnessing Social Media To Drive Business Results* (2011) showing that of the asset managers responding to the kasina survey, the percentage active in at least one social media channel rose to 80% in 2011 from 48% in 2010.

of social media include shareholder education, branding, enhancing relationships with customers, increasing the visibility of portfolio managers, and assisting in sales efforts.

Funds typically participate in social media through their affiliated broker-dealers or investment advisers. The SEC and FINRA regulate broker-dealer communications with the public, including the use of social media. The SEC also regulates investment adviser communications with the public, including the use of social media.

We commend FINRA's interest in reviewing issues relating to broker-dealers' use of social media. It established an industry task force, the Social Networking Task Force, in 2009 that assisted it in providing guidance early last year.<sup>117</sup> The guidance was intended to help broker-dealer firms in applying FINRA's rules on communications with the public to their use of social media sites. FINRA supplemented that guidance with two webinars, to provide industry with additional clarity regarding the guidance. Since then, FINRA has reconvened its Social Networking Task Force to assist in its efforts to provide still further guidance. The task force should provide FINRA greater insights to enable it to better align the existing rigid regulatory requirements with the fast and ever-evolving media used to communicate with the public.

Indeed, the most vexing issue is how to apply antiquated rules on recordkeeping to this dynamic communications medium. In particular, the regulations that govern broker-dealers' use of social media are based on a statutory provision written in 1934. When one considers how much has changed since 1934, it quickly becomes obvious that the regulatory framework has not kept pace with the technological advances and current means of communication.

While some firms have been able to establish policies and procedures that adequately oversee their participation in social media, strict application of current recordkeeping rules based on the 1934 law has inhibited greater use of social media, particularly with respect to broad usage of interactive features. We believe that the securities regulators should work with the industry to develop a reasonable framework for public communications and related recordkeeping requirements that provides firms with enough flexibility to allow them to communicate more broadly using today's and tomorrow's technologies consistent with investor protection. The ICI is working closely with its members on these issues, and stands ready to assist regulators in this important endeavor.

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<sup>117</sup> See FINRA Regulatory Notice 10-06, (January 2010) ("2010 Guidance"). We were pleased that the task force included representatives from the fund industry.

## 6. The Potential for Investor Confusion with Less Regulated Alternatives to Funds

A final issue facing funds as issuers that we would like to call to the Subcommittee's attention involves exchange traded notes ("ETNs"), which, like funds, are marketed widely to retail investors. Many have touted ETNs as better than funds because they take advantage of gaps in the tax law to provide investors with superior tax treatment. Investors have been listening. The ETN market has grown in the past year from \$9.8 billion to \$16.6 billion.<sup>118</sup>

ETNs are forward contracts with unique features. The return of an ETN, typically, is measured by an assumed (notional) investment, or a series of assumed investments and reinvestments, in a basket of commodities or securities. Unlike the typical forward contract, which is settled at maturity, the investor in an ETN pays up-front; consequently, these derivatives are known as "prepaid" forwards. Moreover, unlike the typical forward contract, which is short-lived, the ETN does not mature for up to 30 years. The prepayment feature and 30-year maturity, with no interim payments, create two tax advantages not obtained by investors in comparable financial instruments.

The first tax advantage involves deferring all taxable income until either the ETN matures or the investor sells it. The second tax advantage involves treating all income arising from the investment as (tax-favored) capital gain. These advantages arise because the tax laws do not treat the ETN for what it is: a loan to the issuer for a return based upon constructive ownership of a basket of commodities or securities.

ETNs and funds both provide important investment opportunities – including gaining investment exposure to a diversified pool of securities – but with different risks. The ETN investor's return is based both on the return of the securities and the credit risk of the issuer. The fund investor's return, in contrast, is based solely on the return of the securities.

Comparable products should be treated comparably. Financial services firms should not be incentivized to create derivatives that take advantage of tax law gaps to provide unintended advantages while subjecting investors to unnecessary risk. The investors in Lehman's ETNs, having lost their investments when the bank filed for bankruptcy, surely agree.

### B. Issues Affecting Funds as Investors in the Securities Markets

A second set of significant issues concern the fund industry primarily as investors in the markets. As institutional investors that held 27 percent of the value of publicly traded U.S. equity outstanding at the end of 2010, and that invest over \$13.8 trillion on

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<sup>118</sup> See <http://www.nsx.com/content/etf-assets-list>. These asset figures are as of May 2010 and May 2011.

behalf of over 91 million fund shareholders, funds have a strong interest in market regulation—and particularly in ensuring that the financial markets are highly competitive, transparent and efficient, and that regulations encourage, rather than impede, liquidity, transparency, and price discovery. Consistent with these goals, we have strongly supported efforts to address issues that may impact the fair and orderly operation of the financial markets and investor confidence in those markets, and we have long advocated for regulatory changes that would result in more efficient markets for investors.<sup>119</sup>

#### 1. Derivatives and Title VII of the Dodd-Frank Act

The implementation of the Dodd-Frank Act will dramatically change the derivatives markets, establishing a new regulatory framework for the swaps markets and their participants.<sup>120</sup> Funds are participants in these markets, and they use swaps and other derivatives in a variety of ways to manage their portfolios.<sup>121</sup> Accordingly, ICI and its members have encouraged reform efforts in these markets.<sup>122</sup> During the hearings that led to the Dodd-Frank Act, for example, ICI specifically supported measures that would

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<sup>119</sup> See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 21, 2010 (Concept Release on Equity Market Structure), available at <http://www.ici.org/pdf/24266.pdf>; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 22, 2010 (Non-Public Trading Interest), available at <http://www.ici.org/pdf/24142.pdf>; Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2004 (Regulation NMS), available at <http://www.ici.org/vgn-ext-templating/v/index.jsp?vgnextoid=efeb68d4041de110VgnVCM1000005bo21oacRCRD>; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 12, 2000 (Market Fragmentation Concept Release), available at <http://www.ici.org/pdf/11894.pdf>; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 28, 1998 (Regulation of Exchanges and Alternative Trading Systems), available at [http://www.ici.org/pdf/comment98\\_reg\\_exch\\_ats.pdf](http://www.ici.org/pdf/comment98_reg_exch_ats.pdf); and Letter from Craig S. Tyle, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 16, 1996 (Order Execution Obligations), available at <http://www.ici.org/pdf/7561.pdf>.

<sup>120</sup> Throughout this section of the testimony, we will use the term “swaps” to refer to both swaps and security-based swaps. Likewise, we will use the term “major swap participant” or “MSP” to refer to both major swap participants and major security-based swap participants.

<sup>121</sup> For example, funds use derivatives to hedge positions; equitize cash that a fund cannot immediately invest in direct equity holdings; manage the fund’s cash positions more generally; adjust the duration of the fund’s portfolio, managing bond positions in general; or manage the fund’s portfolio in accordance with the investment objectives stated in its prospectus.

<sup>122</sup> Testimony of Karrie McMillan, General Counsel, Investment Company Institute, before the Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, United States House of Representatives, on “Implementing Dodd-Frank: A Review of the CFTC’s Rulemaking Process” (April 13, 2011).

increase transparency and reduce counterparty risk of certain over-the-counter derivatives.<sup>123</sup> We, therefore, have urged the CFTC and the SEC to promulgate regulations in a manner that provides the protections sought by the Dodd-Frank Act while minimizing disruptions to the markets, market participants, and customers.<sup>124</sup> Among others, three issues rise to the forefront: the implementation process for the final rules; the definition of “major swap participant” (“MSP”); and the reporting of swap transaction data and the determination of block trades.

a. Implementation of Title VII

The process of finalizing and implementing the rulemakings proposed under Title VII of the Dodd-Frank Act must ensure that the new rules are tailored appropriately, work in tandem with one another, and strike the right balance between costs and benefits. ICI commends the SEC and CFTC (together, the “Commissions”) for their extraordinary efforts in the very difficult task of developing rules to address the complexities of the swaps markets while avoiding unintended consequences. To ensure that the final regulatory framework “gets it right,” however, it is critical that the CFTC and SEC sustain a transparent and open rulemaking process that: (1) solicits public comment in a manner that provides affected parties a meaningful opportunity to comment; (2) harmonizes and coordinates with domestic and international regulators, as appropriate; and (3) phases in the effective and compliance dates of the final rules.

ICI believes that the following steps are necessary for the Commissions to achieve these goals.<sup>125</sup> First, the Commissions should repropose for a brief period the swaps rules in the order in which they will be implemented. This will allow the public the opportunity to assess the implications of any changes from the rules as proposed, particularly in light of concerns regarding regulatory certainty and unintended consequences.<sup>126</sup> In this regard, we have no intention of protracting or impeding the adoption and implementation of the final swaps rules. In light of the complex and highly interdependent nature of these rules, however, we strongly believe that any changes

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<sup>123</sup> Stevens July 2009 Testimony, *supra* note 50.

<sup>124</sup> The Dodd-Frank Act was enacted to reduce risk, increase transparency, and promote market integrity within the financial system.

<sup>125</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated June 10, 2011 (commenting on phase-in schedule for requirements for Title VII of the Dodd-Frank Act) (“ICI Phase In Letter”), available at <http://www.ici.org/pdf/25276.pdf>.

<sup>126</sup> We suggest that the Commissions provide a minimum 30-day comment period for each of the reproposed rules.

made in response to comments may raise new considerations for the Commissions to address in the amended rule or other interrelated proposals.<sup>127</sup>

Second, implementation of the new regulatory framework must follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies.<sup>128</sup> Specifically, the implementation periods should afford adequate time for the Commissions to gather additional market data to inform rulemaking; allow market participants to build market infrastructures, modify business operations, complete testing, and perform outreach and education of customers; and phase in rule requirements by type of market participants and asset class. Market participants are struggling with the implications of the proposed rules on their activities in these markets, and are hampered in developing compliance strategies by the need to wait for action from other market participants. Phasing in the rules will provide market participants with essential time to identify the cumulative impact of the rule changes, build upon the actions of other market participants, and manage the cumulative costs of the rule changes.

Ultimately, the Commissions should not celebrate speed over precision in finalizing the rules and establishing the compliance deadlines. By seeking public input on the revised rules in the way we recommend and by carefully phasing in the effective dates of the rules to allow the markets and market participants to come into compliance, the Commissions will have far greater assurance of the quality and efficacy of the final regulatory framework.

#### b. Definition of Major Swap Participant

ICI continues to be greatly concerned about the potential regulation of funds as “major swap participants.” Regulating funds as MSPs would not further the important goals of the Dodd-Frank Act, such as minimizing systemic risk. Instead of providing important protections for the markets, regulation of funds as MSPs would impose costs

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<sup>127</sup> We note and appreciate the CFTC’s recent extension of the comment periods on the proposed swap rules by 30 days. The extension was provided, however, at a time when market participants also were first presented with a set of newly proposed rules, including proposed margin rules, capital rules, swap definition rules, and customer collateral rules – all of which are extremely complex and have significant import to market participants. Thus, the opportunity to review and comment on the entire framework of published rules has been limited. Further, the extension did not afford commenters the opportunity to assess the final rules—the rules as may be amended in response to comments.

<sup>128</sup> See Letter from American Bankers Ass’n, ABA Securities Ass’n, The Clearing House Ass’n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass’n, Investment Company Institute, Managed Funds Ass’n and Securities Industry and Financial Markets Ass’n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated December 6, 2010, available at <http://www.ici.org/pdf/24761.pdf>.

well in excess of the benefits sought to be achieved and would disregard guidance from members of Congress to consider the existing regulatory regime of swap market participants.<sup>129</sup> To avoid unnecessary and burdensome regulatory overlap, we have recommended that the SEC and CFTC exclude funds from the definition of MSP on the grounds that funds do not present the risks that underpin the proposed definition.

As discussed, funds are subject to a comprehensive regulatory framework under the federal securities laws that sets them apart from other types of financial entities and ensures that their swap activities do not threaten the U.S. financial system.<sup>130</sup> Current regulation of funds addresses their margin, capital, leverage, risk disclosure, recordkeeping, registration, and business conduct. The risk associated with funds' swap activity is mitigated by their use of collateral and asset segregation, and regulatory limits on their ability to use leverage.<sup>131</sup> The provisions of the Dodd-Frank Act establish regulatory oversight for leverage, volatility, and collateral related to swap trading. Applying these provisions to funds would unnecessarily subject them to duplicative or potentially inconsistent regulatory requirements, with significant additional costs for fund investors and no corresponding benefits.

#### c. Reporting of Swap Transaction Data and the Determination of Block Trades

Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals that would require, upon execution, reporting of swap transaction data to a registered swap data repository ("SDR"). The SDR would make certain of the swap data publicly available in real time. Market transparency is a key element to ensuring the integrity and quality of these markets,<sup>132</sup> but ICI is deeply concerned that neither the SEC's nor the

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<sup>129</sup> In formulating regulation and further defining the term MSP, among others, the SEC and CFTC were advised to focus on those risk factors that contributed to the recent financial crisis such as excessive leverage and under-collateralization of swap positions and to consider the nature and current regulation of swap market participants. See Congressional Record, S5907, July 15, 2010 (remarks by Senator Lincoln, Chair of the Senate Agriculture, Nutrition, & Forestry Committee, in a colloquy related to the passage of the Dodd-Frank Act).

<sup>130</sup> For a detailed discussion of the federal securities laws applicable to funds in this regard, see Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010 and February 22, 2011 ("ICI MSP Letters"), available at <http://www.ici.org/pdf/24551.pdf> and <http://www.ici.org/pdf/24987.pdf>.

<sup>131</sup> See, e.g., Section 18 (asset coverage requirements and restrictions on leverage and senior securities) and Section 17 (custody requirements for collateral) of the Investment Company Act and the rules promulgated thereunder.

<sup>132</sup> As part of its recommendations to the SEC and CFTC regarding the sequence for implementation of the new swaps regulatory framework, ICI has recommended that the Commissions begin by finalizing and implementing rules requiring reporting of swap transaction data to the regulators. Initially, reporting should be limited to non-public, regulatory reporting to gather data to inform, for example, block trading rules without significantly disrupting the swaps market and market participants' trading strategies by

CFTC's proposal adequately protects information regarding a fund's block trades. Failure to do so would compromise funds' sensitive trading data, enabling market participants to identify funds and their trading strategy to the detriment of funds, their shareholders and the liquidity of the market in which those trades occur. To prevent this outcome, we have recommend that in each of their proposals the SEC and CFTC should (1) define a block trade by evaluating the market for a particular swap category to determine what might be an illiquid size and (2) change the reporting timeframe to the later of 24 hours after trade execution or the opening of trading the following day. We also recommend that the Commissions harmonize and coordinate their proposals to the extent possible.

#### 1) Block Trades

Block trades enable funds, on behalf of their shareholders, to transact in large amounts off an exchange with minimal disruption to the swaps market. After a block trade has been executed, one or more of the counterparties will seek to reduce risk by hedging its exposure, usually by transacting on an exchange. Knowledge of a block trade therefore signals to other market participants that there is the potential for subsequent trading activity.<sup>133</sup> This signaling can negatively affect the market and fund shareholders by significantly skewing pricing if the market does not have sufficient time to digest the block order. In addition, opportunistic market participants may piece together information about a fund's holdings or trading strategy, leading to front running of a fund's trades, which also adversely impacts the price of the swap and the underlying security to the detriment of fund shareholders.

Flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity. First, swaps are not as liquid or traded as frequently as futures. Without block trading in the swaps market, market participants will not execute larger size transactions, further impeding the development of more liquidity in these markets. Second, the signaling problem discussed above is more severe for swaps than futures or other securities because the highly distinctive terms of even "standardized" swaps reveal larger amounts of information about the positions and trading strategies of the counterparties to a trade, and can often be used to infer the identity of at least one of the counterparties to the trade.<sup>134</sup> Third, swaps are commonly

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impacting liquidity. ICI believes that the information gathered through this process will assist the Commissions in better understanding the structure and operations of the swaps markets and adopting appropriately tailored and effective rules. Further, only after such analysis can the Commissions accurately determine the effect of public dissemination of certain of the swap transaction data. See ICI Phase In Letter, *supra* note 125.

<sup>133</sup> In post-transaction analysis of block trades, our members report being able to see that the market tracked their movements.

<sup>134</sup> Identification would be particularly easy in swaps markets in which there are a limited number of market participants actively trading and such participants were required to disclose a large amount of transaction data.

used by market participants to hedge their exposures in the futures market because of the extremely limited block trading in that market.

## 2) Thresholds for Qualifying as a Block Trade

The best way to identify the appropriate thresholds for block trades in the swaps market is to account for the liquidity in each unique category of swaps.<sup>135</sup> The risks, trading and liquidity associated with a particular swap differ for each individual swap category within an asset class based on type, term and underlying security.<sup>136</sup> The SEC and CFTC should reflect these granular but significant differences by creating narrow buckets to which the threshold formulas would apply. These thresholds should be calculated regularly (*e.g.*, quarterly) to ensure that they are appropriately tracking liquidity in the swap categories.

In addition, the thresholds must be low enough to encourage the use of block trades. Setting the thresholds too high could cause significant market disruption and harm to fund shareholders by eliminating the use of block trades in these markets and the associated benefits provided by such trades. Further, the Commissions should err on the side of caution by setting the thresholds low initially to collect data to enable them to evaluate the thresholds and the appropriate delays for data dissemination.

## 3) Delayed Reporting

The SEC and CFTC proposals take different approaches to the proposed reporting period for block trade information. The CFTC proposal would provide that the reporting party for a block trade would report the transaction data in real time but data would not be publicly disseminated before the expiration of 15 minutes. The SEC proposal would delay public dissemination of the notional size of block trades for a minimum of 8 hours or, in certain cases, until re-opening of an SDR.<sup>137</sup> These timeframes are inadequate to allow the market to absorb the impact of a block trade and could result in higher costs for block trades which, ultimately, would be felt by fund shareholders. We recommend instead that reporting for block trades be delayed until the later of 24 hours following execution of the trade and the opening of the next following trading day.

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<sup>135</sup> Under the proposed CFTC thresholds, many transactions that should be treated as block trades would not qualify as such. The SEC proposal does not include thresholds. Instead, the SEC seeks comment on the general criteria that should be used by SDRs to determine whether a transaction is a block trade.

<sup>136</sup> The SEC proposal states that it would be inappropriate to establish different thresholds for similar instruments with different maturities. We strongly disagree because of the unique characteristics associated with each swap.

<sup>137</sup> ICI recommends that all block trade information be delayed, not just the notional amount. The absence of the notional amount in the reported transaction data will be an indicator to other market participants that there is the potential for subsequent trading activity.

Swaps are not as liquid or traded as frequently as futures or equities so time frames for dissemination of block transaction data in other markets is of limited value. In some cases, it may take a day or more for large or illiquid transactions to be off-set in the swaps market. Moreover, whether a swap is illiquid may depend on the time of day and the term. Longer delays are unquestionably needed for swaps to avoid front running by opportunistic market participants looking to trade ahead of the hedging (or risk-offsetting) transaction.

In fact, we believe that the appropriate time for dissemination of block trade data is best determined by evaluating the type of swap and the factors considered in establishing a “block trade.” The SEC and the CFTC do not yet have the information to make these determinations. A 24-hour reporting time frame generally should be adequate to account for off-setting a trade regardless of the type of swap. Once the Commissions gain a better understanding of the appropriate thresholds for a “block trade” and the time it takes the market to absorb a block trade in the various categories of swaps, our 24-hour recommendation could be revisited.

#### 4) Consistency between CFTC and SEC Reporting Requirements

As identified above, the SEC and CFTC proposals differ, sometimes substantially. The principles guiding the regulatory approaches and the underlying rules should be the same with respect to real-time reporting. The approach to reporting should be uniform and consistent, reflecting the unique characteristics of the swaps market even though application of the final rules to the individual swaps within the Commissions’ jurisdictions should differ in recognition of the liquidity for those products. Duplicative requirements are burdensome and inconsistent requirements pose operational problems.

At a minimum, we recommend that the agencies coordinate their proposals with respect to reporting parties, reporting time frames, data to be reported, the approach to establishing block trade thresholds, and the time frames and data requirements for reporting block trades. Such coordination would be in keeping with the Dodd-Frank Act mandates and would help to minimize excessive and unnecessary regulatory burdens caused by the different regulatory requirements.

#### 2. Trading and Market Structure Issues

Efficient financial markets are critical for investors given the dramatic changes to market structure that have occurred in just the last few years alone. The structure of the markets in the United States today is an aggregation of exchanges, broker-sponsored execution venues and alternative trading systems. Particularly in the equity markets, trading is fragmented with no single destination executing a significant percentage of the total U.S. equity market. Some of the biggest and most active traders are so-called high frequency traders, who by most accounts trade more than half of the daily volume of the equity markets. Tremendous competition exists among exchanges and other execution

venues, primarily driven by differences in the fees they charge and the speed by which they execute trades, with floor-based exchanges quickly becoming irrelevant.

With all that said, the Institute believes that the U.S. equity markets generally are functioning well. Investors, both retail and institutional, are better off than they were just a few years ago. Trading costs have been reduced, more tools are available to investors for executing trades, and technology has increased the overall efficiency of trading. A primary driver and enabler of the market changes has been the continual evolution of technologies for generating, routing and executing orders, and related improvements to the speed, capacity and sophistication of the trading functions available to investors. Nevertheless, long-time challenges for funds remain and the changes we have experienced in the structure of our markets have not addressed all of the components we believe necessary for a fully efficient market structure. Posted liquidity and average execution size is lower, while trading large blocks of stock has become more difficult. In addition, new challenges have been created due to some of the recent market structure developments discussed below.

Investor confidence in the financial markets also has been shaken of late, notably by the May 6, 2010 “flash crash.” As SEC Chairman Schapiro stated in a speech at ICI’s recent General Membership Meeting:

[The] significance of May 6 is greater than the investor harm caused by [the] wild swings in prices – it lies in the significant blow to investor confidence this volatility delivered, as well. Because, while every investor accepts financial risk as a fact of life, they operate under the assumption that America’s markets are structurally sound – that the funds you represent and the investors you advise could confidently entrust their capital to the world’s most sophisticated financial markets. When that confidence declines, the ramifications – in lost wealth and increased cost of capital – can be great.<sup>138</sup>

Regulators have made great strides in addressing needed market structure reforms. We were particularly pleased when the SEC determined to take a broad look at the current U.S. equity market structure and its impact on long-term investors, such as mutual funds, through its concept release on the structure of the equity markets.<sup>139</sup> The SEC’s concept release raised a number of significant market structure issues, including the need for improved transparency of information about the markets, high frequency trading and liquidity that is not displayed in the public markets.

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<sup>138</sup> See Speech by SEC Chairman Mary L. Schapiro, *Remarks Before the Investment Company Institute's General Membership Meeting*, May 6, 2011, available at <http://www.sec.gov/news/speech/2011/spcho506umls.htm>.

<sup>139</sup> SEC Release No. 34-61358 (January 14, 2010).

These issues have taken on increased importance since the “flash crash.” It is clear that the large and sudden price dislocations experienced on May 6, 2010 were, at least in part, the result of inefficiencies in the current market structure. Most significantly, while the financial markets have become highly automated and increasingly complex and fragmented, the rules governing the markets have not kept pace with the level of complexity and growth of the wide variety of trading venues and market participants.

As Congress and regulators continue to examine the reform of the rules overseeing the financial markets, it is important not to view any specific market structure issue in a vacuum. The congeries of complex issues posed by the current market structure are closely linked – decisions made about one will impact, in one way or another, many others.

In addition, it is important that Congress and regulators take a measured approach to market structure reform. Otherwise, by restricting new practices or technology, policymakers may impede funds’ use of new and innovative trading venues and of tools designed to assist in executing large orders. Automated trading systems, for example, have become an important tool for funds in the normal course of the routing and execution of orders. Regulatory initiatives should not impede funds’ use of legitimate trading practices. Similarly, as discussed further below, while we strongly support the need for more transparency of information about the financial markets, Congress and regulators must be careful to not create a regulatory environment that allows for the premature disclosure of critical information about fund orders to the detriment of fund shareholders.

Finally, should regulations become too onerous or costly for certain market participants, they may decline to offer certain products or services to investors. Similarly, trading costs may increase as market participants shift the burden of compliance to investors. We therefore urge policymakers to carefully balance these and other potential costs with the benefits any new regulations would provide to investors.

a. Need for Increased Transparency of Information Regarding the Financial Markets

Given the complexities of the current market structure, there is a clear need for improved market information to investors and regulators. As the events of May 6, 2010 illustrated, information about a growing portion of trading in the financial markets is insufficient. Improved information would allow investors to make better informed investment decisions, and help regulators and market participants better assess current market performance.

We have urged the SEC to examine the sufficiency of the information about trade execution provided to investors by brokers and other trading venues, including whether brokers are providing adequate and accurate information directly to investors about how

orders are handled and routed; the need for more public disclosure about how orders provided to brokers are handled; and better trade reporting by all types of execution venues regarding order execution.

We also have urged the SEC to continue to examine ways to improve transparency about current trading practices and market participants. The SEC has taken a number of steps in this area. For example, the SEC has proposed to develop, implement, and maintain a consolidated audit trail and a central repository for the consolidated audit trail data for the trading of listed equities and options. The SEC also has proposed the creation of a large trader reporting system that would enhance the SEC's ability to identify the effects of certain large trader activity on the markets, reconstruct trading activity following periods of unusual market activity, and analyze market events and trading activity for regulatory purposes. While concerns remain over several aspects of the implementation of these systems, together these systems could enhance the SEC's ability to identify large market participants, collect information on their trades, and analyze their trading activity.<sup>140</sup>

#### b. Role of Liquidity Providers and High Frequency Trading

The role of liquidity providers under the current market structure has garnered significant attention from Congress, regulators, and market participants in general. Much of this focus has been on the increased presence of high frequency traders in the markets. The role of high frequency traders, as well as traditional liquidity providers such as market makers, has taken on more significance since the events of May 6, 2010, as the sudden absence of liquidity in the markets played a critical role in the severe decline in stock prices.

High frequency trading represents, by most estimates, a majority of the activity in the U.S. equity markets today. The rapid increase in high frequency trading has, at the very least, raised questions about the lack of transparency into this practice and about the costs and/or benefits that high frequency traders bring to the markets.

To be clear, funds do not object to high frequency trading per se. High frequency trading arguably brings several benefits to the markets. There is no doubt that a group of market participants that represents such a significant portion of the daily trading volume does provide liquidity to the markets and, in turn, facilitates the tightening of spreads.

At the same time, however, there are potential concerns associated with high frequency trading. These include, among other things, the potential for "gaming" through the use of high-speed computer programs for generating, routing, and executing orders. In addition, the submission of numerous orders that are cancelled shortly after

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<sup>140</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated August 9, 2010, available at <http://www.ici.org/pdf/24477.pdf>.

submission can create unnecessary market traffic and misleading market “noise.” Of particular concern, Institute members report that strategies employed by high frequency traders (as well as by other market participants) can be designed to detect the trading of large blocks of securities by funds and to trade with or ahead of those blocks.

We believe the issues surrounding this trading practice are ripe for further examination by regulators given the significant amount of the daily trading volume that high frequency trading now constitutes. First and foremost, there is an immediate need for more information about high frequency traders and the practices of high frequency trading firms. We believe it would be extremely helpful for regulators to have access to increased information to better understand the impact of high frequency trading on the markets, and for investors likewise to make more efficient trading decisions.

Second, high frequency traders, to some extent, may have replaced more familiar liquidity providers in the equity markets such as market makers, but they are not subject to many of the obligations that in the past attached to market makers. We therefore recommend that the SEC examine the trading activity of high frequency trading firms versus the liquidity they provide and consider whether they should be subjected to further obligations.<sup>141</sup>

Third, the SEC should examine the strategies employed by high frequency trading firms to determine whether certain strategies should be considered as improper or manipulative activity. While many high frequency trading strategies may not be in violation of any specific regulation, this does not mean that they are beneficial to the markets or to investors, nor that they promote with efficient price discovery.<sup>142</sup>

Fourth, the SEC should act to address the increasing number of order cancellations in the securities markets, particularly when numerous orders are cancelled shortly after submission. Institute members report that certain of the practices and strategies surrounding cancellations can be designed to detect the trading of large blocks of securities by funds and to trade with or ahead of those blocks. At the very least, this is an area worthy of further examination.

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<sup>141</sup> We also believe that the SEC should examine whether more stringent obligations are necessary for traditional market makers in times of market stress.

<sup>142</sup> ICI supports, in general, action by regulators to clearly define practices involving trading strategies that may constitute market abuse, in order to ensure adequate regulatory consequences for these practices. The varied and complex trading practices used by market participants today often makes it difficult to distinguish between legitimate and disruptive trading practices in a number of situations. Lack of clarity also may have a chilling effect on legitimate practices or make enforcement of illegal activities more difficult.

Finally, regulators need to examine the incentives that currently exist for market participants to route orders to particular venues and any related conflicts of interest that may arise due to these incentives.

Investors deserve careful examination of the issues surrounding high frequency trading. To the extent that the additional restrictions on high frequency trading can increase investor confidence in the markets, such restrictions should be carefully considered.

c. Undisplayed Liquidity and the Need for Increased Public Display of Orders

Much of the current debate over the structure of the U.S. securities markets has centered on the proliferation of undisplayed, or “dark,” liquidity and the venues that provide such liquidity, particularly so-called “dark pools.” Funds have long been significant users of undisplayed liquidity and the trading venues that provide such liquidity. These venues provide a mechanism for transactions to interact without displaying the full scale of a fund’s trading interest, thereby lessening the cost of implementing trading ideas and mitigating the risk of information leakage. These venues also allow funds to avoid transacting with market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders. The confidentiality of information regarding fund trades is of significant importance to ICI’s members. Any premature or improper disclosure of this information can lead to frontrunning of a fund’s trades, adversely impacting the price of the stock that the fund is buying or selling.<sup>143</sup>

At the same time, we recognize that while venues providing undisplayed liquidity bring certain benefits to funds, not displaying orders detracts to some extent from overall market transparency. We therefore understand regulators’ desire to examine trading venues that do not display quotations to the public and its concerns about, for example, the creation of a two-tiered market.

Nevertheless, there is real value in enabling entities, such as funds, that frequently trade in large amounts to have access to venues that do not disclose their trading interest. We therefore believe it is imperative that policymakers take a measured approach to making trading through venues such as dark pools more transparent and we urge policymakers to ensure that there are no unintended consequences for funds from further regulations in this area.

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<sup>143</sup> See, e.g., Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, SEC, dated September 14, 2005, August 29, 2006, and September 19, 2008.

#### d. Other Market Structure Issues Arising from May 6, 2010 Events

The events of May 6, 2010 not only highlighted the need for improved transparency of information about the financial markets and for an examination of high frequency trading and undisplayed liquidity but also the need to examine several other related questions. These include: (1) market-wide and stock-by-stock circuit breakers; (2) better procedures for resolving clearly erroneous trades; (3) the use of market orders; (4) the inconsistent practices of exchanges regarding addressing major price movements in stocks; and (5) coordination across all types of markets.

Regulators have taken steps to address several of these issues, including implementing a stock-by-stock circuit breaker program, approving rules designed to bring clarity to the process of resolving “clearly erroneous” trades, enhance the quotation standards for market makers and eliminate “stub quotes,” and require broker-dealers with market access to put in place pre-trade risk management controls and supervisory procedures. The Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues also recently issued its final report containing a number of recommendations related to the “flash crash.”<sup>144</sup> The Institute strongly supports these initiatives and encourages regulators to continue to examine these issues.

#### e. Review of Fixed-Income Markets Needed

Compared to the attention given to the equity markets, there has been far less debate about the structure of the fixed-income markets. This clearly has not been the result of the lack of need for reform in this area. Many of the concerns relating to the structure of the equity markets—such as improving transparency by certain market participants, addressing conflicts of interest that may be present, and assuring regulation keeps pace with how securities actually are traded—all these are present in the fixed-income markets, perhaps to an even greater degree. ICI has long advocated for reform in this area, particularly relating to municipal securities, as discussed below.

We strongly believe that more needs to be done to enhance the structure of the fixed-income markets. To start, the SEC should issue a comprehensive concept release examining the fixed-income markets to gather comments from a wide variety of market participants to assist in determining what regulatory changes are needed to best serve investors. Such an examination is long overdue. Investors would be well served by such an initiative.

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<sup>144</sup> See “*Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010*,” available at <http://www.sec.gov/spotlight/sec-cftcjointcommittee/o21811-report.pdf>.

### 3. Municipal Securities Markets Reform

The tax-exempt municipal securities market provides an important mechanism for the almost 90,000 units of state and local government to access capital primarily for infrastructure needs including schools, streets and highways, bridges, hospitals, public housing, sewer and water systems, power utilities, and various public projects.<sup>145</sup> The tax treatment of municipal securities in Section 103 of the Internal Revenue Code, which states that the interest on municipal bonds is exempt from federal income tax, serves to bolster demand for municipal securities. For many of these small government units, the municipal securities markets are the only way in which they can truly raise needed funding for their operations. Funds are a critical part of this market. At the end of 2010, individual investors held 33 percent of the \$2.9 trillion municipal securities market through funds and another 37 percent directly.<sup>146</sup>

Funds provide an efficient and cost-effective means for individual investors to obtain municipal securities. With approximately 1.2 million active municipal bonds,<sup>147</sup> however, the municipal securities markets are complex. Investors will naturally gravitate toward issues for which they have ready access to the detailed, consistent, and timely disclosure necessary to informed investment decisions. Unfortunately, under the current municipal securities regulatory regime, disclosure too often is limited, non-standardized, and often stale.<sup>148</sup>

For these reasons, we repeatedly have called for reform of the municipal securities disclosure regime.<sup>149</sup> ICI consistently has supported SEC efforts to enhance the disclosure of information regarding municipal securities by amending Rule 15c2-12 under the Securities Exchange Act of 1934,<sup>150</sup> which establishes requirements on the initial

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<sup>145</sup> In addition to the 50 State governments, there were about 87,500 local governments in 2007, according to the U.S. Census Bureau. These included about 3,000 county governments; 19,500 municipal governments; 16,500 townships; 13,500 school districts; and 35,100 special districts.

<sup>146</sup> ICI Fact Book, *supra* note 3.

<sup>147</sup> According to Interactive Data, there are approximately 1.2 million active municipal bonds, with a continuous flow of new securities.

<sup>148</sup> See, e.g., Recent Trends in Municipal Continuing Disclosure Activities, DPC Data, Peter J. Schmitt (February 3, 2011) (finding that failure to file annual financial disclosure documents appears to be rising among issuers and obligors of municipal bonds and that annual financial statements are filed too late to be of practical use in credit risk analysis).

<sup>149</sup> See e.g., Stevens July 2009 Testimony, *supra* note 50, Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009, available at [http://www.ici.org/policy/markets/domestic/09\\_oversight\\_stevens\\_stmt](http://www.ici.org/policy/markets/domestic/09_oversight_stevens_stmt); and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, SEC, dated September 22, 2008.

<sup>150</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, SEC, dated September 8, 2009 (“ICI Municipal Securities Letter”).

disclosure, periodic disclosure, and secondary market reporting of municipal securities.<sup>151</sup> The Rule requires dealers and underwriters, through contract, to obtain issuer representations that certain disclosures may be made. Since adoption, time has shown that the attenuated nature of this disclosure system is extremely difficult to enforce.<sup>152</sup>

A better disclosure regime should be devised for this important market. Municipal securities now trade on a nationwide scale; their trading volume has increased substantially; and the market is composed of many complex instruments. Individual investors increasingly must evaluate not only default risk, but also market price and the corresponding value of a bond. The credit environment for municipal securities has become, and likely will continue to be, more challenging in the coming years, primarily in small or unrated issues.

Until 2008, the need for better disclosure was tempered by the fact that most municipal securities were insured. It was presumed that in the absence of publicly available information, a bond insurer had ready access to the municipal issuer's most recent financial statements and had performed necessary due diligence. Now, however, a smaller segment of the municipal securities market has bond insurance because of the skepticism of investors about the ability of the insurance industry to conduct quality risk assessments following the 2008 financial crisis. Disclosure gaps have been compounded by the adoption of a single global rating scale, which rates corporate and municipal securities on the same scale, and reduces the granularity of available information on municipal securities. Headline risk and the cyclical nature of retail trading further exacerbate the problem. Industry initiatives have made some headway for disclosure improvements in certain categories of municipal securities but these too are limited and voluntary.<sup>153</sup>

Improvements should begin with all investors in municipal securities receiving all material information related to an issue. Disclosure improvements should, at a minimum, include enhancements to timeliness *and* the number and type of individual data points.<sup>154</sup> It also could involve providing investors with information that is produced

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<sup>151</sup> See SEC Release No. 26985 (June 28, 1989) and SEC Release No. 34961 (November 10, 1994).

<sup>152</sup> Section 15B(d) of the Exchange Act, known as the Tower Amendment, prohibits the SEC or Municipal Securities Rulemaking Board ("MSRB") from directly or indirectly requiring issuers of municipal securities to file documents with them before securities are sold. As a result, the SEC has had to resort to indirect regulation of disclosure by placing certain obligations on those that distribute municipal securities.

<sup>153</sup> We commend, for example, the National Association of Bond Lawyers for its recent efforts in the area of pension disclosure and we are working with the Association to address investor concerns. We also commend the Government Finance Officers Association for its many "Best Practices" for issuers, including those related to disclosure.

<sup>154</sup> The Governmental Accounting Standards Board ("GASB") recently reported that the usefulness of financial report information to investors diminishes quickly over time. The study stated that, "89 percent of respondents to a survey rated information received within 45 days as 'very useful,' but that proportion

for other purposes, issuing interim disclosures of unaudited information, or establishing incentives for meeting (or consequences for failing to meet) disclosure obligations. Any of these steps would aid investors in navigating the municipal securities markets and making informed investment decisions.<sup>155</sup>

We recognize that the benefits of increased disclosure will entail added costs to municipal issuers. Many issuers have claimed that such costs could be significant and therefore have been opposed to increasing disclosure. We believe, however, that these costs would be minimal for many issuers as they currently provide the major rating agencies with financial information such as annual reports and budgets on a regular basis. In addition, some issuer information is available at public meetings, on the Internet and through a government's annual financial report. This information could be extremely useful to investors in a form that provided for consistency, standardization or comparability.

New disclosure obligations also may raise concerns because of the wide disparity in the size of municipal issuers and differences in primary and secondary market disclosure. These concerns may be misplaced, however, because the quality of disclosure seems to be issuer specific and independent of these factors.<sup>156</sup> In addition, technological advances should help to minimize costs of increased disclosure. Specifically, relatively minor costs would be incurred to provide investors, via the Internet or the MSRB's EMMA system,<sup>157</sup> with material information that is currently produced and provided for underwriters, rating agencies, or internal use.

Ultimately, better communications with investors, especially during times of stress, increase the likelihood of investors sticking with a particular issuer. Municipal securities issuers should recognize that complete, accurate and timely disclosure improves the investors' ability to accurately price their bonds. This, in turn, has the potential to enhance the marketability of municipal securities, which over time could

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dropped to 44 percent for information received within 3 months and fewer than 9 percent for information received within 6 months." See Research Brief: The Timelines of Financial Reporting by State and Local Governments Compared with the Needs of Users, GASB, March 2011.

<sup>155</sup> We believe investors in the municipal securities markets should have access to full, accurate, and timely information comparable to that provided to investors in many other U.S. capital markets. We are not, however, seeking a disclosure regime exactly the same as that imposed, for example, on corporate issuers. The disclosure regime should be tailored to the needs of the municipal securities market. See ICI Municipal Securities Letter, *supra* note 150

<sup>156</sup> *Id.*

<sup>157</sup> We commend the MSRB for its creation and expansion of the EMMA system. EMMA has improved municipal market disclosure by bringing certain disclosure information together in a central, easily navigated depository at no cost to the user.

increase the liquidity of the entire market.<sup>158</sup> Consequently, ICI believes that the benefits of improving disclosure likely would outweigh the associated costs.

ICI commends Congress for including the municipal securities markets within its review of the financial system under the Dodd-Frank Act, including directing the U.S. Government Accountability Office (“GAO”) to study the municipal securities markets. ICI has provided and will continue to provide the GAO with comments regarding the operation of these markets and the absence of appropriate disclosure within these markets. ICI also commends the SEC on its efforts to study the municipal securities markets through field hearings and public outreach, and to identify creative ways to improve disclosure in these markets within the limitations of its authority. We note, however, that the SEC has stated on numerous occasions that it has generally reached the limits of its authority to increase disclosure in the municipal securities markets.<sup>159</sup> Instead of forcing the SEC to develop attenuated and piecemeal rules designed to target disclosure deficiencies, we urge Congress to go beyond its Dodd-Frank Act mandate by providing the SEC with the additional authority it needs to improve disclosure in the municipal securities markets.

#### 4. Housing Finance Reform

As of year-end 2010, funds held about thirteen percent of the outstanding agency and agency-backed mortgage pool securities (“MBS”) outstanding in the market, much of which are MBS guaranteed by, and debt securities issued by, the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”; together with Fannie Mae, the “GSEs”).<sup>160</sup> Currently, Congress is

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<sup>158</sup> For example, if increased availability of financial information reduces overall search and transaction costs, this has a positive effect on liquidity in the market. See “Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board,” Brian Bushee and Christian Leuz, *Journal of Accounting and Economics*, 2005, vol. 39 (finding that firms that were newly compliant with the SEC disclosure regulation experienced significant increases in liquidity consistent with a reduction of information asymmetry from improved disclosure; the authors also found that firms that were already in compliance prior to the disclosure regulation taking effect experienced positive stock returns and permanent increases in liquidity after the rule took effect, indicating positive externalities from the mandatory regulation disclosure).

<sup>159</sup> See *Opening Statement Before the Commission Open Meeting*, Mary L. Schapiro, Chairman, Securities and Exchange Commission, July 15, 2009 (“These proposals represent an important Commission effort to do what we can, within our statutory authority, to address the disclosure disparity that exists for municipal securities.”). See also, *Keynote Address at the National Federal of Municipal Analysts 28<sup>th</sup> Annual Conference*, Elisse B. Walter, Commissioner, Securities and Exchange Commission, May 4, 2011 (“And, speaking of there always being room for improvement... as you well know, the SEC’s authority with respect to the municipal securities market is quite limited. We do not have the ability to set even general disclosure requirements or require that reports be issued on a periodic basis in the municipal securities arena.”).

<sup>160</sup> Data are unpublished information drawn from a quarterly survey of the Investment Company Institute as of December 2010.

considering a variety of options to shrink, and ultimately eliminate, the role of the GSEs in the mortgage market, and increase the role of private mortgage financing. In winding down the GSEs, we believe it is essential to the stability of the markets that Congress ensure that the GSEs have sufficient capital to perform under their existing or future MBS guarantees and the ability to meet their debt obligations. The Department of the Treasury and the U.S. Department of Housing and Urban Development, in their report to Congress earlier this year, stated in strong terms their agreement with this principle.<sup>161</sup> If Congress does not ensure that the GSEs can satisfy their commitments on legacy securities, prices on these securities will fall, and prices on Treasury securities will likely rise sharply as investors move out of GSE securities into Treasury securities. Thus, regardless of the housing finance reform option Congress ultimately may decide upon, it is clear that ensuring the GSEs are able to satisfy their current, and any future, obligations is critically important.

## 5. Proxy Voting Disclosure

Section 951 of the Dodd-Frank Act added Section 14A(d) to the Securities Exchange Act of 1934 (the “Exchange Act”), which imposes a new requirement on certain institutional investment managers to report annually how they voted on three new types of shareholder advisory votes: say on pay; say on frequency; and golden parachute (collectively, the “Section 14A Votes”).<sup>162</sup> Although we strongly support the purpose and intent of this requirement, it is only a step in the right direction. Congress or the SEC should require all institutional investors to disclose every proxy vote they cast, as funds currently do.<sup>163</sup>

Since 2004, registered investment companies—alone among all institutional

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<sup>161</sup> The Department of the Treasury and the U.S. Department of Housing and Urban Development, *Reforming America’s Housing Finance Market: A Report to Congress* (Feb. 2011) at 12, available at <http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf> (“Our commitment to ensuring Fannie Mae and Freddie Mac have sufficient capital to honor any guarantees issued now or in the future and meet any of their debt obligations remains unchanged. Ensuring these institutions have the financial capacity to meet their obligations is essential to continued stability, and the Administration will not waver from its commitment.”).

<sup>162</sup> “Say on pay” votes are shareholder advisory votes to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K. “Say on frequency” votes are shareholder advisory votes to determine how often an issuer will conduct a say on pay vote. “Golden parachute” votes are shareholder advisory votes on certain compensation arrangements in connection with a merger or similar transaction.

<sup>163</sup> We have consistently and strongly supported requiring institutional investors to disclose every proxy vote they cast. See Statement of the Investment Company Institute on “Corporate Governance and Shareholder Empowerment” before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (April 21, 2010), available at [http://www.ici.org/policy/ici\\_testimony/10\\_house\\_corp\\_gov\\_tmny](http://www.ici.org/policy/ici_testimony/10_house_corp_gov_tmny). See also letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated Oct. 20, 2010 (“ICI Proxy Concept Release Letter”), available at <http://www.ici.org/pdf/24636.pdf>.

investors—have been required to publicly disclose each and every proxy vote they cast.<sup>164</sup> As a result of this unique disclosure requirement, ICI has been able to conduct the broadest study of funds’ proxy votes ever undertaken, covering more than 10 million proxy votes cast by over 200 of the largest fund families from 2007 to 2009.<sup>165</sup> That research indicates, among other things, that: (1) funds devote substantial resources to proxy voting; (2) funds vote proxies in accordance with their board-approved guidelines; (3) funds do not reflexively vote “with management,” as some critics claim, but rather make nuanced judgments in determining how to vote on both management and shareholder proposals in order to promote the best interests of funds and their shareholders; and (4) fund voting patterns are often broadly consistent with vote recommendations of proxy advisory firms, although funds do not reflexively adopt the recommendations of proxy advisors.

Unless current law changes, however, one aspect of fund proxy voting that will remain undocumented is how most fund votes compare with those of other institutional investors. At present, such a comparison is not possible because other institutional investors are not required to disclose their proxy votes, except for Section 14A votes.

We have long advocated for a provision that would require institutional investors to disclose each and every proxy vote they cast.<sup>166</sup> In the aggregate, institutional investors other than funds hold approximately thirty-five percent of outstanding U.S. equity securities. Requiring these investors to disclose proxy votes would significantly enhance the quality of the debate concerning how the corporate franchise is used. Section 951 of Dodd-Frank was certainly a step in the right direction by requiring certain of these other institutional investors to disclose their advisory votes on “say on pay” and “golden parachute” proposals. But more can be done. The universe of institutional investors subject to the disclosure requirements should be broadened, and the requirement should extend to all types of votes, not just Section 14A votes.

We are not alone in calling for increased transparency about the proxy votes of other institutional investors. As early as 2003, House Financial Services Committee Chairman Barney Frank questioned the appropriateness of a proxy voting disclosure

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<sup>164</sup> See Rule 30b1-4 under the Investment Company Act. As a result, Section 951 has little practical import for funds, because they would have had to disclose Section 14A Votes regardless of whether Section 14A(d) was added to the Exchange Act. The purpose of Section 14A(d) is to extend proxy vote disclosure to other institutional investors.

<sup>165</sup> See Investment Company Institute, *Trends in Proxy Voting by Registered Investment Companies, 2007-2009*, November 2010, Vol. 16, No. 1, available at <http://www.ici.org/pdf/per16-01.pdf>.

<sup>166</sup> See, e.g., 2007 ICI Testimony, *supra* n.9; Investment Company Institute, Submission to U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century, January 26, 2007, available at [http://www.ici.org/policy/comments/07\\_reg\\_cap\\_mark\\_stmt](http://www.ici.org/policy/comments/07_reg_cap_mark_stmt); Letter from Paul Schott Stevens, Investment Company Institute, to Professor Hal S. Scott, Director, Committee on Capital Markets Regulation, Nov. 20, 2006, available at <http://www.ici.org/pdf/20606.pdf>.

requirement unique to funds.<sup>167</sup> The late Senator Edward M. Kennedy commissioned a 2004 GAO study that concluded, among other things, that workers and retirees would benefit from increased transparency in proxy voting by pension plans.<sup>168</sup> More recently, a number of notable commentators have supported the notion, including the Investors' Working Group, an independent task force sponsored by the CFA Institute and Council of Institutional Investors and chaired by former SEC Chairmen Arthur Levitt and William Donaldson.<sup>169</sup> The AFL-CIO has also strongly supported increased transparency in proxy voting by all capital market participants,<sup>170</sup> and voluntarily discloses its proxy votes and proxy voting policies even though it is not legally required to do so.

The rationale for requiring funds to disclose their proxy votes is that such disclosure helps achieve important public policy aims by enhancing the quality of the debate concerning how the corporate franchise is used. That rationale is not specific to mutual funds, but extends equally to all types of institutional investors. The disclosure rules should do so as well.

#### **Section 4: Oversight by the Securities and Exchange Commission**

##### **A. Funds Have an Interest in a Strong, Effective SEC**

As major participants in the securities markets and as issuers of securities (fund shares) that are held by almost half of all U.S. households, funds have a vested interest in a strong and effective SEC. Funds and their shareholders stand to benefit if the SEC has the tools needed to fulfill important policy objectives, such as: preserving the integrity of the capital markets; ensuring the adequacy and accuracy of periodic disclosures by public issuers; and promoting fund regulation that protects investors, encourages innovation, and does not hinder market competition.

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<sup>167</sup> See H.R. 2420, Mutual Fund Integrity and Fee Transparency Act of 2003, Committee on Financial Services markup (July 23, 2003). See also Siobhan Hughes, Rep. Frank Plans Hearing on Disclosure of Proxy Votes, Dow Jones News Service, March 22, 2007.

<sup>168</sup> See GAO-04-749, *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting* (August 2004), available at [www.gao.gov/new.items/do4749.pdf](http://www.gao.gov/new.items/do4749.pdf).

<sup>169</sup> See *A Report by the Investors' Working Group, An Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors*, July 2009, at p.6 ("Institutional investors—including pension funds, hedge funds and private equity firms—should make timely public disclosures about their proxy voting guidelines, proxy votes cast, [and] investment guidelines."), available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf).

<sup>170</sup> See "Facts about the AFL-CIO's Proxy Votes," available at [http://www.aflcio.org/corporatewatch/capital/upload/facts\\_aflcio\\_proxy\\_votes.pdf](http://www.aflcio.org/corporatewatch/capital/upload/facts_aflcio_proxy_votes.pdf).

For this reason, ICI consistently has supported adequate funding for the SEC to carry out its critical regulatory functions.<sup>171</sup> To pursue its regulatory mission successfully, the SEC needs to attract and retain experienced, high-caliber professional staff with specialized expertise in a variety of areas. In addition to this “human capital,” the SEC needs sophisticated technology—for example, to facilitate analysis and protect the security of data it collects.

These longstanding needs have only increased in the wake of the most recent financial crisis. The Dodd-Frank Act gave the SEC significant new responsibilities. Among other things, it both formalized and expanded the SEC’s role as a federal financial regulator with front-line responsibility for monitoring for potential systemic risks, including in areas where regulatory gaps previously existed such as over-the-counter derivatives and the oversight of hedge fund advisers. Other recent rulemakings, such as the SEC’s 2010 money market fund reform measures, also have increased the amount of data the SEC collects and must analyze.

#### B. The SEC Must Utilize Its Resources to Their Maximum Effect

While we there support providing the SEC with the resources it needs to do its job, we also believe it is vitally important for the SEC to utilize its resources to the best effect. Intensive, high-level, and sustained attention to improving the agency’s internal operations and management will be necessary to achieve this goal. While the SEC has taken some steps to improve its management and operational efficiency, it is clear that much work remains to be done.<sup>172</sup> Chairman Mary Schapiro has acknowledged this and has indicated plans to devote substantial additional attention to improving the agency’s management infrastructure and correcting problems that have surfaced.<sup>173</sup> We strongly support these efforts.

#### C. Robust Cost-Benefit Analysis Is Critically Important

One area that cries out for further improvement concerns building strong capabilities to conduct economic research and analysis, and using this analysis to inform SEC rulemaking and oversight activities. Economic analysis must play an integral role in

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<sup>171</sup> See, e.g., Statement of the Investment Company Institute on the U.S. Securities and Exchange Commission’s Appropriations for Fiscal Year 2012 Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations (May 27, 2011), available at [http://www.ici.org/pdf/i\\_senate\\_sec\\_approp.pdf](http://www.ici.org/pdf/i_senate_sec_approp.pdf).

<sup>172</sup> See, e.g., Boston Consulting Group, U.S. Securities and Exchange Commission Organizational Study and Reform (March 10, 2011), available at <http://www.sec.gov/news/studies/2011/967study.pdf>.

<sup>173</sup> See, e.g., Testimony on the President’s 2012 Budget Request for the SEC by Chairman Mary Schapiro, U.S. Securities and Exchange Commission, Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations (May 4, 2011), available at <http://www.sec.gov/news/testimony/2011/tso504u/mls.htm>.

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 is not just a good idea—it is a statutory mandate. Generally speaking, when the SEC engages in rulemaking it is obligated to consider—in addition to the protection of investors—whether a proposed rule will promote efficiency, competition, and capital formation.<sup>174</sup> The United States Court of Appeals for the District of Columbia Circuit has emphasized repeatedly how important it is for the SEC to consider the costs regulated entities would incur in order to comply with a rule.<sup>175</sup> And yet, SEC rulemaking efforts continue to be seriously deficient when it comes to carefully analyzing costs and benefits, as the following examples illustrate.<sup>176</sup>

### 1. Regulation of Mutual Fund Distribution Fees

As discussed above, the SEC proposed rule changes that would replace Rule 12b-1 with a new regulatory framework to govern fund distribution costs.<sup>177</sup> Given the important role 12b-1 fees have played in the growth of the industry for forty years, it would appear incumbent upon the SEC—when proposing far-reaching changes to the current economics of the industry—to conduct a careful, comprehensive economic analysis. Unfortunately, our review of the SEC’s economic analysis and the results of our own independent analysis revealed serious flaws in the SEC’s consideration of the rule’s costs and benefits.<sup>178</sup> In light of the uncertain and, quite possibly, illusory benefits of the proposal, and the significant operational and transitional costs on funds, intermediaries,

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<sup>174</sup> See Section 3(f) of the Securities Exchange Act of 1934 and Section 2(c) of the Investment Company Act.

<sup>175</sup> See, e.g., *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133, 144 (June 21, 2005) (“Uncertainty...does not excuse the Commission from its statutory obligation to do what it can to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation before it decides whether to adopt the measure.”); *American Equity Investment Life Insurance Company v. Securities and Exchange Commission*, Case No. 09-1021 (July 21, 2009) (finding that the SEC’s analysis of effects on efficiency, competition, and capital formation in adoption of rules related to indexed annuities was arbitrary and capricious, and remanding the matter to the SEC for reconsideration).

<sup>176</sup> This concern about cost-benefit analysis is not unique to the SEC. As discussed above, the CFTC’s cost-benefit analysis of a proposal of critical concern to ICI’s members – amendments to CFTC Rule 4.5 – is seriously lacking.

<sup>177</sup> See Section 3.A.1, *supra*.

<sup>178</sup> Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, U.S. SEC, dated November 5, 2010, at 7-9, available at <http://www.ici.org/pdf/24689.pdf>. See also Letter from Karrie McMillan, General Counsel, Investment Company Institute and Brian Reid, Chief Economist, Investment Company Institute, to Elizabeth Murphy, Secretary, SEC (December 1, 2010), available at <http://www.ici.org/pdf/24752.pdf>.

and investors, we have urged the SEC to conduct a more careful economic analysis before proceeding with this rulemaking.

## 2. Proxy Access Rules

Another disappointing example is the SEC's adoption in August 2010 of new rules and rule amendments ("proxy access rules") to facilitate shareholders' ability to nominate directors of companies, including funds.<sup>179</sup> In particular, new Rule 14a-11 under the Securities Exchange Act requires companies, in certain circumstances, to include shareholder nominees for director in their proxy materials.

Unfortunately, in adopting the proxy access rules, the SEC failed to address the distinct burdens that Rule 14a-11 would impose on funds. In addition, the SEC failed adequately to consider Rule 14a-11's effect on efficiency, competition, and capital formation.

The Business Roundtable and U.S. Chamber of Commerce filed a petition in the U.S. Court of Appeals for the District of Columbia Circuit challenging the validity of the proxy access rules and urging the court to vacate the rules with respect to both operating companies and funds.<sup>180</sup> ICI and the Independent Directors Council, as amici curiae ("friends of the court"), filed a joint brief<sup>181</sup> in support of the Business Roundtable's and U.S. Chamber of Commerce's petition. The Brief urges the court to vacate the proxy access rules solely as applied to investment companies.

## 3. Legislation Mandating Robust Cost-Benefit Analyses

The preceding examples make abundantly clear that there is room for improvement in the SEC's process for evaluating the relative costs and benefits of rulemaking actions. Concerns about inadequate cost-benefit analysis, particularly by the CFTC, also are part of the impetus behind proposed legislation co-sponsored by Capital Markets Subcommittee Chairman Garrett. H.R. 1573 would require the SEC and CFTC ("Commissions"), in connection with regulation of the over-the-counter swaps markets, to conduct public hearings and roundtables and take testimony and comment on proposed rules before they are made final, and factor those comments into cost-benefit analysis. Specifically, the Commissions would be required to evaluate the time and

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<sup>179</sup> See SEC Release No. 33-9136 (August 25, 2010), available at <http://www.sec.gov/rules/final/2010/33-9136.pdf>.

<sup>180</sup> See [Business Roundtable, et al. v. SEC, No. 10-1305](#) (D.C. Cir. Filed Sept. 29, 2010). The SEC subsequently stayed the effectiveness of the rules pending resolution of the case. See also [Opening Brief](#) of Petitioners Business Roundtable and Chamber of Commerce of the United States of America (D.C. Cir. Filed Nov. 30, 2010).

<sup>181</sup> See [Brief of Amici Curiae Investment Company Institute and Independent Directors Council](#) In Support of Petitioners and Vacatur as Applied to Registered Investment Companies (December 9, 2010) ("Brief").

resources that would be required of affected parties to develop systems, infrastructures, and policies and procedures to comply with any new rules as well as any alternative approaches capable of accomplishing the rulemaking objectives.

As we indicated in a letter to the leadership of the House Agriculture Committee and the House Financial Services Committee, ICI strongly concurs with the policy goals that are reflected in H.R. 1573—rulemaking that is informed by robust public input; meaningful cost-benefit analysis that reflects those public comments; and careful consideration by regulators of alternative approaches to achieve their objectives.<sup>182</sup> We appreciate Congress’ attention to cost-benefit analysis in the implementation of Title VII of the Dodd Frank Act,<sup>183</sup> and urge its continued oversight of the Commissions’ analyses in other rulemakings.

#### D. The Future of Adviser Oversight

While recognizing the many challenges facing the agency, we believe that, on balance, the SEC should retain its responsibility to oversee the largest US investment advisers, including mutual fund advisers. Entrusting this function to a self-regulatory organization would raise a host of complex issues, and would not necessarily improve the regulatory oversight of investment advisers or substantially reduce the overall costs of adviser regulation. To assure that the SEC has the resources necessary to conduct effective oversight of all advisers under its jurisdiction, we would support the imposition of user fees to fund the SEC’s examination program.

### **Conclusion**

We appreciate the opportunity to share our views with the Subcommittee, and we look forward to working with Congress and regulators as they seek to address these many important issues in the best possible way for the millions of American investors who rely on funds to achieve their investing goals.

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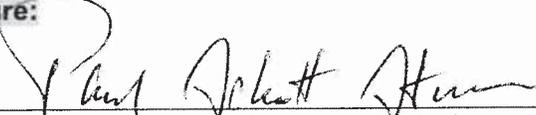
<sup>182</sup> See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Hon. Frank D. Lucas, Chairman, Committee on Agriculture, Hon. Collin Peterson, Ranking Member, Committee on Agriculture, Hon. Spencer Bachus, Chairman, Committee on Financial Services, Hon. Barney Frank, Ranking Member, Committee on Financial Services, U.S. House of Representatives, dated May 3, 2011.

<sup>183</sup> See Section 3.B.1, *infra*.

United States House of Representatives  
Committee on Financial Services

**“TRUTH IN TESTIMONY” DISCLOSURE FORM**

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

<b>1. Name:</b>  Paul Schott Stevens	<b>2. Organization or organizations you are representing:</b>  Investment Company Institute
<b>3. Business Address and telephone number:</b>  	
<b>4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<b>5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>6. If you answered “yes” to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.</b>	
<b>7. Signature:</b>   6/22/11	

Please attach a copy of this form to your written testimony.