MEMO# 32509

June 5, 2020

SEC Asset Management Advisory Committee: Highlights from the May 27, 2020 Meeting

[32509]

June 5, 2020 TO: ICI Members SUBJECTS: Compliance
Disclosure
Exchange-Traded Funds (ETFs)
Fixed Income Securities
Fund Governance RE: SEC Asset Management Advisory Committee: Highlights from the May 27, 2020 Meeting

The SEC's Asset Management Advisory Committee (AMAC) held a virtual meeting on May 27, 2020.[1] AMAC Chair Edward Bernard led the meeting, which began with opening remarks by Chairman Jay Clayton Commissioner Allison Herren Lee, and Division of Investment Management Director Dalia Blass, among others.[2] After opening remarks, the meeting was organized as follows:

- Updates from the ESG and Private Investments Subcommittees;
- Panel discussion on the Industry Response to the COVID-19 Crisis;
- Committee discussion on ETFs, Money Market Funds, and Operational Impact of COVID; and
- Committee members' key takeaways from the meeting.

This memorandum provides highlights of each portion of the meeting below.

Opening Remarks

- **Chairman Jay Clayton:** Chairman Clayton emphasized that the SEC's focus during COVID-19 has been the continuing, orderly operation of markets and the continued flows of capital and credit throughout the economy.[3] To that end, the SEC has been assisting funds and advisers, including by providing targeted relief, to enable them to continue their operations, meet their regulatory obligations, and meet the expectations of their investors. Chairman Clayton noted that despite this difficult time, the Division of Investment Management has been continuing its ongoing work to modernize the regulatory framework for investment funds and advisers.

Chairman Clayton also shared his views on ESG disclosure. While he believed that standalone “E”, “S”, or “G” issues may be material to an investment decision, he was skeptical of the value combining an analysis of E, S and G together.

- **Commissioner Allison Herren Lee:** Commissioner Lee noted that money market funds required Federal Reserve Board (FRB) assistance during the COVID-19 crisis and posed the question whether the need for government intervention raised issues of systemic risk. Commissioner Lee also noted that Congress recently expanded the ability of business development companies (BDCs) to use leverage and that BDCs sought and received even greater flexibility to borrow beyond those limits during the crisis. Finally, Commissioner Lee stated that funds that experienced significant outflows received relief to borrow from affiliated funds beyond typical limits in order to fund redemptions. She inquired whether that relief led to exposing investors in less volatile funds to additional risk.[4]

- **Division of Investment Management Director Dalia Blass:** Director Blass expressed appreciation to AMAC members and panelists for their willingness to pivot the meeting agenda to issues related to COVID-19. She indicated that a “preliminary, data driven conversation” with the AMAC could help the SEC “analyze what is happening and lay the groundwork for determining future steps.” She noted her own hesitation to “draw conclusions or make recommendations for regulatory changes to address potential impacts discerned to date,” commenting that “[d]oing so risks being premature as we are still in the middle of the pandemic and its evolving impact on the U.S. and global markets.”

  Director Blass emphasized that her staff has been focused on extensive outreach and market monitoring efforts and stands ready to address pressing regulatory issues identified by registrants—but also continues to move forward with the Division’s regulatory agenda and core initiatives. She expressed interest in hearing about how money market fund and liquidity management reforms have functioned during the pandemic and about fund and adviser business operations in the current environment, including how firms adjusted their business continuity plans to account for dispersed, telework locations for staff. In particular, she was interested in feedback on advancing the use of e-delivery, given challenges experienced in printing and delivering paper, and on virtual board meeting attendance.[5]

ESG Subcommittee Update[6]

Subcommittee Members: Michelle Beck – TIAA; Jane Carten – Saturna Capital; Rich Hall – University of Texas/Texas A&M; Jeffrey Ptak – Morningstar; Aye Soe – S&P Dow Jones.

The subcommittee members provided an update on some of their workstreams:

- **Assessing the Performance of ESG Strategies:** One member noted the challenge in this workstream is that ESG strategies have become prominent in only the past five years, which coincides with the overall rise of healthcare and technology companies and decline of energy companies in the market. The member also noted that in tracking the performance of ESG strategies, the subcommittee is mindful of survivorship bias and the practice of backfilling ESG scores. They are considering each element of ESG separately and as a whole and the different visions and sizes of ESG funds.

- **Proxy Voting in ESG Strategies:** One member discussed several considerations in this area, particularly what funds’ ESG strategies are hoping to accomplish, how to hold those funds accountable, and the role of proxy advisory firms when funds vote on ESG matters. As for proxy advisory firms, the subcommittee is thinking about whether funds can outsource ESG proxy voting considerations to those firms and considerations for funds that vote differently from the proxy advisory firms' recommendations.

- **Issuer Disclosure of ESG Data:** This workstream focuses on whether issuer ESG disclosures can be accurate, helpful, comprehensive, material, and comparable. One member noted the current multiple standards for ESG reporting as well as the multiple stakeholders, each with their own incentives. He also noted that some issuers cherry-pick the ESG information that they disclose. The subcommittee hopes to develop recommendations for a disclosure framework that would address these issues and be both backward-looking and forward-looking. In response to a question, subcommittee members noted that there was both a lack of data overall and a lack of consistency in the data that exists.
- **ESG Rating Systems:** A primary consideration of this workstream is whether a rating system for funds' ESG performance or strategy should score the elements of ESG separately or in combination. One member noted that there is a meaningful difference between ratings systems such as those that provide an absolute score for funds or provide a relative ranking, and those that score funds' ESG performance or merely their ESG policies. A committee member asked whether ratings consider if managers of ESG funds incorporate values such as diversity in their own business practices.

Subcommittee members hope to develop recommendations on potential guidance or regulation relating to these issues by the end of 2020.

Private Investments Subcommittee Update[7]

Subcommittee Members: Rama Subramanian – GTS; Adeel Jivraj – E&Y; Erik Sirri – Babson College/Natixis Funds; Joe Savage – FINRA; John Bajkowski – American Association of Individual Investors; John Suydam – Apollo.

- **Subcommittee mission:** One subcommittee member discussed the relevance of having a subcommittee focused on retail investor access to private market investments. He noted the rise of defined contribution plans (e.g., 401(k)s), which are limited in their ability to invest in the private market. He also noted the trend of companies staying private longer and the decrease in the number of listed companies. These trends affect the supply and demand for private market investments.
- **Private market data challenges:** The subcommittee member noted the lack of reliable data for private market investments. Notably, private companies tend to provide valuations infrequently, and sometimes use opaque methodologies. The subcommittee is seeking to understand how mutual funds that hold private assets factor in those assets when assessing daily liquidity. The lack of reliable data makes it difficult to determine whether private market investments provide diversification in a portfolio or provide additive returns over public benchmarks.
- **Potential subcommittee recommendations**: Given these trends, the subcommittee is thinking about how to balance investor protection with providing more retail investor access to the private market. In particular, the subcommittee is considering possible evolutionary, rather than revolutionary, recommendations about expanding investor access to private markets by asset class.

Panel on the Industry Response to the COVID-19 Crisis[8]

Panelists: Sean Collins – Investment Company Institute; Marc Seidner – PIMCO; Ben Phillips – Deloitte Consulting.

- **Overview of the COVID-19 crisis and response**[9]: One panelist noted the financial market shock caused by COVID-19 caused the credit markets to lock up and led to fund outflows. This persisted until the FRB announced its lending facilities, Congress passed the CARES Act, and the SEC provided regulatory relief. These quick, comprehensive actions restored the flow of credit and calmed markets. This panelist also noted the mere announcement of FRB facilities calmed the market. Funds have not taken up the facilities to the same extent that they did during the 2008-09 financial crisis. Another panelist concluded that the "system worked" and the markets generally functioned.

  Panelists noted that the COVID-19 crisis fundamentally is a health crisis, not a financial one. As a result, markets are attuned to vaccine and treatment developments. For funds, there has also been an operational shift that requires firms to consider the health and safety of their staff. Panelists noted that the transition of the financial industry to working from home creates communications challenges associated with a dispersed workforce.

  One panelist noted that compared to the 2008-09 financial crisis, the fund industry began 2020 on a "shakier foundation." Organic growth in new shareholders has stalled and fund growth relies on taking shareholders from competitors rather than reaching shareholders new to fund investing. Concurrently, funds face greater fixed costs, especially technology expenses. At the same time, public capital markets are declining, and market participants are focused on improving investor access to the private market.

- **Funds as market participants:** Panelists noted that registered fund trading is a fraction of trading in the fixed income markets. Other fixed income investors, however, do not have the transparency that registered funds have and therefore get less attention. One panelist recommended the different characteristics of trades (e.g., whether they are levered) should factor into any regulatory response.

- **ETF pricing:** Panelists discussed the discount in fixed income ETFs' market prices compared to their net asset values. Panelists noted the lack of liquidity in the bond market in March, and one panelist posited that ETFs provided price discovery during that time.

- **Recommendations and predictions:** One panelist recommended that the FRB provide buyside investors with direct access to policy tools. A committee member made the point that doing so may lead to funds being regulated more like banks, despite the different structures and risk models between the two types of institutions. The panelist also recommended exploring "all-to-all" trading platforms that reduce reliance on intermediaries to match buyers and sellers. It was mentioned that solvency issues will be a concern going forward.

  Another panelist thought that firms may begin to consider ESG reporting to be a competitive advantage to differentiate themselves from competitors. Firms may also consider that a work from home operational model makes globalized strategy more unwieldy and places an emphasis on data management.

Director Blass noted her interest in better understanding the behavior of retail and institutional investors in funds during the COVID-19 crisis. In response, one panelist pointed out that on the money market fund side, institutional investors typically are not trading for their own accounts but rather are investing on behalf of 401(k) plans or omnibus brokerage accounts and their underlying participants/account owners.

Committee Discussion on the Impact of COVID-19 on ETFs

Presenters: Ryan Ludt – Vanguard; Jeffrey Ptak – Morningstar; Reginald Browne – GTS.

- **What Happened?** Members noted that, against the backdrop of extreme market volatility, ETFs performed well and as designed. These funds continued to provide investors diversification in a cost-efficient way and acted as a shock absorber against market volatility. Members noted that the inclusion of ETFs in the FRB's Secondary Market Corporate Credit Facility was indicative of the impact ETFs have in the markets. Announcement and establishment of the facility helped calm the markets and increase liquidity in the corporate bond market.

- **What Worked/Didn't Work?** Members noted that the equity market structure supported ETFs well. However, during times of extreme volatility (including the four times when circuit breakers were tripped), some ETFs traded at a discount to the value of their underlying assets. This was particularly true for ETFs with credit sensitive bonds and the divergence tended to be asset-specific and not market-wide. By contrast, the market prices for equity ETFs typically did not diverge from the value of their underlying assets.

- **Areas for Further Study/Potential Improvements:** Panelists believed the following areas deserved further study or potential improvements:
  - The divergence of market price from the underlying net asset value of underlying assets for some non-equity ETFs.
  - The lack of transparency in fixed income markets. There is a need to create a better pricing process with more transparency for corporate bonds including, perhaps, the posting of prices (*e.g.*, the aggregation of bid and ask prices across the bond markets). Members recommended a more methodical and measured approach to the pricing of corporate bonds. In response to a question from Director Blass, members clarified that their recommendation to improve the transparency of corporate bond pricing was not specific to ETFs.
  - Better classification of exchange traded products (ETPs). It was noted that ETFs are but one type of ETP and there are differences between ETFs and other ETPs, such as exchange traded notes (ETNs). A panelist expressed concern that investors may be harmed by presuming all ETPs are ETFs when they are not and recommended adoption of a clearer set of standards to distinguish ETFs from non-ETF ETPs. It was noted that the SEC sought comment on this issue when proposing its ETF rule.

Committee Discussion on the Impact of COVID-19 on Money Market Funds

Presenters: Joseph Lynagh – T. Rowe Price; Jonathan De St. Paer – Charles Schwab; Russ Wermers – University of Maryland's Smith School of Business.

- **What Happened?** The members noted the contrast between what happened with money market funds (MMFs) in 2020 in response to the pandemic and in the 2008 financial crisis. Unlike in 2008, during the pandemic, MMFs experienced a liquidity crisis and not a credit crisis. Indeed, there did not appear to be credit deterioration in response to the pandemic and it was the demand for liquidity in the credit markets that affected MMFs. Notwithstanding this, MMFs performed well. The members expressed surprise at the extreme differences in how various sectors of the fixed income markets were impacted by the pandemic and the speed with which events in March overtook the markets. According to the members, there was a distinction between how retail investors and institutional investors in MMFs reacted to market developments.

In March, while the markets were moving very fast, in institutional prime MMFs there was a large rotation of assets from prime funds to government funds. Redemptions from institutional prime MMFs were triple the redemptions from retail prime MMFs.

- **What Worked/Didn't Work?** The members noted that Form N-MFP data provided more insights into the holdings of MMFs, so regulators were better able to see what was going on in the markets.

  One member noted that the recent crisis was about as close to a pure liquidity crisis as one can imagine. Because of this, market participants need to better understand what happened that resulted in a liquidity crisis, causing some investors to redeem their shares despite the quality of assets held by MMFs. It was noted that MMFs had been maintaining higher levels of liquidity than required by law and did not have to resort to the use of gates or fees to stem redemptions. It was also noted, however, that, due to market uncertainty, some funds struggled to avoid dipping below the 30 percent weekly liquid asset threshold when they experienced heavy volumes of redemptions. A member observed that the threshold may have acted more as a "cliff" rather than the "cushion" it was designed to be.

  Other features of the market that worked well included the credit facilities established by the FRB, the presence (or even just announcement) of which helped to stabilize the markets even if the facilities were not utilized. Also, the pricing services and data providers, as well as ICI, were good sources of information about market color.

- **Areas for Further Study/Potential Improvement:** One member noted that, during the crisis, retail investors were less apt to redeem than institutional investors and, among institutional investors, there appeared to be competition to redeem ahead of others. The SEC was commended for distinguishing retail investors from institutional investors when it enacted MMF reforms. The panel noted that, because a small number of institutional investors hold a large percentage of MMF assets, they are able to cause a great deal of market disruption. The panel recommended that the AMAC explore ways to slow down institutional investor redemptions during stress periods. For example, the AMAC may want to explore whether to tie the frequency of institutional investors' ability to redeem to the MMF's weighted average maturity (WAM).

Committee Discussion on the Impact of COVID-19 on Funds' Operational Challenges

Presenting committee members: Mike Durbin – Fidelity; Joe Savage – FINRA; Neesha Hathi – Charles Schwab.

- **What Happened?** Members noted that operational challenges remain a fluid situation as the pandemic continues. Of the challenges that could be described as "operational," the panelists focused their comments on transitioning staff to working from home and the regulatory implications of that transition. Members noted the success with which the industry transitioned almost overnight to a working-from-home environment for most employees. Members continue to consider:

- How can supervisors fulfill FINRA's inspection requirements if the branch office is closed and the employees dispersed?
- How can registrants avoid issues with delivering required disclosures to investors on a timely basis that resulted from printing firms during the pandemic?
- How are registrants able to authenticate or notarize signatures on regulatory or other documents that require manual signatures?

The members noted that regulators (SEC and FINRA) were quick to recognize these and other challenges and provide necessary relief and guidance. For example, FINRA noted that it had issued Notice 20-08 to address registrants working from home as well as FAQs that they continue to update. Among other actions, FINRA provided registrants with staff working from home with relief regarding FINRA's Form U-4 update requirements, supervision, fingerprinting, qualification examinations, and receipt of mail.

- **What Worked/Didn't Work?** The members concurred that, due to regulators' prompt response to events, firms have been successful in continuing to operate from remote work locations and comply with all applicable regulatory requirements.

- **Areas for Further Study/Potential Improvement:** While the members commended the regulatory response to the pandemic, they expressed concern with the limited duration of the relief provided by regulators; in their view, such relief should be made permanent. For example, FINRA should permit homes to become permanent work locations without having to treat these locations as branch offices.

  The members also strongly recommended that the AMAC encourage the SEC to permit broader use of e-delivery of documents to investors and the use of e-authentication, while considering the interests of those investors who want hard copy documents. The Schwab panelist noted that 80% of Schwab's customer accounts are opened online, 95% of their customers have elected e-delivery of documents, and these numbers are increasing as a result of the pandemic. E-delivery was particularly important during the pandemic for those investors who reside outside the U.S. when the U.S. Post Office halted mail delivery to certain countries. Other advantages from e-delivery include largely eliminating concerns with printers who faced their own operational challenges and support for the environment. The Schwab panelist mentioned that, each year, Schwab sends 10 million pieces of mail to customers notwithstanding the high adoption rate of e-delivery by customers.

  With respect to working from home, the members noted that, when employees are not required to work at a firm's office, it expands the pool of talent a firm can hire. In response to a question from Director Blass about whether certain fund employees should be required to work from an office, the members noted that, while bandwidth was a challenge in the early part of the crisis with employees working from home, that is no longer the case. Firms have seen an increase in employees' productivity and efficiency as a result of the firms investing in the technology necessary for employees to work from home. One panelist noted that an office environment may be more appropriate for certain roles or functions, such as trading and its related functions and shareholder servicing. If firms decide to bring employees back to the office, they may focus on those employees best suited to work from the office based on their role. One panelist noted that their institutional clients are comfortable engaging with the firm virtually rather than through in-person meetings. One member wondered whether there would be a loss of relationship capital in a permanent work-from-home environment if employees don’t have the same opportunity to develop meaningful work relationships.

In response to a question about offshoring from Director Blass, one panelist noted that, during the pandemic, they were able to transfer the work previously conducted in India to the US United States over three days and enhanced automation will lessen reliance on outsourcing to India.

Key Takeaways from AMAC Members

During the final part of the meeting, AMAC Chair Bernard requested that each member share key takeaways or observations from the day’s presentations. Members provided recommendations in the following topics:[10]

- **ETF Pricing:** One member remarked that the industry needs to better understand the implications of the divergence that occurred between fixed income ETFs’ market prices and NAVs.
- **Mutual Fund Liquidity/Redemption Issues:** One member recommended the AMAC explore swing pricing, noting that non-US funds that used swing pricing during the pandemic crisis experienced less redemption activity than US funds (which have been unable to implement swing pricing due to operational obstacles). The member recommended that the AMAC study the role of the mutual fund vehicle and consider whether it is necessary to have daily liquidity requirements for all mutual funds.
- **MMF Issues**: A member indicated that the policy response to the crisis addresses liquidity issues but not solvency. The member expressed concern about the impact on MMFs if state and local units of government begin to default in response to COVID-19. Another member agreed with the observation that the 30 percent “liquidity buffer” had unintended consequences and operated as a “tripwire” during the crisis. The member thought that tying institutional investors’ ability to redeem to a MMF’s WAM is an idea the AMAC should explore. A third member commented on the MMF “conundrum,” noting that the reforms put in place over the last decade put MMFs in a better position but did not stop an “event,” so it is unclear where we go from here. Another member was struck by the statistics about fund flows and evidence that MMFs did not really use the FRB credit facilities—investors just needed some assurance. A takeaway was that “we don’t know a lot about investor behavior,” including “what they really care about in a big drawdown event.”
- **Government/Regulatory Response to the Crisis:** One member thought that by comparing government interventions in 2008 to those in 2020, it was obvious that an early response is better than a later response; experience dealing with the crisis in 2008 provided the ability to move quickly in 2020. Industry and regulators working together to solve problems quickly during the pandemic made a positive difference. One member recommended that the AMAC consider what would have happened if the FRB had not intervened in the markets either at all or to the extent that it did. This member thought the AMAC also should consider whether the FRB’s action buffered the consequences of risk taking, which has profound implications for investors, including Main Street investors. Another member raised questions about how the market will “wean itself off” the large amount of direct and indirect government support.

- **E-delivery:** One member noted that the crisis has demonstrated the importance of e-delivery. Requiring the mailing of certain documents to shareholders, however, necessitated certain employees continuing to work in an office while the office was shut down and other employees were working remotely. Broader e-delivery is something the AMAC needs to explore with the SEC.

- **Retail Investors:** One member thought that the AMAC should keep protection of Main Street investors front and center. In thinking about investors, however, the AMAC needs to consider categories of investors beyond just institutional and retail.

- **Negative Interest Rates:** One member recommended that the AMAC consider negative rate environments and what the industry should be thinking about if that occurs in the future.

- **ESG:** Many members were struck by the quality of the subcommittee presentation on ESG and remarked that it was a complex topic. One member noted that ESG funds are not a one-size-fits-all product. The AMAC must consider how E, S, and G work together in an investment product. The AMAC also should consider how to enhance investor understanding of ESG funds. The SEC could benefit from detailed engagement and discussion with the industry on ESG issues rather than merely getting input via written comments on SEC proposals. One member expressed concerns with working through ESG issues identified by the AMAC subcommittee within the two-year life of the AMAC and suggested tackling the issues in stages.

- **SEC Approach to Preparing for the Next Crisis:** One member thought it was refreshing to hear that the SEC staff is in learning mode mindset and wants to gather information and data before proposing any regulatory changes. Another member cautioned about the difficulty of conducting a post-mortem while the crisis is continuing.

- **Fixed Income Markets:** Many members had takeaways about the fixed income markets. One member stated that innovation in fixed income pricing is imperative. Other members agreed with the need to improve the bond market and enhance price discovery. Another member raised the concern that models used by pricing vendors "are tuned to normal times" and suggested that other inputs such as ETF prices should be considered.

- **Staff Working from Home:** One member remarked on the resiliency of the industry, noting the effectiveness of business continuity plans and the seamless transition to working from home. With respect to employees continuing to work from home, another member recommended that firms should be aware that their staff has been running on adrenaline and consider whether this is sustainable for the long term. Firms should think about what happens when fatigue sets in and employees are adversely impacted by the lack of social interaction.

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endnotes

[1] *See* the AMAC Spotlight Page for a complete list of committee members and their bios as well as the meeting agenda and webcast: https://www.sec.gov/page/asset-management-advisory-committee.

[2] Commissioner Hester Peirce and AMAC Chair Bernard also delivered welcoming remarks that did not address substantive issues.

[3] *See* Chairman Jay Clayton, Remarks at Meeting of the Asset Management Advisory Committee (May 27, 2020) *available at* https://www.sec.gov/news/public-statement/clayton-amac-opening-2020-05-27.

[4] *See* Investment Company Act Release No. 33821 (Mar. 23, 2020), *available at* https://www.sec.gov/rules/other/2020/ic-33821.pdf.

[5] *See* Director Dalia Blass, Opening Remarks at the Meeting of the Asset Management Advisory Committee (May 27, 2002), *available at&/em> https://www.sec.gov/news/public-statement/blass-statement-amac-opening-2020-05-27.*

[6] *See* Presentation of the ESG Subcommittee, *available at* https://www.sec.gov/files/ESGSubcommitteeUpdate_0.pdf.

[7] *See* Presentation of the Private Investments Subcommittee, *available at* https://www.sec.gov/files/PrivateInvestmentsSubcommitteeUpdate.pdf.

[8] *See* panelist presentations, *available at* https://www.sec.gov/files/ici-fund-flows-covid-19.pdf; https://www.sec.gov/files/marc-seidner-pimco.pdf; and https://www.sec.gov/files/CaseyQuirkPandemicReponse_0.pdf.

[9] ICI’s Chief Economist, Sean Collins, presented to the Committee regarding the impact of COVID 19 on the financial markets and fund flows.

[10]Topics are listed in the order that they were first discussed and bucketed together with subsequent members’ discussion of the same topics.