

Speech

Keynote Address: ICI Mutual Funds and Investment Management Conference



Dalia Blass
Director, Division of Investment Management

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Introduction

Good morning. Thank you, Susan [Olson], and thank you for inviting me here to San Diego. This is my second year attending this conference as Director of the Division of Investment Management, and I have been looking forward to speaking with all of you again. I also have the pleasure of speaking on the same day as Commissioner Roisman, who is delivering keynote remarks after lunch. The Commissioner has spent many years immersed in securities law and policy, and I have greatly appreciated getting to know him both during his years on the staff and as a Commissioner.

This morning, two of my colleagues will also be joining the panels: Paul Cellupica and Sarah ten Siethoff. Paul is the Division's Deputy Director and Chief Counsel, and Sarah is the head of our rulemaking office. Those of you who have met Paul and Sarah know that they exemplify what is remarkable about the entire staff of the Division – they have a deep dedication to the interests of investors, a commitment to thoughtful policy and a desire to engage and understand. If you have not already, I would encourage you to catch up with them before or after their panels.

When I joined you last year, the Division was still in the early stages of developing and working through its 2018 agenda. Today, I would like to start by taking stock of what we have accomplished in 2018 and share with you what's ahead for 2019.

I also want to step back and talk more broadly about trends in asset management and the resulting dialogue. Rapid changes and growth over recent decades have sparked a range of public debates – maybe more today than any time since the 1930s. I would like to offer a few thoughts on these debates and their relationship to future policy.

Before I start, however, I'll remind everyone that I am speaking today only for myself and not for the Commission, the Commissioners or the staff.^[1]

2018 Agenda and Accomplishments

Last year was a busy time for the Division. We had ambitious goals – improving the investor experience, modernizing current regulatory approaches and using our resources with the greatest efficiency possible. These goals are built around care for the basic infrastructure of asset management policy – the roads and bridges. While this work, by its nature, is never finished, we hope that our efforts in 2018 strengthened that infrastructure.

Among the highlights, for me, was our work to improve the investor experience. For example, the Commission issued a request for comment on how to improve investment company disclosures to the benefit of Main Street investors. It proposed a package of reforms to improve variable annuity disclosure, including the long-awaited introduction of summary prospectuses. And, it adopted a notice and access approach to the delivery of shareholder reports.

The Commission also proposed for comment a package of rulemakings designed to bring the legal requirements and mandated disclosures of financial professionals in line with investor expectations.^[2] The Division led the development of a proposed "Relationship Summary" – Form CRS – which I believe could help retail investors have the right conversations with their financial professionals. The Division also developed proposed interpretive guidance under the Advisers Act, which would clarify the investment adviser fiduciary duty. In addition, we supported our colleagues in the Division of Trading and Markets, who led the development of Regulation Best Interest. As you know, the proposed Regulation is designed to enhance the standard of conduct for broker-dealers when making recommendations to their retail customers.

Together, these initiatives are intended to help retail investors find and use important information and to empower them when choosing a financial professional or product.

Our roads and bridges agenda also prioritized modernizing the regulatory framework. As part of this, we made recommendations to the Commission on a number of rules, including exchange-traded funds ("ETFs"), fund of funds, fund liquidity reporting and fund research reports.^[3] We are proud to look back at the Division's ambitious agenda for 2018 and note that we achieved 100% of our planned milestones.^[4] That is a reflection of the dedication and hard work of staff from all of the offices in the Division.

Our modernization efforts also extended beyond rulemaking. The Division launched its Board Outreach Initiative and set out to review and reevaluate what we ask fund boards to do. Here, we issued no-action letters on the affiliated transaction rules and in-person meeting requirements. In addition, as part of this effort, we have engaged with many boards, and many of you, on our work to update the Commission's valuation and auditing guidance.

Looking Ahead at 2019

While it is good to look back and reflect on our accomplishments, our work is far from done. Much of the Division's work this year will be built on the foundations we laid in 2018. For example, the Investor Experience Initiative will take its next steps. We are considering ideas from the request for comment on improving investment company disclosure and studying the comments on the variable annuity disclosure proposal. Some preliminary areas of focus for that work are exploring options for a summary shareholder report and ways to improve fee and risk disclosures. We also continue to prioritize delivering to the Commission recommendations on Form CRS and the fiduciary duty interpretation. And, of course, we are working closely with the Division of Trading and Markets to support their efforts on Regulation Best Interest.

Our modernization efforts this year will also start with rules that the Commission proposed last year. For example, finalizing the ETF and fund of funds rules will be a high priority for the Division. For our Board Outreach Initiative, I anticipate that the next milestone will be recommending updates to the Commission's valuation guidance. On that project, we are grateful to our colleagues in the Commission's Office of the Chief Accountant, who have been tremendous partners. In addition, I expect that we will advance into the public comment process a number of projects we announced last year.^[5] For example, you should see a proposal for business development company and closed-end fund offering reform in the near future.^[6] I also anticipate that the Division will present recommendations for a proposal on modernizing the advertising and solicitation rules for investment advisers and a proposal for use of derivatives by investment companies.

We will also continue work on several of what I think of as "good government" projects. For example, the Chairman and I have previously spoken about the staff's review of prior staff statements.^[7] The goal of this review is to look back and identify whether any of these statements should be modified, rescinded or supplemented in light of market or other developments. This project is advancing in both our Chief Counsel's Office and our Disclosure Review Office with the help of very capable staff leads in those offices. You may have noticed some of the results of our review in recent rule proposals. For example, in the variable annuity disclosure and fund of funds proposals, the releases noted that we would be reviewing certain staff statements to determine whether they should be withdrawn in light of any Commission action. The staff intends to continue with this approach for rulemaking projects currently on the agenda.

In addition, our Chief Counsel's Office has been working on ways to improve the exemptive applications process. Many of the applications we see are routine and would benefit from a more streamlined approach. Our exemptive review process is a key part of how innovation takes place under the 1940 Acts. We would like to find ways to free resources so Division staff can focus more on the requests for exemptions that represent the next generation of potential developments under the Acts. Stay tuned for more to come on that.

I know that I have given you a whirlwind tour of the many projects that we hope to advance this year as part of our investor experience and regulatory modernization initiatives. However, before I turn to discussing trends in asset management, I would like to highlight two additional areas where we will spend significant time in 2019: use of proxy advisors; and international policy.

Proxy advisors

Last November, the staff hosted a roundtable on the proxy process. While the roundtable looked at the proxy system broadly, a portion of the agenda was dedicated to discussing the role of proxy advisory firms. This is, of course, a topic of interest for many investment advisers and funds. The roundtable was valuable because it brought together a number of different perspectives, including investment advisers, academics, issuers, business groups and proxy advisors. Equally valuable have been the letters submitted to the comment file.

This discussion revealed, on the one hand, a general recognition that proxy advisors can provide a valuable service to their clients. On the other hand, it has also helped identify some areas where the current guidance would benefit from updating and clarification. For example, as Chairman Clayton recently highlighted, some matters put to a shareholder vote may call for a company-specific analysis rather than application of a more general market or industry-wide policy.^[8] In many cases, I believe investment advisers may be well-positioned to perform that kind of company-specific analysis because they bring to bear their research and knowledge of the individual companies they select for client portfolios.

In 2019, we will be exploring ways to update current guidance to clarify how investment advisers should fulfill their fiduciary duties in this area. Our focus will include questions such as:

- how to promote voting practices that are in the best interests of advisory clients, including voting on an issuer-specific basis when appropriate;

- whether advisers are expected to vote every proxy;
- how advisers should evaluate recommendations of proxy advisers, particularly where the issuer disagrees with the factual assumptions of the recommendation; and
- how advisers should address conflicts of interest that a proxy adviser may have.

I anticipate developments on this project around the end of proxy season this year.

International policy

Another significant area of focus for the Division is international policy. Our work in this area really follows two major themes. First, monitoring the effects of foreign policy on our regulated entities. And, second, engaging with international organizations that have shown an interest in asset management policy.

The first theme is a side-effect of growth – financial markets and asset managers operate today on a global scale. As a result, a regulatory change in Europe can pose significant challenges for U.S. firms. A clear example is MiFID II.^[9] The research rules under MiFID II came into effect early last year. By changing how asset managers could pay for research in the E.U., these rules raised questions concerning market practice and compliance among broker-dealers and asset managers in the U.S.

As you know, in 2017 Commission staff issued three no-action letters to assist in compliance. One of these provides temporary no-action assurances to broker-dealers that receive certain payments under MiFID. That relief expires in July 2020, so a team from our Chief Counsel's Office, working with colleagues in other Divisions, started engaging with a wide variety of interested parties soon after we issued the letter. In a press release last December, the team also reminded market participants of the need for concrete and relevant data to support policy initiatives.^[10]

We have been carefully reviewing the information we have received so far and analyzing options for next steps. At this stage, I would like to share four observations.

First, I believe that, in considering any potential regulatory steps, we should be mindful of the many parties and interests involved. The production, use and costs of research affect investors, advisory clients, issuers, broker-dealers and investment advisers, and the firms affected range from large, global organizations to local, regional and boutique businesses. As we advance our policy dialogue, I will continue to focus on understanding the effects of any options across this range of investors and market participants.

Second, in addition to reviewing the letters submitted to us, the staff has looked closely at the Advisers Act. The Act establishes a principles-based regime that provides significant flexibility to accommodate relationships with both modest retail accounts and large institutional accounts. In this way, the Act, by design, provides protections to both retail and institutional clients.

Third, there are indications that market solutions are developing that may make extending the no-action relief unnecessary. For example, I understand that some fund managers are using reconciliation or reimbursement processes to deliver cost transparency while addressing compliance. At the same time, some broker-dealers have explored or taken steps to offer research through a registered advisory business. These are examples of market-based solutions that are developing, and as they emerge, I believe the staff should explore opportunities to provide support while not getting ahead of the market.

This brings me to my fourth point. We are still looking for engagement on next steps. As of today, taking into account the breadth and flexibility of the Advisers Act, we (the staff) are not yet convinced, based on the data and analysis we have received, that we can support a recommendation to create a permanent blanket exemption from the protections of the Act for providers of research to institutional asset managers. We encourage market participants to address this issue in their comments.^[11] Moving forward, we are particularly interested in hearing about the emerging market-based solutions and how we can support them. Specifically, for those accepting hard dollars, could we use the flexibility of the Advisers Act to ease compliance while honoring its language and purposes? For example, would it be helpful to issue guidance or use the Act's exemptive authority to address concerns around principal trading? Do firms that specialize in research face compliance challenges and, if so, would they benefit from targeted exemptions? Would any of the emerging market-based solutions work well for some segments of market participants but not as well for others? Is there guidance or rulemaking outside the Advisers Act, such as addressing direct, hard dollar payments under section 28(e) of the Exchange Act, that would be beneficial?^[12] We look forward to engaging further with you on all of these issues.

I also mentioned a second theme for our international policy work – engaging with international organizations that have shown an interest in asset management policy. In 2019, we will spend many hours in dialogue with our colleagues from IOSCO, the FSB and their members.^[13] While asset management has long been part of the agenda for these organizations, the growth in asset management, coupled with broader trends, seems to have resulted in greater focus on non-bank finance. Last year, for example, the Governor of the Bank of England and, at the time, Chair of the FSB, described asset management as "a potentially major new vulnerability."^[14] In response to this interest, the Division has made this work a priority and sought to contribute to the conversation insight from our experience with the U.S. asset management markets.

You, too, could help inform this dialogue. These organizations regularly seek input from the public through consultation papers, workshops and other opportunities. The new Chair of the FSB, Fed Vice Chairman Randal Quarles, recently emphasized the value of engagement to the FSB's work and called for "genuine, substantial dialogue with all [affected] stakeholders, to a greater and more effective degree than [the

FSB has] in the past."^[15] I would encourage all of you here today to see that as an invitation and to participate in this international dialogue to the greatest extent possible. These organizations and their members would benefit from the insights and experience you can offer.

Asset Management Trends in 2019

Now, I want to transition away from the Division's priorities in 2019 and talk about long-term trends in asset management. Asset management has evolved significantly since 1940. Over the last two decades, major trends in retirement funding, investment philosophies, technology and capital formation have driven changes that include increased assets, new products, new strategies and new challenges in the business environment for managers. The emergence of index investing and ETFs has changed the way many investors build their portfolios and helped spark new rounds of competition over fees. Increased globalization has also intertwined domestic and foreign markets and policy along the lines I discussed earlier.

In many cases, these changes have been characterized by remarkable successes, as can be seen in the growth in assets under management and in the variety of investment products available to investors today. A retail investor in 2019 can find advice in a local office or over the internet, can buy an index fund with exposure to an entire market or an active fund looking to beat the market, and can choose among mutual funds, ETFs, closed-end funds and other vehicles. In other words, as far as asset management, there's a lot of good news and choice for Main Street investors.

There are, however, other parts to this story. For example, investors may benefit from a downward trend in fees. On the other hand, the same trend may mean that investors end up with less access to small and mid-sized advisers, who do not have the scale of large advisers. Technology has been key to enabling some of the efficiencies and innovations in recent years. On the other hand, asset managers, like all other financial services companies and many other types of companies, now bear the cost of preparing for cyber risks and the broader demands of systems resiliency. Service providers may improve efficiencies for asset managers and enable them to focus on their core capabilities. On the other hand, reliance on service providers may reduce the diversity of perspectives in the market and create shared vulnerabilities.

Change often arrives in the company of mixed opinion, and the long-term trends in asset management have sparked plenty of public debate about the consequences for capital markets, issuers and investors. A wide variety of commenters have taken an interest in debates about, for example, common ownership,^[16] the effect of indexing on markets, the consequences of greater scale in asset management and the increased participation of funds in certain markets historically associated with banks and brokerage firms.

Today, I do not intend to comment on the merits of any of these debates. Instead, I want to acknowledge that a dialogue is taking place in a number of forums. Moreover, that dialogue has the potential to influence how investors, lawmakers, foreign and domestic regulators, and market participants view public policy concerning asset management now and in the future. With that in mind, I want to offer one thought about these debates and then talk about two steps the staff is planning for engaging on these topics.

First, here's my thought. It is undoubtedly important, whether you are a market participant or a regulator, to scan ahead for emerging and future risks. For me, this is a key part of proactive investor protection. However, it is equally important that we approach any such exercise with transparency, engagement and rigor, and weigh any policy response with caution. To me, that means step one is not rewriting policy. Instead, the process should start with gathering and examining evidence. Where we find opportunities to ease compliance and promote choice while protecting investors, I will be the first to support change. But if we are discussing policy responses that could result in significant changes in the products and services that investors rely on, or in the businesses of advisers and managers, we should have a clear understanding of costs and benefits and pay careful attention to unintended consequences.

In the spirit of gathering and examining evidence, the Division is planning two steps in the coming year. First, I am concerned about what it will mean for investors – particularly Main Street investors – if the variety and choice offered by small and mid-sized asset managers becomes lost in a wave of consolidation and fee compression. I recognize that many of the forces shaping investment markets today are not regulatory or even unique to asset management. These include many of the factors I mentioned earlier, like technology, efficiencies of scale and investor preferences. However, I believe it is important to ask, are there barriers making it harder for small and mid-sized fund sponsors to compete? Can the Division do anything to help address that without sacrificing investor protection? Could new technologies, like blockchain, increase access to distribution, and if so, how can we (the staff) help?

With these questions in mind, I have asked Division staff to start a new outreach initiative targeted at small and mid-sized fund sponsors. Our goal is to hear from these groups about regulatory barriers and to begin thinking about ways we could address them. We would also like to focus our 2019 board outreach on smaller fund groups. If you are interested in talking with us about these questions, please let us know.

We are also planning a second step with a potentially broader focus. Specifically, we are considering the formation of an asset management advisory committee. Many of the debates I mentioned earlier could benefit from thoughtful discussion among experts with diverse viewpoints, and I think the Commission is well-positioned to host that discussion. I do not expect that an advisory committee could tackle every one of these topics or answer every unresolved question, but I believe it could lend to the debate some of the transparency, engagement and rigor that I mentioned earlier. We are still in the early stages, but I expect that we will have additional updates to share as we progress further.

Closing

I know that I have covered a lot this morning, so in closing, I just want to take a moment to thank the staff of the Division. Their hard work is reflected in every topic I have covered today and in many other efforts that I could not cover. Each day, I see staff going above and beyond to advance our mission. A great example is Jennifer McHugh, whom many of you know. Jennifer has served the Division in many roles, and twice she has stepped up, with little notice, when her talents were needed: once as acting Director and, most recently, as acting head of our Disclosure Review Office. Even while acting as Associate Director, Jennifer continued in her day job as a thought leader on digital assets and fund disclosure. What we achieved in 2018 is a testament to the skill and dedication of the staff like Jennifer, and I greatly appreciate it.

Thank you again for the opportunity to be here today.

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

[2] See SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Investment Professionals (Apr. 18, 2018), available at <https://www.sec.gov/news/press-release/2018-68>; see also Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Exchange Act Release No. 83063 (Apr. 18, 2018) [83 FR 21416 (May 23, 2018)]; Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Adviser Act Release No. 4889 (Apr. 18, 2018) [83 FR 21203 (May 9, 2018)]; Regulation Best Interest, Exchange Act Release No. 83062 (Apr. 18, 2018) [83 FR 21203 (May 9, 2018)].

[3] See Exchange-Traded Funds, Investment Company Act Release No. 33140 (June 28, 2018) [83 FR 37332 (July 17, 2018)] (proposed rule); Fund of Fund Arrangements, Investment Company Act Release No. 33329 (Dec. 19, 2018) [84 FR 1286 (Feb. 1, 2019)] (proposed rule); Investment Company Liquidity Disclosure, Investment Company Act Release No. 33142 (Jun. 28, 2018) [83 FR 31859 (July 10, 2018)] (final rule); Covered Fund Research Reports, Investment Company Act Release No. 33311 (Nov. 30, 2018) [83 FR 64180 (Dec. 13, 2018)] (final rule).

[4] See Regulatory Flexibility Act Agenda (Fall 2017), available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPubId=201710&showStage=active&agencyCd=3235&Image58.x=37&Image58.y=12.

[5] See Regulatory Flexibility Act Agenda (Fall 2018), available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235.

[6] See Consolidated Appropriations Act, 2018, Pub. L. No. 115-141 (2018) (Small Business Credit Availability Act, Title VIII of Division S, Section 803), available <https://www.congress.gov/115/bills/hr1625/BILLS-115hr1625enr.pdf>; Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 (2018) (Section 509, Parity for closed-end companies regarding offering and proxy rules), available <https://www.congress.gov/115/bills/s2155/BILLS-115s2155enr.pdf>.

[7] See Chairman Jay Clayton, Statement Regarding SEC Staff Views (Sep. 13, 2018), available at <https://www.sec.gov/news/public-statement/statement-clayton-091318>. See also Dalia Blass, Keynote Address – ICI Securities Law Developments Conference (Oct. 25, 2018), available at <https://www.sec.gov/news/speech/speech-blass-102518>.

[8] See Chairman Jay Clayton, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (Dec. 6, 2018), available at <https://www.sec.gov/news/speech/speech-clayton-120618>.

[9] The directive commonly referred to as "MiFID II" is the European Union's ("EU") Directive 2014/65, of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Commission Directive 2002/92 and Council Directive 2011/61, O.J. (L 173) 57, 349.

[10] See SEC Staff Encourages Continued Engagement on Impact of MiFID II Research Provisions (Dec. 21, 2018) ("December Press Release"), available at <https://www.sec.gov/news/press-release/2018-301>.

[11] See December Press Release, *supra* note 8.

[12] See section 28(e) of the Securities Exchange Act of 1934.

[13] "IOSCO" is the International Organization of Securities Commissions; the "FSB" is the Financial Stability Board.

[14] See Mark Carney speech, True Finance – Ten years after the financial crisis (Oct. 19, 2018), available at <https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/true-finance-ten-years-after-the-financial-crisis-speech-by-mark-carney.pdf>. See also FSB reviews financial vulnerabilities and deliverables for G20 Summit (Oct. 22, 2018), available at <http://www.fsb.org/2018/10/fsb-reviews-financial-vulnerabilities-and-deliverables-for-g20-summit/> ("The core of the financial system is much more resilient than before the global financial crisis, with strengthened bank capital and liquidity. At the same time, non-bank financial intermediation (NBFIs) has grown, adding to diversity of funding, but with associated maturity and liquidity transformation risks, and concentrations in holdings of risky assets.

New forms of interconnectedness have emerged that could, in some scenarios, act as channels for domestic and cross-border amplification of risks." "The increasing role of NBFIs underscored the importance of work being taken forward by the FSB and other standard-setting bodies (SSBs) to better understand how new market structures could respond to, and transmit, shocks, and of implementing the FSB's recommendations to address structural vulnerabilities arising from asset management activities.")

[15] See Randal K. Quarles, Remarks at the Bank for International Settlements Special Governors Meeting (Feb. 10, 2019), available at <http://www.fsb.org/wp-content/uploads/Quarles-Ideas-of-order-Charting-a-course-for-the-Financial-Stability-Board.pdf>.

[16] See, e.g., FTC Hearing #8: Competition and Consumer Protection in the 21st Century (Dec. 6, 2018), available at <https://www.ftc.gov/news-events/events-calendar/ftc-hearing-8-competition-consumer-protection-21st-century>.