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STATEMENT

OF

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BEFORE THE

US HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

ON

EMPOWERING A PRO-GROWTH ECONOMY BY CUTTING TAXES AND REGULATORY RED TAPE

JUNE 20, 2018

EXECUTIVE SUMMARY

- ICI's registered fund members are the investment vehicle of choice for more than 100 million Americans seeking to save for retirement or achieve other important financial goals. Their success in achieving these goals depends on a strong economy, fueled by continued innovation and healthy capital markets.

- A more rational approach to regulatory policy can help to empower a pro-growth economy. My testimony offers three suggestions:

    - Policymakers should endeavor to strike the right regulatory balance, so that registered funds can continue to serve the interests of fund investors while also contributing to economic growth.

    - Regulators should examine ways to improve the public capital markets for companies and their investors.

    - Congress should enact legislation to strengthen the competitive position of US mutual funds in the global fund marketplace.

Striking the Right Regulatory Balance for Registered Funds

- The success of the registered fund industry—as reflected in the $21.8 trillion in assets we manage for fund shareholders—depends on sound regulation. Yet the run-up in regulatory activity for the financial sector highlights the need to strike the right regulatory balance if regulation is to succeed in promoting economic growth, innovation, strong and competitive markets, and job creation.

- Unnecessary or inappropriate regulation, or regulation based on faulty analysis, can be harmful for registered funds, their shareholders, and the capital markets. My testimony discusses two examples: our concerns with the Financial Stability Oversight Council's exercise of its authority to designate nonbank financial companies as systemically important financial institutions, and experience with the Department of Labor fiduciary rule.

- Overly broad or prescriptive regulation likewise has unjustified costs. My testimony highlights our serious concerns with certain aspects of the liquidity risk management rule adopted by the Securities and Exchange Commission.

- Even appropriately designed regulation involves costs and burdens, which are cumulative. Continued "piling on" of new regulatory requirements in an ultra-competitive industry can make it no longer economically viable for smaller or mid-sized firms to stay in, or enter, the mutual fund business. Due to regulatory costs and other forces, consolidation within the fund industry already is occurring—a trend that reduces investor choice.

Examining Participation in the Public Capital Markets

- Vibrant public markets lie at the core of healthy capital markets, but data indicate that our public markets are increasingly less attractive than private markets. This has serious negative implications for investors and the broader economy.

- Various factors influence the decision of whether to go public, but we must not overlook the role of regulation in this analysis. The SEC, for example, is studying the feasibility of streamlining the regulatory process for becoming a public company (or continuing as one) without sacrificing investor protections.

- We urge the Committee's support for this and other regulatory efforts to increase the attractiveness of public capital markets without reducing the availability of capital in private markets.

Strengthening the Competitive Position of US Mutual Funds in the Global Fund Marketplace

- Despite the advantages that US mutual funds would offer to retail investors outside the United States, virtually no US mutual fund is offered or marketed to non-US investors. This is because distributions from US funds can cause foreign investors to incur home-country tax that would not be due, or that would be charged at a lower rate, if they invested instead in a foreign fund. This disparate tax treatment is the reason that US-domiciled mutual funds are not currently an "exportable" investment product.

- ICI urges Congress to pass H.R. 4204, the International Regulated Investment Company Act of 2017, to enable US-domiciled mutual funds to attract a greater share of worldwide investment assets and, in turn, generate additional jobs for US workers.

- Importantly, the Joint Committee on Taxation has determined that the changes envisioned by H.R. 4204 would have a "negligible effect" on federal revenues.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute (ICI).[1] Thank you, Chairman Hensarling, Ranking Member Waters, and members of the Committee for inviting me to testify. I am pleased to appear today to share my views on how a more rational approach to regulatory policy can help to empower a pro-growth economy.

ICI's fund members are the investment vehicle of choice for more than 100 million Americans seeking to save for retirement or achieve other important financial goals.[2] Ultimately, their success in achieving these goals depends on a strong economy, fueled by continued innovation and growth. Speaking in October 2016 to the American Chamber of Commerce in Japan, I highlighted the importance of robust economic growth.[3] That remains just as true today: economic growth is key to achieving wealth and prosperity for individuals, families, communities and nations.

Greater economic growth cannot be achieved without robust capital markets, in which registered funds are major participants. Registered funds channel and allocate investors' capital to businesses of all kinds, helping to finance their operations, research and development, innovation, and growth in employment.

The US capital markets are widely recognized as being the fairest, most efficient and most competitive in the world. But we must not take for granted that our markets will remain that way. We need to foster and maintain conditions necessary to ensure that our capital markets are as efficient, productive, and innovative as possible.

Our continued pursuit of economic success must not overlook the role properly-tailored regulation plays in creating a healthy, growing economy. Capital markets and their participants flourish in a regulatory environment where requirements are calibrated to address demonstrated problems. Overly broad or prescriptive regulation, in contrast, can stifle growth and competition. Section II of my

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States (registered funds), and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.8 trillion in the United States, serving more than 100 million US shareholders, and US$7.6 trillion in assets in other jurisdictions.

[2] *See* Holden, Schrass, and Bogdan, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2017," *ICI Research Perspective* 23, no. 7 (October 2017), *available at* www.ici.org/pdf/per23-07.pdf; and Holden, Schrass, and Bogdan, "Characteristics of Mutual Fund Investors, 2017," *ICI Research Perspective* 23, no. 8 (October 2017), *available at* www.ici.org/pdf/per23-08.pdf.

[3] *Enough Already: Is Post-Crisis Financial Reform Going Too Far?,* Paul Schott Stevens, President and CEO, ICI (Oct. 19, 2016), *available at* https://www.ici.org/pressroom/speeches/16_pss_japan_finreg.

testimony highlights examples illustrating the importance of striking the right regulatory balance from the perspective ICI knows best—the regulations affecting registered funds and their managers.

Maintaining robust capital markets in the United States also requires addressing a troubling trend—the long-term decline in the number of US-listed companies. As explained in Section III of my testimony, the fact that fewer companies are choosing to participate in the public capital markets (or may be delaying their participation) limits opportunities for individuals and families to reap the benefits of investment in promising new companies. Given these stakes, we urge the Committee to support regulatory efforts to increase the attractiveness of public markets without diminishing the vitality of private markets.

Finally, policies that place US companies on a more competitive footing in markets outside the United States can translate to higher revenues and more jobs at home. Section IV of my testimony describes pending legislation that would facilitate foreign investment in US mutual funds, allowing fund managers to increase their assets under management (and hence their revenues) while foregoing the potentially high costs of establishing operations overseas.

II. STRIKING THE RIGHT REGULATORY BALANCE FOR REGISTERED FUNDS

Registered funds view regulation as a necessary component for building and sustaining the confidence of their millions of investors. The US fund industry has prospered for more than 75 years under a comprehensive framework of laws and regulations administered by the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 and other federal securities laws. The success of our industry—as reflected in the $21.8 trillion in assets we manage for over 100 million shareholders—depends on sound regulation.

In the past decade, however, we have seen a run-up in regulatory activity for the financial sector that is unprecedented in its pace, reach, and complexity. Some of these measures were vitally needed to address weaknesses revealed by the global financial crisis and to put the financial system on a stronger footing. Other regulatory initiatives, however, did not adhere sufficiently to principles of sound regulation, which in our view include the need to:

(1) clearly identify a problem that necessitates a regulatory solution;

(2) appropriately tailor that solution to address the problem while minimizing harm to efficiencies and competition; and

(3) ensure that the benefits of that regulatory solution outweigh its costs.

Striking the right regulatory balance is essential if regulation is to succeed in promoting economic growth, innovation, strong and competitive markets, and job creation—goals that current and past

Administrations have shared.[4] While important for all financial market participants, the need for regulatory balance is especially acute for registered funds. Investors in US funds are overwhelmingly retail investors—individual Americans saving to meet goals such as retirement, paying for education, or purchasing a home—and they bear the costs of regulation through reduced investment returns.[5] Regulatory costs also fall on the firms that sponsor or manage registered funds. These costs have a disproportionate impact on smaller firms.

We appreciate the Committee's focus on how to strike the right regulatory balance. The three subsections that follow illustrate the perils of failure to do so, using examples drawn from recent experience. We discuss the consequences of: (1) unnecessary or inappropriate regulation, or regulation based on faulty analysis; (2) overly broad or prescriptive regulation; and (3) the cumulative costs of regulation.

Unnecessary or Inappropriate Regulation or Regulation Based on Faulty Analysis

Two recent examples illustrate how regulation that is unnecessary or inappropriate, or that is based on faulty analysis, can be harmful for registered funds, their investors and the capital markets. Both involve areas with which the Committee is quite familiar: first, the Financial Stability Oversight Council (FSOC) and its process for designating nonbank financial companies as systemically important financial institutions (SIFIs); and second, the Department of Labor (DOL) fiduciary rulemaking.

FSOC Reform

ICI and its members long have been concerned about the prospect of regulation that is not grounded in demonstrable evidence of need or sound policy analysis emanating from FSOC's exercise of its authority under Section 113 of the Dodd-Frank Act to designate nonbank financial companies as SIFIs. More precisely, our concern is the potential designation of a registered fund or fund manager, which

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[4] *See* Executive Order 13772, *Core Principles for Regulating the United States Financial System* (February 3, 2017), 82 Fed. Reg. 9965 (February 8, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-02-08/pdf/2017-02762.pdf (establishing core principles to regulate the financial system, one of which is to "foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry"); Executive Order No. 13563, *Improving Regulation and Regulatory Review* (January 18, 2011), 76 Fed. Reg. 3821 (January 21, 2011), *available at* https://www.gpo.gov/fdsys/pkg/FR-2011-01-21/pdf/2011-1385.pdf (stating that "[o]ur regulatory system must … promot[e] economic growth, innovation, competitiveness, and job creation…[and] identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends."); Executive Order 12866, *Regulatory Planning and Review* (Sept. 30, 1993), 58 Fed. Reg. 51735 (October 4, 1993) *available at* https://www.archives.gov/files/federal-register/executive-orders/pdf/12866.pdf (providing that "[t] he American people deserve a regulatory system that works for them, not against them…regulatory policies that recognize that the private sector and private markets are the best engine for economic growth").

[5] As of mid-2017, the median income of mutual fund investors was $100,000. Investment Company Institute, *2018 Investment Company Fact Book* (2018) at 147; *available at* www.ici.org/pdf/2018_factbook.pdf.

would then become subject to prudential regulation and supervision by the Federal Reserve Board (Federal Reserve).

We repeatedly have cautioned that FSOC, in the name of promoting financial stability, could seek to exercise this authority in a manner broader than Congress intended, sweeping beyond any demonstrably "systemic" risks.[6] This certainly would be the case if FSOC determined to proceed with the designation of a registered fund or fund manager. Registered funds don't fail like banks do—fund investors bear any investment losses, so there's no need for a government bailout. Unlike banks, fund managers act solely as agents, providing investment services to a fund by contract. And, the registered fund structure and comprehensive regulation of funds and their managers under the securities laws already limit risks and risk transmission.

Testifying before this Committee four years ago, ICI's then-Chairman William McNabb of the Vanguard Group pointed to press reports that FSOC was evaluating two large asset management firms for possible designation. He warned:

> If the FSOC continues down this path, it could result in extension of the Federal Reserve's supervisory authority to companies whose business is rooted in the capital markets and which the Federal Reserve does not have the expertise to regulate. And it could mean the application of bank regulatory standards that are entirely out of keeping with the way in which [registered] funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.[7]

While the prospect of such an ill-suited designation does not currently loom as large as it did in 2014, it remains vitally important that Congress act now to make needed changes to FSOC's SIFI designation authority. Such reforms should underscore that FSOC's primary goal is to reduce systemic risk, not to designate nonbank financial companies as SIFIs for the Federal Reserve to regulate.

We commend the Committee for its leadership in this area. Legislation introduced by Committee members Dennis Ross (R-FL) and John Delaney (D-MD)—H.R. 4061, the FSOC Improvement Act—was approved by the Committee earlier this year on a 45-10 vote and subsequently passed by the full House, likewise with bipartisan support. The legislation seeks to make the SIFI designation process more accountable and transparent, and to ensure that the designation of a nonbank financial company

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[6] *See, e.g.,* Statement of Paul Schott Stevens, President and CEO, ICI, Before the US Senate Committee on Banking, Housing and Urban Affairs, Regarding FSOC Accountability: Nonbank Designations (March 25, 2015), *available at* https://www.ici.org/pdf/15_senate_fsoc.pdf.

[7] *See* Statement of F. William McNabb III, Chairman and CEO, The Vanguard Group, and Chairman, ICI, on Examining the Dangers of the FSOC's Designation Process and Its Impact on the US Financial System ((May 20, 2014) at 2, *available at* https://www.ici.org/pdf/14_house_fsoc.pdf. The testimony highlights several ways in which registered funds and their managers are fundamentally different from banks. It explains why SIFI designation of a fund manager is unwarranted and why even the very largest registered funds likewise are not SIFIs. And it discusses the investor harm and market distortion that would stem from such a SIFI designation.

as a SIFI occurs only when identified risks to financial stability cannot be addressed more effectively by the company's primary regulator or action by the company itself.

H.R. 4061 represents a reasonable, bipartisan approach to improving the SIFI designation process and enhancing FSOC's ability to mitigate systemic risk. But there may be other ways to achieve these same goals. We accordingly encourage Chairman Hensarling and other Committee members to continue to work with colleagues in the Senate to reach agreement on an appropriate legislative solution.[8]

DOL Fiduciary Rule

For a cautionary tale about how *not* to make sound regulation, one need only consider the experience of the "DOL fiduciary rule"—a rulemaking by the Department of Labor to redefine the term "fiduciary" in the context of providing investment advice under the Employee Retirement Income Security Act of 1974 (ERISA).

Promoting retirement security and preserving investment choices for all Americans are important policy priorities for ICI and its members. The mutual fund industry is especially attuned to the needs of retirement savers because mutual funds hold about half of retirement assets in defined contribution (DC) plans and individual retirement accounts (IRAs).[9] ICI has engaged extensively with DOL and other stakeholders on the DOL fiduciary rule from the time it was first proposed.[10] And we greatly

[8] In the meantime, ICI has urged FSOC to implement (preferably by codifying in rules) the recommendations set forth in the November 2017 Treasury report on the nonbank SIFI designation process. *See* US Department of the Treasury, *Financial Stability Oversight Council Designations* (November 17, 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf.

[9] At year-end 2017, US retirement assets totaled $28.2 trillion, DC plan assets were $7.7 trillion, and IRA assets were $9.2 trillion. Investors held $4.3 trillion of IRA assets and $4.5 trillion of DC plan assets in mutual funds. *See* Investment Company Institute, *The US Retirement Market, Fourth Quarter 2017* (April 2018), *available at* https://www.ici.org/research/stats/retirement.

[10] ICI submitted a comment letter in response to DOL's 2010 proposal and four separate letters responding to the DOL's 2015 proposal. ICI also testified at the DOL's August 2015 public hearing regarding the rulemaking. ICI submitted five letters in 2017, each responding to the DOL's requests for comment. *See, e.g.*, Letter from Dorothy Donohue, Acting General Counsel, and David Abbey, Deputy General Counsel, ICI to The Office of Exemption Determinations, Employee Benefits Security Administration, DOL, dated August 7, 2017, *available at* https://www.ici.org/pdf/17_ici_rfiresponse_ltr.pdf (responding to the DOL's July 2017 request for information regarding potential changes to the final regulation and prohibited transaction exemptions); *see also* Letter from Brian Reid, Chief Economist, and David Blass, General Counsel, ICI, to Office of Regulations and Interpretations, Employee Benefits Security Administration, DOL, dated April 17, 2017, *available at* https://www.ici.org/pdf/17_ici_dol_fiduciary_reexamination_ltr.pdf (responding to the DOL's request for input regarding the re-examination of the fiduciary rulemaking as directed by the February 3, 2017 White House memorandum to the Secretary of Labor).

appreciate that this Committee has paid close attention to the implications of this rulemaking for the millions of Americans seeking to save for retirement.[11]

ICI fully supports the principle underlying the DOL fiduciary rule—that financial professionals should act in the best interests of their clients when they offer personalized investment advice. But the rule adopted by DOL in 2016 was seriously misguided—so much so that the mere prospect of the rule's application caused dislocation and disruption within the financial services industry, to the detriment of retirement savers.

The Fifth Circuit Court of Appeals recently vacated the DOL rule.[12] Nonetheless, many of the harmful effects that ICI and others had predicted—including that the rule would significantly limit the ability of retirement savers to obtain the guidance, products, and services they need to meet their financial goals—had already come to pass.[13] The rule's overbroad and convoluted fiduciary definition turned investors' routine inquiries into fiduciary relationships, thus threatening to severely reduce exchanges of information that historically were provided at no cost to millions of retirement savers through call centers, walk-in centers, and websites. Many financial professionals serving retirement investors concluded that the Best Interest Contract or "BIC" exemption was unworkable or too burdensome to continue to offer certain products and services. According to media reports, some firms concluded that they simply could not justify the potential risk and liability, including the substantial threat of unwarranted litigation, for certain types of accounts.

In many instances, intermediary partners informed ICI members that they would no longer service certain account holders deemed undesirable or uneconomic in light of the rule, leaving those account

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[11] *See, e.g.*, House Financial Services Committee, Subcommittee on Capital Markets and Government-Sponsored Enterprises and Subcommittee on Oversight and Investigations, Hearing on Preserving Retirement Security and Investment Choices for All Americans (September 10, 2015), *available at* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=399634. At that hearing, I testified about the harmful effects of the DOL's proposed fiduciary rule and the why the DOL's RIA did not support the proposed rule. *See* Statement of Paul Schott Stevens, President and CEO, ICI, on Preserving Retirement Security and Investment Choices for All Americans (September 10, 2015), *available at* https://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-ba09-wstate-pstevens-20150910.pdf.

[12] The court's opinion was highly critical of the DOL rulemaking, echoing concerns expressed by ICI and other stakeholders. According to the court, the DOL's "interpretation of 'investment advice fiduciary' fatally conflicts with the statutory text and contemporary understandings." The court observed that "[h]ad Congress intended to abrogate both the cornerstone of fiduciary status—the relationship of trust and confidence—and the widely shared understanding that financial salespeople are not fiduciaries absent that special relationship, one would reasonably expect Congress to say so." The court further found that the DOL abused its exemptive authority, exploiting its "narrow exemptive power in order to 'cure' the Rule's overbroad interpretation of the 'investment advice fiduciary provision.'" And, the court opined that "[r]ather than infringing on SEC turf, DOL ought to have deferred to Congress's very specific Dodd-Frank delegations and conferred with and supported SEC practices to assist IRA and all other individual investors." US Chamber of Commerce v. Department of Labor, No. 17-10238, 2018 WL 1325019 (5th Cir. Mar. 15, 2018), available at http://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf.

[13] For a more complete description of these and other harms, *see* Letter from Brian Reid and David Blass, *supra* n. 10.

holders "orphaned."[14] Members indicated that, depending on the outcome of the rule, they expected the volume of orphaned accounts to increase and that a significant increase could affect their ability to service shareholders.[15] The unfortunate result was an "advice gap" for savers, especially those with small account balances.

How did a well-intended idea—providing advice in the best interest of investors—result in such negative outcomes? The weaknesses in the rulemaking stem primarily from a severely flawed regulatory impact analysis (RIA). The DOL's RIA did not serve as a tool to understand a problem and determine the best solution. Rather, the DOL started with a predetermined agenda of eliminating perceived "conflicts" in the retirement marketplace and used the 2016 RIA to justify that effort. The result was an impact analysis that focused on claims supporting the DOL's narrative and summarily dismissed facts raising contrary conclusions about that narrative.

Compounding these shortcomings was a plainly inadequate understanding of the marketplace and the workings of financial intermediaries. Not only did the 2016 RIA fail to address adequately the harms of the rule, but also the DOL based its conclusions on a limited review of the market and then misapplied the academic studies upon which it relied. As a result, the RIA drastically overstated any potential benefits of the rule. In contrast, ICI's analysis showed that the rule would bring an estimated $109 billion in financial harm to retirement savers.[16]

The DOL's lack of enforcement authority over individual retirement accounts also contributed to the rule's flaws, leading the DOL to adopt a bootstrap approach for enforcement—using the BIC exemption's written contract and warranty requirements to create a private right of action and relying on the plaintiff's bar as a means of enforcement. Further, because of the boundaries of the DOL's regulatory authority, application of the DOL rule necessarily was limited to retirement accounts.

We are encouraged that the SEC now is taking the lead on this important issue[17] and is coordinating with the DOL, as ICI has advocated.[18] As the primary federal regulator of both broker-dealers and investment advisers, the SEC is the right agency to determine and enforce an appropriate standard of conduct that will serve the interests of retail investors when they receive recommendations from

[14] When an intermediary resigns as broker-dealer of record, the abandoned account remains invested in the mutual fund but without a designated intermediary to provide ongoing investment recommendations to the account holder.

[15] Based on available information, we surmised that the number of orphaned accounts likely would run into the hundreds of thousands.

[16] *See, e.g.,* Statement of Paul Schott Stevens, *supra* n. 11, at 23-26.

[17] *Regulation Best Interest*, 83 Fed. Reg. 21574 (May 9, 2018); *Form CRS Relationship Summary*, 83 Fed. Reg. 21416 (May 9, 2018); *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 83 Fed. Reg. 21243 (May 9, 2018). ICI is reviewing the details of the SEC's proposal and will file formal comments by the August 7, 2018 deadline.

[18] *See* Letter from Dorothy Donohue, Acting General Counsel, ICI, to Jay Clayton, Chairman, SEC, dated Aug. 7, 2017, *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2188873-160255.pdf; Letter from Dorothy Donohue and David Abbey, *supra* n. 10.

financial intermediaries, regardless of whether they are investing for retirement or other important financial goals.

Overly Broad or Prescriptive Regulation

The regulatory framework for registered funds was almost 75 years old and had proved its worth many times over when, in December 2014, former SEC Chair Mary Jo White announced plans to strengthen further the SEC's regulation of the asset management industry.[19] ICI expressed its support for Chair White's initiative, pointing to the SEC's expertise and authority as the primary regulator for funds and their managers.[20] Yet, experience to date with one of the rules the SEC adopted as part of this effort—the liquidity risk management rule[21]—shows that even when the expert primary regulator is in charge, issues of regulatory imbalance can arise.

As daily redeemability is a defining feature of mutual funds, ICI supports requiring funds to have formal written liquidity risk management programs overseen by fund boards of directors. The industry has a long history of success in managing fund liquidity, yet there is merit to "raising the bar" for all funds. ICI also fully supports the rule's 15 percent limit on fund investments in illiquid investments and required reporting to the SEC and fund board when a fund exceeds this limit. But the SEC's liquidity framework goes much further, dictating that funds use a standard approach to classify the liquidity of each portfolio holding at least monthly (the so-called "bucketing" requirements) and a uniform means of reporting the liquidity of each portfolio holding. The bucketing requirements make an otherwise useful rule both too broad and too prescriptive, and this has real costs.

Indeed, since adoption of the final rule, the bucketing requirements have proven to be by far the most costly and vexing element to implement.[22] A September 2017 ICI survey showed that:

- For most firms, bucketing requirements are expected to account for more than half of initial compliance costs;
- 35 percent of respondents anticipated spending more than *$1 million* in initial costs to comply with the bucketing requirements;

[19] Speech by Mary Jo White, Chair, SEC, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (December 11, 2014), *available at* https://www.sec.gov/news/speech/2014-spch121114mjw.

[20] *See* ICI Statement on SEC Chair White's Speech on Asset Management (December 11, 2014), *available at* https://www.ici.org/pressroom/news/14_news_white_speech.

[21] *Investment Company Liquidity Risk Management Programs*, 81 Fed. Reg. 82142 (November 18, 2016); *see also Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs*, 83 Fed. Reg. 8342 (Feb. 27, 2018).

[22] In classifying each portfolio holding, funds must consider a range of complex and interrelated fund-, market-, trading-, and investment-specific factors and make judgment calls. At the time the rule was adopted, systems to allow funds to synthesize this disparate information and generate uniform outputs for a wide array of fund investments did not exist. Fund complexes and third parties have invested significant time and money to build such rule-compliant systems.

- Most firms expect bucketing requirements to account for more than half of annual ongoing compliance costs; and
- 56 percent of respondents anticipated spending more than *$500,000* each year thereafter to comply with these requirements.[23]

Costs such as these fall heaviest on small and medium-size fund complexes, which already face brutal competition for investor dollars in a fast-changing marketplace for funds and fund distribution. It has been especially disturbing to hear from ICI member firms that this "bucketing" is *nothing more and nothing less than a compliance drill*. They will do what they must to comply with the bucketing requirements, but these efforts are completely separate from, and will not affect or enhance how the firms actually manage, fund portfolio liquidity. In sum, when it comes to costs, the buckets are sure to overflow. But when it comes to benefits to funds, their investors, the capital markets, and the SEC, the buckets will come up nearly empty.

In addition to requiring funds to report investment-specific bucketing information to the SEC monthly, the SEC's liquidity framework requires funds to report aggregated bucketing information to the public quarterly.[24] The public disclosure requirements raise serious concerns because of the likelihood that the public will be misled by, or fail to understand the inherent limitations of, this subjective, forward-looking, and hypothetical bucketing information.

To its credit, the SEC is considering steps to address these concerns. Earlier this year, the SEC proposed to improve funds' liquidity disclosure by requiring funds to discuss the operation and effectiveness of their liquidity risk management programs in fund shareholder reports. The SEC simultaneously proposed to rescind the requirements for public reporting of bucketing information, acknowledging in the proposing release the risks and shortcomings involved.[25] ICI strongly supports these proposed changes.[26] We agree with the SEC's assessment that these two actions would more effectively achieve the policy goal of promoting better investor understanding of funds' liquidity risks, while minimizing investor confusion. The SEC, under the leadership of Chairman Jay Clayton, deserves commendation for its willingness to reexamine and revise aspects of its liquidity framework before compliance is required, based on input received after the rule's adoption.

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[23] ICI surveyed its members about their experience to date in implementing the liquidity rule. Sixty-six firms responded, representing 48 percent of the total number of long-term mutual funds and ETFs, and 73 percent of long-term mutual fund and ETF total net assets. For complete results, *see* Letter from Dorothy Donohue, Acting General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated November 3, 2017, at Appendix B, *available at* www.ici.org/pdf/17_ici_sec_liquidity_ltr_supp.pdf.

[24] *See Investment Company Liquidity Risk Management Programs*, *supra* n. 21.

[25] *Investment Company Liquidity Disclosure*, 83 Fed. Reg. 11905 (March 19, 2018).

[26] *See* Letter from Paul Schott Stevens, President and CEO, ICI, to Brent J. Fields, Secretary, SEC, dated May 18, 2018, *available at* https://www.ici.org/pdf/18_ici_sec_lrm_rule_comment.pdf.

Unfortunately, the SEC has not proposed to rescind or even modify the rule's bucketing requirements. Consequently, funds still are obligated to make changes to their operations and shoulder enormous initial and ongoing costs to comply with a requirement that will not serve efficiently and effectively the interests of fund investors, the capital markets, or the SEC.

The SEC's recent liquidity disclosure release requested comment on whether there are advantages to the Treasury Department's recommendation that the SEC embrace a "principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements."[27] ICI's comment letter to the SEC discussed the considerable advantages to a principles-based approach, including that it would reduce costs and other concerns raised by the bucketing and related reporting requirements. As our letter indicated, we hope that the measured scope of the SEC's disclosure proposal does not foreclose the possibility of future changes to the current liquidity framework.

The Cumulative Costs of Regulation

The registered fund industry is *highly* competitive. As we explain below, US households have benefitted from this dynamic, through wider choices, lower costs and higher returns on their investments. But as with our capital markets, we cannot take this degree of competition for granted. Instead, we must actively foster the conditions necessary to preserve this competitive environment, and this includes attention to the cumulative costs of regulation.

Over the past quarter-century, the expense ratios that investors incur for holding funds have trended down. For example, since 2000, expense ratios on equity mutual funds have fallen 40 percent.[28] At the same time, investors are focusing increasingly on lower-cost funds. Figure 1 shows, for instance, that among domestic equity funds in 2017, those funds with the lowest expense ratios tended to receive the most inflows, while those with higher expense ratios saw either outflows or more moderate inflows.

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[27] *See* US Department of the Treasury, *A Financial System That Creates Economic Opportunities: Asset Management and Insurance* (October 2017) at 153, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

[28] *See* Figure 1 in Duvall and Mitler, "Trends in the Expenses and Fees of Funds, 2017," *ICI Research Perspective* 24, no. 3 (April 2018), *available at* www.ici.org/pdf/per24-03.pdf.

Figure 1
Lower-Cost Domestic Equity Funds Receive Majority of Inflows
Mutual funds and ETFs ranked from lowest to highest expense ratios, net flow in billions of dollars, 2017

	Percentile of expense ratios			
Type of fund	**< 5th**	**≥ 5th to < 25th**	**≥ 25th to < 50th**	**≥ 50th**
Actively managed				
Expense ratio	< 0.56%	≥ 0.56% to < 0.87%	≥ 0.87% to < 1.15%	≥ 1.15%
Net flow	$3	-$117	-$80	-$78
Index				
Expense ratio	< 0.06%	≥ 0.06% to < 0.20%	≥ 0.20% to < 0.42%	≥ 0.42%
Net flow	$115	$93	$13	$8

Note: Data exclude funds available as investment choices in variable annuities, funds that invest primarily in other funds, new funds without reported expense ratios, and funds with missing expense ratios.
Sources: Investment Company Institute and Morningstar

In this environment, costs—including regulatory compliance costs—become all-important to fund sponsors that hope to compete and survive. Unnecessary or inappropriate regulation, regulation based on faulty analysis, or regulations that are overly broad or prescriptive add to costs without providing commensurate benefits. But even appropriately designed regulation involves costs and burdens, which are cumulative.

A member survey we conducted last year sheds light on trends in regulatory compliance costs over the past five years, in response to new regulations (including the liquidity risk management rule discussed above, among others).[29] Among members surveyed, the *median* increase in compliance costs was an estimated *20 percent* over the past five years.[30] Members cited one-time compliance costs (*e.g.*, legal costs, preparation of new policies and procedures, creation of internal controls, and staff training), increased technology expenditures, increased use of third-party fund service providers (*i.e.*, vendors), increased vendor costs,[31] increased oversight of vendors and intermediaries, and increased staffing needs

[29] 42 ICI member firms responded, representing 46 percent of US registered fund assets.

[30] 35 of the 42 respondent firms were able to quantify the percent by which compliance costs had increased over the past five years. In comparison, over the five-year period from December 2011 to December 2016, consumer prices, as measured by the personal consumption expenditure index, rose 6.3 percent. In addition, over the same five-year period, the employment cost index for professional, scientific, and technical sectors rose by 8.7 percent.

[31] Because of the prevalent use of vendors by funds, increased vendor costs directly and significantly impact overall fund costs. Nearly all members who responded (40 of 42) reported using vendors to obtain at least some of the services funds need to operate. Of these 40 members, 75 percent (30 of 40) reported that over the past five years vendors had increased their charges for such services, citing higher compliance costs.

as primary drivers of these overall cost increases. And these numbers do not necessarily capture all of the opportunity costs associated with these efforts, including the diversion of resources that may have otherwise gone to bolstering portfolio and risk management capabilities, enhancing oversight of existing legal, compliance, and accounting obligations, improving customer service, and product innovation.

As we move forward, continued "piling on" of new regulatory requirements—and associated costs and burdens—in an ultra-competitive industry threatens to bring the industry to a tipping point at which it no longer is economically viable for smaller or mid-sized firms to stay in, or enter, the mutual fund business. Although all fund providers are affected by added regulatory costs, such costs often fall disproportionately on small- to mid-sized fund providers because they must spread the costs of adapting to new regulatory requirements over a smaller base of assets. As a result, small- to mid-sized fund providers may leave the business and other potential providers may elect not to enter the business, both of which result in reduced investor choice.

Regulatory costs are one of a number of factors contributing to industry consolidation.[32] For example, the share of mutual fund and ETF assets managed by the five largest fund firms rose from 36 percent in 2005 to 50 percent in 2017 (Figure 2).

Figure 2
Share of Mutual Fund and ETF Assets at the Largest Fund Complexes
Percentage of total net assets of mutual funds and ETFs; year-end, selected years

	2005	2010	2015	2016	2017
Largest 5 complexes	36	42	45	47	50
Largest 10 complexes	47	55	56	58	60
Largest 25 complexes	69	74	75	76	77

Note: Data include only mutual funds and ETFs registered under the Investment Company Act of 1940. Mutual fund data exclude mutual funds that invest primarily in other mutual funds. ETFs registered as UITs and ETFs that invest primarily in other ETFs are excluded.
Source: Investment Company Institute

Concerns about the impact of the cumulative costs of regulation are properly within the purview of this Committee. We urge the Committee to continue to exercise close oversight of regulation affecting registered funds. This will help ensure that the industry remains vibrant, so it can continue to serve the interests of fund investors while also contributing to economic growth.

[32] *See* Owen Walker, *Funds 'snowball' means big firms can only get bigger*, Financial Times (June 9, 2018), *available at* https://www.ft.com/content/1611bea8-68d3-11e8-b6eb-4acfcfb08c11.

III. EXAMINING PARTICIPATION IN THE PUBLIC CAPITAL MARKETS

We urge the Committee to support regulatory efforts to increase the attractiveness of public capital markets. A vibrant public market lies at the core of healthy capital markets, but data showing a long-term decline in the number of US-listed companies suggest that our public markets are becoming increasingly less attractive than private markets. Over the past two decades the number of public companies in the United States has dwindled from more than 7,300 in the late 1990s to approximately 3,500 today, and there have not been 5,000 stocks to include in the Wilshire 5,000 Index since 2005.[33] During this time, overall market capitalization has increased, but micro-, small-, and even mid-cap companies are disappearing from US exchanges. These trends reflect a tendency for companies to rely on private capital longer to go public at a later stage in their development, if they do so at all.

The concerns associated with the declining number of public companies are particularly serious for individual investors trying to build wealth and meet other financial goals. Most individuals are ineligible to participate directly in the private markets, and few mutual funds invest in private companies.[34] Consequently, the returns generated by promising new companies increasingly have accrued to investors in private markets and not to the millions of retail investors that mutual funds serve.

SEC Chairman Clayton has recognized that "[r]egardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally."[35] Others have argued that less attractive public markets may lead the founders of high-growth companies to merge their businesses with larger firms, rather than conducting initial public offerings (IPOs)—an outcome that may hurt job creation, because job growth typically accelerates when companies go public and decelerates when companies merge.[36] Furthermore, the IPO process itself provides benefits to companies, investors, and the capital markets. As Chairman Clayton has noted, companies that go

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[33] *See* Michael J. Mauboussin, Dan Callahan, and Darius Majd, *The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities* (March 22, 2017), *available at* https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf; Wilshire 5000 Total Market Index Fact Sheet (March 31, 2018), *available at* https://wilshire.com/Portals/0/analytics/indexes/fact-sheets/wilshire-5000-fact-sheet.pdf.

[34] *See* US Department of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets* (October 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf (Treasury Capital Markets Report) (citing a study that finds private company investments totaled only 0.13 percent of assets held by equity and allocation funds as of June 2016).

[35] *See Remarks at the Economic Club of New York*, Jay Clayton, Chairman, SEC (July 12, 2017), *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[36] *See* President's Council on Jobs and Competitiveness, *Taking Action, Building Confidence: Five Common-Sense Initiatives to Boost Jobs and Competitiveness*, Interim Report (October 2011), *available at* http://files.jobs-council.com/jobscouncil/files/2011/10/JobsCouncil_InterimReport_Oct11.pdf.

through the SEC public registration and offering processes "often come out better companies on the other side of an IPO." [37]

I discussed the downward trend in the number of public companies with David Rubenstein, a Co-Founder and Co-Executive Chairman of the Carlyle Group, at ICI's General Membership Meeting in May 2018. We agreed that policymakers and regulators must not overlook the role of regulation in a company's analysis of whether to go public or remain public (for firms presently listed on US exchanges). Others have offered similar observations and put forward proposals designed to increase the attractiveness of public markets without diminishing the availability of capital in private markets.[38]

The SEC presently is examining two promising ideas from these proposals. One is to consider the feasibility of streamlining the regulatory process associated with going public or remaining public without sacrificing investor protections. Regulatory burdens on public companies have increased greatly during the past two decades, and the cumulative effect of this regulation should be examined to ensure that public companies do not face unnecessary requirements. The SEC also is weighing potential reforms to optimize equity market structure so that it promotes liquidity for small- and mid-sized public companies. Such reforms could provide a greater incentive for companies to go public earlier.

We urge the Committee to support these efforts, which promise to benefit US companies, their investors, and the US economy more broadly.[39]

IV. STRENGTHENING THE COMPETITIVE POSITION OF US MUTUAL FUNDS IN THE GLOBAL FUND MARKETPLACE

As the Committee looks for ways to spur economic growth and job creation, we urge you to examine pending legislation that would enable US-domiciled mutual funds to attract a greater share of worldwide investment assets and, in turn, generate additional jobs for US workers. The legislation—

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[37] *See* Jay Clayton, Chairman, SEC, Testimony before the Financial Services and General Government Subcommittee of the Senate Committee on Appropriations (June 5, 2018), *available at* https://www.sec.gov/news/testimony/testimony-financial-services-and-general-government-subcommittee-senate-committee.

[38] *See e.g.*, Treasury Capital Markets Report, *supra* n. 34, at 25-45; American Securities Association, Biotechnology Innovation Organization, Center for Capital Markets Competitiveness, *et al.*, *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public* (Spring 2018), *available at* https://www.sifma.org/wp-content/uploads/2018/04/Expanding-the-On-ramp-Report.pdf.

[39] Chairman Clayton has directed the SEC's Division of Corporate Finance to explore ways to improve the attractiveness of listing in public markets without reducing investor protections. *See Remarks to the Investor Advisory Committee*, Jay Clayton, Chairman, SEC (June 22, 2017), *available at* https://www.sec.gov/news/public-statement/clayton-6-22-17. And, the Division of Trading and Markets recently held a roundtable to discuss ways to improve market structure for thinly traded exchange-traded securities, including many small and mid-capitalization companies. A transcript of this meeting is available on the SEC's website at https://www.sec.gov/spotlight/equity-market-structure-roundtables/thinly-traded-securities-rountable-042318-transcript.txt.

H.R. 4204, the International Regulated Investment Company Act of 2017—would reduce the disparate tax treatment between US mutual funds and their foreign counterparts. In so doing, it would allow US mutual funds to compete more effectively with foreign funds for foreign investors.

US mutual funds are the investment vehicle of choice for Americans saving for retirement or to achieve other financial goals.[40] And, by way of comparison, US mutual funds offer several advantages over funds sold to retail investors outside the United States:

- The size and sophistication of US funds allow them to invest more efficiently and operate at lower cost than their smaller foreign counterparts.
- The protection afforded by the Investment Company Act of 1940 and other US securities laws is considered state of the art.
- The US has a deep pool of highly skilled workers to run its investment products.
- US mutual funds offer a wide variety of investment choices across all major asset classes.

Yet virtually no US mutual fund is offered or marketed to investors outside the United States. This is the case even though "cross-border" funds (those organized in one jurisdiction but sold in others) have enjoyed explosive growth in the recent past. So what is keeping US funds from tapping into this growth opportunity?

A US mutual fund is required to distribute its income on a current basis to its investors. Many foreign funds, in contrast, can retain (or "roll up") their income without either current taxation of the fund or any obligation to distribute the income to investors. Distributions from US funds can cause foreign investors to incur home-country tax that would not be due, or that would be charged at a lower rate, if they invested instead in a foreign fund. This disparate tax treatment is the reason that US-domiciled mutual funds are not currently an "exportable" investment product.

H.R. 4204 seeks to change that. The bill would allow a US fund manager to create an "international regulated investment company" (IRIC) through which foreign investors could access a US mutual fund without triggering negative tax consequences in their home countries. The IRIC structure would not reduce the US tax incurred by these foreign investors and has been scored by the Joint Committee on Taxation as having a "negligible effect" on federal revenues. Creating IRICs is critical if US fund

[40]At year-end 2017, mutual funds accounted for 59 percent of all DC plan assets and 47 percent of all IRA assets (see Figure 2.4, in *2018 Investment Company Fact Book*, *available at* https://www.ici.org/pdf/2018_factbook.pdf). Moreover, the $8.8 trillion of mutual fund assets held in DC plans and IRAs represents 47 percent of all mutual fund assets ($18.7 trillion) at year-end 2017 (Id, at Tables 1, 63, and 64).

managers—particularly small and mid-sized firms—are to compete globally and increase their assets under management without establishing operations overseas and offering foreign investment vehicles.

ICI urges this Congress to address and pass this vital legislation.

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On behalf of ICI and its members, I thank you for the opportunity to testify today. I look forward to answering the Committee's questions.