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Navigating a New Environment

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General Counsel's Address: 2017 Mutual Funds and Investment Management Conference

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As prepared for delivery.

Good morning, everyone. Welcome, and thank you all for joining us.

Just about everywhere I go these days, it seems the news out of Washington, DC, finds a way into the conversation. I've got a pretty good feeling that this conference will be no different, so I thought I'd spend a little time on the subject myself.

There are three areas I'd like to cover:

- First, opportunities emerging from this era of political and regulatory change.
- Second, ICI's priorities for this new era.
- And third, one potential challenge on the horizon.

But before I get started, I'd just like a show of hands here from the audience. Raise your hand if you know who Nick Saban is. We'll come back to him later.

So, the first topic—a period of change and the opportunities that might emerge from it.

Regardless of your political stripes, I think you'll agree with me that the new year ushered in a new era of politics in DC—or what some of us affectionately call "the swamp." Our legislative and executive branches are under a single party's control for the first time in six years. Republicans hold both branches for the first time in eight. And we have a president unlike any we can remember.

As is true of any change in Administration, the months following an inauguration bring a great deal of change—a great deal of uncertainty. That's where we are right now.

But this is not our first rodeo—the fund industry has been through this before.

We know how to manage through transitions. Since the days of President Franklin Delano Roosevelt, ICI and the fund industry have seen the White House flip from one party to the other eight times. And every two years, we welcome new faces into both houses of Congress.

We also know that the uncertainty fades—as Congress moves to confirm new leadership, and the regulatory agenda firms up.

As that begins to happen this time around, I'd argue that the fund industry will have excellent opportunities to advance our policy goals. These opportunities are evident in the White House's "core principles" for regulating the US financial system, which President Trump issued early last month.

The president wants to:

- empower Americans to make independent and informed financial decisions;
- foster economic growth and vibrant financial markets;
- and make regulation efficient, effective, and appropriately tailored.

I don't know about you, but I can get on board with these principles. If you think about it, they're at the heart of what makes our capital markets so strong—and what has enabled the fund industry to serve investors so well.

If policymakers follow these principles, we're likely to see:

- capital allocated more efficiently and productively;
- greater diversity in sources of financing for the economy;
- a stronger culture of entrepreneurship and ownership;
- and more jobs and faster economic growth.

These are all goals worth striving for. The hard part is to put the president's principles into action so that we can reach them. Well, we at ICI have a few thoughts about how to do just that, at least as far as the fund industry is concerned.

That brings me to my second topic—ICI's priorities. What ideas do we have to capitalize on the opportunities that this new political era presents?

Let me start on the regulatory front.

The pile of rulemakings on our plate has just been getting bigger and bigger over the past few years. Regulators need to give us a chance to implement all of them in an orderly pace, and rethink a couple of items.

Three complex rules from the Securities and Exchange Commission—data reporting, liquidity risk management, and swing pricing—all were completed last fall. We're still in the early stages of preparing to implement them, but doing so is already proving to be enormously expensive and time-consuming.

You'll recall that these rules hit the books just as we were wrapping up more than two years

of implementing the sweeping 2014 money market fund reforms. It took thousands of people and countless hours to implement those reforms, which themselves came on top of an earlier round of changes from 2010.

That's just at the SEC. There's also the Department of Labor (DOL). In the 11 months since the DOL finalized its fiduciary rule, all of ICI's members have been working tirelessly with intermediaries and service providers to gear up for compliance.

Just this month, the DOL proposed to delay the rule, and the agency might consider revising or rescinding it. We applaud that. But there is no way to recapture the extraordinary amount of time, money, and resources that the regulated fund industry has devoted to coming into compliance.

And, of course, how could I forget—the Volcker Rule and the deluge of other new rules that have poured in under Dodd-Frank over the last few years.

If all of this sounds like too much—well, that's because it is.

Another way to assess the extraordinary pace of regulatory change is to look at how many comment letters ICI alone submitted to regulators in just the last fiscal year.

If you can believe it, we filed 111 comment letters—totaling 1,600 pages.

That's nearly one comment letter every other working day, filed with an alphabet soup of organizations all over the world: the SEC, the CFTC, FINRA, the FSB, IOSCO. All the organizations you see on the screen before you—and many others.

Our members were right there with us, filing comment letter after comment letter, often on top of their day jobs.

Really, it's been exhausting. And I think it's about time our shops get a little space to go about implementing all these rules.

To that end, the regulatory agencies—especially the SEC—could give us a huge helping hand.

That means putting any unfinished, non-essential rulemakings to the side for the time being, so that we can focus on the substantial compliance and implementation burdens we're already dealing with.

It means extending compliance dates of two major rules—data reporting and liquidity risk management—and sequencing them in a way that allows asset managers to implement the rules in an orderly fashion instead of as a big bang.

And it means keeping an open mind about revisiting some portions of the rules, to prevent any negative unintended consequences or unnecessary costs. Personally, I find portions of the liquidity risk management rule to fall squarely in that category.

While we're talking about compliance, let's remember that fund directors are not compliance professionals. So let's take compliance functions off the board's plate—and leave that work to the CCOs (chief compliance officers).

Now, to be clear, we are not asking regulators for a full stop. There are very important

policy issues that need to be dealt with.

Four stand out for me today.

First: The fund industry, together with the brokerage industry, has been leading an effort to shorten the settlement cycle for a range of securities for the first time in 20 years—from trade-date plus three days to trade-date plus two. We can't afford to put this important work on the backburner.

Second: Although the DOL has good reason to delay, revise, or even rescind the fiduciary rule adopted last year, the best course is for the SEC or FINRA to establish a uniform conduct standard for broker-dealers that applies to both retirement and non-retirement accounts.

Third: The SEC needs to figure out what to do with its proposal on funds' use of derivatives. On balance, we support a derivatives rule, but it needs to be done right—without the harmful portfolio limits and with an appropriate focus on asset segregation.

And fourth: There is fund disclosure.

If you were with us last year in Orlando, you might recall seeing this happy couple. I said then—and I say again today—that's probably not a shareholder report they're opening. Their expression would be quite different if it were.

Last year, the paper lobby and other interest groups fought tooth and nail against the SEC's proposal to let registered funds deliver shareholder reports by posting them online and notifying shareholders that the report is available on the Internet.

We were bitterly disappointed that the SEC delayed consideration of that rule and did not adopt it in 2016.

This year, the Commission should make every effort to get online delivery for shareholder reports across the finish line—and do the same for summary prospectuses and closed-end fund distribution notices.

Really, the case for online delivery couldn't be more compelling: fund shareholders would save billions of dollars, and our industry's environmental footprint would shrink dramatically.

With online delivery in place, the SEC could then get to work on reforming fund disclosure more broadly, to help funds make the information they provide to shareholders more accessible, more interactive, and more visually appealing.

And while they're at it, the Commission should look again at required disclosures in light of its recent rulemakings. For example, what's in the shareholder report that shareholders actually need to know? Now that the data reporting rule has been adopted, some of the information in the shareholder report could be superfluous. Having read a few of these reports, I think they can do a much better job serving shareholders.

We stand ready to work with the SEC to make required disclosures more useful to fund shareholders—and we'll do everything we can to get online delivery in place. But regardless of what happens with online delivery, FINRA needs to take over the regulation of the fees for delivery of shareholder reports to broker-held accounts. We'll redouble our efforts to

make sure that happens.

I'd like to turn now to my third and final topic. It's a new issue that you might not have heard about—but one that should concern us all.

I'm referring to a new theory out there suggesting that fund investing in concentrated industries—like airlines or banking—is causing companies in those industries to suppress competition.

According to this theory, when a fund complex owns stocks in several firms in the same concentrated industry, those firms have less incentive to compete—even when the complex is a minority shareholder in each company. It claims to show that this common ownership drives prices up to the detriment of everyday consumers.

This is not something we take lightly—because the theory has plenty of flaws, yet people are already using it as a basis for policy proposals.

So, what does the theory get wrong?

- First, it profoundly misunderstands the fund industry. It assumes, for example, that every fund complex is a monolith and acts with one strategy. We all know better—each fund and separate account within any complex has its own, unique investment strategy.
- Second, the theory assumes that common ownership—even with funds or fund complexes holding 5 or 10 percent of a company—can create incentives for a company's management not to compete. This exaggerates the influence of minority shareholders and distorts the incentives of corporate managers.
- Third, and perhaps most important, the theory seems to have taken an apparent correlation between an increase in institutional ownership and rising prices in the airline and banking industries—and used that to claim that institutional investors are causing prices to rise.

Now, I'm no economist—but even I know not to confuse correlation with causation.

Here's an analogy that hit home for me. It borrows from my love of Alabama Crimson Tide college football. If you'll indulge me—and a lame sports analogy—for a moment, I think you'll come away with a better understanding of the problem here.

For those of you who didn't raise your hands earlier, Nick Saban coaches the University of Alabama's football team. He was hired in 2007. Let's imagine that, after he was hired, Coach Saban brought in a new ball boy.

Since 2007, Alabama has won four national championships—quite a remarkable run. But think about how the academics behind this common-ownership theory might write up the Crimson Tide's success. The headline might say something like ["History's Greatest? Ball Boy Delivers Four National Championships in Seven Years"].

You see, there's a positive correlation between the hiring of the ball boy and Alabama's success. But the academics' headline misses another factor—Nick Saban, arguably the greatest college football coach of all time. Similarly, when the academics look to explain rising prices in the airline and banking industries, they seem to be missing the impact of factors other than institutional ownership.

In fact, there are much likelier explanations—such as the increase in demand for airline and banking services we saw as the economy recovered from the Great Recession.

Now, the fund industry attracts a lot of—shall we say—unique academic theories. We're used to that.

But what's alarming about this theory is that it's drawn an awful lot of official attention—here in the United States, and in Europe as well. Some are already using this theory to push for misguided policy solutions. One of them would tell a fund complex, "If you own more than one company in a concentrated industry, you must own less than 1 percent of each of them—or risk facing antitrust enforcement."

That means fund complexes could own United, but not Delta—unless they owned less than 1 percent of both. AT&T, but not Verizon—unless they owned less than 1 percent of both. Coca-Cola, but not Pepsi—unless they owned less than 1 percent of both.

I should point out that these restrictions would also apply to holdings of small companies, not just major corporations. And remember, I'm talking about the ownership stake of an entire fund complex here, not a single fund.

This so-called solution would have some serious negative consequences:

- It would undermine the very concept of index investing.
- It would cost active managers their flexibility in portfolio management.
- It would punish the capital markets by forcing draconian sell-offs and swings in fund holdings.
- And, worst yet, it would impose higher costs and potential losses on fund investors, who would struggle to achieve their investment goals under theses constraints.

As this issue plays out in the coming months, we will urge academics, the antitrust bar, and policymakers to take a closer look at the data and their theories before drawing any conclusions or suggesting policy changes.

When entering an era of change, it seems like there's something new every day—new ideas to pore over, new plans to hash out, new tasks to take on. But as we navigate this new era, we mustn't lose sight of what has helped us prosper for more than 76 years:

- sound legal and economic analyses;
- advocacy based on facts and evidence;
- and an unwavering focus on the interests of investors.

That's what ICI will be bringing to the table as we urge regulators and other policymakers to stay true to the president's common-sense principles for financial regulation. Indeed, that's what we'll need if we're to emerge from this era of change in good shape.

Thank you for your time and attention.

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