The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

October 16, 2002

Comment Letter on SEC CEO Certification Proposal, October 2002

October 16, 2002

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549-0609

Re: Certification of Management Investment Company Shareholder Reports (File No. S7-33-02)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's rulemaking proposal to further implement the certification requirements of Section 302 of the Sarbanes-Oxley Act of 2002 with respect to investment companies.[2] The Commission's proposal would require registered management investment companies to file certified shareholder reports with the Commission on new Form N-CSR, and would designate these reports as reports that are required under Section 13(a) or 15(d) of the Securities Exchange Act of 1934. The Commission's proposal would also require all registered investment companies to maintain and regularly evaluate the effectiveness of disclosure controls and procedures with respect to filings under the Securities Act of 1933, the Exchange Act, and the Investment Company Act of 1940.

The Commission's proposal is intended to better implement the intent of the certification requirement of Section 302 of the Sarbanes-Oxley Act as applied to investment companies.[3] The Institute supports that goal and, insofar as the proposal would require certification of the financial statements and other financial information in shareholder reports, we support the proposal.

Unfortunately, however, the proposal also goes beyond the intent of the Act in several significant respects and inexplicably places a significantly heavier burden on investment companies than Congress has placed on other public companies required to file periodic reports under the Exchange Act. First, the proposal would require investment company officers to certify both shareholder reports and Form N-SAR. Second, the proposal would require certification of non-financial information contained in fund shareholder reports.

Third, the proposal would extend the requirements relating to the establishment and maintenance of "disclosure controls and procedures" to filings made under the Securities Act and the Investment Company Act. These aspects of the Commission's proposal would involve substantial costs, which ultimately would be borne by investment company shareholders.

In a previous comment letter to the Commission on the application of Section 302 to investment companies, the Institute recommended that the certification requirement should apply exclusively to the financial statements and other financial information included in investment company reports to shareholders.4 We continue to believe that the application of the requirement in this manner would be consistent with Congressional intent and would avoid imposing unnecessary costs and burdens on registered investment companies.

Our specific comments on the proposal are summarized as follows:

We support the part of the Commission's proposal that would require the certification of financial statements and other financial information in shareholder reports, as this is the type of information contemplated by Section 302 of the Sarbanes-Oxley Act.

We recommend eliminating the Form N-SAR certification requirement. The form contains only limited financial information, is not relied upon by investors in evaluating an investment company's results or financial condition and, therefore, does not satisfy the intent of Section 302. In addition, a dual certification requirement would impose an unjustified and unreasonable burden on investment companies.

We recommend that the certification requirement not apply to non-financial information contained in a fund's shareholder report, including the "Management's Discussion of Fund Performance." Requiring certification of such information would be inappropriate because of the subjective nature of the information, and would go beyond the intent of the Sarbanes-Oxley Act.

We recommend that the Commission exclude unit investment trusts from the requirements of Section 302 of the Act because of their unique structure and operations.

We oppose extending the disclosure controls and procedures requirement to filings made under the Securities Act and the Investment Company Act. The proposal goes beyond the scope of the Sarbanes-Oxley Act and singles out investment companies for disparate treatment. It would impose significant costs and burdens with no clear benefits.

We recommend that, if the Commission's proposals are adopted, the Commission provide for a 90-day period before compliance is required in order to give investment companies sufficient time to implement the new requirements.

Each of these comments is discussed more fully below.

A. Scope of Certification

B. Disclosure Controls and Procedures for Securities Act and Investment Company Act Filings

C. Compliance Date

A. Scope of Certification

According to the Proposing Release, the Commission believes that certification of Form N-SAR alone is not sufficient to fully implement the intent of the certification requirement in Section 302 of the Sarbanes-Oxley Act, which is to improve the integrity of the information that a company provides about its financial condition to investors. The Commission's proposal thus would amend Rule 30b2-1 under the Investment Company Act to require registered management investment companies also to certify their required reports to shareholders which, unlike Form N-SAR, contain financial statements. The Commission notes in the Proposing Release that these reports, rather than Form N-SAR, "are the primary vehicle for providing financial statements to investors."5 The Commission has requested comment, however, on whether it should require certification of both shareholder reports and Form N-SAR.

As discussed below, the Institute supports applying the certification requirements of Section 302 to the financial statements and other financial information included in reports to investment company shareholders. At the same time, we believe that if this part of the Commission's proposal is adopted, the requirement to certify the Form N-SAR would become completely unnecessary and therefore should be eliminated.

1. Certification of Financial Information in Shareholder Reports Would Satisfy the Intent of the Sarbanes-Oxley Act

The Commission's proposal would, in part, require the certification of financial statements and other financial information contained in investment company annual and semi-annual shareholder reports. The Institute supports this part of the Commission's proposal. Shareholders who wish to evaluate an investment company's results of operations and financial position, as contemplated by Section 302 of the Sarbanes-Oxley Act, would rely upon the financial information in these shareholder reports.6 This information is the closest analogue to the financial information included in the periodic reports that operating companies file with the Commission under the Exchange Act, which are required to be certified under Section 302. As such, a requirement for investment company officers to certify this information best accomplishes the goal of Section 302.

2. The Requirement to Certify Form N-SAR Should Be Eliminated

If the Commission adopts its proposal to require investment companies to certify the financial information in shareholder reports and to designate those reports as reports required under Section 13(a) or 15(d) of the Exchange Act, it will no longer be necessary to require certification of Form N-SAR to implement Section 302 of the Sarbanes-Oxley Act. Form N-SAR is ill-suited for this purpose in that it does not contain the type of information that Congress intended to be certified. It is a data collection form designed to elicit information from investment companies for use by the Commission's staff to, among other things, develop its compliance and inspection programs.

Form N-SAR does not contain financial statements; it contains only limited financial information derived from the investment company's financial statements, along with a significant amount of information that is not financial in nature.7 Thus, the information in Form N-SAR does not "fairly present in all material respects the financial condition and results of operations of the issuer."8 Moreover, Form N-SAR is not delivered to shareholders, nor is it relied upon by investors in evaluating an investment company's results or financial position. It became the vehicle through which the Commission implemented Section 302 with respect to investment companies solely because it is

currently the only form such companies file under Section 13(a) or 15(d) of the Exchange Act.9 By designating shareholder reports as reports filed under Section 13(a) or 15(d) of the Exchange Act, the Commission will be in a position to apply the certification requirement to a fund's financial statements, consistent with the intent of the Sarbanes-Oxley Act.10

The Institute strongly believes that investment company officers should not be required to certify both the shareholder report and Form N-SAR. Such a dual certification requirement would impose an unjustified and unreasonable burden on investment companies, especially given that certification of Form N-SAR would add no value due to the nature and content of the form, for the reasons described above. Unlike an operating company, which will file a single certified report four times per year, an investment company complex would be required to file two reports on Form N-SAR and two reports on Form N-CSR each year for each investment company within its complex, many of which may have different fiscal years. The Institute is concerned that the process involved in preparing, reviewing and certifying this information would be disproportionately burdensome for investment companies, particularly those complexes with numerous funds and/or series.

The Commission does not seem to fully appreciate the significant compliance burden that would be imposed on an investment company complex as a result of a dual certification requirement. The Commission's cost/benefit analysis in the Proposing Release concludes that it would take a single investment company five hours to comply with the proposed certification requirement for shareholder reports.11 This seems significantly lower than the time that likely will be required to comply with the proposed requirement.12 More importantly, the Commission's analysis does not reflect the additional time that it would take for an investment company also to comply with the Form N-SAR certification requirement.13 In fact, based on Institute members' early experiences, the process involved in complying with the current Form N-SAR certification requirement took considerably longer than the 5 hours per report suggested by the Commission.14

It is important to note that, in addition to the tangible costs and burdens of a dual certification requirement, requiring certification of a wide range of information, including information that is immaterial to shareholders, also involves certain intangible costs. Namely, it presents a serious risk of diluting the certification requirement prescribed by Congress. Not only are there practical limits on the amount of information on which investment company principal executive and financial officers can focus, but also the certification of immaterial information risks the perception that the entire process is a meaningless ritual.

For these reasons, the Institute strongly recommends that the Commission eliminate the Form N-SAR certification requirement.

3. The Certification Requirement Should Not Apply to Non-Financial Information in Shareholder Reports

The Commission's proposal would require certification of the entire shareholder report. The Institute believes that it is inappropriate and beyond the intent of the Sarbanes-Oxley Act to require investment companies to certify non-financial information contained in those reports. Therefore, consistent with the recommendations in our earlier letter, we recommend that the Commission's proposal be revised to require certification of only the financial information (i.e., the financial statements and condensed financial information) included in shareholder reports.15

Investment company shareholder reports typically include additional, voluntary non-

financial information, such as “President’s letters,” interviews with portfolio managers, and the like.16 The purpose of this information is to assist investors in understanding fund performance and portfolio composition. This information is subjective in nature and often expresses views on, among other things, the overall economic outlook for the market in which the fund invests.17 It is not the type of objective financial information that the Section 302 certification requirement was intended to cover and, thus, does not lend itself to meaningful personal certification by an investment company’s principal executive and financial officers. Moreover, imposing a certification requirement on this type of information could have unintended consequences. In particular, investment companies might reduce its scope or even cease providing it, which would be a disservice to investors.

The Institute also believes that the Commission should not require certification of the “Management’s Discussion of Fund Performance” (or “MDFP”). Many open-end investment company shareholder reports include the information otherwise required in mutual fund prospectuses under Item 5 of Form N-1A.18 The MDFP is designed to provide investors with disclosures regarding a fund’s past performance and describes the factors that materially affected that performance, including a discussion of relevant market conditions and the investment strategies and techniques used by the fund’s investment adviser. Like the voluntary, non-financial information described above, the discussion in the MDFP typically provides the portfolio manager’s well-informed, but subjective, opinions (e.g., about why the fund performed as it did during the period covered), and thus is not readily certifiable.19 Requiring the MDFP to be certified almost certainly would result in a scaled back, less robust discussion of information that investors find useful.

We further note that the MDFP stands on its own, and does not analyze or provide context for the fund’s financial statements. This is in contrast to an operating company’s “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (or “MD&A”),20 which is required to be included in such company’s periodic reports filed under Section 13(a) or 15(d) of the Exchange Act, and which is required to be certified under Section 302. The MD&A is intended to provide a narrative explanation of an operating company’s financial statements and to provide the context within which the financial statements should be analyzed. Accordingly, the MD&A (unlike a fund’s MDFP) is an integral part of the financial information included in quarterly or annual reports of operating companies. Any resemblance of the MDFP to the MD&A is superficial. Accordingly, we do not believe that the fact that officers of operating companies are required to certify the MD&A provides any rationale for including the MDFP within the scope of the certification requirement for investment companies.

For all of the above reasons, the Institute strongly recommends that any certification requirement extend only to the financial statements and other financial information contained in investment company shareholder reports.21

4. Unit Investment Trusts Should Be Excluded from the Certification Requirement

The Commission’s Form N-CSR proposal would apply to management investment companies and, therefore, would not apply to unit investment trusts. The Commission requested comment, however, on whether, if it removed the certification requirement from Form N-SAR, it would be appropriate to effectively eliminate the certification requirement for UITs. We believe that it would.

In our previous comment letter, we recommended excluding UITs from the requirements of

Section 302 because of their unique structure and operations. In particular, we pointed out that UITs are fixed investment pools with no management and that after an investor receives a prospectus containing financial information about the trust, there is little additional material information contained in subsequent financial disclosures. Moreover, we explained that UITs are not required to send periodic reports to unitholders or to file such reports with the Commission, and any such reports that are sent to unitholders are provided to them voluntarily by the trustee and generally prepared on a cash basis and are unaudited. We do not believe this is the type of disclosure at which Section 302 is aimed. We continue to believe that the foregoing reasons justify exempting UITs from the requirements of Section 302 and we again urge the Commission to do so.

B. Disclosure Controls and Procedures for Securities Act and Investment Company Act Filings

As the Proposing Release points out, investment companies filing reports under Section 13(a) or 15(d) of the Exchange Act will be required to maintain disclosure controls and procedures under new Exchange Act Rules 13a-15 and 15d-15 with respect to Exchange Act reports. The Commission has proposed new Rule 30a-3 under the Investment Company Act, which would require all registered investment companies: (1) to maintain disclosure controls and procedures with respect to all reports, registration forms, and other filings under the Exchange Act, the Securities Act and the Investment Company Act; and (2) under the supervision and with the participation of the principal executive and financial officers, to conduct an evaluation of such controls and procedures within the 90-day period before the filing date of each report requiring certification under Rule 30a-2 under the Investment Company Act.[22]

The Institute does not believe that it is necessary or appropriate to expand the disclosure controls and procedures requirement for investment companies to cover filings made under the Securities Act and the Investment Company Act. The Commission's proposal goes beyond the scope of Section 302 of the Sarbanes-Oxley Act and singles out investment companies for disparate treatment, for no apparent reason.[23] There has been no demonstrated abuse or shortcoming in this area sufficient to justify extending this requirement to all filings made by investment companies under the Securities Act and the Investment Company Act,[24] and the Commission has not provided any other compelling basis for this proposal.[25]

Moreover, while investment companies already have controls and processes in place that "operate so that important information flows to the appropriate collection and disclosure points in a timely manner,"[26] extending the disclosure controls and procedures requirement to Securities Act and Investment Company Act disclosure documents likely would require investment companies not only to revise their existing processes to fit a new mold[27] but also to formalize and document those processes.[28] It is not clear what benefits this formalization would provide, but it is clear that it will entail additional costs and burdens—which could be substantial—in terms of time and resources.[29] In fact, it is highly plausible that the effort that would need to be devoted to creating what may amount to no more than additional bureaucracy could divert resources from more important functions.

For all of these reasons, we oppose extending the disclosure controls and procedures requirement to filings made under the Securities Act and the Investment Company Act.

C. Compliance Date

If adopted, the Commission's proposal would require compliance with the proposed amendments, including the requirement to file certified reports on Form N-CSR and the requirements with respect to disclosure controls and procedures, thirty days after the final rules are published in the Federal Register. We believe that a longer compliance period of 90 days after publication is necessary to allow investment companies adequate time to develop and implement appropriate compliance procedures. An even longer period will be necessary if the Commission extends the disclosure and controls procedures requirement to Securities Act and Investment Company Act filings.

* * *

We appreciate the Commission's consideration of our comments. If you have any questions, or would like additional information, please contact me at (202) 326-5815, Amy Lancellotta at (202) 326-5824, or Barry Simmons at (202) 326-5923.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable Harvey L. Pitt
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Paul F. Roye, Director
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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,982 open-end investment companies ("mutual funds"), 513 closed-end investment companies and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.373 trillion, accounting for approximately 95 percent of total industry assets, and over 90.2 million individual shareholders.

2 SEC Release Nos. 34-46441, IC-25723 (August 30, 2002); 67 Fed. Reg. 57298 (September 9, 2002) (the "Proposing Release").

3 Section 302 of the Sarbanes-Oxley Act requires an issuer's principal executive officer and

principal financial officer to certify periodic reports it files under Section 13(a) or 15(d) of the Exchange Act. Currently, investment companies file Form N-SAR to satisfy their obligations to file periodic reports under Section 13(a) or 15(d). Consequently, the Commission's initial rules to implement Section 302 with respect to investment companies require investment company officers to certify Form N-SAR. See SEC Release Nos. 33-8124, 34-46427, IC-25722 (August 28, 2002); 67 Fed. Reg. 57276 (September 9, 2002) (the "Form N-SAR Release").

4 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated August 16, 2002.

5 Proposing Release at 57299.

6 This information includes the fund's financial statements for the period as required under Regulation S-X, along with the condensed financial information for the same period (see Items 22(b)(1) and (2) of Form N-1A and Instructions 4.a. and b. and 5.a. and b. of Form N-2).

7 See, e.g., Item 15 (custodial arrangements), Item 39 (account maintenance fees), and Item 61 (minimum initial investment).

8 Section 302(a)(3) of the Act.

9 See Rule 30a-1 under the Investment Company Act.

10 If the Commission determines to remove the certification requirement from Form N-SAR, then it should re-designate Form N-SAR as an Investment Company Act-only form to make clear that the form is not a filing under Section 13(a) or 15(d) of the Exchange Act and thus not subject to the certification requirements of Section 302 of the Sarbanes-Oxley Act.

11 See Proposing Release at n. 35.

12 While we question the reasonableness of the Commission's five-hour estimate for a stand-alone fund, it clearly understates the burden hours for a fund with multiple series, each of which has its own financial statements. For example, in the case of an investment company consisting of 10 series, the Commission's projected five-hour time frame would suggest an allocation of only 30 minutes for each such series to comply with the certification requirement, which is wholly unrealistic. Moreover, the Commission's aggregate estimate of 37,500 hours (i.e., 3,750 registered management investment companies x 5 hours x 2 filings per year) underestimates the aggregate burden hours required for compliance with the proposal because it is based on the number of registered investment companies, rather than the number of financial statements that such investment companies are required to prepare. See id. Based on Institute data, there are approximately 9,500 funds and/or series, which means that the aggregate burden hours (even using the Commission's conservative, five-hour estimate) would be 95,000—more than two and a half times the Commission's estimate.

13 The Form N-SAR certification is likely to be even more burdensome than the shareholder report certification due to the broad range of information that is required by the form and the fact that historically the review of Form N-SAR has not typically involved the same level of scrutiny as would now be required under the new certification requirement.

14 Form N-SAR Release at 57284. Moreover, the time required is likely to increase in the

future when compliance with paragraphs (4), (5), and (6) of Rule 30a-2 (concerning disclosure and internal controls and procedures), which was not required for Form N-SAR reports filed for periods ending on or before August 29, 2002, will be required. Based on the experience to date, one investment company complex with 130 funds estimates that on an ongoing basis, the N-SAR certification process will take approximately 20-25 hours per fund.

15 See supra note 6. Specifically, we recommend that Form N-CSR be revised to include only an investment company's financial statements and condensed financial information, and that all other information included in a shareholder report be filed exclusively under the Investment Company Act. This change will make clear that the certification requirement extends only to the financial information in shareholder reports.

16 The periodic reports filed by operating companies under the Exchange Act that are subject to the Section 302 certification requirement do not include similar "soft" material. Instead, the annual "glossy" reports that operating companies provide to shareholders typically include such non-financial discussions. These reports, however, are not filed under Section 13(a) or 15(d) of the Exchange Act and therefore are not subject to the certification requirement.

17 For example, a portfolio manager might discuss his or her belief that "long-term rates are not poised to go up substantially," or that "the global economy is going to continue to improve," and the reasons behind these opinions.

18 Item 5 of Form N-1A provides that this information is not required to be included in a fund's prospectus if it is included in the fund's annual report.

19 For example, a fund's MDFP might state that "the fund benefited from overweighting retail stocks relative to the broad market during the period" or that "the fund's performance was helped by its underweighting in global consumer products companies and certain cyclical stocks."

20 Item 303 of Regulation S-K.

21 We note that investment company shareholder reports contain other non-financial information in addition to that discussed above, such as certain basic information about directors and officers. See, e.g., Items 22(b)(5) and 13(a)(1) of Form N-1A. We do not believe that certification of this information would provide any benefit to fund shareholders or the market generally, inasmuch as it does not appear to have any relevance to "the financial condition and results of operations of the issuer." Nevertheless, certification of similar factual information is required of operating companies and is not as objectionable as certification of the MDFP or the other subjective non-financial information included in shareholder reports.

22 As noted in the Proposing Release, this evaluation is intended to form the basis for the certification required by Section 302 of the Sarbanes-Oxley Act regarding disclosure controls and procedures required by Investment Company Act Rule 30a-2(b)(4). Proposing Release at 57300.

23 The Commission has not proposed to expand the scope of disclosure controls and procedures that public operating companies must maintain.

24 It is not clear whether the Commission's proposal is intended to encompass investment company advertisements and/or sales literature, because "disclosure controls and

procedures” are defined in proposed Rule 30a-2(c) to relate to “information required to be disclosed” in filings made under the Securities Act, Exchange Act and Investment Company Act. We submit that these are not the types of required disclosure documents as to which there would be an interest in ensuring that the information they contain is “recorded, processed, summarized and reported on a timely basis.” Similarly, it would be inappropriate to expect direct participation by the principal executive and financial officers in establishing and periodically evaluating disclosure controls and procedures with respect to these materials. Given the liability standards and specific regulatory requirements that apply to these materials, and the fact that they are generally filed with and reviewed by the NASD, it seems especially unnecessary to extend the requirement to them. Moreover, extending the disclosure controls and procedures requirements to these materials would, without any justification, make the disproportionate burdens of the Commission’s proposal on investment companies as compared to other types of issuers even more pronounced. For all of these reasons, we recommend that, if the Commission adopts this proposal, it clarify in the adopting release that investment company advertisements and sales literature are not covered by the disclosure controls and procedures requirement.

25 The Proposing Release simply states the Commission’s belief “that it is important that investment companies maintain effective disclosure controls and procedures with respect to the information required in filings under the Securities Act and the Investment Company Act as well as with respect to Exchange Act filings.” Proposing Release at 57300. There is no evidence, however, that they do not do so, or that there are weaknesses that suggest that additional remedial measures are needed.

26 Form N-SAR Release at 57281. Existing controls and processes are necessitated by the continuous nature of the disclosure requirements applicable to investment companies and the attendant liability under Sections 11 and 12 of the Securities Act, as well as the specific, ongoing regulatory requirements that govern the day-to-day operations of investment companies (e.g., daily pricing).

27 For example, the Commission has recommended that issuers create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. See Form N-SAR Release at 57280. While this approach may be appropriate in some instances, if existing procedures are working effectively, it seems an unnecessary exercise.

28 We recognize that investment companies likely will be changing their existing processes to comply with the requirement to establish disclosure controls and procedures relating to Exchange Act reports. Nevertheless, expanding the requirement to cover Securities Act and Investment Company Act filings would necessitate more extensive changes and impose substantial additional burdens with respect to documentation.

29 These burdens result not only from the sheer number of filings that investment companies make under the Securities Act and Investment Company Act, but also from the range of different types of filings, each of which could require a unique set of procedures.
