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Regulatory Climate Change and the New Environment for Funds

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March 18, 2013
Mutual Funds and Investment Management Conference
Palm Desert, CA

As prepared for delivery

Thanks very much, Frank, and let me say that all of us involved with organizing this event have been grateful for your contributions and leadership. I certainly hope that we can make this conference another memorable one for you—and memorable in a good way, not the Bear Stearns way!

As Frank mentioned, this event has been held for decades, and its aim has always been the same: to bring together some of the best minds in the business, so we can share expertise, collectively get ourselves up to speed on the pressing issues facing our industry, and worry a bit about those that might lie ahead.

From rulemaking, to tax legislation, to litigation, to business preparedness, we are going to go deep into the nitty gritty of our business over the next few days. But over the next 20 minutes, my job is not to deliver nitty gritty but rather to provide you an overview on the big trends that I see shaping, well, everything.

Now, regular attendees of this conference may recall that I tend to frame this big picture with weather metaphors. In 2011, the theme of my opening speech was “Sunlight Through the Clouds.” Last year, I went with a more somber view: “Clouds Overhead.”

This year, I’m going stick with a weather theme, but I’d like to take it to a global level. I want to talk about climate change in our industry.

Yes, that’s right—climate change. But don’t worry. This is not going to be a speech about global warming. I may lay down some inconvenient truths, but I will not urge you to buy a hybrid car or to change to a more efficient light bulb, although I have done both.

No, the climate change that I’d like to discuss today is regulatory climate change. Because when I look at our industry—as ICI lawyers pile draft comment letters on my desk for review—it’s clear to me that the global regulatory environment is changing. And this new environment has implications for how we all do business.

In the weather context, scientists say that climate change will produce strange and disruptive phenomena: shifting patterns, stronger storms, and new risks in places that were thought to be high and dry.

Similar dynamics are at work in the world of fund regulation.

I think it’s safe to say we already see shifting patterns in at home and abroad, a few of which I’ll discuss today. For one thing, regulators in Washington seem more inclined to either blur or reconfigure jurisdictional lines. Now, this isn’t necessarily a bad thing inside the Beltway. We can all appreciate some thinking outside the box to get good results. A willingness to work cooperatively for the interests of investors is welcome.

But there are potential negatives here too. There’s the risk of regulatory duplication and needless overlap in the rules. And as we all

know, when rules are duplicative or, worse, conflicting, that raises costs—costs that are ultimately borne by investors.

Let's take a closer look at these shifting patterns with an example: the Commodity Futures Trading Commission (CFTC) and its amendments to Rule 4.5.

As you know, that rule excludes certain market participants from being deemed "commodity pool operators," based on their use of derivatives.

In 1985, the CFTC adopted Rule 4.5 to avoid overlapping regulation on a variety of entities that have other regulators—including insurance companies, banks, pension funds, and registered investment companies. From 1985 to 2003, however, that exclusion was strictly limited—it was only available to entities that met certain trading and marketing conditions.

But just ten years ago, the CFTC eliminated those conditions, in part on the basis that if you operate an entity that is "otherwise regulated" by another agency, such as the SEC, you don't need a second layer of regulation by the CFTC. And what financial product is more comprehensively regulated than registered funds?

In 2012, however, the CFTC sharply narrowed Rule 4.5—and only for registered funds and their advisers. It reinstated the trading and marketing tests, and added swaps to the mix, so that virtually every fund adviser must now monitor its use of derivatives against the tests adopted by the CFTC.

Those advisers that don't meet the Rule's tests are now subject to CFTC oversight in addition to their current Securities and Exchange Commission (SEC) oversight. This duplicative regulation will increase costs for investors, without meaningful benefits to them or the markets.

Other advisers, particularly those that are close to the threshold, may choose to reduce their use of futures, options, and swaps to avoid duplicative regulation. If so, investors will feel the impact as their choices may be diminished.

Our serious concerns with Rule 4.5 led ICI, joined by the U.S. Chamber of Commerce, to file a legal challenge to the CFTC and its amendments. The district court did rule against us, but we've appealed that decision to the court of appeals. The D.C. Circuit Court has granted our request for an expedited hearing, and we hope to get a ruling before the end of the year.

For ICI, which has a long history of working with regulators, litigation like this is highly unusual and, honestly, painful. I think the fact that we're in court should underscore for all that these shifting regulatory patterns are not just some academic curiosity. There is much at stake in this changing regulatory climate.

We can also see how high the stakes are in another area marked by shifting regulatory patterns: money market funds.

As you know, last summer, the SEC staff were working on set of proposals for structural reform. A bipartisan majority of SEC Commissioners, however, declined to support making those proposals.

One reason for their resistance—a highly commendable reason in my view—was that the SEC, simply put, hadn't laid the groundwork for the staff's proposals. Namely, they felt that there hadn't been enough study of the impact of the comprehensive reforms for money market funds that the SEC had adopted in 2010. As Commissioner Aguilar said at the time, "This critical analysis must precede any proposals to further amend our rules."

At this point, shifting regulatory patterns became apparent when then-Chairman Schapiro got the newly-created Financial Stability Oversight Council (FSOC) engaged on the issue of money market funds. Her thinking, as she's said recently, was that "otherwise it would have died at the SEC."

At ICI, we viewed this handoff to FSOC with deep concern, and we still do.

For one, we never thought the issue was going to "die at the SEC"—and indeed, it has not. Last November, the agency's Division of Risk, Strategy, and Financial Innovation released an economic study that was a thorough and dispassionate examination of what happened with money market funds during 2008, as well as the effectiveness of the 2010 reforms. We commend that study and hope to see more like it in other complicated rulemakings.

A second concern with the FSOC intervention: as the regulator of mutual funds, the SEC is far and away the most appropriate agency in Washington to evaluate additional money market fund reforms. It has the strong expertise. It has the seven-plus decades of experience.

Yet the FSOC's actions, taken despite the RiskFin's study, seemed calculated to undermine the SEC's role, its independence, and the democratic process at the heart of its approach to rulemaking. As a group of former SEC commissioners and senior staff recently

wrote to FSOC, the Council's intervention "could disrupt the long-standing collaborative nature of the [SEC's] deliberative processes."

Finally, consider the substance of the FSOC's recommendations. The Council put forth last November the very same concepts that the majority of SEC commissioners had declined to support just three months prior.

More recently, we've seen SEC reassert its authority over money market funds, which we welcome. The shifting regulatory patterns that led to money market funds getting tangled up in the FSOC process, however, remain something I think we should stay wary of.

Now, as Frank mentioned, we can't just worry about shifting regulatory patterns on the home front. In my mind, a clear, defining feature of the new regulatory environment for funds is its global nature.

Of course, it's not as though we've all been ignoring international developments in recent years. But the global picture has evolved a great deal lately, and it continues to change rapidly. Let's look at how.

First, the very notion of "overseas" is expanding. It wasn't so long ago that when we spoke of developments overseas, we basically meant Europe. But now we're seeing many more jurisdictions, across Asia in particular, gain prominence both as markets and as regulatory spheres of influence.

Second, we've seen the increasing clout of a new class of global super-regulators like the Financial Stability Board (FSB), headquartered in Basel, and the Madrid-based International Organization of Securities Commissions (IOSCO).

It's clear by now that these super-regulators are not just comparing and contrasting existing regulatory regimes—or making vague pronouncements that can be safely ignored. Even if your business is focused only on the U.S. market, you need to pay attention to what they're doing.

Why is that? If the FSB sets out principles of regulation, those principles may not determine the specific rules of every jurisdiction, but they will act as a persuasive force that shapes policy. Yes, even here in the United States.

In this environment, isolationism is not an option. Super-regulators largely deal in issues that are global by nature. These issues affect everyone, and thus, they bind us to the super-regulators. They grant the super-regulators entrée into our world.

The broadest of these global issues, of course, is systemic risk. The Lehman Brothers failure illustrated the need to pay closer attention to the interconnected aspect of global markets. Ferreting out and mitigating systemic risk has now become a guiding principle of global regulation.

This search has led, for example, to heightened scrutiny of so-called "shadow banking." Now, if the phrase "shadow banking" sounds pejorative to you, that's because it is pejorative. Nonetheless, this is the mindset of many super-regulators who, like the FSOC, are largely made up of banking regulators and thus naturally tend to look at things through the prism of what they know best: banking regulation.

The FSB, for example, has defined shadow banking broadly as "the system of credit intermediation that involves entities and activities outside the regular banking system." The implication here is that investing and lending outside of the banking system is inherently destabilizing and thus should be subjected to more bank-like regulation.

That implication is flat out wrong.

First, just look at history. In the United States, the banking and capital markets models have successfully coexisted for centuries. Over the years, regulatory frameworks have been built painstakingly around both. These regimes may differ, but they are both robust.

Second, vibrant capital markets add resiliency to the financial system, because the capital markets sometimes weather times of turbulence better than banks do.

Remember, the financial crisis was at its origin a banking and real estate crisis. I can't help but recall a comment that former Federal Reserve Chairman Paul Volcker made at an SEC roundtable on money market funds two years ago. He was suggesting, essentially, that the 650 U.S. money market funds should be turned into banks. He said, "This country could use 650 more banks. We just lost about 1,000 during the crisis!"

That kind of thinking, in our view, is deeply flawed. Moving more financial activity into the banking system will concentrate risks and make the financial system more vulnerable, not less.

Unfortunately, getting regulators around the world to fully accept these points has been by and large an uphill battle.

Think about it. The worldview of regulators often takes shape over the course of decades: institutionally, politically, nationally. It can very difficult for regulators to step outside that worldview.

Compounding the problem, it's easier than ever these days for bad policy ideas to spread from jurisdiction to jurisdiction.

Take the issue of financial transaction taxes (FTTs). As you know, these taxes can be crafted to hit purchases and sales of stocks, bonds, and derivatives, whether held directly or indirectly. Some proposals would apply even to repurchase agreements and securities loans.

Whatever FTT proponents may say, it is crystal clear that FTTs harm investors and retirement savers. They increase taxes, thereby reducing investment returns. They reduce market efficiency, again reducing investment returns. And they slow economic growth which, and you can see where I'm going here, also reduces investment returns.

The prospect of this harm, however, has not prevented FTT legislation from being enacted in France and Italy. A far broader, more extraterritorial tax proposal—with potentially devastating effects—is advancing in Europe. Legislation also has been introduced in the U.S. Congress.

I won't comment on the prospects of the EU or U.S. legislation, but we need to be vigilant. And we must redouble our efforts to educate—to make sure policymakers have the best grasp possible of how our funds work, and the benefits they bring to investors.

This leads me to a final set of thoughts on our new and evolving environment. How do we cope with it? How do we adapt to regulatory climate change? I wish it were as easy as using a different kind of light bulb.

Our panels will do a much more thorough job than I can answering these questions, but permit me to float ways that ICI is dealing with this.

First, and this is an appropriate suggestion for a California audience, we must be prepared to channel our inner Steve Jobs and "think different." Putnam Investments CEO Bob Reynolds picked up this idea recently in one of his Twitter posts. He tweeted "In the investment world, innovative thinking is no longer an option, it's imperative."

Innovative thinking, of course, comes in many forms. But in this new environment, I'd say a key part of innovative thinking means expanding our horizons to get a more global view.

ICI is certainly doing our best to expand our own horizons. As I'm sure you know, we launched a new division, ICI Global, 18 months ago. ICI Global is headquartered in London, but its staff is on the road frequently. Working with folks who liaise so regularly with members, regulators, and other thought leaders in Europe and in Asia has been highly valuable as we track far-reaching reforms in global fund regulation, market structure, pensions, and tax.

This coming May, ICI Global will open an office in Hong Kong. The new office will give us even more ability to gather that real-time information in the exciting and burgeoning markets across Asia.

That brings me to ICI's second suggestion for coping with regulatory climate change. More than ever, we need to arm ourselves with the best information we can get, and to use that information effectively.

I finally got around to reading the book Freakonomics. One interesting quote from the book is this: "Information is a beacon, a cudgel, an olive branch, a deterrent—all depending on who wields it and how." As shifting regulatory patterns affect our business, we have to be ready to use information in all these ways.

Here again I think of money market funds. I still find it amazing how quickly myths and misperceptions arose around these funds after the financial crisis, and how such inaccuracies have persisted. At home and overseas, we've seen policymakers and the media repeat the same incorrect assertions like, "Money market funds are unregulated," or "Money market funds caused short-term markets to freeze during the financial crisis." Seriously, the FSOC put that last one in its 2012 annual report.

To counter this misinformation, ICI and others have marshaled facts and data as intensively as I've seen during my career in and around the fund industry. We've crunched the numbers, we've published research papers and mammoth comment letters, and we've written what seems like a gazillion blogs. Yes, good information has been our beacon—and at times our cudgel.

My final suggestion. The changing regulatory climate for funds may require us to adapt in new ways, but we must never lose sight of the fundamentals that make this great industry what it is.

We put our investors first. We stand by our comprehensive, effective regulatory system. We value diversification, transparency, simplicity, disclosure, and strong governance.

With these values anchoring us, with our minds open to new ways of thinking, and with good information that we're ready to use, we can do more than simply survive regulatory climate change. We can prosper in it. Thank you.

I'm pleased now to introduce Norm Champ, Director of the SEC's Division of Investment Management.

A Harvard law grad, Norm joined the SEC in 2010 after serving for 10 years as general counsel and partner at Chilton Investment Company.

During Norm's relatively short tenure at the SEC, he has already compiled an impressive record of accomplishment, notably for his role in helping the Office of Compliance Inspections and Examinations (OCIE) to reorganize and carry out its new obligations under the Dodd-Frank Act. As deputy director of OCIE, Norm helped lead the creation of the Office's first-ever examination manual.

Norm also deserves special recognition for his role in the SEC staff's removal of the moratorium on granting ETF applications for actively managed ETFs using leverage. Lifting that moratorium took courage, because it's always safer to prohibit something than to permit it. But it was unquestionably a positive development for industry and investors. It leveled the playing field, both among ETFs, and between ETFs and mutual funds that pursue similar strategies. So it enhanced fairness and investor choice.

More recently, Norm has also shown himself to be quite the trooper. As the SEC examined the budget implications of Congress' sequester order, it decided it could not send as many staff as planned to this conference. While we're disappointed that Doug Scheidt and David Grim aren't able to join us today to share their insights, we are grateful that Norm has once again shown courage and stepped forward to cover both those panels.

Norm, we at ICI salute your accomplishments and look forward to working with you as your division and the SEC tackle the key issues facing investors. Ladies and gentlemen, Norm Champ.

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