ICI VIEWPOINTS

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Do Bears Run Away from Firefighters? This Question and a Few Others We Heard After SEC Chair Gary Gensler Spoke at the ICI Leadership Summit

By ICI Strategic Communications

ICI was honored to host the Chair of the Securities and Exchange Commission, Gary Gensler, at our annual *Leadership Summit* and to hear from him about his priorities. Appearing virtually, Gensler spoke at length about financial stability and his agenda regarding open-end funds. However, the Chair's comments did raise a few questions, which we try to answer below.

Why do we keep hearing the debunked theory that bond mutual funds were responsible for market volatility in March 2020?

In March 2020, investors faced an unprecedented economic and financial market shock stemming from the global coronavirus pandemic. As we've explained, our in-depth findings on what happened three years ago indicate that bond mutual fund investors behaved much as they always have in response to financial market shocks: They redeemed shares moderately, in proportion to the size of the shocks they faced. Although bond funds experienced steady outflows, investors still retained 95% of their bond fund assets.

Our research clearly demonstrates that any knock-on effects to the corporate and Treasury bond markets from these redemptions were negligible. From February 28 to March 23, bond mutual funds sold, on net, **only** $8 billion in investment-grade corporate bonds—a minor amount. Although bond mutual funds sold Treasuries to help fund redemptions, their net sales of $101 billion were dwarfed by net sales from foreign actors. Foreign private investors, sovereign wealth funds, and foreign central banks dumped Treasuries to the tune of more than $400 billion—which, at four times larger than mutual funds' sales, provides some important perspective when discussing outflows in March 2020. In addition, ICI's research shows that net sales by bond mutual funds had very little impact on Treasury yields and credit spreads of corporate bonds during the first few weeks of March 2020.

Why are heavily regulated and transparent products like mutual funds in regulators' crosshairs?

The Chair introduced a range of metaphors, referring to run risk as a bear in the woods or a fire, and central banks, like the Federal Reserve, as firefighters. But one thing that Chair Gensler did not mention was the fact that foreign central banks, a group no US regulator oversees, did call on the "fire department"—the Federal Reserve—for almost $450 billion in US lending. While the need for dollar liquidity is understandable in the unprecedented context of March 2020, the aftermath has seen regulators avoid analyzing why those calls came.

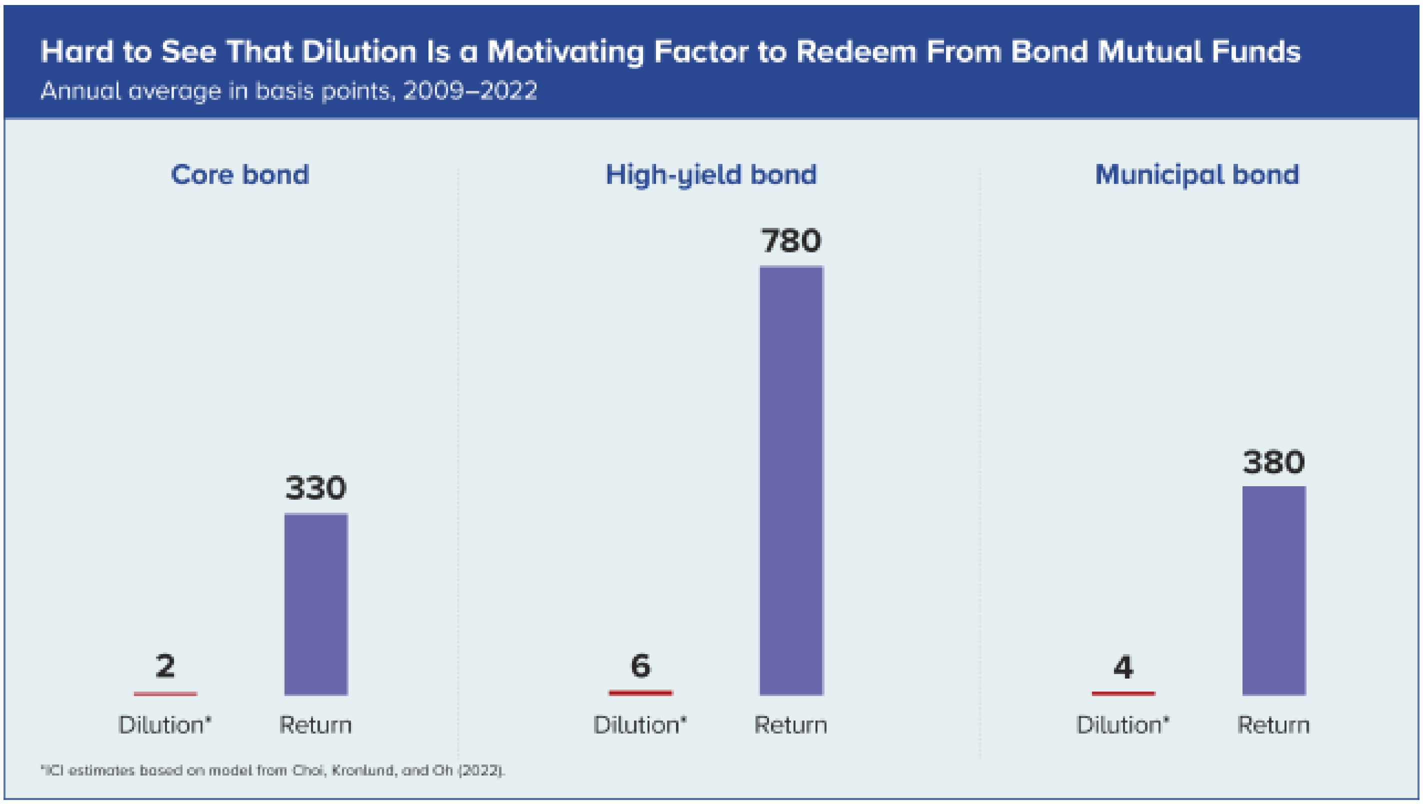
Instead of talking about a bear in the woods, perhaps the Chair should have discussed the role of foreign central banks—the elephant in the room. Unfortunately, there do *not* seem to be any current policy discussions addressing that elephant.

Are runs unique to open-end funds?

The Chair's opening speech on risk of runs in open-end funds appeared to ignore that there have been actual runs in the banking sector in the past few months. While open-end fund regulation is very important, it seems incongruous, however, to skirt discussion of banks simply because prudential regulators like central banks are closer to banks than they are to funds. ICI's President Eric Pan took the opportunity to point this out to Gensler during Q&A, remarking that this shows "*that the run behavior you're worried about is not unique to open-end-funds—and is more present in other areas of the financial system*."

Is the SEC's proposed overhaul of mutual fund pricing really about dilution—and is dilution a significant issue?

When we look at dilution, it's important to examine hard evidence and see what the numbers say. ICI performed a detailed economic analysis of the SEC's liquidity risk management, swing pricing and hard close proposal. Pan asked Gensler: "*Is dilution of such a size to have the effect that you're worried about?*" and went on to remind the Chair that ICI's data show that average daily dilution is "*merely tenths or hundredths of a basis point in size*." This seems far too small to have the risky knock-on effects the SEC claims it is worried about. Indeed, even aggregated over an entire year, we estimate that dilution averages between 2 and 6 basis points, depending on the type of bond mutual fund—miniscule when compared to returns.



How closely will the SEC listen to Congress and investors?

Pan pointed out that thousands of commenters, from members of Congress to retail investors, have joined ICI in raising serous concerns about the SEC's liquidity risk management, swing pricing and hard close proposal, which threatens mutual funds and will harm middle-class families trying to build financial security. He asked directly if the SEC was worried that "*overregulation of these products will be killing the thing that you value…denying these very useful products to middle-class Americans*." Chair Gensler said the agency takes all the comments it receives seriously. Hopefully this is true. Any final rule in this area will need to show to what extent the SEC is listening to these comments.

So, Do Bears Run Away from Firefighters?

This one stumps us, but it is a fun question to ask.

*Staff members across ICI Strategic Communications contribute to various ICI publications, including*ICI Viewpoints*.*