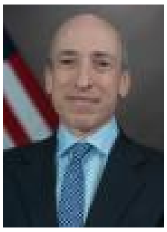
"Bear in the Woods" Remarks before the Investment Company Institute



Chair Gary Gensler

May 25, 2023

Thank you, Jose. As is customary, I'd like to note that my views are my own as Chair of the Securities and Exchange Commission, and I'm not speaking on behalf of my fellow Commissioners or the SEC staff.

Investment Company Act of 1940

There is a saying when you're in the woods. "You don't have to outrun the bear; you just have to outrun one of your fellow campers."

A bit gruesome, yet this helps explain why investors might try to cash out of investments before the proverbial bear—of dilution and illiquidity—catches them.

It also helps explain why savers might try to cash out of deposits before that proverbial bear catches them at the bank.

Bear this in mind, this is not a new feature of finance; it has been around for centuries.

Runs, when otherwise uncorrelated actors suddenly become correlated, have brought down many a financial firm over time. Financial fires at banks and nonbanks alike have led policymakers to put in place laws to prevent such fires and associated runs, as well as to help fire departments contain fires.

The Panic of 1907 ultimately led to President Wilson's reforms to establish the Federal Reserve with authorities both as a regulator and as a form of a fire department.[1]

The 1929 Crash and ensuing Great Depression led President Roosevelt and Congress to set up the Federal Deposit Insurance Corporation[2] and SEC.[3]

When I started at Goldman Sachs, there was lore about how the firm barely survived the crash, in part due to a closed-end fund, Goldman Sachs Trading Corp. Author and journalist William Cohan said it "nearly bankrupted all the investors that invested in it; it was a bit of a Ponzi scheme."[4]

Due to many failures of investment trusts and investment companies, Congress adopted the Investment Company Act and Investment Advisers Act of 1940, also the year the Investment Company Institute was established.[5] Among the abuses that served as a backdrop for the Investment Company Act, were "practices which resulted in substantial dilution of investors' interests."[6]

In advocating for passage of the Acts, SEC Commissioner Robert Healy said, "The functions of investment trusts should be to afford the small investor an opportunity to spread his investment risks by a diversification of security holdings."[7]

Benefits to Investors

Well-regulated collective investment vehicles—as opposed to the failures of the investment trusts of the 1920s and 1930s—are among the great financial innovations of the last 90 years. They provide everyday investors diversification and lower costs than buying individual stocks or bonds. As Jack Bogle aptly said: "Don't look for the needle in the haystack. Just buy the haystack."[8]

Registered investment funds have grown to more than $30 trillion, with more than 16,000 funds.[9] More than half of American households and more than 120 million individual Americans own registered funds.[10] When I started on Wall Street, it was less than 6 percent of households.[11]

There have been significant innovations over the decades. Money market funds came about in the early 1970s.[12] Individual retirement accounts and 401(k)s began investing in mutual funds after the Revenue Act of 1978.[13] Exchange-traded funds (ETFs) brought even lower costs to investors in the 1990s.[14]

Fund Dilution and Liquidity

The 1940 Acts along with SEC rules to implement them addressed the failures of the Depression-era investment funds and have lowered the risk of financial fires spreading from funds. They've done so through fiduciary duty obligations, liquidity requirements, leverage limits, daily net-asset valuations, and pricing rules for sales and redemptions to help guard against dilution.

To be sure, however, risk remains—particularly in times of stress. Money market funds and open-end bond funds, by their design, have a potential liquidity mismatch—between investors' ability to redeem daily on the one hand, and on the other, funds' securities holdings that may have lower liquidity.

Indeed, in 2008 and 2020, sparks emanated from registered funds, particularly money market and open-end bond funds, putting everyday Americans at risk.

In 2008, after one money market fund "broke the buck," the government's fire departments stepped in with extraordinary actions. The Federal Reserve established liquidity facilities, and the Department of the Treasury temporarily guaranteed money market funds.[15]

In response, the SEC sought to address structural issues in these funds through a series of reforms adopted in 2010 and 2014.

At the onset of COVID-19, during the "dash for cash," again there were calls for fire department support both for money market and open-end bond funds—in other words, Federal Reserve support.

I'm not going to name any names, but you in the industry who called the SEC and other agencies know who you are.

The government stepped in yet again to stabilize short-term funding markets, establishing the Money Market Mutual Fund Liquidity Facility[16] and other programs. It also, for the first time, broadened that support to the corporate and municipal bond markets, including through the Secondary Market Corporate Credit Facility[17] and the Municipal Liquidity Facility.[18]

As these real-world events demonstrate, stress on these funds is not unsubstantiated hypothesis.

President's Working Group[19] and Financial Stability Oversight Council[20] reports under several Treasury secretaries and presidents have written about them. The Financial Stability Board has written about them as well.[21]

Liquidity and dilution management has been a bedrock principle of open-end funds since the passing of the Investment Company Act. As Commissioner Healy said in the hearings leading to the Act: "Due to the right of the stockholder to come in and demand a redemption, the [open-end fund] has to keep itself in a very liquid position. That is, it has to be able to turn its securities into money on very short notice."[22]

Recent events are a reminder there is more work to be done. Thus, we've put out proposals intended to address the structural issues and enhance liquidity risk management for both money market and open-end funds.

SEC Proposals

Money Market Funds

Money market funds came about in the 1970s, offering a cash management tool to investors. This was a time when high inflation surpassed Federal Reserve regulations limiting what banks could pay on deposits.[23] Money market funds gave shareholders market-based returns fully backed one to one in the markets.

Money market funds and banks both are involved in the transformation of maturity and liquidity risk. Thus, policymakers over the years have put in place laws and rules to address such risks.

Based on the reforms of the 1940s and subsequent SEC rules, money market funds' assets are valued on a daily basis as well as priced for redeeming and purchasing shareholders.

Money market funds are invested dollar for dollar in readily marketable securities—in essence, a narrow bank concept.

Further, money market funds are invested in instruments with short maturity duration. Subsequent to the SEC reforms adopted in 2014, nearly 80 percent of money market fund assets are in government funds.[24] These funds primarily are invested in and funding the U.S. Treasury and Federal Reserve.

Such money market funds, though, are not without risk. Remember that bear rattling the campers—there still is the risk of runs and resulting dilution. Money market funds also have no capital buffer.

Money market funds now stand at $5.8 trillion. During the last year, when interest rates were rising, we saw an increase of $717 billion in these funds.[25]

Further, given the rise of the digital economy coupled with the higher-rate environment, we might see consequential changes to the deposit and banking landscape. Money market funds could potentially take a greater share.

This is all the more reason to update rules last addressed in 2014 to lower the chance the fire department, the Federal Reserve, has to be called in yet again.

Given the experience of the last nine years, we proposed changing a rule from 2014 that could be procyclical in times of stress. The proposal would prevent money market funds from imposing limits on redemptions in times of stress, such as so-called "gates."

We also proposed enhanced liquidity requirements.

To better address pricing and reduce dilution in times of stress, we proposed so-called swing pricing as well as alternatives regarding liquidity fees. Such swing pricing or liquidity fees would apply only to institutional prime and tax-exempt money market funds, less than 20 percent of the field. These institutional funds invest in bank-issued commercial paper and certificates of deposit, which tend to be illiquid in stress times.

Open-end Funds

Aside from providing investors diversification, open-end funds also provide maturity and liquidity transformation.

Lest we forget, the Federal Reserve in 2020 bought corporate bond ETFs, amongst other actions, to alleviate stresses in the markets. Thus, we've issued proposals regarding the liquidity, pricing, and plumbing of these funds.

First, we proposed updating the 2016 liquidity rule. The proposal would establish minimum standards for liquidity classifications, designed to prevent funds from overestimating the liquidity of their investments.

Second, as to pricing, we put forward a number of alternatives. These alternatives—either within the framework of swing pricing or liquidity fees—are being considered with the goal that redeeming shareholders bear the appropriate costs associated with their redemptions, particularly in times of stress.

Third, as to the plumbing, we proposed to shorten the lag between when investors' orders are placed and when the fund receives those orders. Such lag in the data getting to fund companies can create vulnerabilities; shortening that lag can lessen risk.

Similar Products Overseen by Bank Regulators

Before I close, I want to touch upon two related forms of collective investment vehicles overseen by bank regulators, short-term investment funds and collective investment funds.

Such funds managed by bank trust departments or for certain tax-qualified retirement funds are exempt from SEC oversight.[26]

Short-term investment funds, estimated to total more than $300 billion in assets, operate similarly to money market funds. Collective investment funds are estimated to be $7 trillion, $5 trillion at the federal level and $2 trillion at the state bank level.[27] The Office of the Comptroller of the Currency last substantively revised rules for short-term investment funds in 2012.[28]

Rules for these funds lack limits on illiquid investments and minimum levels of liquid assets. There is no limit on leverage, requirement for regular reporting on holdings to investors, or requirement for an independent board.

We know from history that financial fires can spread from regulatory gaps as well as herding and network interconnectedness. Such gaps include when regulations don't treat like activities alike. Market participants may then seek to arbitrage such differences.

We're in discussions with the bank regulators on these topics.

Conclusion

I hope you can tell from my bear hug of collective investment vehicles that I believe they have really benefited investors. That doesn't mean, though, that we don't need to protect investors from the bear of dilution.

To me, this is about getting back to what Roosevelt and Congress were trying to address in 1940—that funds are liquid to meet redemptions, and valuations appropriately reflect the prices of the underlying portfolio.

We've benefitted from a great deal of feedback on the SEC's proposals. The goal, if adopted, is that the rules help keep investors from getting eaten by the bear and minimize calls for fire department support.

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[1] See "History of Economic Turmoil in the U.S. Part 1 of 3 – The Early Years," available at https://americandeposits.com/history-economic-turmoil-united-states-early-years/.

[2] See Federal Deposit Insurance Corporation, "Historical Timeline," available at https://www.fdic.gov/about/history/timeline/1930s.html.

[3] See Library of Congress, "National Recovery Administration (NRA) and the New Deal: A Resource Guide," available at https://guides.loc.gov/national-recovery-administration/new-deal#:~:text=The%20crash%20led%20to%20Congress,clear%20rules%20of%20honest%20dealing.%22.

[4] See "Goldman Sachs' Long History Of 'Money And Power'" (April 11, 2011), available at https://www.npr.org/2011/04/11/135246269/goldman-sachs-long-history-of-money-and-power.

[5] See Investment Company Institute, "History of the Investment Company Institute," available at https://www.ici.org/ici-history.

[6] See Statement of SEC Commissioner Robert E. Healy before subcommittee of Committee on Banking and Currency on Wagner-Lea Act, S. 2580, to regulate investment trusts and investment companies (April 2, 1940),

at 5, available at https://www.sec.gov/news/speech/1940/040240healy.pdf.
[7] Ibid at 13.

[8] See Paul A. Merriman, "The genius of John Bogle in 9 quotes" (Nov. 25, 2016), available at

https://www.marketwatch.com/story/the-genius-of-john-bogle-in-9-quotes-2016-11-23.

[9] Staff analysis of Form N-CEN filings as of April 2023.

[10] See Investment Company Institute "2023 Investment Company Fact Book" (May 2023), available at https://www.ici.org/system/files/2023-05/2023-factbook.pdf.

[11] See Investment Company Institute, "ICI Research Perspective: Ownership of Mutual Funds and Shareholder Sentiment, 2022" (October 2022), at 1, available at https://www.ici.org/system/files/2022-10/per28-09.pdf.

[12] See Karen Arenson, "Impact of Money Market Funds" (March 6, 1979), available at https://www.nytimes.com/1979/03/06/archives/impact-of-money-market-funds-rapid-growth-could-distort-feds.html.

[13] See Kathleen Elkins, "A brief history of the 401(k), which changed how Americans retire" (Jan. 24, 2017), available at https://www.cnbc.com/2017/01/04/a-brief-history-of-the-401k-which-changed-how-americans-retire.html.

[14] See Bob Pisani, "The first ETF is 30 years old this week. It launched a revolution in low-cost investing," (Jan. 23, 2023), available at "https://www.cnbc.com/2023/01/23/the-first-etf-is-30-years-old-this-week-it-launched-a-revolution-in-low-cost-investing.html.

[15] See Financial Stability Oversight Council, "Annual Report" (December 16, 2022), available at https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf.

[16] See Federal Reserve, "Money Market Mutual Fund Liquidity Facility," available at (https://www.federalreserve.gov/monetarypolicy/mmlf.htm.

[17] See Federal Reserve, "Secondary Market Corporate Credit Facility," available at https://www.federalreserve.gov/monetarypolicy/smccf.htm.

[18] See Federal Reserve, "Municipal Liquidity Facility," available at https://www.federalreserve.gov/monetarypolicy/muni.htm.

[19] See "President's Working Group on Financial Markets Releases Report on Money Market Funds" (Dec. 22, 2020), available at https://home.treasury.gov/news/press-releases/sm1219.

[20] See Gary Gensler, "Money Market Funds Statement" (June 11, 2021), available at https://www.sec.gov/news/public-statement/gensler-fsoc-money-market-funds-2021-06-11.

[21] See "FSB publishes final report with policy proposals to enhance money market fund resilience" (Oct. 11, 2021), available at https://www.fsb.org/2021/10/fsb-publishes-final-report-with-policy-proposals-to-enhance-money-market-fund-resilience/ to-enhance-money-market-fund-resilience/.

[22] See Investment Trusts and Investment Companies: Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 112 (1940), at 57 (Statement of Robert E. Healy). The SEC said in a report in 1942: "Open-end investment companies, because of their security holders' right to compel redemption of their shares by the company at any time, are compelled to invest their funds predominantly in readily marketable securities." See Investment Trusts and Investment Companies: Report of the Securities and Exchange Commission (1942), at 76.

[23] During the 1970s, the Federal Reserve Regulation Q limit ranged from 4.75 percent to 5.25 percent, while three-month Treasury bill rates rose to exceed 14 percent. See R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away" (February 1986), available at https://files.stlouisfed.org/files/htdocs/publications/review/86/02/Requiem_Feb1986.pdf. See also "The 1970s:

New Inflation High Interest Rates, and New Competition" (1991) available at https://fraser.stlouisfed.org/files/docs/publications/ERP/pages/6688_1990-1994.pdf.

[24] Based on Form N-MFP data (77 percent).

[25] Per Form N-MFP filings.

[26] 3(c)(3) and 3(c)(11) of the Investment Company Act.

[27] Estimates are based on SEC staff analysis of data from FFIEC Call Reports, Morningstar, Brightscope, and other industry reporting.

[28] 12 CFR § 9.18.