

COMMITTEE RELEASES COATES' RECOMMENDATIONS ON MUTUAL FUNDS AND OTHER COLLECTIVE INVESTMENTS

CAMBRIDGE, Mass., June 10, 2009—The Committee on Capital Markets Regulation (“Committee”), an independent and nonpartisan research organization dedicated to improving the regulation of U.S. capital markets, released a set of recommendations today made by Professor John C. Coates of Harvard Law School. His recommendations and accompanying study focus on tax and regulatory reforms for the domestic mutual fund industry. The Committee has taken no position on these recommendations.

In 2007, U.S. mutual funds held more stock in U.S. companies than did either individuals or any other type of financial institution for the first time. Given the increasing importance of U.S. mutual funds for individuals and the global economy, several changes are needed to ensure the industry’s continued growth and long-term stability.

Most Americans invest through mutual funds and U.S. tax policy imposes unjustified burdens on these most cost effective, safest, and highly regulated investment vehicles. Further, although the U.S. mutual fund industry continues to be the world’s largest, its growth-rate now lags behind domestic and foreign competitors.

Professor Coates’ comparison of U.S. and E.U. tax and securities laws governing mutual funds reveals key features of the U.S. regime that are anti-competitive.

Harvard Professor Hal S. Scott, the Committee’s President and Director, said: “Compared to E.U. counterparts, U.S. mutual funds are taxed less favorably and regulated less intelligently.” He added that “the 70-year-old structure of U.S. regulation, unlike the more modernized E.U. system, makes the success of U.S. mutual funds dependent on the resources, responsiveness, and flexibility of an under-funded, under-resourced, and out-dated SEC.”

Finally, Professor Coates’ study demonstrates that despite tight regulatory constraints in the E.U., competitive pressures have forced supervisors in the E.U. to be more flexible in adopting implementing regulations—unlike their SEC counterparts for whom flexibility is curtailed by both regulatory structure and historical practice.

Professor Coates seeks to correct U.S. taxation of mutual funds by bringing it into line with the tax regime for collective investments in other developed nations. Specifically, he recommends that Congress:

- permit investors owning less than 2% of a U.S. mutual fund’s shares¹ to defer capital gains tax until they sell their fund shares—making it possible for U.S. funds to market themselves directly to foreign investors.²

¹ The reason for the 2% cap is to ensure that mutual funds are not effectively controlled or established by individuals for the purpose of deferring capital gain tax.

² This recommendation is substantially similar to the effect of a bi-partisan-sponsored bill in the 110th Congress – H.R. 2796, the Generate Retirement Ownership Through Long-Term Holding Act of 2005 (“the GROWTH Act”).

- allow U.S. mutual fund investors to realize capital losses in the same manner and at the same time as they realize capital gains—re-stimulating investors to invest in U.S. rather than foreign mutual funds; and to
- permit U.S. investors to invest in foreign funds in countries that only impose tax on investors when profits and dividends are distributed without incurring any additional U.S. taxes or penalty. This measure would make it practical for U.S. investors to invest directly in foreign funds.

Professor Coates finds that from a regulatory standpoint, the U.S. mutual fund industry has two main problems. First, the Investment Company Act imposes such stringent restrictions and requirements, without clear benefit to investors, that future growth and innovation in the industry depends on the responsiveness, resources, and flexibility of the Investment Management Division (IMD) of the SEC. Second, the IMD's budget and staff depend on the SEC, which in turn depends on Congress. Unfortunately, the IMD's resources have not kept pace with the growth of the U.S. fund industry, nor do they come close to matching the funding and resources of the SEC's counterparts in the E.U.

Professor Coates makes four specific recommendations for regulatory reform. The first is aimed at Congress and the remainder are directed to either Congress or the SEC.

- create a dedicated off-budget funding mechanism for the IMD, such as a fee-based revenue source drawn from the fund industry, which might require spinning it off into a separate entity.³ This would give the IMD the ability to make long-term investments, such as adding top-level economists, risk analysts and experienced business personnel to its current staff, which consists almost exclusively of lawyers.
- review exemptive applications with the same cost/benefit principles that guide regulation generally. Provided the organization is equipped with a broader array of staff specialists proficient in cost-benefit analysis, the IMD's supervisory capacity will inevitably improve.
- grant automatic approval of exemptive requests upon filing, where precedent exists, as certified by counsel in good standing, in order to free up IMD resources for other regulatory and supervisory tasks.
- extend mutual recognition from broker-dealers to mutual funds and eliminate the effective current ban on cross-border fund competition. This final measure holds long-term potential for improving the administrative efficiency of the IMD and enhancing cross-border competition, with attendant benefits for U.S. investors.

The Committee is a non-partisan group of independent U.S. business, financial, investor and corporate governance, legal, accounting and academic leaders. It was formed in the fall of 2006 to study and report on ways to improve the regulation of the U.S. capital markets.

For more information about the Committee, please visit: www.capmksreg.org/.

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³ The Committee has previously recommended that the SEC be consolidated with other financial regulators. If consolidation were to take place, this new entity would be part of the new consolidated agency, e.g. U.S. Financial Services Authority (USFSA), rather than part of the SEC.

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