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January 14, 2011

European Securities and Markets Authority
11-13 avenue de Freidland
75009 Paris
France

Re: Implementing Measures on the Alternative Investment Fund Managers Directive

Dear Ladies and Gentlemen:

The Investment Company Institute (“ICI”) welcomes the opportunity to respond to the European Securities and Markets Authority’s (“ESMA’s”) Call for Evidence on implementing measures on the Alternative Investment Fund Managers Directive (the “AIFMD”).¹ The ICI is the national association of registered U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). The 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 the ICI manage total assets of \$12.31 trillion and serve over 90 million shareholders.

The AIFMD will have far-reaching consequences in the European Union (“EU”) and throughout the world for third country alternative fund managers; it is, therefore, critical that the AIFMD’s implementing measures are carefully drafted. We are pleased with ESMA’s recognition that implementing regulations will need to appropriately differentiate between different types of entities that will fall under the scope of the AIFMD so as to ensure that specific rules are appropriately tailored to the structure and circumstances of these entities. Some types of pooled investment vehicles that will be considered “alternative investment funds” (“AIF”) under the AIFMD, such as investment companies

¹ The Call for Evidence is available at <http://www.cesr.eu/popup2.php?id=7318> and the European Securities and Markets Authority’s (“ESMA’s”) mandate is available at http://ec.europa.eu/internal_market/investment/docs/alternative_investments/level2/mandate_en.pdf. The text of the AIFMD that serves as the basis for ESMA’s mandate is available at <http://register.consilium.europa.eu/pdf/en/10/st15/st15053-re01.en10.pdf>. As of January 1, 2011, the work of the Committee of European Securities Regulators has been taken over by ESMA.

registered under the U.S. Investment Company Act of 1940 (“RICs”), are already subject to strict regulatory standards, and may not have the flexibility to deviate from their home jurisdiction’s statutory requirements. To assist ESMA in the drafting of its advice to the European Commission, we describe below the main characteristics of RICs. In order to give some perspective on how the regulation of RICs compares with the AIFMD, we have tried to generally identify the RIC regulations that correlate to the AIFMD, as well as the AIFMD provisions that may pose unique issues for RICs. Appendix A contains a chart showing some potential areas of conflict between U.S. law applicable to RICs and the AIFMD.

I. Which categories of investment manager and investment fund will fall within the scope of the AIFMD in your jurisdiction?

RICs whose shares or units are marketed to EU investors will fall within the scope of the AIFMD.² RICs are similar to UCITS, which are excluded from the scope of the AIFMD. Like UCITS, RICs are highly and well regulated investment vehicles that disclose substantial information regarding their activities to both regulators and the market and do not raise the same concerns regarding lack of oversight as have been raised with certain alternative investment funds that are less regulated, or not regulated at all.³

We describe below the salient features of RICs and the regulatory regime under which they operate. Should you desire additional information, please visit ICI’s website, www.ici.org, which contains a wealth of information about RICs, or contact the undersigned.⁴

Types of Registered Investment Companies

Fund sponsors in the U.S. offer four types of RICs: open-end investment companies (commonly called “mutual funds”), closed-end investment companies, exchange-traded funds (ETFs), and unit investment trusts (UITs). The vast majority of RICs are mutual funds, both in terms of number of funds and assets under management.⁵ Our letter focuses primarily on mutual funds and discusses the other types of RICs briefly.

² See Articles 39 (Conditions for the marketing in the European Union with a passport of non-EU AIF managed by a non-EU AIFM) and 40 (Conditions for the marketing in Member States without a passport of AIF managed by a non-EU AIFM) of the AIFMD.

³ See http://www.ici.org/investor_ed/brochures/faqs_hedge for a description of the differences between mutual funds and hedge funds in the U.S.

⁴ In particular, we refer you to the 2010 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry, available at <http://www.icifactbook.org/>.

⁵ Mutual funds hold approximately 91% of industry assets.

Mutual Funds. Mutual funds issue “redeemable securities” (a statutorily defined term), meaning that the fund stands ready to buy back its shares at the current net asset value, or NAV.⁶ They can have actively managed portfolios, in which a professional investment adviser creates a unique mix of investments to meet a particular investment objective, or passively managed portfolios, in which the adviser seeks to track the performance of a selected benchmark or index.⁷ Mutual funds are typically categorized as equity, bond, hybrid, or money market funds.⁸

Closed-End Funds. Unlike mutual funds, closed-end funds do not issue redeemable shares. Instead, they issue a fixed number of shares that trade intraday on stock exchanges at market-determined prices. Investors in a closed-end fund buy or sell shares through a broker.⁹

Exchange Trade Funds (ETFs). ETFs are a hybrid of other types of RICs. They are structured and legally classified as mutual funds or UITs, but trade intraday on stock exchanges like closed-end funds. ETFs only sell and redeem fund shares directly to certain “authorized participants” in large blocks, which are often 50,000 shares or more.¹⁰ Because a substantial majority of ETFs are organized as mutual funds, our discussion below is limited to such ETFs.

UITs. UITs are also a hybrid of other types of RICs, with some characteristics of mutual funds and some of closed-end funds. Like closed-end funds, UITs typically issue only a specific, fixed number of shares, called “units.” A UIT does not actively trade its investment portfolio, instead buying and holding a fixed set of investments until a termination date, at which time the trust is dissolved and proceeds are paid to shareholders.¹¹ Like mutual funds, the units are redeemable, but unlike mutual

⁶ The Investment Company Act of 1940 (the “Investment Company Act”), defines a “redeemable security” as any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his or her proportionate share of the issuer's current net assets, or the cash equivalent thereof. See Investment Company Act, Section 2(a)(32).

⁷ Money market funds are a type of mutual fund, but are subject to heightened regulation under Rule 2a-7 under the Investment Company Act, which contains numerous additional provisions that limit the risk in a money market fund portfolio.

⁸ For more information about mutual funds, see http://www.ici.org/pdf/bro_understanding_mfs_p.pdf.

⁹ For more information about closed-end funds, see http://www.ici.org/pdf/bro_g2cef_p.pdf.

¹⁰ For more information about ETFs, see http://www.ici.org/pdf/bro_g2etf_p.pdf.

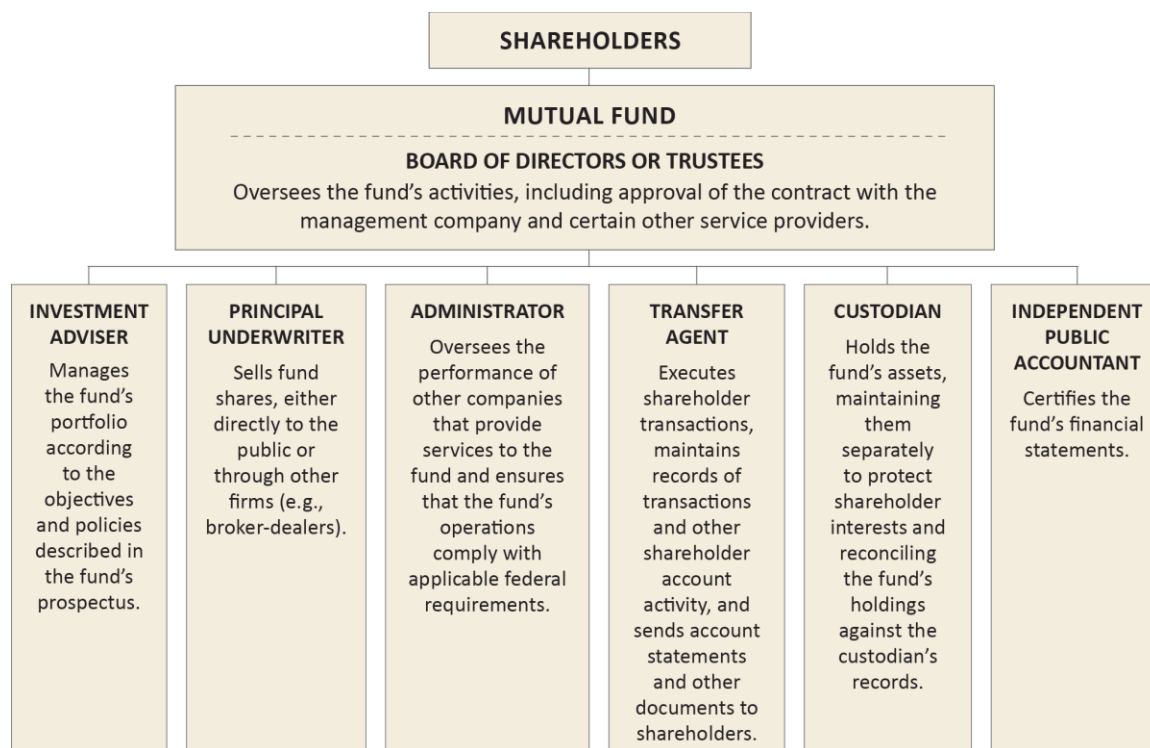
¹¹ A UIT does not have a board of directors, corporate officers, or an investment adviser to render advice during the life of the trust. Instead, the UIT's trustee and sponsor handle day-to-day administrative activities. A UIT's portfolio can only be changed in very limited circumstances and must be approved by regulators. For more information about UITs, see http://www.ici.org/pdf/bro_g2uits_p.pdf.

funds, the UIT sponsor generally will maintain a secondary market in the units to avoid depletion of the UIT's assets.

The Organization of a Mutual Fund

Each mutual fund is a separate legal entity, organized under state law either as a corporation or a business trust (sometimes called a "statutory trust"), with its own officers and board of directors or trustees. A mutual fund typically engages third parties or service providers to invest RIC assets and carry out other business activities.

The diagram below shows the primary types of service providers usually retained by a mutual fund.



Core Principles Underlying the Regulation of RICs

RICs are subject to a comprehensive regulatory scheme under the U.S. securities laws that provides important protections for shareholders and limits the potential for systemic risk. RICs are regulated under all four of the major U.S. securities laws: the Securities Act of 1933, which requires registration of the RIC's shares and the delivery of a prospectus; the Securities Exchange Act of 1934, which regulates the trading, purchase and sale of fund shares and establishes antifraud standards

governing such trading; the Investment Advisers Act of 1940, which regulates the conduct of fund investment advisers and requires them to register with the U.S. Securities and Exchange Commission (“SEC”); and, most importantly, the Investment Company Act, which requires all RICs to register with the SEC and to meet certain operating standards.

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other U.S. federal securities laws by imposing substantive requirements and prohibitions on the structure and day-to-day operations of a RIC. The core principles of the Investment Company Act are:

- (1) ensuring that the market and investors receive sufficient information about the RIC, including its strategy and investment risks, and that the information is accurate and not misleading;
- (2) strict separation of the RIC’s assets from the RIC’s investment adviser through explicit rules concerning the custody of portfolio securities;
- (3) prohibiting complex, unfair, or unsound capital structures by, for example, placing constraints on the use of leverage;
- (4) offering shareholders liquidity and objective, market-based valuation of their investments;
- (5) prohibiting or restricting affiliated transactions and other forms of self-dealing;
- (6) providing for specific diversification standards; and
- (7) providing for a high degree of oversight and accountability.

Each of these core principles is discussed in more detail below.

Transparency

Similar to the disclosure and reporting provisions in the AIFMD, RICs are subject to extensive disclosure requirements that ensure that the market and investors receive sufficient information about the RIC.¹² The combination of registration statements, annual and semi-annual shareholder reports, quarterly portfolio holdings disclosure, and proxy voting disclosure, described below, provide the investing public, regulators, media, and other interested parties with far more information on RICs

¹² The U.S. Securities and Exchange Commission’s (“SEC’s”) website contains a description of information available to RIC shareholders, available at <http://www.sec.gov/answers/mfinfo.htm>.

than is available for other types of investments in the U.S., such as separately managed accounts, bank-sponsored collective investment trusts, and private pools, such as hedge funds or private equity funds. The forms filed by RICs are publicly available via the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. In addition, numerous private-sector vendors, such as Morningstar, are in the business of compiling publicly available information on RICs in ways designed to benefit investors and the market.¹³

Registration Statements

The cornerstone of the disclosure regime for RICs is the registration statement, which in the case of mutual funds, ETFs, and closed-end funds, is comprised of the prospectus, the statement of additional information ("SAI") and certain other information.¹⁴

Mutual funds and ETFs are required to maintain a current prospectus, which provides investors with information about the fund, including its investment objectives, investment strategies, risks, fees and expenses, and performance, as well as how to purchase, redeem, and exchange fund shares. Importantly, the key parts of this disclosure with respect to performance information and fees and expenses are standardized to facilitate comparisons by investors.¹⁵ Certain information is required to be included in a specific manner (*e.g.*, a fee table with specified entries and nothing additional), location or order in the prospectus. The prospectus must be provided to investors who purchase fund shares. In addition, most mutual funds deliver an updated prospectus to existing shareholders annually.

Mutual funds and ETFs also are required to make their SAI available to investors upon request and without charge. The SAI conveys extensive and more detailed information about the fund. The SAI includes information about the history of the fund, offers detailed disclosure on certain investment policies (such as borrowing and concentration policies), lists officers, directors, and persons who control the fund, discloses the compensation paid to directors/trustees, certain officers, affiliated persons and service providers, and describes a range of information about a RIC's portfolio managers, including their management of other accounts. In addition, funds must disclose in their SAI the extent

¹³ Investment advisers to RICs are also required to register with the SEC and disclose information about their business and operations.

¹⁴ The registration statement for mutual funds (Form N-1A) is available at <http://www.sec.gov/about/forms/formn-1a.pdf>; for closed-end funds (Form N-2) at <http://www.sec.gov/about/forms/formn-2.pdf>; and for UITs (Form N-8B-2) at <http://www.sec.gov/about/forms/formn-8b-2.pdf>.

¹⁵ Mutual funds and ETFs are permitted to provide investors with a "summary prospectus" containing key information about the fund, while making more information available on the Internet and in paper upon request.

of the board's role in the risk oversight of the fund, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure.

Mutual fund and ETF registration statements are amended at least once each year to ensure that financial statements and other information have not become stale. These funds also amend registration statements throughout the year as necessary to reflect material changes to their disclosure.¹⁶

Annual and Semi-Annual Reports

Mutual fund, ETF, and closed-end fund shareholders receive audited annual and unaudited semi-annual reports within 60 days after the end and the mid-point of the RIC's fiscal year, respectively. These reports contain updated financial statements, a list of the RIC's portfolio securities,¹⁷ management's discussion of financial performance, and other information current as of the date of the report.

Portfolio Holdings and Proxy Voting Disclosure

Following their first and third quarter, mutual funds, ETFs, and closed-end funds file an additional form with the SEC, Form N-Q, disclosing the complete schedule of their portfolio holdings.

Mutual funds, ETFs, and closed-end funds are also required to annually disclose how they voted on specific proxy issues at portfolio companies on Form N-PX.¹⁸ These funds are the only shareholders required to publicly disclose each and every proxy vote they cast.

Custody

Unlike the AIFMD, which requires an AIFM to ensure that a single depositary is appointed for each AIF it manages and specifies the tasks that shall be performed by the depositary, the Investment

¹⁶ Closed-end funds and UITs also provide investors with extensive disclosure, but under a slightly different regime that reflects the way shares of these funds trade. Both closed-end funds and UITs file an initial registration statement with the SEC, containing a prospectus and other information related to the initial offering of their shares to the public. A UIT's prospectus will also typically list the securities that the UIT holds.

¹⁷ A fund is permitted to include a summary portfolio schedule in its shareholder reports in lieu of the complete schedule of holdings in securities of unaffiliated issuers, provided that the complete portfolio schedule is filed with the SEC and is provided to shareholders upon request, free of charge. The summary portfolio schedule includes each of the fund's 50 largest holdings in unaffiliated issuers and each investment that exceeds 1 percent of the fund's NAV. Investments in and advances to affiliates and investments that are not securities are fully disclosed in each report, regardless of whether a summary schedule is used.

¹⁸ Article 24(2)(d) of the AIFMD requires AIF to provide to competent authorities "the main categories of assets in which the AIF invested."

Company Act has no provision for a single entity acting as a “depository” to carry out the tasks set forth in Article 21 of the AIFMD.¹⁹ Rather, depository functions for a RIC are carried out by various entities and mechanisms under the Investment Company Act and other U.S. laws.²⁰ In particular, to protect a RIC’s assets, the Investment Company Act requires all RICs to maintain strict custody of their assets, separate from the assets of the adviser. Although the Investment Company Act permits other arrangements, nearly all RICs use a bank custodian for domestic securities.²¹ Foreign securities are required to be held in the custody of a foreign bank or securities depository.

A RIC’s custody agreement with a bank is typically far more elaborate than the arrangements used for other bank clients. The custodian’s services generally include safekeeping and accounting for the RIC’s assets, settling securities transactions, receiving dividends and interest, providing foreign exchange services, paying RIC expenses, reporting failed trades, reporting cash transactions, and monitoring corporate actions at portfolio companies.

A RIC’s portfolio assets are never considered assets of the investment adviser, custodian, or any other RIC. No creditor of the adviser or custodian will have a claim against the assets of the RIC, and gains or losses of the fund cannot be used to offset losses or gains in any other RIC or portfolio.²² As a result, the failure of the RIC’s custodian or investment adviser would have little impact on the portfolio.

The Investment Company Act’s strict rules on custody and reconciliation of fund assets are also designed to prevent the types of theft and other fraud-based losses that have occurred in less regulated investment products. Shareholders are further insulated from these types of losses by a provision in the Investment Company Act that requires all mutual funds and closed-end funds to have fidelity bonds designed to protect them against possible instances of employee larceny and embezzlement.

¹⁹ See Article 21 (Depository) of the AIFMD.

²⁰ For example, transfer agents typically record changes of ownership, maintain a fund’s shareholder records, cancel and issue certificates, and distribute dividends. The Securities and Exchange Act of 1934 governs transfer agent processing activities. With respect to valuation, a RIC’s board, supported by the RIC’s investment professionals and chief compliance officer, is responsible for overseeing that valuation is calculated according to U.S. law. In addition, the board of a RIC is responsible for generally overseeing the activities of the RIC’s service providers, such as the custodian and transfer agent.

²¹ The Investment Company Act contains six separate custody rules for the different types of possible custody arrangements for mutual funds, closed-end funds, and ETFs. UITs are subject to a separate rule that requires the use of a bank to maintain custody.

²² As a result, each RIC stands on its own. It will generate gains or losses based on the performance of its portfolio, less its expenses, independent of the fortunes of any other fund managed by the adviser or serviced by the custodian, and indeed, independent of the fortunes of the adviser or custodian themselves.

Limits on Leverage

The Investment Company Act prohibits complex capital structures and, similar to the AIFMD, limits RICs' use of leverage.²³ It imposes various requirements on the capital structure of mutual funds, ETFs, and closed-end funds, including limitations on the issuance of "senior securities" and borrowing.²⁴ Generally speaking, a senior security is any debt that takes priority over the RIC's shares, such as a loan or preferred stock.²⁵ These limitations greatly minimize the possibility that a RIC's liabilities will exceed the value of its assets.

The SEC also takes the view that the Investment Company Act prohibits a RIC from creating a future obligation to pay unless it "covers" the obligation. A RIC generally can cover an obligation by owning the instrument underlying the leveraged transaction. For example, a RIC that wants to take a short position in a certain stock can comply with the Investment Company Act by owning an equivalent long position in that stock. The RIC can also cover by segregating or earmarking, on its or its custodian's books, liquid securities equal in value to the fund's potential exposure from the leveraged transaction. The assets set aside to cover the leveraged security transactions must be liquid, unencumbered, and marked-to-market daily. They may not be used to cover other obligations and, if disposed of, must be replaced.

The Investment Company Act also limits borrowing. With certain very limited exceptions, any promissory note or other indebtedness would generally be considered a prohibited senior security. Mutual funds and ETFs are permitted to borrow from a bank if, immediately after the bank borrowing, the fund's total net assets are at least three times total aggregate borrowings, *i.e.* the fund must have at least 300 percent asset coverage.

Due to their structure, closed-end funds have a slightly different set of limitations. They are permitted to issue debt and one class of preferred stock, subject to certain conditions, including asset coverage requirements of 300 percent for debt and 200 percent for preferred stock.

²³ Article 15(4) of the AIFMD requires the AIFM to set a maximum level of leverage that the AIFM may employ on behalf of each AIF it manages.

²⁴ The Investment Company Act also significantly restricts the ability of a RIC to invest in securities of other investment companies ("pyramiding").

²⁵ The SEC has historically interpreted the definition of senior security broadly, taking the view that selling securities short, purchasing securities on margin, and investing in many types of derivative instruments, among other practices, may create senior securities.

Many RICs voluntarily go beyond the prohibitions in the Investment Company Act, adopting policies that further restrict their ability to issue senior securities or borrow. RICs often, for example, adopt a policy stating that they will borrow only as a temporary measure for extraordinary or emergency purposes and not to finance investments in securities. In addition, they may disclose that borrowings will be limited to a small percentage of RIC assets (such as 5 percent). These are meaningful voluntary measures, because under the Investment Company Act, a RIC's policies on borrowing money and issuing senior securities (as well as other policies the RIC may deem "fundamental") cannot be changed without the approval of fund shareholders.

Valuation and Liquidity

Nearly all RICs offer shareholders liquidity and objective, market-based valuation of their investments. ETF and closed-end fund shares are traded intraday on stock exchanges at market-determined prices, giving shareholders "real time" liquidity. Mutual fund shares are redeemable on a daily basis at a price that reflects the current market value of the fund's portfolio securities, calculated according to pricing methodologies established by each fund's board of directors.

The Investment Company Act includes detailed provisions for determining the value of each security in a mutual fund's portfolio.²⁶ The value is determined either by a market quotation, if a market quotation is readily available, or at "fair value" as determined in good faith by the board of directors.²⁷ Under the Investment Company Act, the board of directors is specifically responsible for the fair value of securities.

The daily pricing process is a critically important core compliance function that involves numerous staff, the mutual fund board, and, in some cases, pricing vendors.²⁸ The fair valuation process, a part of the overall pricing process, receives particular scrutiny from funds, their boards, regulators, and independent auditors. Under SEC rules, all mutual funds must adopt written policies

²⁶ See Investment Company Act Section 2(a)(41) and Rule 22c-1 under the Investment Company Act. Article 19 (Valuation) of the AIFMD requires an AIFM to ensure that, for each AIF that it manages, appropriate and consistent valuation procedures are established and imposes upon it other detailed requirements regarding valuation. Article 21 (Depositary) provides that the depositary shall ensure the valuation of shares is calculated as required under applicable national law.

²⁷ Like mutual fund shares, UIT shares are also typically redeemable at their approximate net asset value.

²⁸ While RICs do retain independent pricing services to assist them in fulfilling their valuation responsibilities, those services simply provide an evaluation based on their own methodologies and judgment of a security's value. RICs consider this evaluation together with other information in establishing the price of any particular security.

and procedures that address the circumstances under which securities may be fair valued, and must establish criteria for determining how to assign fair value in particular instances.

The daily valuation process results in a net asset value, or NAV, for the mutual fund. The NAV is the price used for mutual fund share transactions—new purchases, sales (redemptions), and exchanges from one fund to another within the same fund family. It represents the current mark-to-market value of all the fund’s assets, minus liabilities (*e.g.*, fund expenses), divided by the total number of outstanding shares.²⁹

The Investment Company Act requires mutual funds to process transactions based upon “forward pricing,” meaning that shareholders receive the next computed share price (NAV) following the fund’s receipt of their transaction order.³⁰ When a shareholder redeems shares in a mutual fund, he or she can expect to be paid promptly. Mutual funds may not suspend redemptions of their shares (subject to certain extremely limited exceptions)³¹ or delay payments of redemption proceeds for more than seven days.

In furtherance of these requirements, SEC guidelines require a mutual fund to have no more than 15 percent of its assets in illiquid securities.³² A security is generally deemed to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the mutual fund has valued it. Many funds adopt a specific policy with respect to investments in illiquid securities; these policies are sometimes more restrictive than the SEC requirements.³³

²⁹ The pricing process is also critical for ETFs, although for slightly different reasons. ETFs operate like mutual funds with respect to transactions with “authorized participants,” who trade with the ETF in large blocks. The NAV is the price used for these large transactions. Closed-end funds are not required to strike a daily NAV, but most do so in order to provide the market with the ability to calculate the difference between the fund’s market price and its NAV. The difference is called the fund’s “premium” or “discount.”

³⁰ Mutual funds must price their shares at least once per day at a time determined by the fund’s board. Many funds price at 4:00 pm eastern time or when the New York Stock Exchange closes.

³¹ With the exception of a newly adopted provision for money market funds, the SEC must declare an emergency to exist to trigger an exception. An example of circumstances deemed an emergency by the SEC include the assassination of President Kennedy in 1963, the blackouts that affected lower Manhattan in 1990, or certain other natural disasters. A RIC would not be permitted to unilaterally suspend redemptions on the basis of a suspension being in the best interests of the integrity of the market.

³² Article 16 (Liquidity management) of the AIFMD states that the Commission shall adopt measures specifying liquidity management systems and procedures.

³³ Money market funds have more specific liquidity requirements under Rule 2a-7 under the Investment Company Act, including specific daily and weekly requirements, and must limit their illiquid investments to 5 percent of the portfolio.

Conflicts of Interest and Prohibitions on Transactions with Affiliates

Article 14 of the AIFMD contains several provisions related to the identification of conflicts of interest. The Investment Company Act similarly contains a number of strong and detailed prohibitions on transactions between the RIC and RIC insiders or affiliated organizations (such as the corporate parent of the RIC's adviser).³⁴ These prohibitions are intended to prevent over-reaching and self-dealing by RIC insiders.

Although there are a number of affiliated transaction prohibitions in the Investment Company Act, three are particularly noteworthy:

- Provisions generally prohibiting direct transactions between a RIC and an affiliate;
- Provisions generally prohibiting joint transactions, where the RIC and affiliate are acting together vis-à-vis a third party; and
- Provisions preventing investment banks from placing or "dumping" unmarketable securities with an affiliated RIC.³⁵

Diversification

Both tax law and the Investment Company Act provide diversification standards for RICs. Under the tax laws, all mutual funds, closed-end funds and ETFs, as well as most UITs, qualify as "regulated investment companies" and, as such, must meet a tax diversification test every quarter. The effect of this test is that a RIC with a modest cash position and no government securities would be required to hold securities from at least 12 different issuers. Another tax diversification restriction limits the amount of an issuer's outstanding voting securities that a RIC may own.

The Investment Company Act sets higher standards for RICs that elect to be diversified. For these RICs, the Investment Company Act requires that, with respect to at least 75 percent of the portfolio, no more than 5 percent may be invested in the securities of any one issuer and no investment may represent more than 10 percent of the outstanding voting securities of any issuer. Diversification is

³⁴ In addition, a RIC's investment adviser has a fiduciary duty to put the fund's interest before those of the adviser and is subject to numerous restrictions on transactions that may pose conflicts of interest. Among other things, an investment adviser owes a fiduciary duty to obtain best execution of a RIC's securities transactions. See Article 14(3) of the AIFMD (requiring that the services of a prime broker used by an AIFM on behalf of an AIF be specified in a written contract).

³⁵ The Investment Company Act grants the SEC the ability to exempt certain transactions by rule or order, provided that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act.

not mandatory, but all mutual funds, closed-end funds and ETFs must disclose whether they are diversified under the Investment Company Act's standards.

Oversight and Accountability

All RICs are subject to a strong system of oversight from both internal and external sources. Internal oversight mechanisms include boards of directors or trustees, which include independent directors, and written compliance programs overseen by chief compliance officers, both at the RIC and adviser levels. External oversight is provided by the SEC, the Financial Industry Regulatory Association,³⁶ and external service providers, such as certified public accounting firms.

RIC Boards

Mutual funds, closed-end funds, and most ETFs are organized as corporations, with boards of directors, or business trusts, with boards of trustees.³⁷ The Investment Company Act requires at least 40 percent of the members of a fund board to be independent from fund management. An independent director is a fund director or trustee who does not have any significant business relationship with a fund's adviser, underwriter, or affiliates. An independent director also cannot own any stock of the investment adviser or certain related entities, such as parent companies or subsidiaries. In practice, most fund boards have far higher percentages of independent directors or trustees. As of year-end 2008, independent directors made up 75 percent of boards in almost 90 percent of fund complexes.³⁸

Independent fund directors play a critical role in overseeing fund operations and are entrusted with the primary responsibility for looking after the interests of the fund's shareholders. They serve as "watchdogs" furnishing an independent check on the management of funds. Like directors of operating companies, they owe shareholders the duties of loyalty and care under state law. But independent fund directors also have specific statutory and regulatory responsibilities under the Investment Company Act, beyond the duties required of other types of directors. Among other things, for example, they oversee the performance of the fund, fair valuation determinations for securities held by the fund, and

³⁶ The Financial Industry Regulatory Association ("FINRA") is a self-regulatory organization that oversees those who distribute RIC shares and RIC advertising.

³⁷ A UIT does not have a board of directors.

³⁸ See Fund Governance Practices: 1994-2008, Investment Company Institute and Independent Directors Council, available at <http://www.ici.org/pdf/23833.pdf>.

voting of proxies for the fund's portfolio securities. They also approve the fees paid to the investment adviser for its services, and oversee the fund's compliance program.³⁹

Compliance Programs

The internal oversight function played by the board is complimented by a formal requirement that all RICs have a chief compliance officer ("CCO") and adopt a written compliance program reasonably designed to prevent, detect, and correct violations of the federal securities laws.⁴⁰

Compliance programs must be reviewed at least annually for their adequacy and effectiveness, and RIC CCOs are required to report directly to the independent directors. Like RICs, investment advisers must also have their own written compliance programs that are overseen by CCOs to ensure compliance with all relevant laws and regulations.⁴¹

A RIC's compliance program must address:

- portfolio management processes (*e.g.*, allocation of trades);
- trading practices (*e.g.*, best execution, trade aggregation);
- proprietary and personal trading;
- accuracy of disclosure to investors;
- safeguarding of assets;
- accurate and safe records;
- valuation processes;
- privacy safeguards; and
- business continuity plans.

In addition, the SEC expects fund compliance programs to address:

- pricing of portfolio securities;

³⁹ For more information on governance, see http://www.ici.org/idc/policy/governance/overview_fund_gov_idc and http://www.ici.org/idc/policy/governance/faq_fund_gov_idc

⁴⁰ For mutual funds and closed-end funds, the compliance program must be adopted by the fund's directors, including a majority of the fund's independent directors. For a UIT, which has no directors, the UIT's principal underwriter or depositor approves the compliance program and the CCO. See Board Oversight of Fund Compliance, Independent Directors Council, Task Force Report, September 2009, available at http://www.ici.org/pdf/idc_09_compliance.pdf.

⁴¹ Article 18 (General principles) of the AIFMD provides that Member States shall require AIFM to have adequate internal control mechanisms, and stated that the Commission shall adopt measures specifying the procedures and arrangements that will be required.

- processing fund share transactions;
- identifying affiliated persons;
- protecting non-public information;
- fund governance requirements; and
- market timing.⁴²

A RIC's board is also typically engaged in the selection and ongoing oversight of its service providers, such as the RIC's custodian. For example, in evaluating a service provider for the first time, the board may consider a wide variety of information regarding the resources, capabilities and reputation of the service provider. Similarly, a board may be involved in evaluating whether to renew a service provider's contract allowing the board to shift focus to an evaluation of the service provider's performance over the existing period, as well as whether or not any different fees may be appropriate. Ongoing oversight is also important. In particular, the board at least annually receives a written report from the CCO regarding the operation of the compliance policies and procedures of its investment advisers, principal underwriters, administrators and transfer agents and the board is required to approve and annually review the policies and procedures of these service providers.⁴³ In addition, many boards receive periodic reports at regular board meetings from fund management regarding service providers' delivery of services and level of performance. The board also may receive periodic reports or presentations from representatives of the service providers.

Regulatory Oversight

Internal oversight of RICs is accompanied by a number of forms of external oversight and accountability. RICs are subject to inspections, examinations, and enforcement by their primary regulator, the SEC. Depending on their circumstances, RICs are also subject to varying levels of oversight by self-regulatory organizations, such as FINRA and stock exchanges; state securities regulators; and banking regulators (to the extent the RIC is affiliated with a bank).⁴⁴

⁴² These are the minimum requirements; RICs may have additional policies and procedures based on the particular RIC (*i.e.*, policies and procedures regarding the use of derivatives).

⁴³ For additional discussion regarding a board's oversight of RIC service providers, see, Board Oversight of Service Providers, Independent Directors Council, Task Force Report, June 2007, available at <http://www.ici.org/pdf/21229.pdf>. This paper provides practical guidance and insight into a RIC board's oversight responsibilities with respect to service providers, such as a RIC's administrator, custodian and transfer agent. This paper may be helpful as ESMA considers the due diligence activities of a depositary.

⁴⁴ In addition, like officers of public companies, officers of RICs are required to make certifications and disclosures required by the Sarbanes-Oxley Act. For example, they must certify the accuracy of the financial statements.

Auditors

RICs' financial statement disclosure is also subject to several internal and external checks. For example, annual reports include audited financial statements certified by a certified public accounting firm subject to oversight by the Public Company Accounting Oversight Board (PCAOB). This ensures that the financial statements are prepared in conformity with generally accepted accounting principles (GAAP) and present fairly the RIC's financial position and results of operations. It also serves as a check on valuation, because as part of the process, auditors independently verify the prices for all portfolio securities held by the fund at the report date.

Additional Regulation of Advisers

In addition to the system of oversight applicable directly to RICs, investors enjoy protections through SEC regulation of the investment advisers that manage RIC portfolios. All advisers to RICs are required to register with the SEC, and are subject to SEC oversight and disclosure requirements.⁴⁵ Advisers also owe a fiduciary duty to each RIC they advise, meaning that they have a fundamental legal obligation to act in the best interests of the RIC pursuant to a duty of undivided loyalty and utmost good faith and to make full and fair disclosure of all material facts.

II. Reporting obligations to competent authorities

ESMA is directed to consider developing a template for reporting the information in Article 24 (Reporting obligations to competent authorities) of the AIFMD. We believe that it is imperative for ESMA to ensure the confidentiality of reported information that is not otherwise available to the public in order to keep proprietary and market-sensitive information confidential.

III. Cooperation arrangements between European competent authorities and the authorities of third countries

The European Commission has requested ESMA to advise it on a common framework to facilitate the establishment of cooperation arrangements between European competent authorities and supervisory authorities from the country of origin of the non-EU AIFM or non-EU-AIF that are contemplated by the AIFMD. In drafting its advice to the European Commission, we urge ESMA to consider whether and how already existing multi-lateral and bilateral agreements may be leveraged. In particular, we urge ESMA to consider whether the IOSCO Multilateral Memorandum of Understanding could be used, with modifications if necessary, to meet the requirements of the AIFMD,

⁴⁵ The investment adviser registration form (Form ADV) requires information about the adviser's business, ownership, clients, employees, business practices, affiliations and disciplinary events.

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recognizing the difficulty that will be faced if competent authorities in each jurisdiction need to enter into new agreements.

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We appreciate the opportunity to provide input on ESMA's Call for Evidence and hope that our comments will be helpful in the development of the AIFMD's implementing measures. Should you require further information about RICs or wish to discuss our comments further, please do not hesitate to contact me at 202-326-5813 (or solson@ici.org) or Eva Mykolenko (202-326-5837 or emykolenko@ici.org).

Sincerely,

/s/ Susan M. Olson

Susan M. Olson

Senior Counsel – International Affairs

APPENDIX A
AIFMD Council Text (October 27, 2010) and Examples of Potential Conflicts with
U.S. Law for Registered Investment Companies

AIFMD Council Text (October 27, 2010)	U.S. Registered Investment Companies (RICs) - Investment Company Act of 1940 (ICA)
<u>General Principles - Article 12(1)(b)</u>: The AIFM shall act in the best interests of the AIF or the investors of the AIF it manages and the integrity of the market.	In the event that suspending redemptions may be deemed to be in the best interests of the integrity of the market, RICs would not be able to comply with this requirement because RICs have statutory restrictions on their ability to suspend redemptions. The ICA provides that a RIC may not suspend the right of redemption except: (1) for any period (a) during which the New York Stock Exchange is closed other than customary weekend or holiday closings; or (b) during which trading on the NYSE is restricted; (2) for any period during which an emergency exists as a result of which (a) disposal by the company of securities owned by it is not reasonably practicable or (b) it is not reasonably practicable for such company fairly to determine the value of its net assets; or (3) for such other periods as the Securities and Exchange Commission (“SEC”) may by order permit for the protection of security holders of the company. The ICA further provides that the SEC shall determine the conditions under which trading shall be deemed to be restricted and an emergency shall be deemed to exist. RICs that are money market funds are allowed to suspend redemptions if: (1) the RIC’s board, including a majority of disinterested directors, determines that the deviation between the fund’s amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results, (2) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (3) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.
<u>Depository Provisions - Article 21</u>: Requires the AIFM to ensure that a single depository is appointed for each AIF it manages in accordance with the provisions of the AIFMD. Among other things, the depository (1) shall ensure that the AIF’s cash flows are properly monitored and that all payments by investors upon subscription of	The ICA has no provision or requirement for a single entity like a “depository.” Rather depository functions in the context of a RIC are carried out by other entities or mechanisms as required under the ICA and other U.S. laws. <u>Custody ICA Requirements</u>. Custody of RIC assets must comply with the ICA which typically means nearly all RICs use a U.S. bank custodian for domestic

AIFMD Council Text (October 27, 2010)	U.S. Registered Investment Companies (RICs) - Investment Company Act of 1940 (ICA)
shares or units of an AIF have been received; (2) shall hold in custody all financial instruments that can be registered in an account and physically delivered to the depositary; (3) shall ensure that the sale and redemption of shares or units of the AIF are carried out in accordance with applicable law and the AIF rules or instruments of incorporation; and (4) shall ensure that the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation. The appointment of the depositary must be evidenced by a written contract. The depositary must be a credit institution having a registered office in the EU and authorized under EU law, an investment firm authorized under EU law, or another institution that is subject to prudential regulation and ongoing supervision that is eligible to be a depositary under UCITS. Third country depositaries are permitted for non-EU AIF subject to certain conditions, including that depositaries in that third country are subject to effective prudential regulation and supervision that is to the same effect as that which is applicable in the EU.	securities, although the ICA permits other limited custody arrangements.¹ Foreign securities are required to be held in the custody of a foreign bank or securities depository. <u>Transfer Agent Activities.</u> Transfer agents typically record changes of ownership, maintain a fund's shareholder records, cancel and issue certificates, and distribute dividends. The Securities and Exchange Act of 1934 governs transfer agent processing activities. In addition, the board of directors of a RIC would be responsible for generally overseeing the activities of a fund's service provider such as a transfer agent. <u>Ensuring Valuation in Accordance with the Law.</u> With respect to valuation, a RIC's board of directors, supported by the RIC's chief compliance officer (CCO), is responsible for overseeing that valuation is calculated according to U.S. law. Under the ICA, the board is specifically responsible for the fair value of securities. <u>Oversight and Accountability Mechanisms in ICA.</u> A RIC is subject to oversight through a variety of internal and external mechanisms. Internal mechanisms required under the ICA include independent directors or trustees, required approvals by the board, independent directors or shareholders of certain contracts or activities and written compliance programs overseen by CCOs. External mechanisms include oversight by regulators as well as through external service providers such as certified public accountants. Independent directors, required under the ICA, play a critical role in overseeing fund operations with specific statutory responsibilities and are entrusted with the primary responsibility for looking after the interests of fund shareholders. In addition, the board's general oversight functions are enhanced by written compliance programs and CCOs. Every RIC and adviser must have a CCO who administers a written compliance program reasonably designed to prevent, detect, and correct violations of the federal securities laws, including the ICA. CCOs are required to report directly to the board.
Valuation - Articles 19(4) and (11): The AIFM shall ensure that, for	RICs are required to value securities in accordance with the requirements of the ICA.

¹ In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories).

AIFMD Council Text (October 27, 2010)	U.S. Registered Investment Companies (RICs) - Investment Company Act of 1940 (ICA)
each AIF it manages, appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed. The AIFM shall ensure that the valuation is performed by (1) an external valuer, being a legal or natural person independent from the AIF, the AIFM and from any other persons with close links to the AIF or the AIFM; or (2) the AIFM itself, provided that the valuation task is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employee is prevented. The external valuer must meet specified requirements. The Commission shall adopt measures specifying the criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit.	The ICA defines the “value” of RIC assets in terms of a dichotomy: (1) securities “for which market quotations are readily available” are to be valued at “market value;” and (2) all other securities are to be valued at “fair value” as determined in good faith by the board of directors. Accordingly, the board of directors and the RIC’s CCO are responsible for ensuring that valuation complies with U.S. law and in addition, the board of directors is specifically given the fundamental responsibility for the fair value of a fund’s securities. While RICs do retain independent pricing services to assist them in fulfilling their valuation responsibilities those services simply provide an evaluation based on their own methodologies and judgment of a security’s value and RICs consider this and other information in establishing the price of any particular security.
<u>Disclosure to Investors – Article 23:</u> The AIFM shall for each AIF that it manages and for each AIF it markets in the EU make available to AIF investors, in a way as set forth in the AIF’s fund rules or articles of association, certain specified information before they invest in the AIF, as well as material changes to such information.² The Commission shall adopt measures further specifying the disclosure obligations of AIFM.	Under U.S. law, RICs have specific and detailed disclosure requirements. For example, certain information is required to be included in a RIC’s prospectus and in some cases, in a specific manner (<i>e.g.</i>, a fee table with specified entries), location or order in the prospectus (<i>e.g.</i>, certain specified information, and no other disclosure, must be in a specific order at the front of the prospectus). Depending on the measures adopted by the Commission and the interpretation of the disclosure provisions, harmonizing disclosure regimes, even if similar, may not be possible.
<u>Initial Capital and Own Funds – Article 9(8):</u> Own funds shall be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions.	While RICs are subject to requirements regarding seed capital, RICs do not have the ability to invest differently for different shareholders. Each share represents a pro-rata interest in the investments of the RIC.

² It is unclear if “in a way as set forth in the AIF’s fund rules or articles of association” includes as mandated under a fund’s national law (*e.g.*, for a RIC, any applicable U.S. law.)