INVESTMENT COMPANY INSTITUTE®

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April 13, 2017

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Re: Legislative Proposals to Promote Economic Growth

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the Investment Company Institute,[1] I am pleased to submit the attached recommendations in response to the Committee's March 20, 2017 release soliciting legislative proposals to foster economic growth and help enable consumers, market participants, and financial companies to better participate in the economy. Our recommendations, as described in the attachment, are as follows:

1. Preclude Inappropriate SIFI Designation of a Registered Fund or Fund Adviser

2. Avoid Inappropriate Application of Bank-Style Stress Testing Requirements to Mutual Funds

3. Modernize Delivery of Fund Disclosure Documents

4. Direct the SEC to Study and Report to Congress on Regulatory Framework for Delivering Periodic Reports

[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, 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$19.3 trillion in the United States, serving more than 95 million US shareholders, and US$1.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

Thank you for your consideration of our submission and for the important work that you do. We look forward to working with you and the Committee as this project moves forward.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President and CEO
Investment Company Institute

Attachment

Legislative Proposals to Increase Economic Growth

1. Preclude Inappropriate SIFI Designation of a Registered Fund or Fund Adviser

Description of Proposal: Preclude the Financial Stability Oversight Council (FSOC) from designating a registered fund or fund adviser as a systemically important financial institution (SIFI) pursuant to Section 113 of the Dodd-Frank Act.

Background/Why Proposal Is Needed:

- FSOC has been reviewing the asset management industry since 2013. Although its current focus is on asset management activities, FSOC has not ruled out designating a large registered fund or fund adviser as a SIFI. Designation therefore remains a threat to registered funds and fund advisers.

- SIFI designation is unnecessary for registered funds and fund advisers. 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 advisers act solely as agents, providing investment services to a fund by contract. And, the registered fund structure and comprehensive regulation of funds and advisers under the securities laws already limit risks and risk transmission.

- FSOC has displayed an insufficient regard for the ways in which companies outside the banking sector are structured and already regulated. This is not surprising. FSOC's composition is weighted toward bank regulators, which tend to view other sectors of the financial system through a banking lens. It also means that bank regulators have the upper hand in designation decisions and other FSOC matters.

- Moreover, the current SIFI designation process is severely flawed. First and foremost, in none of its SIFI designations to date has FSOC explained the basis for its decision with any particularity. The opacity of FSOC's reasoning means that no one—not the designated company, other financial institutions, other regulators, the Congress, or the public—can understand what activities FSOC believes pose risks to the overall financial system.

- There are other serious problems with the current designation process. These include insufficient engagement with companies under evaluation; a perfunctory level of involvement by a company's primary financial regulator; no formal opportunity for a company to "de-risk" as an alternative to SIFI designation; and no guarantee of a robust periodic review of designated companies. In the last Congress, bipartisan legislation to address these and other concerns with

FSOC had 31 Democratic co-sponsors—including a majority of the Democrats on the House Financial Services Committee, which reported out the bill on a bipartisan basis.[2]

- The continued threat of a SIFI designation of a fund or its adviser is heightened by the ongoing review of asset management by the Financial Stability Board (FSB). In the past, FSB designations of non-banks as global SIFIs have foreshadowed SIFI designations by FSOC in the United States. The FSB's membership largely consists of central bankers and finance ministers who represent jurisdictions without large, independent asset managers. Potential G-SIFI designations may be influenced by a desire to constrain a successful US-based asset management industry as much as by lack of experience with and understanding of the sector.

Impact on Economic Growth and Impact on the Ability of Consumers, Market Participants and Financial Companies to Participate in the Economy:

- For a registered fund, SIFI designation would have severe consequences. The measures prescribed by the Dodd-Frank Act—including capital and liquidity requirements and prudential supervision by the Federal Reserve—are designed to moderate bank-like risks. Bank-style regulation is fundamentally incompatible with the basic nature and purpose of registered funds, which allow investors to access the capital markets, bearing both the risks and the rewards of their investment.

- Because of these additional (and unnecessary) regulatory measures, designated funds would face higher costs. These higher costs are born directly by the funds, resulting in lower returns for their investors. This would harm American households saving for college and retirement.

- Competitive imbalances would result if one or more registered funds (or fund advisers) were designated as SIFIs and all remaining registered funds (or fund advisers) were able to engage in the same business without the added layer of SIFI-related regulation. This distortion of the fund marketplace would likely punish the largest and most successful registered funds and advisers, to the detriment of investors.

- These competitive imbalances likewise could impede the important role that registered funds play as a vital source of funding in our nation's capital markets.

[2] H.R. 1550, the "Financial Stability Oversight Council Improvement Act of 2015."

<u>Legislative Language</u>:

Amend Section 113 of the Dodd-Frank Act by adding new subsection (j):

SEC. 113. AUTHORITY TO REQUIRE SUPERVISION AND REGULATION OF CERTAIN NONBANK FINANCIAL COMPANIES.

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> (j) EXEMPTIONS.—For purposes of this section, the terms "nonbank financial company" and "company" shall not include (1) an investment company registered under the Investment Company Act of 1940 or (2) an investment adviser to such an investment company, provided that the investment adviser shall be registered under the Investment Advisers Act of 1940.

2. Avoid Inappropriate Application of Bank-Style Stress Testing Requirements to Mutual Funds

Description of Proposal: Narrow the scope of requirements for bank-oriented, annual company-run stress testing to avoid inappropriate and unnecessary application to mutual funds, exchange-traded funds (ETFs), and other registered investment companies (collectively, registered funds) and to their investment advisers.

Background/Why Proposal Is Needed:

- Section 165(i)(2) of the Dodd-Frank Act requires "financial companies" with total consolidated assets of more than $10 billion and that have a Federal regulator to conduct annual stress tests in accordance with regulations issued by that regulator. The term "financial company" is defined broadly and has been read by the Securities and Exchange Commission (SEC) to sweep in registered funds and their investment advisers. Thus, for registered funds and advisers, the SEC believes it is directed to issue implementing regulations in coordination with the Federal Reserve Board and Federal Insurance Office. The SEC regulations must be "consistent and comparable" with those that the Federal Reserve Board and other banking regulators have adopted for banking organizations.[3]

- It makes no sense to subject registered funds and advisers to stress testing requirements that are "consistent and comparable" with the requirements for banking organizations—requirements that are designed to test for "capital adequacy" in stressed conditions. The concept of "capital adequacy" is entirely appropriate in the banking context. If a bank does not have adequate capital, it risks being unable to meet its obligations to depositors, absent government support. And in times of market stress, inadequate bank capital could have broader implications for financial stability.

- By contrast, the notion of "capital adequacy" is inapt when it comes to registered funds and advisers. For example, unlike banks, registered funds do not guarantee any return to investors or even promise that investors will get their principal back. Fund investors know that any gains or losses belong to them on a *pro rata* basis. And unlike banks, registered investment advisers act as agents in managing investments for registered funds and other clients. Gains or losses are borne solely by funds or other client accounts and do not flow through to the adviser. These characteristics of funds and advisers hold true in both normal and stress periods. They help explain why—even in times of severe market stress—stock and bond funds and fund advisers routinely exit the market in an orderly fashion, with no impact on the broader financial system or need for government intervention.

[3] The SEC has not yet proposed any regulations under Section 165(i)(2).

Impact on Economic Growth and Impact on the Ability of Consumers, Market Participants and Financial Companies To Participate in the Economy:

- Registered funds are the investment vehicles of choice for millions of Americans seeking to buy a home, pay for college, or plan for financial security in retirement. Application of unnecessary, ill-suited stress-testing requirements to registered funds and advisers will increase costs for these funds (and, hence, fund investors) and advisers without providing any corresponding benefits. Such stress testing requirements would do nothing to promote public policy goals, such as financial stability or investor protection, because their underlying purpose is pegged to the business model, operations, and risks of banks and is at odds with the distinct, defining attributes of registered funds and advisers.

- Applying bank-focused stress tests to registered funds and their advisers could paint a misleading picture of their financial "strength," which in turn could lead to misguided or overly prescriptive policy "solutions"—such as dictating particular portfolio management responses (*e.g.*, increases in cash holdings).

- Devoting time and effort to developing rules to implement unnecessary requirements is a wasteful diversion of SEC resources. Those resources could instead be deployed to pursue other initiatives that would promote economic growth and the ability of consumers, market participants and financial companies to participate in the economy.

Legislative Language:

Amend Section 165(i)(2) of the Dodd-Frank Act by adding new subparagraph (D):

(i) STRESS TESTS.—

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(2) BY THE COMPANY.—

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(D) EXEMPTIONS.—The requirement under subparagraph (A) to conduct annual stress tests shall not apply to any investment company that is registered with the [Securities and Exchange] Commission under the Investment Company Act of 1940 or any investment adviser that is registered with the [Securities and Exchange] Commission under the Investment Advisers Act of 1940.

3. Modernize Delivery of Fund Disclosure Documents

Description of Proposal: Direct the Securities and Exchange Commission (SEC or Commission) to modernize how mutual funds, exchange-traded funds (ETFs), and other registered investment companies (collectively, "registered funds") deliver information to investors by permitting funds to fulfill their disclosure delivery obligations by posting required disclosure documents online and providing investors an opportunity to opt for paper.

Background/Why Proposal Is Needed: Printing and mailing fund disclosure documents is an increasingly outdated, expensive delivery mechanism that fund investors pay for as a fund expense. Moving away from this outdated model will create direct and very material cost savings for fund investors.

- Regulations require mutual funds, ETFs, and closed-end funds to mail convoluted shareholder reports twice a year. Additionally, mutual funds and ETFs mail summary or statutory prospectuses to investors annually. And regulations require closed-end funds, mutual funds, and ETFs to mail distribution statements accompanying dividend payments on an as-needed basis.

- Some of these fund disclosure documents contain lengthy, technical disclosure that many fund investors do not read. For example, fund shareholder reports include financial statements, pages and pages of portfolio holdings, and various regulatory disclosures, such as discussion of the reasons the fund board approved any investment advisory contract during the reporting period.

- The SEC proposed in 2015, but did not adopt, a half-step toward modernization that would have permitted funds to deliver shareholder reports by mailing notices and then posting the reports online.

Impact on Economic Growth and Impact on the Ability of Consumers, Market Participants and Financial Companies To Participate in the Economy:

- **Achieving cost savings for fund investors:** Registered funds are the investment vehicles of choice for millions of Americans seeking to buy a home, pay for college, or plan for financial security in retirement. We estimate that moving the fund industry to a more modern delivery framework would create significant cost savings for fund investors—close to $4 billion over the next 10 years.

- **Participating in the digital economy:** In nearly every other corner of our economy and financial system, consumers readily receive and access information online. US households that own mutual funds are no different—as years of research make quite clear. Fund investors should no longer bear the cost of a paper-based framework when those who prefer paper disclosure documents represent a declining share of the investor population.

- **Enabling growth and innovation:** A modernized approach to disclosure delivery would foster innovation and encourage funds to make greater use of technology for the benefit of investors. It would pave the way for funds to create a more interactive disclosure experience that is easy for investors to navigate and allows them to access links to more detailed information, expense calculators, and other interactive features. These improvements would help investors better comprehend important information about the funds they own (or are considering purchasing).

- **Taking a balanced approach to investor protection:** The SEC through rulemaking should ensure that investors receive adequate disclosure along with their account statements that directs them to where fund disclosure documents are located online. The SEC also should preserve for investors the ability to opt for receiving paper disclosure. In promulgating rules to implement this new approach to delivery, the Commission should consider, in addition to the protection of investors, how its rulemaking can promote efficiency, competition, and capital formation.

Legislative Language:

MODERNIZING DELIVERY OF REGISTERED INVESTMENT COMPANY DISCLOSURE DOCUMENTS

(a) RULEMAKING REQUIRED.—Within eighteen months after the date of enactment of this subtitle, the Securities and Exchange Commission shall adopt rules or rule amendments that permit registered investment companies to satisfy requirements for delivering information to stockholders, including: periodic reports under section 30(e) of the Investment Company Act of 1940 [15 U.S.C. 80a-29(e)]; prospectuses (as defined in section 10 of the Securities Act of 1933 [15 U.S.C. 77j]); statements regarding the source or sources of dividend or distribution payments from a registered investment company under section 19(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-19(a)]; and proxy materials under section 14(a) of the Securities Exchange Act of 1934 [15 U.S.C. 78n(a)], by posting the information on an Internet Web site.

(b) CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.—In promulgating rules or rule amendments under subsection (a), the Commission shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

(c) DEFINITIONS.—"Registered investment company", as used in this section, means an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.].

4. Direct the SEC to Study and Report to Congress on Regulatory Framework for Delivering Periodic Reports

Description of Proposal: Direct the SEC to issue a report to Congress (1) examining the appropriateness of fees charged to registered investment companies ("funds") for delivering fund shareholder reports to shareholders who own fund shares in accounts held by broker-dealers ("brokerage accounts"); and (2) reviewing the degree to which the SEC or FINRA has authority—including sanctioning authority at both the individual and corporate level—to regulate the activities of any person that delivers fund shareholder reports to such brokerage accounts.

Background/Why Proposal Is Needed: Broker-dealers ("brokers") are required to deliver fund shareholder reports to their customers, and funds are required to pay for the brokers' reasonable delivery expenses. In practice, brokers outsource fund shareholder report delivery to the dominant vendor—Broadridge Financial Solutions—which controls 99% of the market. This system has led to funds paying twice as much for delivering shareholder reports to brokerage accounts as compared to accounts held directly with a fund. In effect, Broadridge acts as a market utility, but with no oversight.

Impact on Economic Growth and Impact on the Ability of Consumers, Market Participants and Financial Companies To Participate in the Economy:

- **Examining appropriateness of government-set fees:** Section 14 of the Securities Exchange Act of 1934 provides the SEC with authority to set fees that brokers may charge funds for delivering fund shareholder reports to brokerage accounts. The SEC has delegated this authority to the self-regulatory organizations, and the New York Stock Exchange (NYSE) has implemented a fee schedule for all brokers. Although NYSE rules technically set maximum fees, brokers have no incentive to negotiate lower rates with Broadridge since funds pay the bill. Given the misalignment of incentives (*i.e.*, brokers negotiate while funds pay), it is no surprise that these fees are unreasonably high. A survey of ICI members found that, on average, funds pay more than twice as much to deliver the same shareholder report to a brokerage account as compared to a customer account held directly at the fund—in other words, funds are forced to pay twice as much for the same service. This disparity demonstrates that the current fee structure is in dire need of SEC review.

- **Reviewing need for oversight of a government-created monopoly:** The misaligned incentives inherent in this broken fee structure allow Broadridge, effectively a government-created monopoly, to function as a utility with no oversight. Although the government regulates the fees, the government does not regulate the utility charging the fees. Rather, the government permits a utility to dominate a market where the parties negotiating the fee do not actually pay the bill. This troubling scenario absolutely necessitates robust oversight of fees. We estimate that funds pay Broadridge over $100 million per year under the current regime with absolutely no oversight.

Legislative Language:

SEC STUDY AND REPORT TO CONGRESS ON REGULATORY FRAMEWORK FOR DELIVERING PERIODIC REPORTS

(a) STUDY.—

(1) IN GENERAL.—The Securities and Exchange Commission shall conduct a study of: (i) the appropriate regulation of any person who delivers, or receives fees, directly or indirectly, for delivering, periodic reports under section 30(e) of the Investment Company Act of 1940 [15 U.S.C. 80a-29(e)] to customers of a broker or dealer who are beneficial owners of securities issued by a registered investment company; and (ii) the fees any such person receives, directly or indirectly, for such delivery.

(2) ISSUES TO BE STUDIED.—The study conducted under subsection (a) must address the following:

(A) the appropriateness of fees that such persons receive for delivering registered investment company periodic reports as described in subsection (1);

(B) the extent to which the Securities and Exchange Commission or the Financial Industry Regulatory Authority has authority—including sanctioning authority at both the individual and corporate level—to regulate any such person that receives fees for delivering registered investment company periodic reports as described in subsection (1); and

(C) an identification of, and recommendation to Congress for, any authority needed to regulate any such person who delivers, or receives fees for delivering, any such registered investment company periodic reports as described in subsection (1).

(b) REPORT TO CONGRESS.—Within three months after the date of enactment of this subtitle, the Securities and Exchange Commission shall prepare and submit a report to Congress summarizing the results of the study conducted under subsection (a).

(c) DEFINITIONS.—“Registered investment company,” as used in this section, means an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.].