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Keynote Address, 2021 ICI Tax and Accounting Conference

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As prepared for delivery.

Thank you, Jon Davis, for the warm welcome and for your service to ICI as chair of the Institute's Tax Committee for the past five years. My thanks as well to our many speakers and panelists, everyone joining us in attendance, and all those who have helped organize this conference—especially my colleague Greg Smith, who will be retiring at the end of this year after serving the industry in ICI's operations department for nearly three decades.

My address to the Tax and Accounting Conference—my first since becoming president of ICI a little over 10 months ago—takes place at an important time. Tax issues have come to the forefront these past few weeks as Congress debates two significant pieces of legislation: the bipartisan infrastructure bill and the $3.5 trillion reconciliation package.

As Congress debates what and how much to spend, there is understandably a need to consider how to pay for such spending priorities. While the current debate revolves around imposing new taxes to raise revenue, taxes also reflect policy priorities. How and what we tax affects behavior—taxes create incentives and disincentives for Americans—and policymakers must carefully consider the impact taxes may have on economically beneficial activities.

This leads me to the focus of my remarks here today, which is a discussion of Senate Finance Committee Chair Ron Wyden's draft legislation that seeks several changes to the tax code to pay for the Biden administration's $3.5 trillion budget plan.

As you are all aware, one of Chair Wyden's provisions would revise the manner in which pass-through entities and partnerships are taxed. This provision would implicate the ability of exchange-traded funds (ETFs) and mutual funds to distribute appreciated property as in-kind redemptions to shareholders without the requirement to recognize gains on the property. As this issue is top-of-mind for Main Street investors as well as to our members, I would like to take this opportunity to discuss ICI's position and the reasons why we strongly oppose this provision, which would repeal section 852(b)(6) of the Internal Revenue Code and change the tax treatment for in-kind redemptions.

Building Financial Security and Wealth Through Regulated Funds

ICI is against this proposed change to the tax treatment for in-kind redemptions because it could adversely impact tens of millions of Americans who invest in ETFs to save for retirement, pay for higher education, afford a down payment for a house, and reach other milestones that help American families build financial security.

Before I discuss in greater detail our opposition to the legislation, I want to do a quick refresher on the important role that regulated funds play in helping Americans, especially middle-income Americans, achieve their financial goals.

ETFs, along with mutual funds, are the most convenient, cost-effective, transparent, and well-regulated investment vehicles available to investors with limited capital and experience in the financial markets. These funds provide a diverse portfolio of assets and strategies with exposure to a wide range of companies, industries, and economic sectors that otherwise would be cost prohibitive to achieve except for the wealthiest Americans. This is because such exposure would require the purchase of individual stocks and bonds and the expertise to engage in sophisticated asset management strategies.

Funds such as ETFs and mutual funds occupy a critical role in financing the real economy and today hold $28 trillion in assets in the United States, up almost 600 percent over the past 20 years. The overwhelming majority of those assets are held by households. Not

major corporations, not high-frequency traders, but retail investors. Everyday people—families—reaching their short-term and long-term financial goals such as a down payment on a home, higher education, retirement, and building financial equity for the next generation.

As to why regulated funds are so popular, four benefits stand out as the most important: professional management, diversification, regulation and disclosure, and fiduciary duty.

Professional management: Professional management provides investors the benefit of the expertise of the fund manager, who executes the fund's investment strategy and selects investments that best match the fund's objectives. Fund managers' decisions are based on extensive knowledge of financial markets and research on the most efficient ways to meet the fund's objectives.

The fund manager has a legal obligation to manage the fund's portfolio consistent within its stated investment objectives and strategies, bringing to bear the manager's expertise in how best to design and manage funds. In recent months, for example, ICI has noted that the fund industry has been responding to investor demand by offering a larger number of funds focused on environmental, social, and governance (ESG) considerations. In 2020, more than 90 new ESG criteria funds—focused on climate and broader ESG criteria—opened in the United States alone, representing about 16 percent of total US open-end fund launches that year.

Diversification: A second benefit of regulated funds is diversification. It is expensive and difficult for everyday retail investors to build a diversified portfolio on their own. Funds provide a simple, cost-effective approach to diversification of investments and risk.

Regulation and disclosure: A third benefit that contributes to the popularity of regulated funds is that US funds are subject to a strict regulatory framework. This regulatory framework is centered on protecting investors and providing them with the information they need to make informed investment decisions, including on funds' structure, operations, risks, portfolios, and investment objectives. I know that many of you know this very well, but it is worth repeating this often as sometimes investment funds are described as being part of the "shadow banking" system, suggesting that they are unregulated and in dark corners away from any regulatory oversight. Nothing could be further from the truth.

Fiduciary duty: Lastly, the concept of fiduciary duty provides a significant benefit to investors to ensure that advisers work in the best interests of their clients. All advisers to registered funds are required to register with the SEC and are subject to SEC oversight and disclosure requirements. Advisers also owe a fiduciary duty to each fund they advise, meaning that they have a fundamental legal obligation to act in the best interests of the fund pursuant to a duty of undivided loyalty and utmost good faith.

Chair Wyden's Proposal Will Make It More Difficult for Main Street Investors to Build Wealth

Regulated funds such as ETFs and mutual funds are popular investment choices for many Americans, and they are the cornerstone of many American families' financial portfolios. Chair Wyden's proposal to change the tax treatment for in-kind redemptions will harm middle-income investors saving for important goals, especially those saving through ETFs, by subjecting them to more frequent and larger capital gain distributions—on which they will have to pay taxes. Paying taxes on more distributions will have the consequence of increasing the cost of investing in these funds.

This is particularly alarming given that ETFs are very important investment vehicles used by Main Street investors to build wealth, and any legislative or regulatory changes to these funds should encourage more investment by Americans, not less.

Because the immediate impact of this proposal will make it more expensive for Americans to invest in regulated funds, and hence build wealth and achieve financial security, this proposed tax would seem contrary, and even directly opposed, to the goal to increase financial security for all Americans.

In the discussion draft of his tax proposals and the provision to change the tax treatment for in-kind redemptions, Chair Wyden remarked that "[t]his particular proposal simply applies the same rules already in place for corporations to regulated investment companies, so wealthy investors can no longer avoid all tax on their gains," and that "[w]e're only talking about the taxable accounts of the wealthiest investors."

Respectfully, Chair Wyden is mistaken. In actuality, changing the tax treatment for in-kind redemptions will penalize the exact same American investors that the Biden administration has identified as the individuals who most need to build financial security. President Biden promised throughout his campaign that he would limit any tax hikes to families with incomes above $400,000. The White House confirmed this pledge in March of this year, when White House Press Secretary Jen Psaki reiterated, "[t]he President remains committed to his pledge from the campaign that nobody making under $400,000 a year will have their taxes increased." And President Biden stated it again just last week when he tweeted: "If you make less than $400,000 per year, I'll never raise your taxes one penny." And yet Chair Wyden's proposal would contradict this pledge.

ICI data highlights that nearly 12 million US households own ETFs. Out of these households, the median income is $125,000, and

more broadly, 92 percent of all ETF-investing households have income of less than $400,000.

Let me repeat this: nearly 12 million US households own ETFs. Out of these households, the median income is $125,000, and more broadly, 92 percent of all ETF-investing households have income of less than $400,000.

I will reiterate that these are families saving for some of the most precious milestones in American life—a down payment on a home, college education for their kids, and their own retirement. And we know that home ownership is how many families build generational wealth, which we all recognize is the key to greater inclusivity and participation in the American Dream.

The provisions that Chair Wyden has included in his draft proposal would add barriers to this Dream.

In-Kind Redemptions Under Section 852(b)(6)-What Is at Stake?

To understand how changing the tax treatment for in-kind redemptions will make investing in regulated funds more costly, it is helpful to quickly review the in-kind redemption process for ETFs and mutual funds.

This provision of the tax code, which was enacted in 1969, permits all “open-end” investment companies to transfer in-kind property, typically portfolio securities, to a redeeming shareholder in lieu of cash without triggering capital gain at the fund level.

All requests to redeem mutual fund shares are executed by the fund itself. Individual mutual fund investors redeem their shares for cash, and large redemption orders from institutional investors, such as 401(k) plans, sometimes will be redeemed in-kind. These in-kind redemptions are beneficial to the fund’s remaining shareholders because they prevent the fund from incurring the substantial costs of selling substantial portfolio positions to raise the cash otherwise required.

The current tax treatment for in-kind redemptions provides an additional benefit because any gains attributable to the securities redeemed in-kind are not includable in the fund’s taxable income. As presently written, the relevant tax treatment prevents the remaining fund investors from paying tax attributable to the actions of other investors.

Retail investors of ETFs, sell (and buy) shares of ETFs on exchanges in the secondary markets—rather than directly with the ETF. Only authorized participants (Aps), which are large institutional investors, execute redemptions directly with the ETF. The APs often redeem ETF shares in kind for portfolio securities, which it then sells in the secondary market. By giving a redeeming AP securities instead of cash, an ETF can avoid the transaction costs of selling securities that the ETF, and ultimately the remaining shareholders, would otherwise have to pay.

The ETF structure lends itself to greater use of in-kind redemptions. ETFs create and redeem shares to meet demand, to ensure they are tracking their indexes, and to deliver value for their investors—and fund managers benefit ETF investors by doing these transactions in the most cost-effective and tax-efficient way possible. In-kind transactions fill that need.

The current tax treatment prevents the ETF from having to recognize capital gains on the redeemed securities that must be distributed to the ETF’s remaining shareholders. In other words, an in-kind redemption can postpone capital gains distributions to remaining investors while they hold their fund shares. In-kind redemptions affect the timing when ETF investors realize gains, not the amount of gains they realize.

It is important to note that all investors’ gains will be taxed—either as distributions while they hold the ETF shares or as gains realized when they sell the ETF shares. In this respect, ETFs are like all investments (including direct holdings of securities). Specifically, investors are taxed on their full value of capital gains—nothing less and nothing more over the life of the investment.

This current tax treatment of in-kind redemptions helps prevent investors from incurring unexpected tax bills, but still ensures that fund investors pay all the tax that they owe when they ultimately sell or redeem their shares. As a result, the provision as currently drafted in Chair Wyden’s bill would not close a “loophole,” as he suggests, but would instead result in many middle-income US households having to pay more taxes.

Chair Wyden’s Proposal May Make Long-Term Investing Less Attractive to Younger Americans

There are broader ramifications to Chair Wyden’s proposal than just its adverse impact on existing investors. Let me highlight one consequence in particular. Chair Wyden’s proposal will likely make investment in certain regulated funds less attractive to younger Americans to the detriment of their future financial security and wealth.

Investing is more accessible than ever, especially for Generation Z and Millennial Americans, who are exposed to many different ways of investing and types of investment vehicles—not all of which are suitable to build financial security. Easy investing in risky products is almost a cultural phenomenon. And while these products do encourage younger Americans to participate in the financial

markets, which is a very good thing—unlike regulated funds, these flashier products are not structured to reap the rewards of long-term investing.

We all know the story of the tortoise and the hare, and it never turns out well for the hare. The path to financial security takes patience. There is a trusted way to provide young investors the possibility of financial security that investments can offer, and that is by using regulated funds.

The good news is that younger Americans have an interest in investing, and we want to ensure that regulated funds—with their benefits of professional management, diversification, regulation, and the concept of fiduciary duty—retain their attractiveness as investments.

And this is where Chair Wyden's proposal to change the tax treatment of in-kind redemptions has an additional consequence. The increased taxes and costs that will result from this proposal will make it harder for ETFs to be viewed by young Americans as a desirable investment choice, and it could very well discourage long-term investing by younger Americans.

Congress should not want this outcome.

Instead, we should encourage younger Americans to invest in their futures by investing in the stock market in responsible ways that can lead to financial security and accumulation of wealth. Chair Wyden's proposal unhelpfully places another impediment on our ability to make this happen.

Conclusion

In closing, I emphasize that the current tax treatment of in-kind redemptions in section 852(b)(6) serves investors, saves costs, and is not a loophole to avoid taxes. Like investors in stocks and bonds, ETF investors—both those redeeming and those remaining—are taxed fully on any appreciation in their fund shares when those shares are redeemed.

Repealing this provision will have a significant negative impact on Main Street investors saving for the quintessential American milestones such as a home, education, and retirement and those are just a start. And the impact of a repeal will reverberate across generations—down to our younger investors who are just starting to make choices about savings and investments that will materially impact their future financial well-being. Changing the current tax treatment of in-kind redemptions will make it that much harder for these investors to see the value and importance in investing through regulated funds to build their own financial futures.

Thank you for your time.

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