SPEECH

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2020 Academic and Practitioner Symposium on Mutual Funds and ETFs

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As prepared for delivery.

Good morning, and welcome.

ICI is pleased to cohost today's symposium with the Richard A. Mayo Center for Asset Management at the University of Virginia's Darden School of Business. I'd like to thank the Mayo Center for working as our partner on this, the fourth of these valuable meetings that bring together scholars and practitioners to foster a shared understanding of regulated funds and the financial markets in which they operate.

Our topic today is the dramatic rise of private markets—a defining feature of today's financial landscape. The growth of private equity and debt shows no sign of abating, and that has very significant implications for public markets, investors, valuation, regulators, and the economy at large.

As you likely are aware, ICI is a global association of regulated funds. Our members include US mutual funds, exchange-traded funds (ETFs), and closed-end funds, and similar funds offered to investors in jurisdictions worldwide. Our US members manage over $25 trillion in assets on behalf of more than 100 million shareholders and half of US households.

Because ours is a retail industry, it is natural that ICI concerns itself with helping to assure that ordinary investors continue to have access to the most promising opportunities for wealth creation. Indeed, that value proposition was the very basis of the modern fund industry at its inception 80 years ago. So, among the many questions raised by the vast growth of private equity and debt, it is vitally important that we develop appropriate ways in which retail investors can share in the gains of the private markets.

Why important? Well, just a few facts explain why. Private markets are a global phenomenon, and today they raise more capital than public ones. Companies are staying private longer. If they do go public, much of their value may have been already realized by the time of their initial public offering (IPO).

In the 1990s, the median time between a first venture capital round to an IPO was about four years; now, it is about seven. And many founders choose to cash out by selling their company via merger or acquisition, instead of undertaking an IPO. Paralleling this growth of private finance, of course, is a shrinkage in the public markets—the markets that retail investors can readily access. Today, the United States has fewer than half the number of publicly listed companies as at the peak in 1997—roughly 3,500 now, versus 7,500 then. The Wiltshire 5000 hasn't been able to fill its index since 2005. The intriguing question of which came first—the growth of private investing or the shrinkage of public markets—is one we could debate endlessly. One thing is certain: both trends are quite clear.

In today's forum, we will examine in some depth what is fueling these trends. They include:

- a dramatic growth in the supply of private capital—from sovereign wealth funds and family offices to private equity sponsors, all seeking higher returns;
- changes in the law, including a provision in 2012 that increased from 500 to 2,000 the number of shareholders that a company could have and still remain "private";
- growing disparities in the regulatory burdens that public companies face as compared to private firms;
- a perception that public companies must answer to the market's short-term expectations about quarterly performance;
- and, as our next speaker, Dr. René Stulz, will discuss, some unique characteristics of today's companies, which lend themselves to a preference for private ownership.

Even as private markets continue to expand, the vitality of public markets should remain of the utmost importance to us all—for investors across the spectrum and for the economy.

Why? In short, because of the efficiency with which public markets set prices and arrive at valuations. This is a function of the transparency provided to myriad investors by mandatory corporate disclosures, the reliability of independently audited financial statements, the accountability of management imposed by various governance mechanisms, and the discipline assured by sound regulations.

Efficient price discovery is the foundation of a well-functioning capital market. Prices provide the signals that channel capital to its most productive uses. They enable investors to decide where to invest their savings for the best returns. Efficient price-setting lends confidence to investors as they choose to access wealth-creating opportunities in capital markets.

The big question now becomes: what happens to Main Street investors' access to those opportunities today, when many of the most innovative companies with the greatest growth potential are turning to private, not public, markets for funding? Will a stark bifurcation among investors—those with access to private markets and those without—be a hallmark of the future? These questions are all the more pressing now when countries around the world are relying more on self-funded retirement to support aging populations and retail investors' access to wealth creation becomes more urgent.

In the face of these trends, policymakers and market participants need to take strong measures to support the vibrancy of the public markets. At the same time, they should provide ways for retail investors to access private holdings without sacrificing the shareholder protections they have in the public markets. It is my hope that today's conference will help shed light on these issues.

In the first instance—to strengthen the public capital markets—regulation and legislation should help ensure that new and growing companies can and will tap these markets. Undue regulation—like some embedded in the Sarbanes-Oxley Act of 2002—can discourage this. I personally believe it is high time to reconsider aspects of public company regulation to reduce burdens and costs and to make public issuance more appealing.

When it comes to retail investors' direct access to private markets, there is a different challenge. How do we square the circle, to find alignment between the way in which private companies operate and private securities offerings are made, and the elemental protections long thought necessary for ordinary retail investors? US capital markets can boast of enormous achievements in both these worlds. Now they need to intersect.

Private companies operate beyond the disclosure, auditing, and governance requirements of public companies. They are less transparent by design. They hold information closely to enable the growth and development of products and services. Their shares do not trade regularly; indeed, purchases and sales may be restricted. Consequently, they lack the liquidity of publicly traded companies and are more difficult to price. And the SEC rightly allows only accredited investors with certain income and net worth levels to qualify for private investments.

Meanwhile, the relative illiquidity of private holdings presents a big challenge for registered investment funds and their retail investors. Mutual funds and ETFs can hold only 15 percent of their assets in illiquid securities. This means that as the private market grows, even indirect investment through funds will only go so far for retail investors.

Main Street investors have long relied on the liquidity, transparency, and regulatory protections of the public markets to help guide their investment decisions. Yet as private markets assume a greater share of capital formation, retail investors risk losing access to those opportunities. How can we enable them to obtain a stake in private offerings and still retain the regulatory safeguards they rely on?

The answer is: let retail investors into private markets through regulated funds. Regulated funds provide both access to private offerings *and* shareholder protections under the Investment Company Act of 1940. These protections include shareholder disclosures, valuation of assets according to board-approved procedures, independent financial audits, strict governance standards, and other requirements.

Today, many regulated funds already invest in securities that retail investors would not—Rule 144A securities, derivatives, repurchase agreements, and more. Enabling retail investors to gain exposure to such assets through professional investment managers is an important function of these funds in our capital markets. Likewise, when it comes to private holdings, interposing a regulated fund between retail investors and private offerings might provide the best of both worlds for Main Street investors: access to the wealth creation of private markets with the regulatory protections of public markets.

Closed-end funds are an especially appropriate vehicle for this purpose. Open-end funds are required to repurchase their shares on demand. To meet such demands, open-end funds must hold the bulk of their portfolios in liquid assets. By contrast, closed-end funds do not buy back shares from shareholders. Instead, outside of a fund's IPO or periodic issuances of new shares, investors buy or sell closed-end fund shares only in the public markets. Therefore, closed-end funds have greater latitude to hold assets that are less liquid and entities that are harder to value, such as private companies. Meanwhile, they still provide investors protections under the Investment Company Act.

Because of these attributes, we strongly believe the SEC should make it easier for closed-end funds to invest in private offerings on behalf of retail investors. Closed-end funds that invest in private funds should be able to sell to any investor, not just accredited ones. And closed-end funds should not have to limit their private fund investments to 15 percent of net assets. That may require that the SEC reconsider some prior staff positions that—without clear legal basis—would bar funds with larger stakes in private firms from selling to retail investors.

You may find it of historical interest that closed-end funds provide Investment Company Act protections because of their own prescience many decades ago. In fact, we have the leaders of the closed-end fund industry largely to thank for the passage of the Investment Company Act, which celebrates its 80th anniversary this year.

Modeled on British funds, closed-end funds were the first fund type in the United States. They flourished in New York and enjoyed greater popularity in the 1920s than open-end mutual funds, which tended to be based in Boston. By the time of the New Deal, when investment companies faced the prospect of federal regulation, closed-end funds helped pave the way. They joined hands with open-end funds to support federal legislation—spurred by a healthy dose of self-interest. Open-end funds had received favorable tax treatment under the 1936 Revenue Act, while closed-end funds had not. Closed-end funds were willing to accept greater regulation to gain that tax treatment.

The rest, as they say, is history. The 1940 Investment Company Act created the investor protections that made the regulated fund industry the great success it is today. Those investor protections, combined with the ability of closed-end funds to hold less-liquid assets, should help them bridge the gap between retail investors and private markets. Old tools sometimes are very handy to address new challenges.
