

Speech

Keynote Address Investment Company Institute 2016 General Meeting

Chair Mary Jo White

Washington, DC

May 20, 2016

Introduction

Thank you, Paul [Stevens], for your kind introduction. Today marks my fourth appearance here in as many years as Chair of the SEC, which should come as no surprise. The Commission is the primary regulator of the mutual fund industry, and it is vital that we all work continuously to protect and serve the broad spectrum of America's investors who depend on your products every day for retirement, for college tuition, and for so many other financial goals.

When we first met in 2013, the industry was anxiously awaiting the SEC's actions on money market fund reform, the question of how to address potential systemic risk in the asset management industry was still nascent, and the Commission had not yet embarked on its latest effort to enhance its regulatory regime for asset management. Much has happened since, including the adoption of final rules for money market funds and a public statement by the Financial Stability Oversight Council (FSOC), issued last month, updating its review of the potential systemic risks in certain asset management products and activities. Today, the Financial Stability Board (FSB) is working toward issuing a second consultative draft analyzing similar issues. And the SEC staff is, at my direction, working hard to finalize recommendations for the rules we proposed last year on fund reporting, liquidity risk management, and the use of derivatives, as well as advancing other proposals and initiatives.

So, there indeed have been many significant issues to discuss with you in the last few years and the spotlight on the asset management industry has been bright. I expect that will continue to be the case, in 2017 and beyond, which is what I want to focus on today. In that future, I believe the asset management industry will continue to evolve and to be of vital importance to investors, providing them a diversity of investment opportunities to meet their financial goals. Dynamic and robust regulation will also be needed that adapts and evolves to meet all of the current and future risks and challenges, while preserving the features that have served investors so well over more than seven decades.

Fostering this kind of dynamic regulation for asset management has been one of the critical responsibilities of the SEC since 1940, and it has been no small task. The 436 registered management companies with 300,000 accounts that had a little more than \$2 billion in assets in 1940,^[1] has grown to 8,131 mutual funds with approximately \$15 trillion in assets held by 54 million

U.S. households as of March 2016.^[2] The current and future health of our markets and the financial security of investors depend on the success of both our regulatory efforts and how well all of you and other industry participants do your jobs as fiduciaries and responsible leaders of the marketplace.

The SEC is keenly focused on our share of that weighty responsibility. In 2014, we fundamentally reformed the way that money market funds operate to both make our financial system more resilient and to enhance the transparency and fairness of these funds for America's investors.^[3] Then, building on a series of regulatory initiatives I announced in December 2014,^[4] last year we proposed rules to modernize reporting,^[5] to strengthen liquidity risk management requirements,^[6] and to address the use of derivatives by registered funds.^[7] And the staff has been closely focused on developing recommendations for transition plans and annual stress testing for certain funds and investment advisers.

Today, as we consider what the future will demand of investment company regulation, I will briefly discuss these current efforts and then share my vision for the next steps in the evolution of regulation for the asset management industry. Our current regulatory initiatives will, of course, continue to be a key element of that vision, but so too are addressing issues like disclosure effectiveness, the oversight of exchange-traded funds (ETFs), accurate portfolio pricing, and cybersecurity, to name a few. You, too, have major responsibilities in all of these areas.

Asset Management Initiatives

Three of the most significant areas of regulation for the asset management industry are: controls on conflicts of interest; a robust registration, reporting and disclosure regime; and controls on specific fund portfolio composition risks and operational risks.^[8] During my tenure as Chair, our rulemaking program has been primarily focused on the third area to address important developments in the industry over the last several years.

Recent Rulemaking on Liquidity and Derivatives

Key among our efforts are the Commission's 2015 proposals focused on liquidity and derivatives. These initiatives are critical: they will position the SEC to better monitor and protect America's investors and the integrity of the industry. And it is our responsibility to promptly finalize these rules, which I expect to move forward on this year.

For an investor, a fundamental feature of a mutual fund is that it will promptly honor a redemption request.^[9] One of the challenges in managing funds is maintaining sufficient liquidity to meet redemptions while also minimizing the impact of redemptions on the fund's remaining shareholders. Last December, when a mutual fund focused on investments in high yield and distressed debt could not meet its redemption obligations, we witnessed a demonstration of the impact on fund investors from an illiquid fund portfolio.^[10] And FSOC and the FSB have been examining how such a risk in open-end funds could also impact the stability of the broader financial system.^[11]

In developing and managing the portfolio of a mutual fund in a changing and competitive environment, funds and their advisers must use all of the tools necessary to effectively fulfill their

legal responsibility to meet shareholder redemptions while minimizing the impact on remaining shareholders. Mutual funds need to be developed and managed in a manner that ensures that this core requirement is met, which includes a consideration of the kinds of products and strategies that are appropriate for mutual fund investments and investors. The SEC has the responsibility to see that this is done.

In September 2015, we therefore proposed rules requiring liquidity risk management programs for open-end funds.^[12] Although commenters have been generally supportive of enhanced liquidity risk management for funds, many expressed concerns about the liquidity classification framework and operational challenges for swing pricing. We appreciated receiving comments from the industry and other interested parties that provided constructive suggestions focused on our shared goal of eliminating the adverse consequences of ineffective liquidity management. This is a critically important area, and I continue to welcome your input as staff works toward finalizing recommendations for these reforms this year.

In December, we proposed another vital rule to enhance the regulation of the use of derivatives by registered investment companies (including mutual funds and ETFs) by limiting the amount of leverage that funds may obtain through use of derivatives and requiring funds to implement derivatives risk management measures.^[13] One core purpose of the Investment Company Act is to protect investors from the potential adverse effects of leveraging a fund's assets, and the Act specifically limits the ability of funds to borrow money or otherwise issue senior securities. The proposed rule would provide an updated and more comprehensive approach to regulating funds' use of derivatives in light of the significant growth in the volume and complexity of derivatives over the past two decades and the increased use of derivatives by certain funds.

There has again been support for the Commission to act to provide an updated and more comprehensive approach to the regulation of a fund's use of derivatives. Many commenters, however, are not in favor of the proposal's portfolio limitations and some have provided a range of suggested modifications and alternatives. Here, too, I continue to welcome your views as staff works to finalize the recommendations on the rulemaking.

A Look Toward the Future

As we build on the significant actions we have already taken and those I expect to come this year, we are also actively engaged in many other areas where important work remains to be done. And that work is a shared responsibility for the Commission and for fund managers and boards. I will first touch on two of the areas where we are taking the initiative – disclosure effectiveness and ETFs –and then highlight some of the other emerging challenges where your role is front and center.

Disclosure Effectiveness in the Fund Industry

One important area we are focused on is whether the disclosure regime for registered funds has evolved sufficiently in response to the changing types of funds and strategies, as well as the evolving needs of investors. Registration is a core regulatory tool that enables the Commission to identify, monitor, and regulate funds and advisers, and the periodic disclosure about their business arrangements, related conflicts, and compliance practices is a key requirement of registration that

provides essential information to investors. The Commission has already taken significant steps to modernize our registered fund disclosure regime, including adopting the summary prospectus to better focus mutual fund investors on the fees and risks of a fund.^[14] But more is needed.

Consequently, as we look forward past 2016, I have directed IM staff to undertake a disclosure effectiveness initiative of their own to consider ways to improve the form, content, and delivery of funds' disclosures. Staff is in the early stages of prioritizing areas of focus, but I expect they will include ways to leverage advances in technology to improve the presentation and delivery of disclosures and ways to enhance disclosure about fund strategies, investments, risks, and fees.

In particular, a fund's disclosure of fees and expenses plays a pivotal role in informing investors about their fund investments. The staff will, for example, consider whether improvements could be made to the fee table to facilitate investor comprehension of the information it presents and whether the most helpful information is required. The SEC's Investor Advisory Committee, at its meeting in April, also recommended that the Commission identify ways to improve mutual fund cost disclosure.^[15] I also encourage you to provide your insights to IM staff.

Other areas of staff focus include how funds can present risks most effectively^[16] and whether the requirement that a fund disclose certain factors that materially affected the fund's performance can be improved.^[17] And there continues to be concern about whether all of the information in a prospectus or statement of additional information continues to be necessary or helpful to investors. The summary prospectus has helped, but the staff is considering whether further improvements could be made.

IM's disclosure effectiveness initiative will seek to aid funds and their managers in preparing their disclosure materials. But do not forget that it is a *fund's* ultimate responsibility to provide investors with the information they need to make informed investment decisions. You should be continuously reevaluating the purpose and value of all of your funds' disclosures. Avoid boilerplate and tailor your disclosure as appropriate for each fund. Ask yourselves regularly: What can I do to improve investors' understanding of the fund's strategies, risks, and costs? These features of your funds change continuously and so should your disclosures.

Need for Further Review of ETFs

Clearer and more robust disclosures are only part of the current and future picture. The SEC's authority and focus go considerably beyond disclosure^[18] and so should your focus and fiduciary decision-making. We regulate funds' practices as well as their disclosures, and certain events over the last decade have sharpened our focus on particular types of funds that we believe require our enhanced attention. ETFs are a prime example, and they are the second challenge for the future of investment company regulation that I want to focus on today.

As you know, the evolution and growth of the ETF industry have been astounding. The number of ETFs has grown from 359 in 2006 to 1,594 in 2015, with a corresponding growth in the amount of net assets from \$408 billion in 2006 to more than \$2 trillion in 2015.^[19] Despite the popularity and broad success of these funds, their history is not without some turbulence. Take, for example, the

May 2010 Flash Crash, which highlighted the need to review disparities in prices for index ETFs and a decline in prices of U.S. equity securities.^[20] Similar issues appeared on August 24, 2015, when the markets again experienced unusual price volatility, including a lack of liquidity in certain securities.^[21]

The staff has been focused on analyzing these events and any broader implications they may have for how we regulate ETFs. They are also analyzing the role that authorized participants and market makers play in the operation and trading of ETFs and how much they impact the liquidity in the markets.^[22] Staff is looking closely at the interconnectedness of the prices of ETF shares and their portfolio holdings and the impact on investors when the ETF's arbitrage mechanism does not function efficiently. And staff is considering the sales practices of broker-dealers in the market and how investors understand and use ETFs, particularly as the product landscape continues to diversify. The SEC has taken a number of initial actions to share our thinking on these issues,^[23] and further regulatory steps beyond additional disclosures may be needed to address some of these issues. I welcome the input of ETFs, investors, and other market participants as we continue to consider the unique and pressing challenges that arise from the ETF structure.

Use of Technology and Service Providers

While the Commission is very actively engaged in enhancing disclosure effectiveness and the regulation of ETFs, there are other emerging challenges that are Commission priorities where your focus, expertise and initiative are particularly essential. One such challenge is the risk in using technology and service providers. This challenge was clearly illustrated for you during the events of August 24th when a fund service provider was unable to timely process system-generated NAV calculations for certain ETFs and mutual funds or to produce current baskets for ETF in-kind creation and redemption orders.^[24] The incident created significant issues for funds and highlighted the challenges that can arise from the technology and interdependencies that drive the modern securities market. It is important that a fund is adequately prepared to promptly and effectively respond to risks that may be triggered by service providers and its own use of technology, including implementing alternative and reliable means to satisfy the fund's regulatory requirements.

Cybersecurity is a particularly critical element of this challenge – as I have said before, it is one of the greatest risks facing the financial services industry. Cyber risks can produce far-reaching impacts, and robust and responsible safeguards for funds and for their investors must be maintained. The Commission has been very active in drawing attention to the issue and examining and enforcing the rules we oversee that relate to cybersecurity.^[25] Our regulatory efforts are focused primarily on ensuring that our registered entities have policies and procedures to address the risks posed to systems and data by cyberattacks. In the asset management space, IM staff issued guidance that discussed a number of measures that funds and advisers should consider.^[26] While no one can prevent all disruptions from cybersecurity events, you should consider the full range of cybersecurity risks to your funds and consider appropriate tools and procedures to prevent breaches, detect attacks and limit harm.

Portfolio Pricing

Another challenge for funds is pricing portfolio holdings and determining per share net asset values (NAV) accurately. Increasingly, funds have acquired portfolio investments that make it difficult to accurately determine their value, especially in a timely manner each day. Many of these portfolio investments may have legal or contractual restrictions on their sale, others may be complex instruments, and still others may not trade that often. As portfolio strategies and permissible investments for a fund are being developed, it is essential that the accurate pricing of the portfolio holdings and NAV calculations are carefully considered. It is also important that the services used to assist funds with pricing do so accurately, in the manner disclosed in the fund's prospectus and consistent with the law. This is of high importance to everyone. I, along with your investors, expect that you will get it right.

Of course, these are not the only challenges for funds. Fund governance is another, as are valuation, performance advertising, and issues that may arise when funds make payments to intermediaries for the distribution of fund shares. I encourage you to continue to work to address these challenges and identify others that may impact your funds and their investors.

Conclusion

With all of the developments in the fund industry that I have discussed today, one thing that has not changed since 1940 is the SEC's duty to ensure that all investors, whether they are investing in mutual funds or other types of investment companies, are protected. The Commission's work over the decades demonstrates how deeply we hold this responsibility, and our current initiatives, while quite consequential, are just the latest example of the agency carrying out its mission.

At the same time, you too bear a weighty responsibility as stewards of the assets of America's investors. While the SEC regulates investment companies, you, as asset management executives, are the standard bearers for your industry and must foster a culture in your organizations that prioritizes responsibility and fairness and asks first – and last – what is in the best interest of investors. As you develop new products and new strategies, your focus should be on helping to ensure that those products and strategies are designed to best meet investors' needs and that America's investors are strongly protected.

Thank you for listening and for all you do, and will do, for your investors.

[1] Securities and Exchange Commission, Report of the Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992), available at <https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf>.

[2] ICI, *Trends in Mutual Fund Investing March 2016*, available at https://www.ici.org/research/stats/trends/trends_03_16.

[3] *Money Market Fund Reform; Amendments to Form PF*, Release No. 33-9616 (Jul. 23, 2014), available at <https://www.sec.gov/rules/final/2014/33-9616.pdf>.

[4] Chair Mary Jo White, Securities and Exchange Commission, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 11, 2014), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370543677722> ("Chair White Dec. 2014 Speech").

- [5] *Investment Company Reporting Modernization*, Release No. 33-9776 (May 20, 2015), available at <https://www.sec.gov/rules/proposed/2015/33-9776.pdf>.
- [6] *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, Release No. 33-9922 (Sep. 22, 2015), available at <https://www.sec.gov/rules/proposed/2015/33-9922.pdf> (“Liquidity Management Proposal”).
- [7] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933 (Dec. 11, 2015), available at <https://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.
- [8] See Chair White Dec. 2014 Speech, *supra* note 4.
- [9] See Section 22(e) of the Investment Company Act.
- [10] *Third Avenue Trust and Third Avenue Management LLC*; Notice of Application and Temporary Order, Release No. IC-31943 (Dec. 16, 2015), available at <http://www.sec.gov/rules/ic/2015/ic-31943.pdf>.
- [11] FSOC, *Notice Seeking Comment on Asset Management Products and Activities*, FSOC-2014-0001 (Dec. 24, 2014), available at <https://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-30255.pdf>; FSOC, *Update on Review of Asset Management Products and Activities* (Apr. 18, 2016), available at <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf>.
- [12] Liquidity Management Proposal, *supra* note 6.
- [13] Derivatives Proposal, *supra* note 7.
- [14] See *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Release No. IC-28584 (Jan. 13, 2009), available at <https://www.sec.gov/rules/final/2009/33-8998.pdf>.
- [15] Securities and Exchange Commission, *Recommendations of the Investor as Purchaser Subcommittee Regarding Mutual Fund Cost Disclosure* (Apr. 14, 2016), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-mf-fee-disclosure-041916.pdf>.
- [16] IM Guidance Update, *Fund Disclosure Reflecting Risks Related to Current Market Conditions*, No. 2016-02, (Mar. 2016), available at <https://www.sec.gov/investment/im-guidance-2016-02.pdf>.
- [17] See Form N-1A, Item 27(b)(7) (requiring that a fund’s (other than a money market fund) annual report to shareholders “discuss the factors that materially affected the Fund’s performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the Fund’s investment adviser.”)
- [18] Chair Mary Jo White, Securities and Exchange Commission, *Chairman’s Address at SEC Speaks - “Beyond Disclosure at the SEC in 2016”* (Feb. 19, 2016), available at <https://www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html>.
- [19] ICI, *Investment Company Fact Book* (2016), available at https://www.ici.org/pdf/2016_factbook.pdf.
- [20] Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, *Preliminary Findings Regarding the Market Events of May 6, 2010* (May 18, 2010), available at <https://www.sec.gov/sec-cftc-prelimreport.pdf>; Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, *Findings Regarding*

Market Events of May 6, 2010 (Sep. 30, 2010), available at <https://www.sec.gov/news/studies/2010/marketevents-report.pdf>.

[21] Division of Trading and Markets, Research Note, *Equity Market Volatility on August 24, 2015* (Dec. 2015), available at https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf ("2015 Research Note"); Chair Mary Jo White, Securities and Exchange Commission, *Opening Remarks to the Investor Advisory Committee* (Oct. 15, 2015), available at <https://www.sec.gov/news/statement/white-investor-advisory-committee-10-15-2105.html> ("Remarks to the Investor Advisory Committee").

[22] Remarks to the Investor Advisory Committee, *supra* note 21.

[23] *Request for Comment on Exchange-Traded Products*, Release No. 34-75165 (Jun. 12, 2015), available at <https://www.sec.gov/rules/other/2015/34-75165.pdf>; 2015 Research Note, *supra* note 21.

[24] See, e.g., BNY Mellon, *Transcript of the BNY Mellon Teleconference Hosted By Gerald Hassell on the Sungard Issue* (Aug. 30, 2015), available at <https://www.bnymellon.com/global-assets/pdf/events/transcript-of-bny-mellon-teleconference-on-sungard-issue.pdf>; Chris Dieterich, Barron's, *BNY Mellon Is Still Having NAV Pricing Problems With Hundreds of Funds* (Aug. 27, 2015), available at <http://blogs.barrons.com/focusonfunds/2015/08/27/bny-mellon-is-still-having-nav-pricing-problems-with-hundreds-of-funds/>.

[25] For example, in March 2014 the SEC hosted a Cybersecurity Roundtable and in 2015, our Office of Compliance Inspections and Examinations ("OCIE") conducted examinations of registrants concerning various cybersecurity issues. See also National Exam Program, Risk Alert: Vol. IV, Issue 8, *OCIE's 2015 Cybersecurity Examination Initiative* (Sep. 15, 2015), available at <https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf>; Regulation Systems Compliance and Integrity, Securities Exchange Act Rel. No. 73639 (Nov. 19, 2014); available at <http://www.sec.gov/rules/final/2014/34-73639.pdf>.

[26] IM Guidance Update, *Cybersecurity Guidance*, No. 2015-02 (Apr. 2015), available at <https://www.sec.gov/investment/im-guidance-2015-02.pdf>.

Modified: May 20, 2016