The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
Washington, DC // Brussels // London // www.ici.org

Submission to U.S. Chamber of Commerce Commission, February 2007

Statement of the Investment Company Institute Commission on the Regulation of U.S. Capital Markets in the 21st Century Submission to the U.S. Chamber of Commerce

January 26, 2007

The Investment Company Institute, the national association of U.S. mutual funds and other investment companies,[1] commends the U.S. Chamber of Commerce for establishing the Commission on the Regulation of U.S. Capital Markets in the 21st Century to consider the appropriate legal and regulatory framework for the U.S. capital markets. The continued strength of our capital markets, and the protection of investors in those markets, is of utmost importance to our members.

The issues that the Commission is examining are critical to investment companies, both as issuers of securities and as investors in the global marketplace. As the Commission found in its recent study, the U.S. capital markets are under significant competitive pressure from other global securities markets.[2] Therefore, as the securities markets continue to evolve, we must ensure that the regulatory framework overseeing the U.S. capital markets promotes competition and encourages innovation and growth. We also must ensure that regulations continue to promote and protect the interests of investors in those markets.

Set forth below are specific regulatory and legislative recommendations for the Commission's consideration as it continues its work. These recommendations relate to two main areas impacting the future strength of the U.S. capital markets – the regulatory structure of our securities markets and retirement and savings issues. To ensure a more efficient and effective regulatory structure, we must ensure that regulatory costs are proportionate to their benefits and that regulatory disparities between similar financial products are eliminated. Several current and proposed regulations that exemplify concerns in this area, and recommendations to improve our markets' regulatory structure, are discussed. Retirement and savings issues also are critical to maintaining the prosperity and strength of our nation's economy. Our recommendations therefore address issues relating to defined contribution plans and IRAs, providing Americans with better retirement savings tools, and creating tax efficiencies.

Table of Contents

Creating a More Efficient and Effective Regulatory Structure

The regulatory structure overseeing our securities markets has a significant impact on the strength of those markets. The Institute and its members support strong regulation and regulatory oversight. Mutual funds historically have enjoyed a very high level of public confidence and that confidence is rooted in a sound regulatory framework. It is critical, however, when formulating new, or reexamining existing, regulations, that regulators properly take into account the costs and benefits of regulation and are cognizant of, and address, any unnecessary and duplicative regulation. It is equally important that substantially similar investment products and market participants be regulated in a fair and consistent manner. As Treasury Secretary Paulson recently stated:

"When it comes to regulation, balance is key. And striking the right balance requires us to consider the economic implications of our actions. Excessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness and job creation. At the same time, we should not engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards for investors in a quest to reduce costs. The right regulatory balance should marry high standards of integrity and accountability with a strong foundation for innovation, growth, and competitiveness."[3]

We strongly agree with Secretary Paulson, and believe that achieving the right balance in regulation is the biggest challenge facing regulators and the future success of our markets. Without a thorough and thoughtful approach to cost/benefit analysis and fair and consistent regulations for similar investment products, an environment of regulatory arbitrage may be created that favors less-regulated markets or products. Regrettably, there are numerous examples of regulations imposed on the fund industry with costs that are disproportionate to their benefits or that unnecessarily and uniquely burden funds.[4]

Ensure that Regulatory Costs are Proportionate to their Benefits

It is imperative that regulators get serious about the impact of the costs of regulation on market participants. When new regulations are required, or existing regulations are amended, regulators need to thoroughly examine all possible options with a focus on their relative costs and benefits. Without a thorough examination of the impact of the costs of regulation on our markets, investors will end up with higher costs, fewer investment options, and ultimately less protection if they turn to less regulated alternative products or markets.

NYSE Broker Voting

A pending New York Stock Exchange proposal on proxy voting offers a prime example of regulation where costs are disproportionate to their benefits. Currently, under NYSE Rule 452, NYSE members (which consist primarily of brokers and banks) are allowed to vote uninstructed proxies for their customers who beneficially own the stock on "routine" items at shareholder meetings. This practice is commonly referred to as discretionary broker voting. An uncontested election of directors is now considered a routine item, and NYSE members are allowed to vote proxies for beneficial owners who have not returned their proxies within 10 days of the date of the shareholder meeting.

A working group established by the NYSE to examine proxy voting issues has recommended that an uncontested election of directors be viewed as a "non-routine" matter on which brokers would not be permitted to vote proxies on behalf of their customers. The NYSE has filed a proposal with the SEC that would implement this recommendation.[5]If approved, the rule proposal would apply to proxies relating to closed-end funds and mutual funds whose shares are held through NYSE member firms.

To assess the costs that would be incurred by funds if discretionary broker voting is eliminated, the Institute surveyed its members and published a report examining these costs.[6] The report found that the proposal will have a disproportionate impact on funds as compared to operating companies and will create significant difficulties for funds because, among other things, funds have a far higher proportion of retail shareholders than most operating companies (and retail shareholders are less likely than institutional investors to vote their proxies). As a result, the report concluded that funds will have significant difficulties achieving quorums and

electing directors if broker voting is eliminated. The report also found that the NYSE proposal could increase costs considerably for funds, as funds will be forced to conduct multiple solicitations to achieve a quorum. The report estimates that funds' costs of soliciting proxies will more than double – from $1.65 per shareholder account to $3.68 – under the NYSE proposal. The proposal also could add between 1 and 5 basis points to funds' expense ratios.[7] Ironically, because the elections that are the subject of the NYSE proposal are uncontested, the same directors, in most instances, will be elected whether or not funds bear these increased costs.[8]

In the proposal and the Working Group report, the NYSE and the Proxy Working Group, respectively, recognized that eliminating discretionary broker voting will increase proxy solicitation costs for issuers. However, as far as we can tell, neither collected or examined any cost data to measure the extent of costs that would specifically be incurred by funds and their shareholders if discretionary broker voting is eliminated.

Recommendations: Because of the difficulties that the NYSE proposal will create for funds and the costs that will result for funds and their shareholders, the Institute recommends that funds be excluded from the NYSE proposal.[9] In addition, to ensure that future regulatory proposals by self-regulatory organizations take into account the extent of costs that would be incurred by market participants subject to those proposals, we recommend that the SEC by rule, or Congress by law, require that all self-regulatory organizations perform a formal cost/benefit analysis prior to submitting regulatory proposals to the SEC. We urge the Committee to support these recommendations.

Sarbanes-Oxley Act Reform

The Institute supports the Commission's review of requirements under the Sarbanes-Oxley Act. The Sarbanes-Oxley Act was initially intended to address the missteps of corporate issuers, and the impetus for the legislation was entirely unrelated to mutual funds. Nevertheless, in rules implementing the Act's provisions, the SEC chose to subject mutual funds to several costly and burdensome requirements.

Among other requirements, mutual funds must provide numerous certifications under the Act. The principal executive officer and principal financial officer of a fund complex must certify in annual and quarterly reports filed with the SEC, on behalf of each individual fund, the accuracy of the fund's shareholder reports. This includes a certification of non-financial information included in those reports, such as a fund's Management's Discussion of Fund Performance ("MDFP"), which includes, among other things, narrative disclosure of the factors that materially affected the fund's performance during the reporting period. The principal executive officer and principal financial officer also must certify that they are responsible for establishing and maintaining controls and procedures designed to ensure that the information contained in shareholder reports is summarized and reported in a timely manner. In addition, they must certify that they have disclosed certain information about the fund's internal control over financial reporting to the auditor and the fund's audit committee.[10]

These requirements go beyond the intent of the Sarbanes-Oxley Act in several respects and place a significant and unnecessary burden on fund executive officers. For example, scores of funds in a single complex often have staggered fiscal year ends, requiring that certifications be made every month. This greatly increases the costs and time of complying with these requirements, including the amount of senior executive attention demanded by the certification process. The Act's certification provisions also are duplicative of a host of unique compliance requirements already imposed on mutual funds. For example, compliance requirements for mutual funds, including rules relating to fund compliance policies and procedures and to the appointment of a chief compliance officer, now focus on and directly address the goals of the Sarbanes-Oxley Act, i.e., improving compliance processes and increasing accountability.[11]

Recommendation: In addition to examining possible reforms of Section 404 of the Act, we urge the Commission to consider the impact of the Act on mutual funds. Specifically, we recommend that the certifications requirements of the Act applicable to mutual funds be withdrawn. At a minimum, a more reasoned approach to regulation should be adopted. For example, we recommend that certifications not be required for non-financial information included in shareholder reports, such as the MDFP. These changes will ease the costs and burdens imposed by the current Sarbanes-Oxley Act requirements without sacrificing investor protections.

Independent Chair Requirement

Another example of the need to perform a thorough cost/benefit analysis involves SEC rule amendments requiring that fund boards be comprised of at least 75 percent independent directors and have an independent director as chair. The SEC originally adopted these amendments in 2004[12] but, as a result of legal challenges, the requirements have never taken effect.[13] Most recently, the SEC released two papers prepared by its Office of Economic Analysis ("OEA") and reopened the comment period to permit public comment on the papers.

The Institute expects to comment in detail on the OEA papers before the March 2, 2007 comment deadline. It is safe to say, however, that we continue to be concerned about the costs of the SEC's rule amendments. In isolation, the costs of the independent

chair and independent director supermajority rules appear small, but they can be significant for smaller fund firms.[14] In addition, when considered along with a host of other new rules for funds, the cumulative costs are quite high. The SEC has failed to establish that any benefits of mandating that funds have an independent chair justify the costs.[15]

Recommendation: Regardless of the final outcome on the merits of this matter, the independent chair requirement illustrates the need to improve the SEC's rulemaking process, particularly through the timely and thorough consideration of the economic consequences of proposed rules. We urge the Commission to support such improvements to the SEC's rulemaking process.

Eliminate Regulatory Disparities Between Similar Financial Products

The mutual fund industry historically has not been heavily concentrated and has welcomed new entrants. In the past, regulations governing funds have not impeded new entrants, particularly smaller size fund firms. While mutual funds have always supported strong and effective regulation to protect the interests of fund investors, the totality of recent regulatory requirements imposed on mutual funds has threatened to reduce the competition, diversity and creativity that new and smaller firms historically have contributed to the fund industry.

Regulatory requirements that single out mutual funds versus other financial products exacerbate these concerns. The U.S. regulatory structure that has emerged for mutual funds is, in many respects, highly divergent from the regulatory structure that has developed for substantially similar products in that mutual funds are subject to more comprehensive disclosure, compliance and governance requirements.

To the extent that regulatory requirements that uniquely and solely affect mutual funds discourage investment advisers from entering into or remaining in the fund business, discourage portfolio managers from managing mutual funds versus other investment products, or cause intermediaries to favor less regulated financial products over mutual funds, then the current regulatory regime penalizes mutual funds as well as the millions of average investors that mutual funds serve. We already see these trends occurring in the overseas markets. U.S. mutual funds are not seen as a competitive product for export to fast-growing foreign markets. Instead, European-based funds, known as "UCITS," are rapidly gaining regulatory approval and sales, particularly in Asia and Latin America. Indeed, European-domiciled investment funds boosted their net sales outside the Continent from $4.5 billion in 2004 to $17.6 billion in 2005, according to a European research firm. One of the strengths of the UCITS "brand" is its ability to accommodate simpler organizational structures – such as common funds and trusts – as well as investment companies. But the European funds also benefit from the fact that they are free of many regulations that apply to U.S. funds.

The regulatory disparities that exist for mutual funds continue to grow and the trend appears to be accelerating. There are a number of rules and regulatory proposals which exemplify these concerns, three of which are discussed below.

Point of Sale Disclosure

The SEC has proposed to require brokers to disclose information to investors at the point of sale about the costs and potential conflicts of interest associated with selling mutual funds. The Institute supports the concept of point of sale disclosure, but not as currently proposed by the SEC.[16] The manner in which the SEC has proposed to effectuate this disclosure, and the amount of information that will have to be disclosed, is inconsistent with the manner in which brokers typically sell mutual fund shares (i.e., by phone). In addition, other financial products that brokers sell would not be subject to these requirements. Therefore, to the extent the SEC crafts point of sale disclosure requirements in a manner that exposes brokers to increased liability risks, complicates the process of selling mutual funds, and imposes significant compliance costs, brokers predictably will steer their customers to alternative investments that are not subject to these requirements and do not offer the same level of regulatory protection and other benefits (e.g., diversification, liquidity and professional management) that mutual funds do.

Recommendations: We urge the Commission to recommend that, if the SEC determines to adopt some form of point of sale disclosure requirements for mutual funds, it does so in a manner that is consistent with the nature of the brokers' business model and that does not create competitive disadvantages for funds. We also recommend that any point of sale disclosure requirements apply equally to other financial products sold by brokers.

Soft Dollars

In obtaining research and similar products and services from brokers using client brokerage commissions (so called "soft dollars"), advisers to mutual funds and pension plans governed by the Employee Retirement Income Security Act ("ERISA") are subject to Section 28(e) of the Securities Exchange Act of 1934. Section 28(e) provides a safe harbor for advisers who determine in good faith that the amount of commissions paid to a broker is reasonable in relation to the value of the brokerage and research services provided to the adviser. Section 28(e) was adopted in response to concerns that advisers would be in breach of their fiduciary duties

if they paid anything but the lowest commission rate to obtain these products and services.

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

Recommendations: The Institute has recommended that the SEC adopt a rule that would prohibit any investment adviser from using soft dollars to pay for any products or services that fall outside the Section 28(e) safe harbor. We also have expressed support for a recommendation of a NASD task force that the SEC urge the Department of Labor (with respect to non-ERISA retirement accounts) and the federal banking agencies (with respect to collective investment funds and similar bank products) to require all discretionary investment advisers not subject to the SEC's jurisdiction to comply with the standards of the safe harbor.[17] In light of the very real market consequences of applying Section 28(e) only to certain institutional investors, we urge the Commission to support these recommendations.

Proxy Voting

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

Recommendation: To the extent that disclosure of proxy voting records is considered to achieve important public policy purposes, these requirements should be applied to all institutional investors. We urge the Commission to support this recommendation.

Consolidation of NASD and NYSE Member Regulation Operations

The NASD and NYSE have announced plans to consolidate their member regulation operations into a new, independent self-regulatory organization. The Institute supports the proposed consolidation plan. By eliminating overlapping regulation, establishing a uniform set of rules, and placing oversight responsibility in a single organization, the regulatory consolidation plan should increase the efficiency and consistency of securities industry oversight and reduce overall regulatory costs. Investors, including mutual funds and their shareholders, will benefit from the consolidation.

NASD member firms recently approved by-law changes necessary for the consolidation of NASD and NYSE member regulation operations. These by-law changes, which will facilitate governance changes at the new self-regulatory organization, are now subject to approval by the SEC. The Institute anticipates commenting favorably on the consolidation plan once the plan is published by the SEC for public comment.

Recommendation: We recommend that the Commission support the consolidation of NASD and NYSE member regulation operations.

Reform of the Mutual Fund Disclosure System

The Institute strongly supports reform of the current mutual fund disclosure system.[18] We believe that the Internet and other technological advances provide unique opportunities to better serve fund investors' information needs and, in general, to encourage the innovation and growth of our capital markets. Internet access and usage have grown rapidly in recent years and this growth is particularly evident among mutual fund investors. An Institute study conducted last year found that more than 90 percent of households owning funds have Internet access.[19] More than seven in ten shareholders with Internet access go online at least once a day and about eight in ten fund investors with Internet access go online for financial purposes. The Institute's findings on Internet access and usage show that mutual fund investors are equipped and ready for a new disclosure regime that takes greater advantage of the Internet.

Under the current paper-based system of fund disclosure, a single document – the fund prospectus – must serve multiple purposes. The prospectus must be crafted to meet legal requirements and thereby protect the fund and its adviser against legal liability under the securities laws. This, along with a continuous stream of new disclosure requirements, has resulted in lengthy, complex and detailed prospectuses that are not well suited to the objective of informing investors. Institute research concerning investor preferences for mutual fund information confirms that most fund shareholders find fund prospectuses difficult to understand and too

long, and that close to half of those surveyed feel the same way about fund shareholder reports.[20] As demonstrated at the SEC's June 2006 Interactive Data Roundtable, there is broad consensus among interested parties that fund investors would benefit from streamlined fund disclosure.[21] At the same time, making additional, more detailed information available online would enable investors, their financial advisers and other market participants to access the levels and types of data most important to them. In addition, over time, we would expect this approach to dovetail with SEC and industry efforts to use technology to better enable investors and others to retrieve and manipulate key fund information and make comparisons among funds.[22]

Recommendation: The Institute recommends that the SEC develop a new disclosure approach for funds under which funds would: (1) provide a clear, concise disclosure document to all investors in paper form or, at the investor's election, electronically; (2) prominently advise investors that additional, more detailed information is available; and (3) make the prospectus and statement of additional information available online and paper copies available promptly upon request at no additional charge.[23] The SEC will need to make clear that such an approach satisfies funds' legal obligations under the federal securities laws. Experience with past SEC disclosure reform efforts suggests that, in the absence of such assurance, funds' concerns about potential liability will severely limit the success of any initiative in this area.

Retirement and Savings Issues

To maintain our nation's prosperity and the strength of our economy, it is critical that we address the challenges Americans face in saving for retirement, education and other long-term goals. Americans are now more likely to live longer in retirement and to face increased health costs and must therefore take increased responsibility for saving. We must provide Americans with the tools they need to invest their assets appropriately for long-term savings and to manage their accounts in retirement. In doing so, we should support policies that encourage competition and eliminate unnecessary complexity, cost and regulatory burdens. Finally, to assure retirement security for today's workers, we must continue to maintain and strengthen tax and regulatory policies that encourage saving.

Defined Contribution Plans and IRAs

Defined contribution plans (the most common of which are "401(k) plans") and individual retirement accounts ("IRAs") are the predominant ways for individuals to save for retirement. These savings vehicles have enormous potential to provide participants with a solid retirement.[24]

A landmark shift in retirement benefits began in 1981 when the Internal Revenue Service proposed rules to allow workers to defer a portion of their salary and contribute it on a pre-tax basis to 401(k) plans.[25] Today, 401(k)s are the most common type of retirement plan offered by private-sector employers in the United States. In 2005, 47 million American workers were active participants in 401(k) plans.[26] 401(k) assets totaled $2.4 trillion and other private-sector defined contribution plans accounted for another half trillion dollars. The total assets of private-sector defined contribution plans – nearly $3 trillion – compares with about $2 trillion in private sector defined benefit plans.[27]

IRAs also play an important role in retirement saving. Traditional IRAs were created with a dual purpose – to provide an individual tax-deferred opportunity to save for retirement and as a vehicle for rolling over savings from employer-sponsored plans. At year-end 2005, IRAs held $3.7 trillion in assets, representing about one-quarter of total U.S. retirement savings. Almost half of these assets resulted from rollovers.

Our tax and regulatory policies have not consistently operated to encourage savings in 401(k) plans and IRAs. After their introduction, 401(k) plans faced regulatory headwinds when the amounts that employees and employers could contribute to these plans were scaled back and complex rules were imposed.[28] The availability of tax benefits for IRAs also was scaled back when Congress imposed complex IRA eligibility rules in 1986. More recently, Congress began to give these important savings vehicles the encouragement they deserve. In 1996, Congress reduced the 401(k) compliance burden for smaller businesses and, in 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased both the amount a worker could contribute and the total contribution amount from both employee and employer contributions to these plans. The 2001 changes also increased contribution limits for IRAs and allowed workers fifty and older to make additional "catch-up" contributions to both 401(k) plans and IRAs. The increased contribution limits and catch-up provisions were made permanent in the 2006 Pension Protection Act ("PPA").[29]

Tax policies also are effective in increasing saving when they are clear and predictable and their benefits widely available. From 1982 to 1986, when IRA tax deductions were universally available, a great influx of savings dedicated to retirement occurred. Financial firms devoted resources to making taxpayers aware of the immediate and long-term benefits of retirement savings and Americans responded. The complex eligibility rules enacted in 1986, on the other hand, have discouraged many Americans from using IRAs.[30] Deductible contributions to traditional IRAs fell from $37.8 billion in 1986 to $14.1 billion in 1987 when the new eligibility rules took effect. In 2004, only 17 percent of U.S. households made IRA contributions.[31]

Recommendations: More must be done to encourage saving through 401(k) plans and IRAs. First, Congress should restore the "universal IRA," which provides tax deductions for IRA contributions without income restrictions. Second, Congress and regulators need to continue to expand 401(k) plan coverage among small employers by reducing the regulatory complexity and compliance costs associated with these plans and should further develop and improve innovations in simplified plan structures begun with the Simplified Employee Pension Plan ("SEP") and Savings Incentive Match Plan for Employees ("SIMPLE"). Third, Treasury and the Department of Labor need to successfully implement the provisions of the PPA that are designed to overcome the inertia that prevents many employees from electing to participate in their employer's 401(k) plans.[32] We urge the Commission to support these recommendations.

Retirement Account Savings Tools

As responsibility for saving has shifted to individuals, we must provide Americans with the tools they need to invest their assets appropriately for the long-term and to manage their accounts in retirement. The mutual fund industry has a significant stake in these matters. Today, 51 percent of 401(k) assets and 45 percent of IRA assets are invested in mutual funds.[33] Seventy-two percent of mutual fund shareholders report that saving for retirement is their primary financial goal.[34] There are several areas where regulators can take important steps to empower Americans with the tools they need to succeed in managing their retirement assets.

Most significantly, we must improve the quality of information provided to 401(k) plan participants about their investment options. Currently, participants may not be receiving all of the information necessary to make fully informed investment decisions. Department of Labor regulations on disclosure are uneven for different investment products and do not cover all participant-directed plans. For plans that are covered, participants must receive full information about mutual funds, in the form of the fund prospectus. For other products, important information – such as operating expenses and historical performance – is available only upon request. To fill in these gaps, the Department of Labor should require that participants in all self-directed plans receive simple, straightforward explanations about each of the investment options available to them. This disclosure should include a concise summary of five key pieces of information: investment objectives; principal risks; annual fees (expressed in a ratio or fee table); historical performance; and the investment adviser that manages the product's investments.[35]

In addition, 401(k) and IRA investors should have greater access to investment advice. The PPA provides an exemption from ERISA rules to permit 401(k) plan participants and IRA beneficiaries to receive investment advice in connection with their accounts from financial professionals associated with plan or IRA service providers. Congressional leaders expect that the exemption will foster new advice programs that do not exist under current Department of Labor interpretative guidance. New advisory programs will not be developed and marketed, however, until the Department of Labor resolves a number of important issues in connection with the new exemption.[36]

It also is important to adopt tax and regulatory policies to facilitate automatic enrollment programs in defined contribution plans. Research shows that plans that automatically enroll employees unless they "opt out" of the plan have greater participation than plans in which employees must "opt in," particularly among lower paid employees, and that the default investment used in automatic enrollment affects the outcome for employees.[37] Specifically, default investments that include exposure to equity securities positively impact account balances over a worker's career. The Institute applauds the inclusion of provisions in the PPA to encourage and facilitate automatic enrollment. For example, the PPA enacts a safe harbor under the tax laws for automatic enrollment arrangements that provide for a specified level of contributions, increase employee contributions annually to a specified level, and provide for matching employer contributions at specified levels. The PPA also provides a safe harbor under ERISA fiduciary rules to allow employers, in automatic enrollment and other situations in which a participant has not directed how the account should be invested, to invest employee accounts in default investments as prescribed by the Department of Labor.[38]

Recommendations: To ensure that 401(k) plan participants have information necessary to make informed investment decisions, the Department of Labor should expand existing disclosure rules to require a summary document for all self-directed plans that provides, for each investment product, the type of information that investors value and use.[39] In addition, the Department of Labor should foster greater use of the Internet as an effective means of delivering disclosure. With respect to the PPA investment advice exemption, the Department of Labor must promptly resolve issues that remain that may prevent the expansion of opportunities for Americans to receive investment advice. Finally, the Department of Labor should adopt a safe harbor for default investments that focuses on investments that provide for capital appreciation and are suitable for long-term investing for retirement. We urge the Commission to support these recommendations.

Creating Tax Efficiencies

Regulatory tax burdens on mutual funds contribute to burdens on saving for retirement. Under present law, mutual funds are required to distribute each year their net capital gains. Investors with taxable accounts are required to pay taxes on these capital gain distributions even though they typically choose to have these distributions automatically reinvested in the fund and take no action to

realize these gains. Legislation strongly supported by the Institute last Congress - the Generate Retirement Ownership Through Long-Term Holding Act of 2005 ("the GROWTH Act") - would address this problem by deferring tax on automatically reinvested capital gain distributions until fund shares are sold.[40] Under the GROWTH Act, the reinvested gains would compound, untaxed, in the fund, and tax on the fund's gains would be paid by an investor when the investor decided to redeem the shares and incur the gain.

By reducing current tax bills and allowing earnings to grow tax-deferred, the GROWTH Act would boost long-term savings.[41] The Act also would help address problems for foreign investors in U.S. funds who incur tax currently in their home countries that would not be incurred if they invested instead in non-U.S. funds. Many European funds "roll-up" (rather than distribute) their income, i.e., this income is taxed only when investors redeem their fund shares. Adopting the GROWTH Act's approach would send a positive message to investors, both within and outside the U.S.

Permanence of the 15 percent maximum tax rate on long-term capital gains and qualified dividend income also will strengthen savings and investment by taxpayers. The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") reduced the maximum tax rate on long-term capital gains and qualified dividend income to its current level (through 2008). The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") extended this maximum tax rate for two additional years (through 2010). Both individual investors and the financial markets need certainty to plan for the future. Making this change permanent will reduce for taxpayers the complexity and confusion of the tax laws.[42] More importantly, taxation of investment earnings hinders savings and economic growth. Permanence of the 15 percent maximum tax rate will strengthen savings and investment, increase dividends and distributions, and contribute to job creation.[43]

Recommendations: We urge the Commission to support adoption of the GROWTH Act. This important legislation is critical to promote a long-term tax policy for long-term investors. We also urge the Commission to support permanence of the 15 percent maximum capital gains tax rate.

ENDNOTES

[1] ICI members include 8,802 open-end investment companies (mutual funds), 656 closed-end investment companies, 287 exchange-traded funds, and four sponsors of unit investment trusts. Mutual fund members of ICI have total assets of approximately $10.163 trillion (representing 98 percent of all assets of U.S. mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

[2] The Commission's study showed that the U.S. share of capital markets activity has been declining steadily for much of the past decade, most significantly, in the U.S. participation rate in the top 25 largest global initial public offerings each year and in U.S. market share of total worldwide listings of public companies. See http://www.capitalmarketscommission.com/portal/capmarkets/061120ipo.htm.

[3] Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets before the Economic Club of New York, November 20, 2006. The full text of Secretary Paulson's remarks can be found at http://www.ustreas.gov/press/releases/hp174.htm.

[4] See Speech by Paul Schott Stevens, President, Investment Company Institute, "Finding the Right Balance for Mutual Fund Regulation," 2006 Securities Law Developments Conference, December 4, 2006. See also Statement of Paul Schott Stevens, President, Investment Company Institute, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, "Mutual Funds: A Review of the Regulatory Landscape," May 10, 2005.

[5] See NYSE File No. SR-2006-92. See also Report and Recommendations of the Proxy Working Group to the New York Stock Exchange (June 5, 2006).

[6] The full report can be found on the Institute's website at http://www.ici.org/pdf/wht_broker_voting.pdf.

[7] The Institute repeatedly has expressed its concerns regarding the impact of the proposal on funds, including its potential costs, to the NYSE Proxy Working Group in conjunction with the issuance of its report. See Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Catherine R. Kinney, President and Chief Operating Officer, NYSE Group, Inc., dated July 18, 2006. See also Letter from Frances M. Stadler, Deputy Senior Counsel, Investment Company Institute, to Larry Sonsini, Chairman, NYSE Proxy Working Group, dated June 3, 2005.

[8] An uncontested director election by its nature is highly unlikely to elicit strong interest or participation from rank and file fund shareholders, only 15 percent of whom ascribe significance to information about a mutual fund's directors when selecting a fund, according to a 2006 Institute survey. See Understanding Investor Preferences for Information, Investment Company Institute (2006).

[9] In its recently published report, the Committee on Capital Markets Regulation, an independent, bipartisan committee of corporate and financial leaders organized to examine issues related to maintaining and improving the competitiveness of the U.S. capital markets, recognized the difficulties created by the NYSE proposal for funds. While the Committee supported the application of the NYSE proposal to corporate issuers, the Committee stated that it believes that the application of the proposal to voting by mutual fund shareholders "should be reconsidered in light of the practicalities of such situations." See Interim Report of the Committee on Capital Markets Regulation, November 30, 2006 (as revised on December 5, 2006) at p.128.

[10] See Rules 30a-2 and 30a-3 under the Investment Company Act; see also SEC Forms N-CSR and N-Q.

[11] See Rule 38a-1 under the Investment Company Act of 1940.

[12] SEC Release No. IC-26520 (July 27, 2004).

[13] After the SEC adopted the amendments, the Chamber of Commerce challenged the SEC's actions. On June 21, 2005, the DC Circuit Court of Appeals stayed the effectiveness of the two requirements and remanded them to the SEC to address deficiencies in the SEC's consideration of (1) the costs of the requirements and (2) reasonable alternatives to the independent chair requirement. Chamber of Commerce v. SEC, 412 F.3d 133 (DC Cir. 2005). Just over a week later, the SEC held an open meeting to address these issues and, the next day, affirmed the requirements. SEC Release No. IC-26985 (June 30, 2005). The Chamber of Commerce again challenged the SEC's actions. The court found that the SEC violated the Administrative Procedure Act by relying on information that was not in the public record without giving the public an opportunity to comment on that information. Chamber of Commerce v. SEC, 443 F.3d 890 (DC Cir. 2006). The court vacated the requirements but suspended issuing its mandate to allow the SEC to seek further comment. The SEC did so, and the comment period ended August 21, 2006. SEC Release No. IC-27395 (June 13, 2006).

[14] See Letter from Members of the Small Funds Committee, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated August 21, 2006.

[15] See Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated August 21, 2006.

[16] See Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 4, 2005.

[17] See Letters from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated September 7, 2006 and from Paul Schott Stevens, President, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 25, 2005.

[18] See, e.g., Securities and Exchange Commission Interactive Data Roundtable, Statement of the Investment Company Institute (June 9, 2006); Letter from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated August 4, 2005.

[19] Investment Company Institute, Ownership of Mutual Funds and Use of the Internet, 2006, *Fundamentals,* Vol. 15, No. 6, October 2006, at 6.

[20] Investment Company Institute, Understanding Investor Preferences for Mutual Fund Information, 2006, at 6, 23.

[21] See Mutual Funds in 2006: Getting Back to Basics and Embracing Core Values, Remarks before the ICI 2006 Securities Law Developments Conference by Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission (December 4, 2006), at 3. ("The Roundtable featured speakers representing a variety of perspectives. Fund industry representatives, investor advocates, third-party users of fund disclosure and even a plain English expert were present. Out of these different perspectives came a strong concensus sic for a short-form disclosure document for investors containing key information about a mutual fund investment, with more detailed information available on-line, or if requested, in paper.")

[22] With Chairman Cox's strong encouragement, the Institute recently released a draft taxonomy for eXtensible Business Reporting Language ("XBRL") data tagging by mutual funds. The draft taxonomy, developed with the assistance of PricewaterhouseCoopers and a working group of interested parties, can be used to "tag" data in the risk/return summary that is included in the front of every mutual fund prospectus. The risk/return summary includes the information of most importance to investors: the fund's investment objectives, principal investment strategies, principal risks, and historical performance, along with the standardized fund fee table. XBRL tagging holds the potential to make risk/return summary data interactive by enabling investors or their advisers to easily search for, retrieve, and compare information on hundreds of mutual funds across multiple fund complexes.

[23] We understand that SEC staff is considering recommending an approach along the lines of our proposal. See Speech by SEC

Staff: Remarks before the ALI-ABA Conference on Life Insurance Company Products, by Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission (November 17, 2006), at 2 (". . . the Division is considering recommending that investment companies be permitted to offer securities pursuant to a streamlined disclosure document that . . . would include key information necessary for an investor to make an investment decision, such as costs, investment objectives and strategies, and risks . . . ").

[24] See "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *Perspective,* Vol. 11, No. 2, Investment Company Institute (July 2005), and Issue Brief, No. 283, Employee Benefit Research Institute (July 2005).

[25] In 1980, 83 percent of workers in private-sector retirement plans had a traditional defined benefit plan. By 1999, just 42 percent of workers in private-sector plans were in defined benefit plans. 87 percent had defined contribution plans, including 401(k)s, and 28 percent participated in both. Tabulations based on data from U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin, Abstract of 1999 Form 5500 Annual Reports*, Summer 2004, at 78.

[26] See "Retirement Market, 2005," *Cerulli Quantitative Update,* Cerulli Associates (2005).

[27] There are many reasons for the shift from defined benefit plans to defined contribution plans. Industries that traditionally offered defined benefit plans declined while industries that traditionally offered defined contribution plans grew. New firms tended to adopt 401(k) plans rather than defined benefit plans. While defined benefit plans offered the promise of additional retirement benefits, many workers left jobs before accruing significant benefits. Finally, benefits accrue more steadily in defined contribution plans, which is important for a mobile workforce. See discussion summarizing this research in "401(k) Plans: A 25-Year Retrospective," Perspective, Vol.12, No.2, Investment Company Institute (November 2006).

[28] "401(k) Plans: A 25-Year Retrospective," *Perspective,* Vol. 12, No. 2, Investment Company Institute (November 2006).

[29] Pension Protection Act, P.L. 109-280, § 811.

[30] "The Individual Retirement Account at Age 30: A Retrospective," *Perspective,* Vol. 11, No. 1, Investment Company Institute (February 2005).

[31] "The Role of IRAs in Americans' Retirement Preparedness," *Fundamentals,* Vol. 15, No.1, Investment Company Institute (January 2006), at 7.

[32] These PPA provisions allow employers to automatically enroll workers, automatically increase their contributions over time, and place employee contributions in investments designed for long-term investment. Research shows that automatic enrollment significantly increases plan participation rates, particularly among lower income workers, and that income replacement rates at retirement depend heavily on the default contribution rate and default investment option that the sponsor selects. See "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *Perspective,* Vol. 11, No. 2, Investment Company Institute (July 2005), and Issue Brief, No. 283, Employee Benefit Research Institute (July 2005).

[33] "The U.S. Retirement Market, 2005," *Fundamentals,* Vol. 15, No. 5, Investment Company Institute (July 2006), at 4, 8.

[34] *Profile of Mutual Fund Shareholders*, Investment Company Institute (Fall 2004), at 10.

[35] ICI research indicates that investors prefer a summary of this information instead of a detailed document. See *Understanding Investor Preferences for Mutual Fund Information*, Investment Company Institute (2006).

[36] For example, to qualify for the exemption, the investment advice either must derive from a computer model or must provide that the fees received by the advice provider in connection with the advice not vary based on the investment option selected. This fee "leveling" condition was not fully defined in the PPA. The Institute believes the level fee requirement should apply to the person or entity with responsibility to provide advice to the participant, not to affiliates of that advice provider. In addition, the PPA requires the Department of Labor to decide whether the computer model option is feasible in the IRA market and, if not, to provide a class exemption as an alternative means to provide advice to IRA owners. If a computer model is not feasible, the Department of Labor should issue the class exemption promptly.

[37] See Sarah Holden and Jack VanDerhei, The Influence of Automatic Enrollment, Catch-up, and IRA Contributions on 401(k) Accumulations at Retirement, *Investment Company Perspective,* Vol. 11, No.2 and Employee Benefit Research Institute Brief, No 283 (July 2005).

[38] The Department of Labor has proposed a safe harbor for default investments that provide for capital appreciation, while

recognizing that alternatives outside the safe harbor may be prudent. The Institute strongly supports this approach. The safe harbor should define investments suitable for long term retirement investing.

[39] See Testimony of Elizabeth Krentzman, General Counsel, Investment Company Institute, before the ERISA Advisory Council, September 21, 2006.

[40] The House version of the GROWTH Act (H.R. 2121) was introduced on May 5, 2005 and garnered 73 cosponsors. The Senate version (S. 1740) was introduced on September 21, 2005 and gained 6 cosponsors.

[41] See Statement of the Investment Company Institute on the President's Proposals for Fiscal Year 2006 before the Committee on Ways and Means, U.S. House of Representatives, February 22, 2005.

[42] See Statement of the Investment Company Institute submitted to the President's Advisory Panel on Federal Tax Reform, March 18, 2005.

[43] See *2005 ICI Annual Report to Members*, at 13.
