

January 17, 2008

Via Email

European Commission  
Directorate-General for the Internal Market and Services  
B-1049 Brussels  
Belgium  
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Re: Call for Evidence on “Substitute” Retail Investment Products

Dear Sirs:

The Investment Company Institute<sup>1</sup> strongly supports the efforts of the European Commission to examine the regulation of retail investment products in Europe. We commend the Commission for its willingness to invite wide-ranging commentary on a set of issues that are commanding increasing attention around the globe from regulators, industry participants, investor advocates, and others. ICI is pleased to offer its perspective on how the Commission might evaluate the critical issue of whether disparate regulatory requirements for “substitute” investment products result in uneven levels of investor protection. As the Commission has suggested, this issue takes on an added urgency in light of the growing reliance by individual investors on private investment to finance their retirement.

There are striking parallels between Europe and the United States with regard to the regulation of investment products offered to retail investors. In both jurisdictions, the regulatory regimes that exist today are an outgrowth of an earlier time, when it was easy to distinguish bank deposits from insurance contracts from investment securities, and it made sense to regulate each according to its distinct characteristics. Now, however, retail investors in Europe and the United States are confronted with an expanding array of increasingly complex investment options, many of which share some key characteristics. As a general matter, we concur that this greater degree of innovation, and the resulting competition it engenders among substitute investment products, provides benefits for retail investors. Yet, as the Commission has rightly identified, it is important for innovation also to occur in how these

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.70 trillion and serve almost 90 million shareholders.

various products are regulated, so that regulation does not inadvertently make some products more attractive or easier to sell than others.

As ICI and its members have considered, from a domestic standpoint, the types of issues outlined in the Commission's Call for Evidence, we have identified certain principles that we firmly believe should guide future public policy determinations. In this letter, we outline those principles that we believe are most relevant to the EC's current inquiry, with examples from the US market that are intended to illustrate each such principle. We encourage the Commission to consider these principles as it evaluates the outcome of this Call for Evidence and the need for future regulatory initiatives. The principles are:

- First, disclosure requirements should be comparable for "substitute" retail investment products that offer risk/return performance similar to investment funds;
- Second, if regulators determine that a particular requirement should be imposed upon retail investment funds, that requirement should be extended to substitute investment products ("regulatory equivalency");
- Third, if there are intentional differences among investment products, the regulatory requirements to which they are subject should respect those differences and should not be allowed to blur together ("regulatory distinctions"); and
- Fourth, differences in tax treatment should not steer an investor toward a particular investment product.

### **Require Comparable Disclosure for Substitute Retail Investment Products**

The Commission's Call for Evidence contains frank and insightful discussion about the implications of requirements that impose different levels of disclosure for "substitute" retail investment products. As the Call for Evidence explains, European Union (EU) legislation imposes varying requirements for disclosure to retail investors based upon the type of investment product; these differences relate to the level of information supplied, how frequently it is provided, its contents and usefulness to retail investors, and the means by which investors may access this information.<sup>2</sup> The Commission notes that these discrepancies in disclosure raise "many potential concerns over whether and how investors are provided with the necessary information to understand properly the characteristics . . . of substitute investment products."<sup>3</sup>

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<sup>2</sup> See *Call for Evidence, Need for a Coherent Approach to Product Transparency and Distribution Requirements for "Substitute" Retail Investment Products* (Oct. 2007) ("Call for Evidence") available at [http://ec.europa.eu/internal\\_market/finances/docs/cross-sector/call\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/cross-sector/call_en.pdf), at Section 2.1.

<sup>3</sup> *Id.*

The Institute applauds the Commission's focus on this critically important issue. During the course of their lives, investors are called upon to make a variety of investment decisions as their personal circumstances change. These decisions may involve saving to buy a home or to finance a child's education, building an adequate nest egg for retirement, or investment of an inheritance, to name a few. Whether they make these decisions individually or with the help of a financial adviser, investors need meaningful, comprehensible information about the range of investment products from which they may choose, so that they can make informed investment decisions based upon their individual needs.<sup>4</sup> We wholeheartedly agree with the Commission's observations that "disclosures directed to the end-investor must be kept short and simple" and that, while some elements of disclosure may need to be tailored to accommodate distinctions among product types, greater comparability in disclosure about various investment products can be achieved.<sup>5</sup>

The U.S. retirement marketplace offers a clear example of the need for meaningful, comparable disclosure to retail investors. Our existing disclosure regime predates the rise in popularity of employer-sponsored retirement plans in which the employee participants make investment decisions for their accounts ("participant-directed plans"). Under current regulations, participants must receive full information about mutual funds (in the form of the fund prospectus), but for other investment products, important information – such as operating expenses and historical performance – is available to participants only upon request. As the SEC staff observed more than fifteen years ago, in plans where the investment risk falls on the employee, "plan participants need the same information as any other individual who invests in securities, and the focus of the securities laws needs to shift [accordingly]."<sup>6</sup>

For more than two decades, ICI has advocated for greater parity in the information provided to investors about the investment options in their retirement plans, so that individuals are empowered to make more informed choices about how to invest their savings for retirement. Most recently, we recommended to the U.S. Department of Labor that employee participants in a participant-directed plan should receive a concise summary containing the following key pieces of information for each investment product offered within the plan:

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<sup>4</sup> Recent ICI research indicates, for example, that the majority of investors who use financial advisers in purchasing mutual funds outside employer-sponsored retirement plans "sometimes" or "always" conduct independent research to confirm investment recommendations made by their advisers. See *Why Do Mutual Fund Investors Use Professional Investment Advisers?*, Investment Company Institute (Apr. 2007), available at <http://www.ici.org/stats/res/fm-v16n1.pdf>.

<sup>5</sup> See Call for Evidence at Section 2.1.

<sup>6</sup> See *Protecting Investors: A Half Century of Investment Company Regulation* (report by the Division of Investment Management, U.S. Securities and Exchange Commission, May 1992) at 120. This report is available at [http://sechistorical.org/collection/papers/1990/1992\\_ProtectInv/](http://sechistorical.org/collection/papers/1990/1992_ProtectInv/).

- Types of securities held and investment objectives of the product
- Principal risks associated with investing in the product
- Annual fees and expenses (expressed in a ratio or fee table)
- Historical performance
- Investment adviser that manages the product's investments

This list is based upon ICI research into the information that investors actually consider before purchasing mutual fund shares.<sup>7</sup> We firmly believe that this basic information is equally appropriate for investors who are evaluating the range of investment products that may be offered in participant-directed plans, which may include insurance separate accounts, bank collective trusts, and separately managed accounts, in addition to mutual funds.

### **Encourage Regulatory Equivalency for Substitute Investment Products**

The Call for Evidence notes that there is “a fear that less transparent or regulated products may be easier to sell, thereby displacing more heavily-regulated products and exacerbating investor protection concerns.”<sup>8</sup> The U.S. fund industry has similar concerns that in our market, heavier regulatory burdens often are placed on mutual funds than on other investment products sold to retail investors. ICI has long sought to make U.S. regulators sensitive to this dynamic in their rulemakings, so that the regulatory requirements placed on funds – however well-intentioned – do not inadvertently create substantial disincentives for brokers and other intermediaries to sell fund shares.

One area of particular current concern to ICI and its members are proposed “point of sale” requirements, both in the U.S. and other jurisdictions, which call for brokers to provide extensive disclosure before selling an investor fund shares, but not before selling other competing investment products. ICI fully supports the concept of point of sale disclosure, and we have repeatedly called for and supported enhanced disclosure by brokers of “revenue sharing” arrangements, in which fund advisers or underwriters make payments out of their legitimate profits to compensate brokers for selling fund shares, and other potential conflicts of interest. If point of sale requirements are imposed only for sales of fund shares, however, many brokers are likely to steer their customers to alternative investments, such as separately managed accounts, that are not subject to these requirements and do not offer the same level of regulatory protection and other benefits (*e.g.*, diversification, liquidity, professional management) that funds do.

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<sup>7</sup> See *Understanding Investor Preferences for Mutual Fund Information*, Investment Company Institute (2006), available at [http://www.ici.org/stats/res/arc-sdem/rpt\\_06\\_inv\\_prefs\\_full.pdf](http://www.ici.org/stats/res/arc-sdem/rpt_06_inv_prefs_full.pdf). The study included in-home interviews with 737 randomly selected investors who had purchased shares in stock, bond, or hybrid mutual funds outside retirement plans at work in the preceding five years. Although this study focused on investors who purchased mutual funds in the retail market, we believe its findings are relevant to the decisions that participants make in employer-sponsored retirement plans.

<sup>8</sup> See Call for Evidence at Introduction.

Most recently, in a letter to the Canadian Joint Forum of Financial Market Regulators (the “Forum”), ICI expressed its disappointment in the Forum’s proposal to require earlier delivery of product disclosure in connection with the sale of mutual funds and segregated funds but not in connection with the sale of other investment products. Our letter explained:

New disclosure regimes for mutual funds are being considered by regulators around the world. These have the potential to result in better-informed investors who know more about and demand more from their investments and the companies that provide those services. The imposition of a more burdensome sales process that applies solely to a limited class of investment products represented by mutual funds and segregated funds may reduce those benefits by making it easier and faster for intermediaries to sell other products, even if those products are less regulated and do not offer the transparency or other benefits of mutual funds.<sup>9</sup>

ICI further urged that, if the Forum considers it beneficial for investors to receive certain information earlier in the sales process, it should impose the same requirement on all retail investment products, and not just mutual funds.

#### **Preserve Regulatory Distinctions for Investment Products That Are Not “Substitutes”**

The Commission’s Call for Evidence focuses on defining the scope of the category of substitute investment products for retail investors. ICI believes that it is equally important for the Commission to identify the investment products that clearly belong *outside* the scope of this category. This issue is not unique to Europe, but is one of concern in financial markets around the world. Generally speaking, investment products that are broadly marketed to retail investors, and the companies that sponsor those products, are subject to a much greater degree of regulatory scrutiny than products intended for sophisticated investors. These distinctions are rooted in the longstanding, and logical, recognition that fewer regulatory safeguards are needed for financially sophisticated investors who have the requisite level of knowledge and financial sophistication and are able to bear the risk of loss associated with their investment.

In the United States, a clear example of this is the intentionally different regulatory treatment for mutual funds and unregistered funds offered privately, such as hedge funds. U.S. mutual funds are required to register with the U.S. Securities and Exchange Commission and comply with comprehensive regulatory requirements in the Investment Company Act addressing such areas as disclosure and reporting, valuation of portfolio securities, conflict of interest prohibitions, and

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<sup>9</sup> See Letter to Neil Mohindra, Acting Policy Manager, Joint Forum Project (Canada), from Susan M. Olson, Senior Counsel – International Affairs, Investment Company Institute, dated Oct. 15, 2007, available at [http://www.ici.org/statements/cmltr/07\\_can\\_point\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/07_can_point_com.html#TopOfPage).

investment limitations. Hedge funds, on the other hand, are effectively outside the purview of the Investment Company Act, provided that the hedge fund sells its securities only to prescribed categories of investors and is not making or proposing to make a public offer of its securities.<sup>10</sup>

ICI firmly believes that these intentional distinctions in the law must be preserved, and that the dividing line between mutual funds and hedge funds should not be permitted to blur. We have expressed our strong support for a proposal by the U.S. Securities and Exchange Commission to provide additional protections for natural persons wishing to invest in certain hedge funds.<sup>11</sup> The proposal would require an individual wishing to invest in a hedge fund organized under Section 3(c)(1) of the Investment Company Act to own at least \$2.5 million in investments, in addition to demonstrating that he or she has sufficient net worth or income. In discussing the need for this additional level of protection, the SEC explained that hedge funds and other private investment pools:

... involve risks not generally associated with many other issuers of securities. Not only do private [investment] pools often use complicated strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such pools' anticipated returns.<sup>12</sup>

ICI believes that this proposal would help to ensure that sales of hedge funds and other private investment pools are made only to individual investors who are able to "fend for themselves."

In ICI's view, it is equally important to maintain the distinction in U.S. law that hedge funds do not make or propose to make a public offering of their securities. For many years, however, the hedge fund community has argued that unregistered hedge funds should be able to advertise through the public media, while remaining free from the regulatory restrictions and shareholder protections to which mutual funds are subject. ICI and its members believe that such a course would represent a

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<sup>10</sup> See Sections 2(a)(51) and 3(c)(7) of the Investment Company Act (funds are excepted from the definition of "investment company" if they sell their shares only to natural persons owning \$5 million (US) in investments and other "qualified purchasers"); Section 3(c)(1) of the Investment Company Act (funds are excepted from the definition of "investment company" if they sell their shares to 100 or fewer investors).

<sup>11</sup> See, e.g., Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated March 9, 2007, available at [http://www.ici.org/statements/cmltr/2007/07\\_sec\\_adv\\_fraud\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/2007/07_sec_adv_fraud_com.html#TopOfPage).

<sup>12</sup> See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Rel. Nos. 33-8766 and IA-2576 (Dec. 27, 2006) at text following n.45. This release is available on the SEC's website at <http://www.sec.gov/rules/proposed/2006/33-8766.pdf>.

dangerous erosion in the clear boundary between retail and non-retail investment products. We recently asked the U.S. Securities and Exchange Commission to issue a clear statement that public marketing efforts by unregistered hedge funds is directly contrary to their exemption from regulation under the Investment Company Act and would raise serious investor protection concerns.<sup>13</sup>

We urge the Commission to consider these observations not only in response to this Call for Evidence, but also in connection with its efforts to develop a private placement regime for the EU.<sup>14</sup>

### **Tax Treatment**

The Commission's Call for Evidence indicates that "taxation regimes [in Europe] may materially influence investor choice between financial products and life insurance products."<sup>15</sup> In the United States, we are currently experiencing a similar situation as regards exchange-traded notes (ETNs), which have entered the retail space in recent years to compete with U.S. mutual funds. ETNs are financial products structured as debt instruments with maturities ranging from five to thirty years, the return on which is typically based on the value of a specified index, such as the MSCI India Total Return Index. Although ETNs provide a substantially similar investment to mutual funds, their investors do not receive the protections afforded to mutual fund investors under the Investment Company Act and other U.S. federal securities laws.

By utilizing a gap in U.S. tax laws, retail ETNs have been able to provide their investors with tax treatment that is far superior to that provided to mutual fund shareholders. ICI recently urged the U.S. Congress to enact legislation to eliminate this disparate tax treatment, for which there is no compelling tax policy rationale.<sup>16</sup> In our letter, we noted that unless the tax treatment of retail ETNs is corrected, mutual funds stand to become substantially less attractive to investors solely for tax reasons.

ICI recognizes that the Commission does not intend to focus on possible distortions created by taxation regimes, instead leaving it to individual EU member states to take corrective action.

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<sup>13</sup> See Letter to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, from Paul Schott Stevens, President & CEO, Investment Company Institute, dated Oct. 9, 2007, available at [http://www.ici.org/statements/cmltr/07\\_sec\\_regd\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/07_sec_regd_com.html#TopOfPage).

<sup>14</sup> For a more complete treatment of ICI's views on the Commission's development of a single private placement regime, see Letter to the European Commission, Directorate-General for the Internal Market and Services, from Susan M. Olson, Senior Counsel – International Affairs, Investment Company Institute, dated June 29, 2007, available at [http://www.ici.org/statements/cmltr/07\\_eu\\_priv\\_place\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/07_eu_priv_place_com.html#TopOfPage).

<sup>15</sup> See Call for Evidence at Section 1.2.

<sup>16</sup> See Letter to Hon. Charles B. Rangel, Chairman, and Hon. Jim McCrery, Ranking Member, Committee on Ways & Means, U.S. House of Representatives, from Paul Schott Stevens, President & CEO, Investment Company Institute, dated Nov. 1, 2007, available at [http://www.ici.org/issues/tax/07\\_house\\_etn\\_ltr.pdf](http://www.ici.org/issues/tax/07_house_etn_ltr.pdf).

Nevertheless, we strongly encourage the Commission to raise member states' awareness of these distortions and the resulting potential detriment for retail investors.

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We hope that ICI's suggested principles will be useful to the Commission as it evaluates the responses to this Call for Evidence and the need for future regulatory initiatives. If you have questions or if we can provide any other information, please feel free to contact me at [solson@ici.org](mailto:solson@ici.org) or +1-202-326-5813.

Sincerely,

/s/ Susan M. Olson

Susan M. Olson  
Senior Counsel - International Affairs

cc: Andrew J. Donohue, Director  
Division of Investment Management  
U.S. Securities and Exchange Commission