INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

July 26, 2001

Letter on Portfolio Investment Programs' Petition, July 2001

July 24, 2001

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

Re: Petition for Rulemaking Regarding Portfolio Investment Programs

Dear Mr. Katz:

The Investment Company Institute[1] submits this response to a letter dated June 14, 2001, submitted by the Securities Industry Association (the "SIA"), opposing the Institute's petition for a rule that would define certain portfolio investment programs ("PIPs") as investment companies under the Investment Company Act of 1940 (the "1940 Act"). The SIA argues, among other things, that the regulation of PIPs under the Securities Exchange Act of 1934 (the "1934 Act") or the Investment Advisers Act of 1940 (the "Advisers Act") provides adequate investor protection and that 1940 Act regulation would chill innovation and should await a demonstrated record of abuse. It further argues, on a more technical level, that as long as investors have the option to control their portfolio investments, "reliance on the efforts of others" cannot serve as a basis for regulation of PIPs as separate securities and that, in any event, PIPs qualify for the safe harbor from 1940 Act regulation established by Rule 3a-4 thereunder. None of these arguments has any foundation in law, fact or policy.

The Adequacy of Existing Regulation

Sponsors of PIPs have chosen to be regulated, if at all, as either broker-dealers under the 1934 Act or as investment advisers under the Advisers Act. The SIA has not attempted to explain, however, how either one of these entirely different regulatory schemes could satisfy the regulatory needs of investors in PIPs. Where, as in the case of PIPs, investors rely for the economic viability of their investments upon the impersonal financial expertise and essential trading services provided by sponsors, the 1934 Act and the Advisers Act, either alone or in combination, do not adequately address the risks of investor abuse. In contrast, investment company regulation focuses on protecting investors from these risks. The differences in such protections include:

- The comprehensive proscriptions against affiliated transactions found in the 1940 Act but not in the 1934 Act or the Advisers Act that will prevent broker-dealers sponsoring PIPs from using pre-packaged portfolios to dump on investors securities from unsuccessful underwritings or proprietary trading programs or as a means to develop trading volume and investor interest in a security.
- Commission review of prospectuses and NASD review of advertising that will serve as necessary checks on potential abuses in the offering of pre-packaged portfolios and the advertising of their performance, checks that are not found under the 1934 Act or the Advisers Act.
- The stringent due diligence obligations created by the civil liability provisions of the Securities Act of 1933 (the "Securities Act") that will inhibit misrepresentations by PIP sponsors.
- Independent board oversight and fiduciary duties arising under the 1940 Act that will prevent PIP sponsors from charging unreasonable fees and from resolving conflicts of interest in favor of themselves rather than investors.

Investment Company Regulation and Innovation

The SIA argument that 1940 Act regulation would chill innovation ignores the fact that innovation has flourished within the regulatory framework of the 1940 Act not despite, but because of, its essential investor protections. The development and rapid growth of money market funds, exchange-traded funds and variable contracts under the aegis of 1940 Act regulation serve as examples of the innovation that such regulation has fostered. To the extent adjustments to the regulatory pattern of the 1940 Act are justified for PIPs, the Commission has broad administrative power to provide them.

The development of new products through applications of information technology, while offering great potential benefits to investors, also creates significant dangers for the unwary. Repeated Commission enforcement sweeps of the Internet show how easy it is for unscrupulous operators to take advantage of investors with sophisticated-looking websites. The use of exciting new technology does not qualify its sponsors for a free pass from regulatory investor protections.

PIPs’ Offerings as Separate Securities

The SIA’s assertion that PIP investors do not rely on the sponsor’s efforts is unsupported by either evidence or realistic expectations. The fact that investors in PIPs have the option to customize their pre-packaged portfolios does not and should not preclude the Commission from finding that the programs form separate securities. [2] The SIA’s submission ignores the Supreme Court’s and other courts’ repeated holdings in Howey and its progeny that an investment opportunity forms a security separate from the underlying portfolio securities if, based on the sponsor’s offer, it is reasonably likely that investors will rely on the sponsor’s efforts, even where an investor has the right to control the management of his or her investment.[3] It is reasonably likely that many investors will expect profits through reliance upon the specialized investment management expertise and upon the essential trading services that PIPs’ sponsors offer through pre-packaged portfolios.

PIPs’ Status as Discretionary Advisory Programs

The SIA’s letter argues that PIPs are not discretionary advisory programs and that, even if they are, they qualify for the safe harbor from 1940 Act regulation under Rule 3a-4. Neither point is correct. First, PIPs should not be treated as non-discretionary programs as a matter of Commission policy. As the Commission release cited by the SIA recognized: "Whether a program is non-discretionary is inherently a factual determination. A program designated as ‘non-discretionary’ in which the client follows each and every recommendation of the adviser may raise a question whether the program in fact is non-discretionary."[4] PIPs’ sponsors are in fact publicly offering pre-packaged portfolios and periodic updates that investors can, and many will likely, purchase unchanged or with minimal changes.

PIPs also would not qualify for the Rule 3a-4 safe harbor. The rule and the underlying Commission policy are based on two necessary conditions. An investment program is not an investment company if (a) it provides investors individualized investment advice,[5] and (b) program investors retain the indicia of ownership of the underlying securities. The SIA’s letter refers only to the second condition, and for good reason: PIPs do not give investors individualized investment advice. PIPs do not, as the rule requires, make reasonably available to their clients personnel who are knowledgeable about their accounts and their management. PIPs do not, as the rule contemplates, actively reach out to clients for updates about their financial situations and investment objectives. Rather, PIPs offer and sell non-personalized, pre-packaged portfolios and periodic portfolio updates to the broad investing public.

The SIA’s Asserted Need for a Substantiated Record of Abuse

The investment company industry has avoided major scandal for sixty years in part because the 1940 Act and the Commission’s administration of the Act have been forward-looking and not reactive. That administration has correctly recognized that, contrary to the SIA’s assertion, it is not in the public interest for the Commission to wait until investors are harmed before appropriately regulating investment products such as PIPs. As Commission enforcement actions have shown, the unscrupulous can take advantage of investors over the Internet with uncanny speed, and then, as experience unfortunately demonstrates, it is usually too late for investors to recover their losses. Commission action is most effective when it proactively regulates or prohibits activities that are likely to mislead or harm investors.

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The Institute seeks the regulation of PIPs as investment companies in order to protect investors from the dangers that PIPs present when offered by unscrupulous sponsors. The Institute’s proposed definitional rule will give the Commission the regulatory framework it needs to protect investors, instill investor confidence, foster responsible innovation, and enhance informed investor choice. The time for Commission action is now, before investors are harmed. We respectfully urge the Commission expeditiously to adopt the Institute’s proposed rule.

Respectfully submitted,

Craig S. Tyle

General Counsel

cc: Laura S. Unger, Acting Chairman
Isaac C. Hunt, Jr., Commissioner
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David B. H. Martin, Jr., Director
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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,598 open-end investment companies ("mutual funds"), 504 closed-end investment companies and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.991 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

2 Offerings of PIPs warrant Securities Act registration independently of their status under the 1940 Act.

3 SEC v. W.J. Howey, Co., 328 U.S. 293, 298-299, 301 (1946); Hocking v. Dubois, 885 F.2d 1449, 1460-1462 (9th Cir. en banc, 1989), cert. denied, 494 U.S. 78 (1990); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577, 582-584 (2d Cir. 1982) (Friendly, J.).

4 Investment Company Act Release No. 22579 at n.18 (Mar. 14, 1997) (adopting rule 3a-4).

5 See id. "[T]he rule contemplates that a client's investment objective will be formulated with appropriate input from the client regarding the client's financial goals and risk tolerance." Id. at n.29. "[The rule] was designed to ensure that sponsors have current information about clients in the program, which, in the Commission's view, is critical to provision of individually tailored advice." Id. at text preceding n.35.
