IDC Independent Directors Council
Promoting Excellence in Fund Governance

# General Counsel's Address, 2019 Mutual Funds and Investment Management Conference

## General Counsel's Address
## 2019 Mutual Funds and Investment Management Conference

**Susan Olson**
**General Counsel**
**Investment Company Institute**

**San Diego**
**March 18, 2019**

*As prepared for delivery.*

Good morning, everyone—thank you so much for joining us!

This is somehow my third visit to San Diego in the past six months. But you can never get too much of a great city, can you? So I'm happy to be back again, and so glad you all could make it.

As Laura [Merianos, principal at Vanguard] said, we have a super three days ahead of us. So how about another big hand for all the folks who helped put it all together? ICI's Law and Conferences teams, our speakers and panelists, our sponsors—really, it's their many invaluable contributions that make this conference go.

You know, I got to thinking recently. From a regulatory standpoint, funds and their shareholders are in a pretty good place right now—a great place, even.

Since this conference last met, a productive SEC and staff have made major headway on an ambitious agenda in the registered fund space—advancing a wide range of initiatives that promise long-term benefits for our shareholders.

They've been getting so much done. But just as encouraging as the progress they've made is the approach that has guided most of their work.

Enterprising and forward-thinking—with an eye on fostering our industry's drive to innovate, on ensuring that we can continue to serve our shareholders as technology and investing evolve.

It's a practical approach—committed to seeking out the insights of professionals with on-the-ground experience and specialized expertise.

And flexible, too—open to fine-tuning ideas that haven't fared as well in practice as they might have looked on paper.

Most of all, the approach has been precise—thorough enough to yield meaningful reforms, yet careful enough to preserve our industry's enduring strengths.

That last one—thorough yet careful—that's a tricky, delicate balance. And in the coming months—as the SEC works to pull together some of the inconsistent, patchwork regulatory regimes that still govern parts of our industry—its commitment to striking that balance will be put to a tough test.

The question is, can the SEC strike that balance?

Can it advance more coherent rules to replace the provisions, exceptions, orders, and letters that have accumulated over decades—without sacrificing what works for fund shareholders?

Well, three proposals can help shed some light on the situation: one is nearing completion, another was just recently released, and a third is still in the offing.

So let's talk about them.

With the first one—last summer's proposal to modernize the ETF [exchange-traded fund] regulatory framework—the Commission has demonstrated just how constructive this kind of endeavor can be.

Under the current framework, similar ETFs must comply with varying conditions, and some ETFs enjoy advantages that others don't.

The Commission's proposal brings the framework into parity. It standardizes a stack of more than 300 individual exemptive orders, with a rule that would allow nearly all ETFs to operate without having to obtain them.

And the benefits are easy to see.

Creating a fairer, more competitive market—and lowering the barriers to enter it. Saving firms the time and expense of applying for exemptive relief—and freeing up the SEC staff who review those applications to focus on other priorities.

All big benefits. Long needed, too.

But the proposal's greatest strength is that it provides these benefits without jeopardizing ETFs' long-term value.

When it's adopted, ETFs won't have to conform to burdensome or unfamiliar conditions. They won't have to reorganize themselves or revamp their investment strategies.

Put simply, the proposal rationalizes the ETF regulatory framework, while preserving everything about the exemptive orders that fostered the creation and evolution of ETFs, and that have made them so valuable for their shareholders.

Now that's striking a balance.

But no one said that striking this balance would be easy. And we can see just how difficult it is with the SEC's latest effort in this area—a proposal to streamline and enhance the regulatory framework for fund-of-fund arrangements.

Of course just like ETFs, fund-of-fund arrangements operate under a patchwork regulatory framework. Only here, it's driven not solely by exemptive orders—but by a mix of the statute, rules, orders, and guidance.

And like the ETF proposal, this one seeks to make the framework clearer and more coherent, save firms the time and expense of applying for relief, and free up SEC staff resources.

It could impart all those benefits. But—unlike with the ETF proposal—those benefits come at a cost.

Because to realize them, the proposal would alter many types of fund-of-fund arrangements lawfully and successfully operating today.

It would drop some conditions that current fund-of-fund arrangements rely on, and add some conditions we've never seen before. Some of the new conditions are quite onerous, yet without evidence to explain their presence.

This would force many fund-of-fund arrangements to either restructure or unwind—even well-established and highly successful ones.

Perhaps the most troubling of the conditions—a brand-new one not tested or found in the statute or in any rule or exemptive order—would prohibit a fund from redeeming more than 3 percent of another fund's shares in any 30-day period.

This one's tough.

Some funds do own more than 3 percent of another fund's shares. And at times they redeem more than 3 percent of another fund's shares during a month—as part of managing flows or rebalancing portfolios.

Limiting and adding complexity to funds' ability to perform those tasks would hinder their ability to most efficiently and effectively serve their shareholders, and depress the appeal of fund-of-fund arrangements.

But that's not all.

Smaller mutual funds would be at an even greater disadvantage—because their 3 percent limit would be easier to reach, likely discouraging other funds from investing in them.

It's puzzling, really.

These limits suggest concern about funds' ability to manage liquidity and meet redemptions, but isn't that exactly what the Commission addressed in the years it spent crafting its liquidity risk management rule?

So it seems what we have here is a good plan that needs some work. It aspires to be comprehensive, yet overcorrects. It solves some problems, yet creates new ones. It seeks to level the playing field, yet tilts the playing field in another direction.

We're confident that—as the SEC staff works to refine the proposal—it will carefully consider the many comments it receives.

Taken together, the ETF and fund-of-funds proposals are instructive. They present a model and a caution for another proposal we expect to see in the fall.

A proposal—or re-proposal, I should say—to modernize how the Commission regulates funds' use of derivatives.

You'll recall that back in 2015, the SEC proposed a rule to do just that—by consolidating the hodgepodge of guidance, no-action letters, and informal staff comments that funds have been relying on in this area for the past 35 years.

It was deeply flawed though—not least because of the strict limits it would have imposed on the notional exposure that funds can obtain through derivatives transactions.

These portfolio limits would have forced hundreds of funds to deregister or substantially alter their investment strategy—and hobbled funds' ability to use derivatives in the many ways they can benefit fund shareholders.

Like managing risks, enhancing liquidity, accessing hard-to-reach asset classes, equitizing cash, and lowering costs—just to name a few.

If the re-proposal is to succeed—if it is to truly streamline the regulatory framework for funds' use of derivatives—the SEC must, at a minimum, fully preserve the benefits that derivatives can provide.

It must be said that these patchwork regulatory regimes—for all the complexities they can create—they do play a positive role. An essential one at that.

Over the years, they've enabled the development of new products—investment solutions—for investors. Innovations that couldn't have been foreseen.

They've provided the SEC with invaluable data and experience regulating these products that can inform rulemakings—that can inform how best to approach the next big idea.

Indeed, one of the '40 Act's greatest strengths is the authority it gives the Commission to promote innovation. Were it not for that authority, some very good ideas might never have come to fruition.

When thinking about these proposals, it's important to remember that the products they're targeting aren't just narrow slices of our industry.

Quite the opposite, actually. ETFs, funds of funds, and funds using derivatives make up a major cross-section of it.

ETFs have enjoyed massive growth, and now manage about $3.6 trillion in assets—more than 100 times the amount they were less than 20 years ago.

Nearly half of all registered funds invest in other funds—as do nearly all target date funds, an essential option for retirement saving.

And fund managers are looking more than ever to derivatives as a means of capturing the wide range of benefits I just mentioned.

These funds have an integral role in upholding our fundamental value proposition—in providing everyday investors with low-cost access to professionally managed, diversified portfolios and investment solutions. A way into markets and strategies they couldn't enter otherwise.

At least 100 million people count on us to sustain this proposition. And that—more than anything—is why it's so important to get these proposals right.

Thank you so much.

---