Speech

# Keynote Address, ICI 2018 Mutual Funds and Investment Management Conference

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## Introduction

Good morning. Thank you, Susan [Olson], for that kind introduction.[1] I want to thank everyone here for the opportunity to speak with you today. It is not every day that I can talk with so many of the professionals in the field at one gathering. And I have the privilege of speaking on the same day as Commissioner Hester Peirce. Commissioner Peirce and Commissioner Rob Jackson joined the Commission together earlier this year, and they have brought with them incredibly valuable perspectives on asset management. I would recommend taking any opportunity you can to hear them speak. I look forward to joining you to hear Commissioner Peirce's remarks later.

Today, I would like to chat with you about the role of data in our work, give you an update on our thinking on the role of directors, highlight two exchange-traded fund (ETF) topics and leave you (especially the practitioners in the audience) with a thought about index providers.

Before I dive in, let me pause for the disclaimer. I am speaking today only for myself and not for the Commission, the Commissioners or the staff.[2]

## Information and analysis

First, I would like to talk about the Division's analytical work. We are all aware of how technology has changed the markets, increasing speed as well as the volume and complexity of information. What does that mean for a Division of 180 people responsible for policy affecting more than 20,000 registered funds and advisers?[3] Well, for one thing, spreadsheets do not cut it anymore.

Fortunately, the Division has an Analytics Office full of really smart, passionate folks who know how to build and use sophisticated tools. A great example is Sankar Nair. He is a quantitative research analyst who, before arriving at the SEC, spent a distinguished career building trading and risk platforms for several firms. Sankar and the other professionals in the Analytics Office have advanced our ability to make sense of data, to focus our resources and to respond with rigor to questions about asset management. In fact, we recently changed the name of the Analytics office, which used to be "Risk and Examinations," to better reflect its contribution to the Division's core work.

One example of their work is an internal tool we call MAGIC. That's an acronym for Monitoring and Analytics GUI for Investment Companies. MAGIC allows us to pull together a number of data sets – including data from registrants and other sources – and look at it holistically. The tool combines performance, flow, holdings and other information and allows us to ask questions such as how does this fund's portfolio compare to its strategy? Are its holdings aligned with its investment restrictions?

Our staff can use this tool to run custom queries across thousands of open-end and closed-end funds. For example, we are able to quickly identify which funds may have exposure to certain assets, like cryptocurrencies. This is important because, not too long ago, we may have needed to call around to sponsors or review unstructured text filings to answer these questions.

So far, MAGIC has been most powerful in helping to improve our disclosure review process. Reviewers in our Disclosure office are able to enter a ticker symbol and see key aspects of a fund's investment program, such as how it has allocated assets and how it has performed. Ultimately, this tool will help us to implement a risk-based approach to reviewing disclosure that will improve the effectiveness and efficiency of our work.

MAGIC is also dynamic. First, as new data – like Form N-PORT – become available, we have the ability to extend MAGIC to incorporate it. Second, we can continue to build on MAGIC's abilities. For example, the Analytics Office has started adding machine learning capabilities. These capabilities may ultimately allow it to detect fact patterns of interest automatically and enable more sophisticated explorations of trends and relationships.

I mention all of this for a few reasons. First, I think it should be clear that we plan to use the data we receive – it will not collect dust in the corner of an old server. Second, I believe the Division needs to be forward-looking. Improving the use of our limited resources is clearly going to be critical to our ability to serve American investors in the future. Finally, we need to be smart about policy – that is in everyone's interest. The only way we can be smart about policy is to have good information. MAGIC represents only one kind of tool, and it has limits – data will not make us clairvoyant, and its use must be balanced with important security considerations. However, within their limits, data tools are an indispensable part of understanding how policy will affect investors and market participants.

## Update on the fund board outreach initiative

The next topic I want to touch on is our "Board Outreach Initiative." I believe fund boards serve investors best when they can focus on areas where their judgment and experience uniquely equip them to provide oversight. Our goal with this project is to understand where board oversight is most valuable.

Over the last few months, Division staff have been meeting with fund boards and groups of independent directors. We have also spoken with counsel to independent directors, counsel to funds and independent auditors. The outreach team even received an abbreviated form of one training that is offered to new independent directors. They had a brief glimpse into the challenging questions that directors can face. As we proceed, we will be comparing what we learn with current board responsibilities and asking whether we can do anything to improve the ability of fund boards to serve shareholders.

What we have found so far across meetings is a number of similar themes. For example, the directors we have spoken with have emphasized the importance of items that shareholders would want to know about if they were in the board meetings – items like fees and expenses, investment performance, the rigor behind the investment process and the quality of services provided to the fund.

At the same time, directors almost uniformly stressed the importance of respecting the line between oversight and management. This comes up most often when we discuss valuation and review of affiliated transactions. Directors acknowledge that boards can play an important role in these areas because of the significant conflicts present. However, there is a difference between overseeing the work of experts and being asked to serve as experts.

For this reason, we have prioritized these areas for consideration. Commission staff has started work on options for updating our valuation guidance to reflect evolution in the markets and the standards for accounting, auditing and reporting. We are in the early stages, but we are hopeful that we can develop recommendations to assist boards in performing their valuation duties under the Act in a way that recognizes this evolution and better serves investors. On affiliated transactions, our work is both backward and forward looking. While we have compiled a list of current responsibilities that potentially blur the line between oversight and management, we want to endeavor not to add to such responsibilities in future policy decisions. As this work and the broader initiative progress, we will continue seeking the practical insights of a wide range of boards as well as those of other stakeholders.

## Exchange-traded funds

Now I would like to move to ETFs. ETFs happen to be one of my favorite subjects, and many of you are probably wondering when we are going to get an ETF rule on the books.

You all know the incredible growth story of ETFs. You also know that the regulatory approach has not always been as dynamic as the market. I was the staff attorney on the ETF proposal back in 2008, but that rule was ultimately not adopted.[4] I felt at the time that an opportunity was missed. The

subsequent decade has only underscored how unfortunate that was. Here is where we stand today: we have an over $3.5 trillion market operating under more than 300 individually issued exemptive orders.[5]

It is not ideal for such an important segment of the asset management market to operate under so many individual exemptive orders. The drafters of the 1940 Act showed remarkable foresight when they gave the Commission exemptive authority. ETFs are, in fact, one of the best examples of the Act's adaptability. However, although exemptive orders are great for flexibility, they have drawbacks too. For example, there is the obvious expense to new entrants of obtaining orders. There are also less obvious costs. These include differences in the playing field as well uncertainty that results from lengthy orders and variable wording.

I am sure I will surprise no one by saying that, with all of this in mind, delivering a recommendation to the Commission for a rule is a high priority for the Division, and our ETF team is hard at work.

The second ETF item I will mention is nomenclature. In the early days, the term "ETF" meant something fairly specific. Today, however, the term is used to describe investment companies with a wide range of strategies as well as a number of products that are not investment companies or even funds. We see this in news reporting sometimes, as in some articles covering the market movements in February. The convenience of shorthand is probably responsible for some of this expansion, but I think the naming and marketing of these vehicles has also sometimes failed to draw clear distinctions. I worry that, as the term has stretched, investors have had to work harder and harder to identify important differences in risk. Are the differences in risks, investment strategies and investor protections among ETFs, commodity pools and exchange-traded notes (ETNs) clear when the term "ETF" is often used for all three? Do people assume, when they see "ETF," that they are looking at a 1940 Act fund? Should we be considering different approaches to ETP nomenclature? I would welcome thoughts from investors, funds and advisers on whether addressing ETP nomenclature would be helpful to investors and the markets.

## Index providers

Finally, I am going to move from ETFs to a related topic – index providers. Index mutual funds and ETFs have evolved significantly since their introduction. At the start, most of the indexes were broad and relatively well understood – the S&P 500 is a classic example. Today, funds track indexes in a huge number of varieties. Some indexes focus on narrower strategies. Others use alternative weighting methods, like those for "smart beta" funds. In some cases, funds track custom indexes or indexes from an affiliated provider.

These changes appear to reflect the progression of a maturing market for index products, and I am sure we will continue seeing innovation. As market practices around indexes change, however, should we revisit the status of certain index providers as investment advisers? I understand that the question of whether an index provider is an investment adviser or a fund adviser might appear to be settled. Under the Advisers Act, I believe index providers have historically concluded that, even if they are investment advisers, they may rely on the publisher's exclusion from the definition of "investment adviser." However, recent developments appear to have moved certain index providers away from what we might think of as publishers.

I do not mean to suggest that we should revisit this analysis with respect to broad-based indexes that are widely used. But what should we make of an index that the provider maintains for only one single fund? What if the provider takes significant input from the fund's sponsor or board regarding the creation, composition or rebalancing of that index? Should affiliation between the index provider and the sponsor affect the conclusion?

Clearly this is a facts and circumstances analysis without a bright-line. When looking at the newer forms of indexes, the publisher's exclusion may still apply. However, I caution against assuming that the status of a provider can be determined based simply on its characterization as an index provider. We are not making that assumption. For the practitioners in the audience, I encourage you to refresh your analysis if you are looking at a bespoke or narrowly focused index.

There is another side to this question as well – disclosure. If a fund is tracking a bespoke or narrowly focused index, is the fund's disclosure clearly describing its strategy to investors? In recent years, investors have shown significant interest in index funds. They may even be shopping specifically for an index fund. Can an investor readily discern how decisions for the fund will be made, especially if the fund uses a bespoke index? An investor reading that a fund seeks to track an index is likely to assume something about the fund's management. It is worth asking, then, would a reasonable investor's

expectations for that fund match how the fund actually operates? If not, then the fund may need to revisit how it characterizes its strategy. Again, there is not a bright-line here. I simply want to encourage you to consider it and to reach out to the staff if you have any questions or thoughts.

## Closing

Before I close, I want to return to a theme you will hear repeatedly from me and my staff – engagement. Quality engagement by the Division is essential to good policy decisions. My staff and I have appreciated every opportunity to discuss with you important areas of the law and ways to improve how we serve investors. We have also managed to wrap up a few projects that, I think, highlight the benefits of quality dialogue. Take, for example, the liquidity rule FAQs and the proposal on public liquidity reporting. Both of these reflect hours of discussion with folks in this room and others aimed at finding solutions that were both pragmatic and intended to preserve the Commission's policy goals.

I am going to close with a nod to the staff of the Division. We are firing on all cylinders these days, and fueling that is the dedication of a remarkable staff. They are putting in long hours and managing a lot of different projects. I hope you get to see more of the results of their labors throughout the year.

In recognition of Women's History Month, I also want to express my appreciation for the incredible diversity of the Division's staff. Among our thought leaders are many remarkable women at all levels of the staff. I believe that the quality of our work owes a lot to the diversity of backgrounds, perspectives and experiences that the team brings to the table.

With that, I am going to wrap up my prepared remarks and take some questions. Thank you again for the opportunity to be here today and I hope you enjoy the rest of the conference.

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[1] I would like to thank Kaitlin Bottock, Robert Shapiro, Stacey Song and Sumeera Younis for their assistance in preparing these remarks.

[2] The Securities and Exchange Commission (the "Commission") disclaims responsibility for any private publication or statement of any Commission employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[3] *See* Investment Company Institute, Trends in Mutual Fund Investing (January 2018), *available at* https://www.ici.org/research/stats/trends/trends_01_18 ; Investment Company Institute: ETF Assets and Net Issuance (January 2018), *available at* https://www.ici.org/etf_resources/research/etfs_01_18 ("January 2018 ETF Data"); U.S. Securities and Exchange Commission, Information About Registered Investment Advisers and Exempt Reporting Advisers, *available at* https://www.sec.gov/help/foiadocsinvafoiahtm.html.

[4] *Exchange-Traded Funds*, Investment Company Act Release No. 28193 (Mar. 11, 2008) [73 FR 14618 (Mar. 18, 2008)].

[5] *See* January 2018 ETF Data; *see also* Investment Company Act Notices and Orders, Category Listing, *available at* https://www.sec.gov/rules/icreleases.shtml.