MEMO# 20838

February 2, 2007

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

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TO: BOARD OF GOVERNORS No. 6-07
SEC RULES MEMBERS No. 12-07
CLOSED-END INVESTMENT COMPANY MEMBERS No. 9-07
EQUITY MARKETS ADVISORY COMMITTEE No. 3-07
ETF ADVISORY COMMITTEE No. 3-07
COMPLIANCE MEMBERS No. 5-07
PENSION MEMBERS No. 4-07
TAX MEMBERS No. 5-07
INTERNATIONAL MEMBERS No. 2-07 RE: INSTITUTE SUBMISSION TO U.S. CHAMBER OF COMMERCE COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY

The Institute has filed a submission with the U.S. Chamber of Commerce's Commission on the Regulation of U.S. Capital Markets in the 21st Century (a copy of which is attached), setting forth recommendations to improve the legal and regulatory framework of the U.S. capital markets. The recommendations relate to two main areas impacting the U.S. capital markets – the regulatory structure of the securities markets and retirement and savings issues. The submission discusses several current and proposed regulations that exemplify concerns relating to the current regulatory structure and proposes several ways to ensure that the costs of regulations are proportionate to their benefits and that regulations do not unnecessarily and uniquely burden funds. In connection with retirement and savings issues, the recommendations discuss issues relating to 401(k) plans and IRAs, retirement savings tools, and creating tax efficiencies. The most significant aspects of the Institute's submission are summarized below.

Creating a More Efficient and Effective Regulatory Structure

The submission states that it is critical, when formulating new, or reexamining existing, regulations, that regulators properly take into account the costs and benefits of regulation, are cognizant of, and address, any unnecessary and duplicative regulation, and that substantially similar investment products and market participants be regulated in a fair and consistent manner. The submission notes that 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. Several examples of regulations imposed on the fund industry with costs that are disproportionate to their benefits or that unnecessarily and uniquely burden funds are discussed.

NYSE Broker Voting – The submission discusses the pending New York Stock Exchange proposal to eliminate discretionary broker voting for uncontested elections of directors, particularly the Institute report examining costs that would be incurred by funds as a result of the NYSE proposal. The submission notes that the report concluded that funds will have significant difficulties achieving quorums and electing directors if discretionary broker voting is eliminated and that the proposal could increase costs considerably for funds, as funds will be forced to conduct multiple solicitations to achieve a quorum. Because of these difficulties and costs, the submission recommends that funds be excluded from the NYSE proposal. In addition, to ensure that future SRO regulatory proposals take into account the extent of costs that would be incurred by market participants subject to those proposals, the submission recommends that the SEC by rule, or Congress by law, require that all SROs perform a formal cost/benefit analysis prior to submitting regulatory proposals to the SEC.

Sarbanes-Oxley Act Reform - The submission recommends that, in addition to examining possible reforms of Section 404 of the Sarbanes-Oxley Act, the Commission consider the impact of the Act on mutual funds. The submission notes that in rules implementing the Act's provisions, the SEC chose to subject mutual funds to several costly and burdensome requirements, particularly the certification requirements under the Act. The submission also notes that the Act's certification requirements are duplicative of a host of unique compliance requirements that apply to mutual funds. The submission therefore recommends that the certification requirements imposed upon mutual funds be withdrawn. At a minimum, a more reasoned approach to regulation should be adopted, e.g., certifications should not be required for non-financial information included in shareholder reports, such as the MDFP.

Independent Chair Requirement – The submission discusses concerns about the costs of SEC rule amendments requiring that fund boards be comprised of at least 75% independent directors and have an independent director as chair. The submission states that while in isolation the costs of the independent chair and independent director supermajority rules appear small, they can be significant for smaller fund firms. The submission also states that the SEC has failed to establish that any benefits of mandating that funds have an independent chair justify the costs. Regardless of the final outcome on the merits of this matter, the submission notes that 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.

Point of Sale Disclosure - The submission states that the Institute supports the concept of point of sale disclosure, but not as currently proposed by the SEC. Specifically, the submission states that 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. In addition, other financial products that brokers sell would not be subject to these requirements. The submission therefore recommends 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. The submission also recommends that any point of sale disclosure requirements apply equally to other financial products sold by brokers.

Soft Dollars – The submission notes that 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. In light of these consequences of applying Section 28(e) only to certain institutional investors, the submission recommends 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. The submission also expresses support for a recommendation of an 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.

Proxy Voting – The submission notes that mutual funds are the only investors required to publicly disclose the manner in which they vote their proxies, which has created unintended consequences for fund firms (e.g., singling out fund firms for scrutiny and unnecessary criticism for the manner in which they voted). The submission therefore recommends that, 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.

Retirement and Savings Issues

The submission states that it is critical that we address issues relating to retirement and savings, particularly those issues relating to 401(k) plans and IRAs, providing investors with the proper tools to invest their assets appropriately and to manage their accounts in retirement, and maintaining and strengthening tax and regulatory policies that encourage saving.

Defined Contribution Plans and IRAs - The submission makes several recommendations relating to 401(k) plans and IRAs. Specifically, the submission recommends that 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 Pension Protection Act that are designed to overcome the inertia that prevents many employees from electing to participate in their employer’s 401(k) plans.

Retirement Account Savings Tools - The submission notes that there are several areas where regulators can take steps to provide investors with the tools they need to better manage their retirement assets. Most significantly, the submission states that the quality of information provided to 401(k) plan participants about their investment options must be improved. The submission notes that Department of Labor regulations on disclosure are uneven for different investment products and do not cover all participant-directed plans. The submission therefore recommends that the Department of Labor require that participants in all self-directed plans receive simple, straightforward explanations about each of the investment options available to them including a concise summary of information relating to: investment objectives; principal risks; annual fees; historical performance; and the investment adviser that manages the product’s investments. The submission also recommends that 401(k) and IRA investors should have greater access to investment advice and that the Department of Labor foster greater use of the Internet as an effective means of delivering disclosure. Finally, the submission recommends that the Department of Labor 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.

Creating Tax Efficiencies - The submission states that regulatory tax burdens on mutual funds contribute to burdens on saving for retirement. In order to address concerns in this area, the submission urges the Commission to support adoption of the GROWTH Act, which would defer taxes on automatically reinvested capital gain distributions until fund shares are sold. The submission states that by reducing current tax bills and allowing earnings to grow tax-deferred, the GROWTH Act would boost long-term savings. The submission also states that permanence of the 15% maximum tax rate on long-term capital gains and qualified dividend income will strengthen savings and investment by taxpayers, will reduce for taxpayers the complexity and confusion of the tax laws, and will strengthen savings and investment, increase dividends and distributions, and contribute to job creation. The submission therefore urges the Commission to support permanence of the 15% maximum capital gains tax rate.

Elizabeth Krentzman
General Counsel

Attachment