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A LOOK AT MUTUAL FUNDS OVER THE NEXT 75 YEARS

A DISCUSSION WITH COMMISSIONER KARA M. STEIN
OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

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P R O C E E D I N G S

MR. ELLIOTT: Good morning, everyone. I'm Doug Elliott, for those of you who don't know me. I'm here in the Economic Studies program at Brookings, and it's my honor today to introduce Commissioner Kara Stein. After she speaks, I'll ask her a few questions and then we'll give a chance for you in the audience to ask a few of your own.

Kara Stein was appointed to the Securities Exchange Commission in August 2013, after a distinguished career in both the private and public sector as an attorney focused on public policy and regulation and then as a key member of the staff of Senator Jack Reed and the Senate Banking Committee. During her period as a staffer, she played a crucial role on major legislation, including most importantly probably, the Dodd-Frank Act.

You have her bio, so I will not take up more time now with details because I'm sure you'd rather hear from the Commissioner. So Commissioner.

MS. STEIN: Doug, can I move this right here? Or unplug it even? Do you need it? Is that keeping that up? Okay.

So thank you for the kind and quick introduction.

Before I begin my remarks, I need to make the standard disclaimer that you will hear other SEC commissioners make, that the views I'm expressing today are my own and do not necessarily reflect those of my fellow commissioners, the staff, or the staff of the commission. I am extremely pleased to be here at the Brookings Institution this morning. Brookings has a long and proud history of tackling difficult public policy issues and I think even more importantly, fostering robust public debate.

Recent discussions on the role of the capital markets in today's economy and systemic risk in the asset management industry are very important contributions to

the national dialogue. So thank you to the Brookings Institution for continuing to drive important conversations, and thank you for having me here today.

This year marks the 75th anniversary of the Investment Company Act of 1940 known as the Investment Company Act, which established the regulatory framework for registered investment companies or registered funds in the United States. This anniversary may not mean all that much to those of you who aren't securities regulators, but this law has touched almost everyone in this room in some way. Most Americans know registered funds as mutual funds, or perhaps as exchanged traded funds or EFTs. And nearly one out of every three Americans, over 90 million people, put their investment dollars to work in registered funds. And these funds play a vitally important role in the ability of many Americans to retire, and I think this role is only likely to increase in the coming years.

In order to put some context around why registered funds matter so much going forward, I want to briefly discuss some recent census figures. As most of us know, over the next 35 years, our country's senior population is expected to swell. Recent government figures estimate that roughly 15 percent of the total population of our country is age 65 or older, or approximately 65 -- actually, yes, 46 million Americans. By the year 2050, there are projected to be nearly 88 million Americans age 65 or over, which is approximately 22 percent of the total projected population. So basically, in the next 35 years, we're expecting a seven percent increase in the number of older Americans. This is a huge shift.

This expansion in the number of Americans age 65 and older coincides with Americans needing to take more and more responsibility for their golden years. For much of the last century, people have thought of retirement as a stable three-legged stool -- social security, a pension, and personal savings. However, for many families, at least

one leg of that stool has disappeared, the pension, and the other two legs have become a bit more wobbly. Former SEC Chairman Arthur Lovett noted back in 1998 that an era of self-reliance has begun with respect to retirement planning, and I would say it has only accelerated in the direction of self-help since 1998.

In 2015, Americans expect less and less of their retirement income to come from Social Security and employer-sponsored pensions, and more and more of it to come from personal investments. Most Americans will make such investments through mutual funds or EFTs, and given current projections, an ever-increasing number of Americans will be relying on these funds for their retirement.

Most of you are probably somewhat familiar with how mutual funds and EFTs operate, but as a quick refresher, a fund will generally pool money from thousands of shareholders who have purchased interest in the fund. An asset manager then invests this pool of money in stocks, bonds, or other financial instruments. The fund shareholders share proportionately in the fund's profits, but they also share proportionately in the fund's losses. The asset manager directing the assets is, of course, compensated for their work usually through a management fee.

Since 1940, the American mutual fund and EFT market has become the largest in the world. It had approximately $18 trillion in assets under management at the end of 2014, which is more than 50 percent of the worldwide market. If you have a 401K plan for your retirement savings, or a 529 plan for a child's education, you are likely an investor in a registered fund. So whether it's for retirement, college, a future home purchase or anything in between, Americans rely on investment companies now more than ever.

The use of these investment vehicles or registered funds is especially pronounced for retail investors. Most retail investors that want to invest in stocks and

bonds do so through mutual fund or EFT. By retail invest I mean the everyday citizen or household that is investing, not institutional investors or pension funds. Eighty-nine percent of mutual fund assets are attributable to retail investors.

So, as we note, the 75th anniversary of the Investment Company Act, we should also acknowledge that the funds that are organized under the Act have never played a more important role in our economy or in our country. And as the census numbers indicate, this role is likely to grow.

The 75th anniversary of the Investment Company Act happens to coincide with a major rulemaking initiative by the United States Securities and Exchange Commission to update and modernize some of the rules having to do with registered funds. The Commission recently proposed new rules that will enhance and improve the data that registered funds report to the Commission and to the public.

The staff is also examining making potential changes to liquidity management rules and rules regarding the use of derivatives by registered funds. All of this comes against a backdrop of the Financial Stability Oversight Council and others taking a closer look at the potential systemic risks posed by asset managers and registered funds.

So this particular anniversary of the Investment Company Act seems to me like a particularly appropriate time to reassess our regulatory framework under the Investment Company Act and see how it's doing on addressing new and emerging risks. I think it's an important time to have a dialogue with the asset management industry and to fortify our commitment to investor protection going forward. Ultimately, all stakeholders involved want the same thing -- 75 more years of stable growth and success. Or at least more, you know, at least 35; right?

This morning, I thought I would share some thoughts regarding asset

managers, registered funds, and registered fund investors. First, maybe because I was a history major in college, I always find it helpful to start with some historical perspective. What was the impetus for the Investment Company Act, and why do we have it? Second, is the Investment Company Act still working? The Act was built on a sturdy foundation of strong rules that have served funds and their investors well for 75 years. Constants, like liquidity requirements and leverage limitations have been cornerstones in this foundation. However, we may need to consider whether certain cornerstones are still working or whether they may need some repairs.

Finally, I will offer some thoughts about alternative mutual funds. These funds often operate in a gray area of mutual fund regulation. Most would not have envisioned these funds taking off even a couple of decades ago, and I think that we all need to be asking questions about the development of these funds and what they mean to the retail investor. Do investors understand these products? Are these funds adhering to the foundational principles of the Investment Company Act which have served investors so well for 75 years?

So to start with a little bit of history. Prior to the Investment Company Act being adopted in 1940, investment funds were essentially only subject to a disclosure regime. There were few hard and fast rules for funds to follow. So long as funds generally disclosed their practices and the risks, they were considered compliant with the law. Congress recognized this was problematic and decided to target through the Investment Company Act "abuses which may grow out of the unregulated power of management to use large pools of cash."

In the run-up to the 1929 crash, investment companies and investment trusts have proliferated. Many of them had high degrees of leverage. The historian John Kenneth Galbraith noted that these vehicles were "greatly and mired marvels of the time."

Unfortunately, many of these marvels were rife with abuse. A Securities and Exchange Commission study around that time noted that these investment companies were often receptacles for the unloading of worthless securities. Many investment companies were operated primarily to advance the interest of management without any care for the interest of investors. The same study noted that investment companies were often organized so that promoters could sell the securities door to door like salesmen regardless of the soundness of the investment.

United States Senator Robert Wagner of New York noted in congressional hearings in 1940 that investment companies were still in their infancy at the time of the crash, and that the industry was not immune to the issues facing the broader marketplace. I think interestingly, the approach adopted in the Investment Company Act clearly recognized that disclosure alone was not sufficient. In order to protect investors in these funds, Congress determined that substantive regulation with strong, predictable minimum standards was necessary. Funds needed to be straightforward and predictable enough so that the average investor knew what he or she was getting into. And as Senator Wagner noted at the time, "the important thing was that the individual should know what type of investment he is making."

United States Security Commissioner Robert Healy, who was actually part of the first commission, reinforced this point in his testimony before the Senate in 1940. He stated, "It should hardly be necessary to point out that existing legislation is not adequate to meet the problems presented by the investment company. The disclosure principle abided in the Securities Act and the Securities Exchange Act is a sound principle but it has its limitations." He also noted, another quote, "There are certain practices that have happened in connection with investment companies that I think everybody agrees ought to be stopped, and they cannot be stopped by mere disclosure."

I think another point I'd like to make, it's important to know that the registered fund regime is not meant to mire the private fund world to which it is often compared. These are two very different forms of investment. Private funds, like hedge funds, operate more on a disclosure basis. They receive certain exemptions as long as only a certain category of investors is involved, and they are generally allowed substantial leeway and are generally not subject to the same substantive rules as registered funds, so long as all the material terms of the investment are disclosed. This flexibility is justified, at least in part, by the fact that investors in private funds have to meet certain wealth requirements, and they tend to be more sophisticated.

Mutual funds, conversely, are invested in by everyday retail investors, and because of this investor base, Congress mandated that the Investment Company Act have strong and clear rules to protect these investors in addition to robust disclosure.

So in many ways, the Investment Company Act of 1940 has remained a prescriptive statute with strong rules and robust disclosures. The retail investor still knows generally what to expect from a mutual fund in many areas, including requirements that major fund contracts be approved and that there be no affiliated transactions. The Investment Company Act's restriction on affiliated transactions is a great example of substantive regulation that has withstood the test of time. I think it's worth spending a little bit of time here on this particular concept because I think it illustrates how the Investment Company Act is supposed to function by setting clear and dependable rules that protect retail investors.

The Investment Company Act itself strictly limits affiliated transactions between funds and their affiliates. This basically means that the people running the fund cannot use the fund to benefit themselves at the expense of fund shareholders. It basically protects against conflicts of interest. Registered funds cannot simply disclose

these conflicts of interest away as a private fund might. As the SEC's Division of Investment Management's 1992 study on registered funds noted -- this is a quote again -- "The Investment Company Act's provisions concerning affiliated transactions are at its heart. The provisions were intended to go beyond those provided under common law, which allows fiduciaries to deal with their beneficiaries if adequate disclosure isn't made." So again, it goes beyond the common law in this area. Maintaining bright line rules on affiliated transactions makes perfect sense and is incredibly valuable. This clear, bright line rule gives retail investors predictability and consistency when investing in mutual funds.

This commitment to clear, dependable disclosure and basic bright line protections from investors is largely responsible for the 75-year-old success story of mutual funds. As the registered fund industry continues to evolve and play an increasingly large role in our economy, I think that we need to remember that a strong, legal framework enabled this growth.

Having said that, I'm concerned that were starting to see some cracks in the foundation of this framework that we should all be thinking about. In some ways, it appears that registered funds have slowly drifted towards a more flexible and permissive disclosure regime. This drift increasingly places the onus on the retail investor to figure out whether a fund is right for him or her. The retail investor, who generally tends to be less sophisticated in financial matters, might not even understand what he or she needs to know to make that decision. For example, the liquidity of registered funds is one area where it seems that regulation has drifted into "buyer beware." A retail investor looks at a mutual fund and expects that he or she will be able to get money out of a fund very quickly if needed.

A retail investor is generally not performing cash flow analyses on mutual

funds to test their true liquidity. I'd say this expectation comes from the Investment Company Act of 1940, which requires mutual funds to honor redemption requests within seven days of a shareholder request. In practice, as many of you probably experienced, the redemption occurs much more quickly than that. In addition, commission guidance only allows mutual funds to invest up to 15 percent of the fund's assets in illiquid securities. As a result of these two requirements, retail investors assume that their investments in registered funds are fairly liquid and they can be redeemed quickly if need be. This liquidity profile and expectation has been a foundational principle of the Investment Company Act since its inception.

I am concerned that this assumption now may be misplaced given some of the new complicated registered funds that have entered the marketplace. For example, registered funds that invest in bank loans have become popular. Since late 2009, assets and bank loan mutual funds and EFTs have increased by almost 400 percent, yet many of the underlying loans in these funds may take over a month to actually settle. If it takes over a month to settle, it is reasonable to wonder how the fund could possibly meet the seven-day redemption requirement in the Investment Company Act in times of market stress.

Additionally, these bank loan funds may be comprised almost entirely of illiquid bank loans which would seemingly violate the 15 percent threshold in the Investment Company Act. Some may also invest in collateralized loan obligations (CLO). How is this happening? Funds have relied on an interpretation of the law that allows them, for example, to base the 15 percent standard on when a contract price is struck to sell the underlying bank loan and not on when the actual settlement of the loan occurs, which is when the fund would actually receive cash and transfer ownership of the loan.

Unfortunately, I'm not sure that retail investors have received the memo

that interpretations of liquidity rules have changed beneath their feet for certain funds. Not only that, retail investors may not even receive disclosure about risk related to that extended settlement period, so over time, this 15 percent liquidity standard, this foundational principle, has arguably become more of a compliance exercise than a true restriction. Bank loan funds are just one example of new types of funds that may require further examination as we consider as a commission updating our liquidity rules.

A prominent investor recently remarked -- I love this quote -- "It's one of my standing rules that no investment vehicle should promise greater liquidity than is afforded by its underlying assets." I fear that this is precisely what is happening with some of the new types of funds that are entering the marketplace. Promising high liquidity, which all mutual funds must do, on illiquid assets that have not been traditionally part of mutual funds does not seem to be in keeping with the intent of the Investment Company Act.

I hope that as the Commission considers action in the area of liquidity, it asks hard questions about new and innovative products as well as emerging risks. Do the retail investors investing in these funds truly understand and appreciate the liquidity of the fund?

Perhaps these investments make sense for a private fund which has a more sophisticated investor base and is often also subject to lockups and gates that can help the fund navigate market stress. But what happens to an open-end mutual fund or EFT which must honor redemptions in seven days? When financial conditions get rocky, redemption requests surge and the fund is primarily invested in liquid assets, what happens?

Another cornerstone principle in cornerstone mutual fund regulation has been the requirement for relatively low leverage as mandated by Section 18 of the

Investment Company Act. Section 18 generally limits the ability of funds to leverage their assets through the issuance of senior securities such as derivatives. In addition, a registered fund generally must maintain 300 percent asset coverage for senior securities. This three-to-one coverage ratio is in line with what investors have thought about mutual funds for decades, namely, that they are not highly leveraged vehicles.

There is also an expectation that embedded leverage obtained through derivatives is low. Commission officials have pointed out over the years that Congress was concerned that abuses could result when funds leveraged without any significant limitations.

The protections of Section 18 of the Act are meant to be substantive and real and not aspirational. Unfortunately, this cornerstone principle appears to have gradually eroded as well. Derivatives usage by registered funds has skyrocketed in the past couple of decades. Without getting too far into the minutia, the Commission issued guidance back in 1979 and the Commission staff have issued almost 30 no action letters all on the issue of leverage obtained through derivatives.

The result has been a mixed bag of patchwork of regulation that does not always comport with Section 18. This ad hoc approach has chipped away at a true leverage restriction. There have been reports of funds being able to obtain notional exposure of up to 10 times the fund's net asset value through instruments like swaps and futures. I think that most would agree that this type of leverage runs counter to the leveraged limitations required by Section 18 of the Investment Company Act.

So I'm very pleased to see the Commission is considering taking up this issue as well. It's difficult, it's complex, but we need to tackle it. It was always intended that leverage be limited under the Investment Company Act, and as I mentioned earlier, many of the early investment companies and the early investment trusts that imploded in

the 1920s were highly levered vehicles. When earnings and values fell, leverage exacerbated the problem in these funds. This might sound eerily familiar to those of us who recently went through a financial crisis. Going forward, the Commission's approach must reflect the Investment Company Act's foundational principles that leverage be limited in registered funds.

So now I'd like to talk about alternative mutual funds. Liquidity, leverage, derivatives, and investor protection are also elements that should be present in any discussion about alternative mutual funds. It's hard to define what an alternative mutual fund is. It can mean different things to different people, but generally, they are mutual funds or EFTs that pursue and investment strategy in a nontraditional asset class, that use nontraditional investment strategies, and/or they invest in liquid assets. They also frequently seem to rely on derivatives for their investment returns.

Assets under management in alternative mutual funds have exploded in recent years. In 2008, there were approximately $46 billion in assets under management for these funds. By the end of 2014, the number had surged to $311 billion in assets under management. So this is an increase of over 575 percent in six years. We continue to see more investment firms pressing to move into this area. An official at the Commission had an interesting description for alternative mutual funds. He called them "bright new shiny objects in the marketplace that are also very sharp and fraught with risk."

Going back to my original theme, it's worth thinking about whether these alternative mutual funds have gradually drifted away from the intent and the foundational principles of the Investment Company Act. For a long time, mutual fund managers did not suggest that they could manage a fund in a way that mimicked the return of a top hedge fund. It was simply understood that the liquidity and the leverage restrictions in

the Investment Company Act were prohibitive and would not allow for a true hedge fund=type strategy.

If you wanted the potential upside that a hedge fund strategy might give you, you had to accept the potential downside; right? The liquidity. A certain level of liquidity with your investment, which you could not do within a registered fund. Yet, today, alternative mutual funds promising the upside of hedge fund investments with the liquidity of traditional mutual funds are all the rage.

I think this trend should give everyone pause and regulators and the public need to be asking questions about this development. Many of these funds may indeed be innovative, but are they consistent with the Investment Company Act and its protection of the retail investor, particularly the leverage restrictions? What should the regulatory reaction be? Should we consider regulating these funds differently than plain vanilla traditional mutual fund?

As I've laid out, the retail investor, many of us in this room, have certain expectations of mutual funds grounded in longstanding rules under the Investment Company Act. Alternative mutual funds seem to operate on the margins of several of these rules. They may be less liquid, employ more leverage, and invest in exotic and complex instruments. At a minimum, this raises the question of retail investor confusion. Do retail investors understand that the unconstrained alternative bond fund that they're being sold may not actually perform like a traditional bond fund at all. What happens during the next crisis when markets are stressed and alternative mutual funds are tested for the first time? All of these questions should be asked and debated now and not during a time of financial market distress.

So in conclusion, as I mentioned earlier, the Commission is at the beginning stages of a rules initiative focused on asset managers and registered funds. In

particular, the Commission and the staff will be considering liquidity and derivatives, and I think this initiative presents a much-needed opportunity to take a holistic look at how the Investment Company Act is currently functioning and if it can be enhanced and updated going forward. I strongly believe that we need to keep in mind what is happening on a macro level. Most people are living paycheck to paycheck, yet we are asking them to take more and more responsibility for saving for their retirement. Americans will be looking to mutual funds and EFTs to help them do this. Given this reality, regulators and the industry have a responsibility to make certain that the legal framework is stable and it remains focused on protecting the investor.

Investment Company Act regulation is not "one size fits all," and that has been one of its strengths. There has been flexibility in the Investment Company Act through the use of exempted orders and other relief. And this flexibility has allowed fund companies to continue to evolve, to innovate, and to develop new investment opportunities, and this is healthy. However, mutual funds have become one of America's most successful industries for a very good reason. The Investment Company Act is a shiny example of smart investor-centric regulation. For decades, there has been tremendous value in the fact that shareholders generally know what to expect structurally from a mutual fund. Retail investors have not had to have a graduate degree in finance to figure out what mutual funds liquidity or leverage really are. Mutual funds have allowed investors to take informed risks within a well understood set of basic restrictions and protections.

So I encourage all of you, whether you're an academic, an attorney, a fund representative, or an interested investor, to help the Commission as it moves forward in updating some of our rules for asset managers and registered funds. Your participation in the notice and comment process is very important. We need to hear from

as many perspectives as possible, and it truly informs our rules and allows us to make better public policy decisions.

I look forward to continuing to work with all of you on these challenging issues and I'm pleased that the Brookings Institution has been a facilitator of and a participant in these discussions, and I know that you'll continue to play an important role. So thank you very much for your time this morning. Thank you again for the Brookings Institution inviting me to speak to you, and I look forward to answering some of your questions.

(Applause)

MR. ELLIOTT: Thank you very much, Commissioner. That was a clear and intriguing speech. One of the intriguing aspects, as I thought you raised a lot of great questions, do you think at this point there are clear answers to any of those? If I could put words in your mouth, which I'm sure you will abjure in a second, it almost sounded to me on the alternative mutual funds as if you were suggesting they cannot within the spirit of the rules actually operate. But are there any things that are clear to you at this point of these questions you raised?

MS. STEIN: One, we're going to be going through active rulemaking, so I probably can't talk in great detail about that. But I want to go back to what I was saying. I think there are foundational principles in the 1940 Act that have stood the test of time extremely well. And as we reexamine and think about how to modernize and update the '40 Act, basically, that we keep those principles in line. You, as an expert on the financial services industry, would understand liquidity and leverage and capitals of, you know, issues that have been tools that we've used in a variety of contexts, and I think we need to go back here to what has worked well and think about that going forward.

MR. ELLIOTT: Okay. Fair enough. I'll give you the rulemaking pass

here. I can understand the restrictions with that.

Now, one thing I was struck by as we've talked about previously, there's a tendency for the existing prudential regulators, banking regulators in particular, to view the SEC and your compatriots in other countries as very focused on some worthy goals, like investor protection, but not very focused on financial stability. And in fact, in the speech in terms of what you chose to focus on today, there was very little mention of financial stability other than the historical background was about a financial crisis, and that clearly motivated many of the rules. Could you talk a little bit about what you see the SEC's role being in regard to financial stability, and maybe a little bit of how in your two years there you've actually seen it enter into the deliberations?

MS. STEIN: So at the Pearson Institute, about a year ago I actually spent a lot of time talking about financial stability in the SEC. I actually think that the SEC's mission, which is actually sort of outlined in legislation as protecting investors, promoting fair and efficient markets, and capital formation, systemic risk is a very important part of all of that. It's sort of implicit in all three of the things that are in our mission statement. I believe that the Dodd-Frank Act has asked all of the financial regulators, through their own work and also through the Financial Stability Oversight Council, to be more focused on the system's financial stability. And I've seen that in action as we have been going through our own policy initiatives and our own rulemakings, that people are focused now on interconnections, you know, between financial institutions where they might affect one another. So I think ultimately we're in a better place than we were in 2008, and we need to keep thinking about how to improve and enhance that sort of mission going forward.

MR. ELLIOTT: Now, on a related question, as you're well aware, there's been a lot of discussion recently about financial market liquidity and whether it's possible

that inadvertently as a result of attempting to achieve other valid objectives, that regulation has contributed to a decline in market liquidity which might have systemic consequences down the line. I wonder if you had some thoughts on that.

MS. STEIN: You know, I think this is a really important debate to be having now and people have been very focused on it, both you and people within all the financial regulators. And I think, you know, some of this is our monetary policy and where people have been striving to achieve yield, right, in a low-interest environment. And I think another part of this is the new regulatory regime and how that's affecting what type of products or activities firms invest in.

I think at the end of the day we need to be very focused on this. Everybody needs to keep asking the right questions but I think we're going to not know until we sort of move forward and have a more volatile market how things have actually evolved and changed.

MR. ELLIOTT: That's fair enough. I guess a background reason why I'm somewhat concerned about this issue, though I think it can be exaggerated, is there really doesn't seem to be anyone whose official role is to try to maintain market liquidity in the broader context. The FSOC, possibly, except the focus has been so much more on financial stability than on the day-to-day maintenance of market conditions. SEC, possibly, but you don't have the power to do much about regulations that are made in, say, the banking sector. Do you think we have the right kind of overall governance structure to deal with this kind of interconnected issue?

MS. STEIN: You know, I think there's not a good answer to that question. I think we are where we are and we need to keep thinking about whether there's a better structure. We --

MR. ELLIOTT: Let me rephrase it then.

Do you see anything we could concretely do to improve the way that we tackled that kind of question given the structure we have?

MS. STEIN: You know, I think the Financial Stability Oversight Council has actually been a good forum for people to talk about these issues where they weren't talking about them before and people were in their regulatory silos and were focused on their particular mission and not necessarily what was happening to the broader financial marketplace. I think our Office of Financial Research that got created in the Dodd-Frank is another good place for those types of studies, thought, and research to be happening to inform the public and the regulatory community about those important issues. So I think we're in a much better place than we were, and if you have good ideas about how we should move forward, we should all be open to that.

Clearly during Dodd-Frank there was a push to eliminate some regulators. I think we've probably added one and lost one.

MR. ELLIOTT: Yes. I think it was an add addition if you added up everything.

MS. STEIN: Right. So there was that push, you know, intellectually to do that. But in the American marketplace, we have a very big market with lots of active players, and we have a regulatory structure that's developed over several hundred years. So we're still figuring out how in this new, very quickly evolving, high-speed marketplace, we can be interacting effectively in regulating it.

MR. ELLIOTT: I guess we'll try to come back with some good ideas because I fear we're not evolving rapidly enough in terms of that regard.

It's interesting when I talk with people in Europe, for example, where they're very keen on moving to something that looks a bit more like our structure because they admire the strength of our capital markets. More credit provision occurs ultimately

through our markets and as under your regulation than occurs through our banks even though that's not how people tend to think about it.

We've been talking about the FSOC just because this issue has come up so much. Do you have any thoughts on how the debate about SIFI designation of asset managers has evolved?

MS. STEIN: Of course, I don't sit on the FSOC; the chair of the Commission does, so I'm not privy to how that debate has actually evolved. But from my perspective, the debate has been healthy and robust. I think it's involved all of the regulators in a way that it would not have before. I think it's allowed the Commission to bring our own special expertise to bear and our understanding of the asset management industry and to share that with the other regulators. So I think it's been a healthy conversation and sort of movement towards developing public policies that are going to work, as I sort of was saying, in the next 75 years. That we're actually having the conversation is a very good thing, and hopefully we'll never be in the position that we actually have to be worrying about a large asset manager being the problem.

MR. ELLIOTT: Okay. I'll ask you two more specific questions about your points you made in your speech and then I'll give the audience a chance here.

One of them is you mentioned bank loan funds as an example of the concern you have particularly about the liquidity issue. Anything else pop to mind as you think about this area?

MS. STEIN: Just in general, I think a lot of times new risks emerge in opaque, highly-levered, complicated products. So we always need to be looking at what the next new thing is. I think we need to follow the money. You know, a lot of times people are negotiating around a current rule and creating a new product that doesn't fit within that rule and we need to go look about where the money is starting to go. So I

think as regulators, we need to always be -- go back to evolving. We need to be out on that frontier and always asking people, "What's happening? What's new in your space? Do you think that's working? How is it going to interact with other products in the market? Are people going to understand what these products are? Are they appropriate for certain -- or suitable for certain groups of investors?"

So I think at the end of the day all of us -- you know, derivatives was a good example. Derivatives sort of were exempted from regulatory treatment because there was a small set of contracts that people used to ensure against certain types of risk. And then you go another 15 years and it's the way many people are doing financial transactions.

MR. ELLIOTT: Actually, that ties in beautifully to my final question. I was just wondering in terms of clarification, because you talked a fair amount about derivatives, are you concerned about it solely when it is
basically a way of effectively gaining leverage or are you -- I'll put it another way -- are you broadly comfortable in situations where an asset manager chooses to take credit risk by buying $10 million of credit exposure via the credit default swap as opposed to buying a $10 million bond because they either think the pricing is better or the CDS market is more liquid and so they just want to do it that way? If they do it in that more straightforward way, is that a concern to you other than technical issues?

MS. STEIN: No. I think people should be able to do what's appropriate in their mind, you know, to get that type of exposure. I'm going to go back to leverage. Right? When it's being used to get around the three to one sort of leverage restriction, I think that's when we should be looking at it. So I think derivatives are very appropriate products. They've grown in popularity because they do a good job at helping people achieve certain objectives. But I think we have to look at why someone chooses a

derivative over another product, and you all here in this room who are public policy experts, is it the tax treatment, the accounting treatment, the bankruptcy treatment? You could ask, has federal policy incentivized people to use derivatives more than other products because of those actual advantages? And I don't think we examined those when we did the Dodd-Frank bill, and I think we need to think about all those things going forward for all types of products. Tri-party repo agreements are another example of why people use that particular structure. There are advantages -- in bankruptcy, accounting, et cetera.

MR. ELLIOTT: Okay. Well, thank you for that.

So let me give the audience a chance now. And just to go through the ground rules, please identify yourself by name and affiliation if you have an affiliation. Please remember a question is a question. I think you do know the difference. And if you could just keep it to one question, if we have time at the end we'll get back to people if they want to do a second question.

Yeah. And wait for the mic. Thank you. That's another important part. Sure.

MR. MILLS: Good morning. Thank you. Ed Mills, FBR Capital Markets.

I wanted to ask a question about consumer protections. The Department of Labor has recently released a draft rule on a fiduciary standard. It's unclear exactly where the SEC will be moving, which has led to concerns about bifurcation and consumer protection. SIFMA has proposed amending FINRA rules to have a best interest standard on all retail transactions. I was wondering if you could give us an update as to your opinion on what the SEC should do related to a fiduciary standard, as well as any opinions as it relates to SIFMA's proposal.

MS. STEIN: I've been looking at this issue a long time. I think if it had

been easy, Congress would have put something in the statute in the Dodd-Frank bill. It's not easy.

That being said, I think there's positive progress that we can make going forward. SIFMA has been thinking about these issues for a while, so I think, again, I'll go back to we need to have these robust policy debates. This is not easy and it doesn't mean we have to solve it with one silver bullet solution, but I think whether we're talking about broker dealers or investment advisors or a variety of other people who help investors, I think we can make progress in making sure the rules are working now in 2015. The world is changing very quickly, as you know, and a lot of people are dual advisors. They're BDs and they're IAs, so I think there's another layer of complexity there about what hat are you wearing when and how you make that clearer.

MR. ELLIOTT: Okay. Over there?

MS. MCKENNA: Francine McKenna from Market Watch.

You were talking quite a bit about the rulemaking process and how we need to update the rules, but in the meantime is it possible that the regulators might look at enforcing disclosures more? In other words, are disclosures sometimes missing or misleading? And can we do more in terms of these funds in some of these situations to enhance disclosure?

MS. STEIN: You know, I think, I was saying earlier, I sit through a closed meeting every Thursday and we're basically deciding who to bring enforcement charges against, so a lot of that is about misleading, inappropriate disclosures. People just outright lying about what a fund is going to do or not do. So I think the SEC has its role that is actively focused on making sure our existing disclosures -- our disclosure regime is being met.

You know, that being said, I think we've also been doing through

examination some interesting work on our private fund advisors and I think that's what's going to be helpful. We've been learning that fees have been shifted to one part of a firm and they weren't necessarily identified as such, so there's a lot of good work going on in that area already. But I think we also just did this rule for investment advisors and mutual fund disclosures that we put out as a proposal about how we can enhance those disclosures. So I've been talking about can we do layer disclosure. You can go right to our Edgar site. You know, drill down as much as you want in a dynamic way with the data to find out more about one of our registrants. I think there's a lot more we can do to be innovative, deal with the disruption in the marketplace, and use technology to make our disclosures that we require more readily available to the public and other market participants. So I think we can do more and we need to be thinking about that every year.

MR. ELLIOTT: Martin?

MR. BAILEY: Martin Bailey, Brookings.

So you've been talking -- thank you very much for your comments which were terrific.

Let me take a slightly different perspective. If you're a saver at age 40 and you mention the need for people taking more responsibility for retirement and you or you and your spouse put money into a very safe bond fund or a bank account or something like that, you're going to earn a return which is, you know, barely above the rate of inflation. It's going to be close to zero, and many people in Europe actually do that. In fact, I was part of a study which showed that the real return was negative on the portfolios in Europe over a very long period. Do you see a risk to taking too little risk? Do you think there's a sense in which savers, particularly long run where you don't really care about the short-run, month-to-month, year-to-year risk? Do we need to educate

savers more, and how do we -- do you have any thoughts on how we do that so that people make good investment decisions which will serve them well over the long run?

MS. STEIN: Absolutely. That's an easy question.

You know, I think that goes to financial literacy and helping people understand things like mutual funds and EFTs that can actually help them get much better returns over time than they will be able to do in a bank account or some other -- you know, it could be a bond fund or something else. So I think we can do much better in that regard and we should be -- maybe that's a Department of Education or another part of the government to be talking to, but I think we all need to be focused on how complicated the financial system is now. How can we help people have the financial literacy they need to make the best choices they can for their own family? And anything we can do in that regard I think will make a huge difference.

MR. ELLIOTT: Just -- yeah, the fellow in the polo shirt there.

MR. MYERS: Thank you. I'd like to follow up on the first question dealing with fiduciary issues.

MR. ELLIOTT: Yeah, sir, could you identify yourself?

MR. MYERS: Oh, I'm sorry, Donald Myers.

As I said, I'd like to follow up on that first issue dealing with fiduciary issues. As was mentioned, the Department of Labor reproposed a regulation that will expand who is a fiduciary under URISA with particular impact on the brokerage industry. One commissioner has already weighed in on that commissioner's thoughts about the proposal. I wonder if you could share with us your thoughts about the reproposal.

And second, could you shed any further light on the status of the Commission's consideration of the fiduciary issue which has been looking at it for a number of years? Thank you.

MS. STEIN: He just asked your question again.

You know, DOL is looking at this in the URISA context, so it's a different context than we are at the Commission. The chair has publicly been talking about moving forward on this and giving the Commission a proposal to consider. And so I think my expectation is that we will be looking at these issues and trying to figure out ways we can enhance and improve investor protection.

But I'm going to go back. I think it's complicated in the effects it can have on a broker dealer, on an investment advisor. In many ways, two very different ways of interacting with investors. So the devil is going to be in the details and how -- what that proposal looks like. And I'm going to go back to, if it were simple, Congress would have put it in the statute. It's really not. It's very complicated. And like most rules, we need to think through both the intended and the unintended consequences. So I hope people who care weigh in on the DOL rule, and if we get to the point that we have a proposal, that you will weigh in with us as well.

MR. ELLIOTT: Okay. Annette?

We have a mic coming around.

MS. NAZARETH: I'm Annette Nazareth from Davis Polk.

I very much --

MS. STEIN: Former SEC commissioner.

MS. NAZARETH: Former SEC commissioner.

I very much enjoyed your remarks. I was intrigued by your response to one of the questions on disclosure because obviously the other leg of the stool with all of these protections is disclosure, particularly to retail investors.

I was intrigued by the proposal in your recent SEC proposal on investment companies and investment advisors, that the Commission proposed a notice

in excess basically rule for the semi-annual reporting. And the reason I was surprised by that is that there has been a lot of discussion as you said about things like layer of disclosure, having more meaningful disclosure for retail investors, and my understanding is that the experience with notice and access, which was applied in the context of proxy disclosure, was a very colossal miss. The retail participation in the proxy was reduced by over 75 percent, and yet the experience with summary prospectus has been very, very successful. So I wondered if you could comment on what I thought was an unusual shift to notice and access for retail investors.

MS. STEIN: I actually commented on that when we put the proposal out, that I wanted to have feedback. Because of these two different examples that you laid out, there's been a very different response. And I'm also -- I tend to be an advocate of doing -- I think we should be doing more investor testing so we actually know what an investor is going to do in a certain context. As you know, and all of us in this room know, because we have a broad group of age group in here, millennials and those who are younger are doing everything on their pone and they're going to click on a link and go to look at whatever it is that's being offered to them. And I have a 75-year-old mother who is not going to do that and would like to get something in the mail. So I think we need to be thinking through how people interact with technology and how they communicate very differently in making sure there's a variety of access points. So I'll be interested in the feedback. I asked for more feedback on this issue and hopefully will receive some.

MR. ELLIOTT: Okay. Why don't we take one more question? Way in the back.

MR. TIMBURG: Tom Timburg, consultant.

I wondered if you could comment on the advantages and hazards from a regulatory point of view of index funds.

MR. ELLIOTT: That's a good question.

MS. STEIN: You know, I try not to comment on products directly because you get quoted on them pretty quickly.

You know, I think some of our consumer groups have -- and through our Investor Advisory Committee, have wanted us to do exactly that and sort of lay out for folks more clearly what might happen in an index fund, what decisions might be made at certain points. So I think we certainly need and could probably have enhance or better disclosure on that front. I think it's an innovative product to the degree people -- there are many people who will stick money in a mutual fund and never touch it. Over three years, they don't rebalance. They don't do that. They don't look at it at least once a year and decide if they're going to change the amount they have invested in bonds versus equities. So I think there's a useful role there and it's going to depend on how that product is actually working. So to the degree you can provide simple, clear disclosure that will allow a retail investor to understand what will happen in different scenarios and they make that choice that they would like to be in the fund, that's probably the right outcome.

But the advantages and disadvantages are similar to being an investor in just a bond fund or just an equity fund, and that goes back to your financial literacy issue, is how can we help a variety of different types of investors who want to be more or less engaged in making their investment decisions. And that goes to your question about invest advisors or broker dealers. How can we allow people to have access to the type of advice they need if they don't feel comfortable making those decisions for themselves. So having a variety of options where people can make active choices and they're financially capable of getting access to that type of help I think is -- we have robo advisors now that sometimes are basically allowing you to interact with effectively a computer that's sort of setting up advice for you based on your risk profile and answering

a variety of questions. I think we need to look at that as well. I don't think the computer should have fiduciary duty, but we need to be thinking through what effects that might have on how people make investment choices.

MR. ELLIOTT: Okay. Thank you very much, Commissioner.

MS. STEIN: Great, thank you.

MR. ELLIOT: Thank you all.

(Applause)

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