



Securities Industry Association

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By hand and email

Jonathan G. Katz

Secretary

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20549

June 14, 2001

Re: Investment Company Institute

Petition for Rulemaking dated March 28, 2001

Dear Mr. Katz:

The Securities Industry Association¹ ("SIA") is submitting this letter in response to a petition for rulemaking by the Investment Company Institute ("ICI"), with respect to "certain portfolio investment programs" that may be available either on-line or through more traditional brokerage or advisory relationships. While these "programs" may have varying characteristics, they generally offer clients the opportunity to purchase a portfolio or basket of individual securities geared to particular types of securities or certain investment objectives. Clients may also receive periodic re-balancing recommendations to enable them to maintain a diversification consistent with their investment objectives. To SIA's knowledge, investors maintain complete ownership and control over the individual securities in their portfolios. They have the right to purchase or sell these securities and to accept or reject any of the securities recommendations made to them. Further, they retain all the rights and privileges that ordinarily attach to ownership.

Notwithstanding the above, the ICI is seeking the adoption of a broad definitional rule which would cause the above described products and services and possibly other types of investments to be deemed investment companies under the Investment Company Act of 1940 and thus subject them to the provisions of that statute. For the reasons detailed below, SIA believes that the rulemaking proposal should not be adopted.

¹ The Securities Industry Association brings together the shared interest of nearly 700 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated \$314 billion of revenue directly in the U.S. economy and an additional \$110 billion overseas. Securities firms employ approximately 770,000 individuals in the U.S. (More information about SIA is available on its home page: <http://www.sia.com>.)

OVERVIEW

At the outset, we would point out that our members, most of whom are dually registered as broker-dealers and investment advisers or are broker-dealers with affiliated advisers, offer investors a full range of brokerage, investment advisory and mutual fund products and services, and in fact are the largest distributors of mutual funds sponsored by ICI's membership. A major goal of SIA members is to offer investors the broadest array of investment choices for their selection in order to help them meet their investment objectives, as well as to assure that all investment products and services are available on a fair and competitive basis.

SIA believes that the adoption of the proposed rule will create unnecessary regulatory burdens that will stifle the development of new and innovative brokerage and advisory services. We do not believe that it is in the public interest to deter technological advances designed to assist investors in achieving their objectives.

ADVERSE IMPACT ON INNOVATION

Technology has had a dramatic and, we believe, beneficial effect on the investment process in recent years. In particular, it has enabled investors to determine their investment objectives more efficiently, and to identify, acquire and maintain portfolios of securities (which may include stocks, bonds, mutual funds, or some combination thereof) consistent with those objectives. Technology systems now assist many investors, whether they seek to structure and monitor their own holdings, access information available on the internet, or otherwise utilize services available through consultation with an investment professional. Thus, clients can now create particular securities portfolios to match their investment objectives, periodically re-balance their holdings to remain consistent with those objectives, and in many cases group or aggregate purchases and sales of securities to maximize execution quality.

All of these components can benefit investors, and we believe it is in the public interest to ensure that such products and services continue to be available on a cost-effective basis. We fear that the adoption of the proposed definitional rule would cast doubt on the regulatory status of a whole range of products and services employing this new technology. Worse still, it could have a chilling effect on the development of future beneficial products and services.

THE CURRENT REGULATORY FRAMEWORK IS ADEQUATE

It is not SIA's intention to reach a conclusion regarding the appropriate regulatory status or governing law for any particular product or service. Rather, we believe a sufficient and effective legal framework already exists to enable the Commission to make such a determination.

As a preliminary matter, we would note that the adoption of additional rulemaking should be based on a substantiated history of abuse, not speculation about the future. SIA is not aware of any current problems, nor have any been cited, relating to these products and services. While we are, of course, always concerned about the potential for future

improprieties, we see no reason to impose the substantive provisions of the Investment Company Act - provisions which were designed to deter particular misconduct known to exist in the fund industry at the time of adoption.

Moreover, we do not believe that the services in question even resemble mutual funds. Fund investors cannot exercise control over the individual holdings of a fund's portfolio. Fund investors cannot exercise corporate governance rights over such individual holdings. Fund investors cannot direct the purchase or sale of such individual securities.

While the securities industry has developed some innovative investment products and services in recent years, the Commission has already (and effectively) addressed these challenges through appropriate rulemaking, including the 1997 adoption of Rule 3a-4 under the Investment Company Act² and proposed Rule 202 (a) (11)-1³ under the Investment Advisers Act of 1940.

In adopting Rule 3a-4, the Commission recognized that an investment company would not exist where clients retained the indicia of ownership, such as the right to pledge securities, to vote those securities, and to proceed directly against an issuer without joining with other participants in an advisory program. Customers of the portfolio services described above retain all these indicia. They have the same rights regarding the securities held in their accounts as if they held the securities in any other brokerage accounts

We would further point out that these services appear to be offered on a non-discretionary basis, where clients determine which portfolios, if any, to purchase or sell and then have the right to accept or reject any recommendations for these portfolios. As the Commission stated in its Rule 3a-4 adopting release:

“The Commission notes that rule 3a-4 is intended to provide a safe harbor for discretionary investment advisory programs. A non-discretionary program (i.e., one in which the investor has the authority to accept or reject each recommendation to purchase or sell a security made by the portfolio manager, and exercises judgment with respect to such recommendations), generally will not meet the definition of investment company under the Investment Company Act or issue securities that are required to be registered under Section 5 of the Securities Act, regardless of whether the program is operated in accordance with the provisions of rule 3a-4. (Citation omitted.)”⁴

However, even if these services might be construed to be discretionary, it would appear that they meet the safe harbor conditions of the Rule.

SIA does not believe that additional regulation is necessary based upon the current record. Additionally, we would note that the final provisions of Rule 202 (a) (11)-1 will provide appropriate criteria for determining whether such services constitute brokerage or

² See release Nos. IC-22579, IA-1623 (March 24, 1997)

³ The SEC's recently issued semi-annual regulatory agenda (May 14, 2001) indicates that issuance of a final rule is currently scheduled for August 2001.

⁴ See 62 Fed. Reg-15101 (March 31, 1997).

discretionary advisory services. Given the above, we urge the Commission to adopt a final version of Rule 202 (a)(11)-1 expeditiously. Together with Rule 3a-4, these Rules will provide an efficient two-step process for first determining whether a given product or service should be deemed investment advisory, and if so, whether it qualifies for this non-exclusive safe-harbor.

We also believe it is important to dispel the notion that these products or services are either currently unregulated or under-regulated. They are offered by or through broker-dealers, and thus will be subject to the full panoply of regulation under the Securities Exchange Act of 1934 and the rules and regulations of self-regulatory organizations such as the New York Stock Exchange, Inc. and NASD Regulation, Inc. Additionally, those services that are investment advisory will also be subject to the Investment Advisers Act, including the enhanced disclosures regarding conflicts of interest, brokerage practices and other pertinent matters required under recently adopted or pending revisions to Form ADV. While the frequency of investment adviser examinations has recently been increased, it does not approach the number of regulatory examinations of broker-dealers conducted by both the Commission and self-regulatory organizations.

Additionally, broker-dealers are subject to an extensive array of Commission and self-regulatory organization rules regarding matters such as communications with the public, disclosure of order routing and execution practices and suitability, all of which may apply here. So, while the regulatory framework under the Investment Company Act is appropriate for mutual funds and other registered investment companies, the absence of its application here does not in any fashion leave a regulatory void.

Finally, SIA respectfully disagrees with the ICI's assertion that these services result in the issuance of a security. Customers make their own decisions as to which portfolios to purchase and which securities to retain. They directly own each individual security in their accounts and exercise complete control over when to sell, how to vote and whether to pledge each security. Since the control and dispositive power over these securities remains with the account owner, there is a conspicuous lack of reliance on others. The Committee believes that there is no "common enterprise," present here, i.e., a customer's profit does not depend on the success of the broker-dealer or investment adviser offering the securities baskets. Similarly, customers do not expect profits "solely from the efforts of" the broker-dealer or investment adviser that created the baskets. In fact, these customers do not rely on the investment expertise of the creator any more than they rely on a broker-dealer or investment adviser for traditional full service brokerage or advisory services, respectively. Therefore we do not believe that these products or services should be deemed to be securities.

CONCLUSION

We believe that the current regulatory framework is fully sufficient for determining the status of the products and services described in the ICI's rulemaking petition. Additional rulemaking is unnecessary and would impose inappropriate and mis-matched regulatory and economic burdens. Further, it would also act as an impediment to innovation. In view of the

above, the Committee urges the Commission to deny the Petition.

Thank you for the opportunity to comment. Any questions regarding this letter should be directed to SIA Vice-President, Michael D. Udoff ([212-618-0509/mudoff@sia.com](tel:212-618-0509)).

Respectfully submitted,

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and General Counsel

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