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Assessing the Impact of Global Regulatory Reform—Are We Best Serving the Markets and Investors?

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Ari Burstein

Senior Counsel, Investment Company Institute and ICI Global

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As prepared for delivery.

Thank you, Larry, for that introduction. It is my honor to speak at this conference, and it is a particularly good time to do so.

In the United States, just a short 24 hours ago we reelected our president for another four years. And what we are doing at this conference…and what we should do at this conference…is very much like what American voters have been doing over the last 12 months or so.

What is that? Taking stock.

In the political context, Americans all have been taking stock of the candidates, of course. We've also been asking ourselves, to one degree or another, are we better off now than we were before the last election? Are things heading in the right direction? What needs to get done? Is it time for a change?

Well, when it comes to the financial markets, we need moments where we take stock too. Like voters, we should ask ourselves some simple, but powerful, questions. Are the markets, and the regulation of the markets, headed in the right direction? Are the markets operating more efficiently than before? Are investors better off than they were just a few years ago?

Answering these questions requires more than just looking at whether the stock markets have gone up or down. It requires reflection, analysis, and candid discussion. That's why we're here.

The Investment Company Institute and ICI Global take a special interest in these questions. ICI represents registered investment companies in the United States. The mutual funds, exchange-traded funds, and other funds in our membership invest more than $13 trillion of assets on behalf of more than 90 million individual shareholders and thousands of institutions.

Just over a year ago, we founded ICI Global to serve as a voice for global investment companies. It now represents a diverse group of members who manage more than $1 trillion in registered fund assets in Europe, Asia, and Australia. Clearly, the structure of the global financial markets has a significant impact on our members.

Whether operating in the United States or in global markets, the fund industry has long recognized that our business is built upon investor trust—and that trust rests upon a foundation of sound regulation. And so both ICI and ICI Global look at issues of financial regulation and market structure through a simple prism: we ask, "What is best for our shareholders?"

On behalf of their investors, funds have a strong interest in ensuring that the regulatory structure that governs the financial markets fosters the most efficient markets possible. We therefore have strongly supported the examination of regulations that may impact the fair and orderly operation of the financial markets and investor confidence in those markets.

In the wake of the worst financial crisis since the Great Depression, it is no surprise that regulators have taken an aggressive approach to regulation. The gaps where financial systems and regulations failed, with catastrophic consequences for investors and the economy, must be identified and repaired. We've supported that process.

Yet we don't always agree with regulators on how regulation can best serve investors. So, when necessary, we must question proposals that could impose unwarranted, redundant, and costly regulation on our funds and their investors.

The same holds true for everyone in this room, no matter whose interests you represent. It is our role as market participants to ensure that regulators are fully informed; that they have a clear understanding of the far-reaching and potential negative impacts of their ideas; that they are equipped with information to help them fulfill their mandates—including, in the American system, mandates to promote efficiency, competition, and capital formation; and that they recognize the importance of cost-benefit analysis in their rulemakings.

In that context, how do we assess the regulatory responses to the financial crisis and other market issues?

There is no doubt that in just the last few years, we have seen an overhaul of regulation in almost every part of the financial system—from bank capital requirements to the equity markets to over-the-counter derivatives. And all of you in this audience, whether on the buyside or sellside, face a formidable array of regulatory and policy challenges.

It would take a whole conference to examine these regulations in the detail that they deserve. Today, I will just touch on a few examples, focusing on regulations issuing from Washington, DC, that have had significant spillover effects into the global markets. Those include:

- the impact of the Volcker Rule, a provision of the Dodd-Frank Act;
- the effects of Dodd-Frank's overhaul of trading in futures, options, swaps, and other derivatives; and
- implementation of the Foreign Account Tax Compliance Act, or FATCA.

I also want to discuss the topics that will consume much of our attention at this conference—the multitude of regulation impacting trading and market structure.

Let's tackle these one at a time.

As you may know, the Volcker Rule was a key feature of the Dodd-Frank Act, America's legislative response to the financial crisis. The U.S. Congress enacted the Volcker Rule to limit "proprietary trading" by banks. The rule also prohibits banks from sponsoring or investing in hedge funds or private equity funds.

The regulations proposed to implement the Volcker Rule raise many concerns for funds and their investors. For one, the rule could prevent banks from exercising their historic role as market makers. The likely result of that could be sharply reduced liquidity—particularly in the fixed income and derivatives markets. Some thinly traded portions of the equity markets could also be hit.

For this audience, the most significant effects of the Volcker Rule may be its serious extraterritorial impacts. The proposed regulations could treat countless registered investment funds around the world as if they were hedge funds—vastly expanding the reach of the law and impairing the organization and activities of non-U.S. retail funds. And the proposal's exemption for foreign trading is so narrow that U.S. registered funds could find it difficult to find foreign counterparties for trading. The result could be significantly impaired liquidity and trading in markets around the globe.

The Dodd-Frank Act's reforms to derivatives trading could have similar far-reaching—if not overreaching—effects. Just in the past few weeks, several Asian banks have said they won't register with U.S. regulators to trade complex derivatives with U.S.-based financial companies. Similarly, banks in Europe have said they do not want to become U.S.-regulated dealers.

Just as with the Volcker Rule, these provisions could constrict liquidity in the market. As interpreted by the U.S. Commodity Futures Trading Commission (CFTC), Dodd-Frank's swaps provisions could extend the CFTC's jurisdiction to non-U.S. entities, including non-U.S. funds, even if those institutions have no significant connection to the United States. ICI and ICI Global have raised serious concerns about this interpretation.

Market participants are not the only ones complaining about the impact of new derivatives rules. Policymakers from the European Union, France, the United Kingdom, and Japan all have warned CFTC Chairman Gary Gensler that these U.S. proposals risk fragmenting the global derivatives market.

Another piece of American legislation with significant global spillover is FATCA. Enacted in 2010 to enhance tax compliance by U.S.

taxpayers, FATCA imposes significant new customer identification, reporting, and withholding obligations on both U.S. and foreign financial institutions. ICI and ICI Global support FATCA's goal of improved tax compliance. But we have tirelessly urged regulators to structure FATCA's rules in a way that is workable.

All three of these matters—the Volcker Rule, the overhaul of derivatives markets, and FATCA—are examples of regulatory initiatives that can raise costs, limit investment opportunities, and, at the end of the day, make markets less efficient. None has been subjected to rigorous cost-benefit analysis. And their ability to protect investors is doubtful at best.

Now, I am not here to paint a completely gloomy picture of the state of global regulation. On the positive side, some of the regulatory problems I've highlighted could be self-correcting.

The unintended effects of the Volcker Rule proposal are so obvious that even the public has taken note. The financial industry's massive resistance may—we hope—lead to a revised rule that addresses our concerns.

The U.S. Treasury is working hard to make implementation of FATCA less disruptive. In particular, the Treasury's model intergovernmental agreement could make FATCA less disruptive for financial institutions around the world.

Let me now turn to a different set of issues—the topics that are occupying most of our attention during our two days at this conference. The same approach that we take to assessing the regulatory initiatives I just mentioned can be valuable in addressing initiatives impacting trading and market structure.

For the moment, I'd like to set out two areas where I see some of our starkest challenges…places where we really do need to take stock. The first is issues surrounding the response by regulators to technology and associated market risks; the second, the need for regulators to take a fresh look at the structure of the markets and whether we are moving in the right direction for investors.

ICI and ICI Global have spent a significant amount of time examining the impact of technology on the financial markets and on investors. One thing is clear: regulations governing the financial markets have not kept pace with the significant changes in trading practices. We are therefore pleased that regulators have started to focus on some of the critical issues surrounding technology, automated trading, and the challenges posed for effectively overseeing the markets.

This is particularly important given the number of market infrastructure disruptions experienced by the markets, starting with the flash crash in the United States to the spate of recent technological problems faced by a number of the exchanges, banks, and other trading venues.

Clearly, it is in everyone's best interests to address these concerns, to prevent technological errors, and to examine the most efficient response to errors that occur. ICI and ICI Global have supported efforts in this area around the globe.

In just the past few weeks, we filed comments on a consultation by the Hong Kong Securities and Futures Commission regarding proposals to enhance the regulatory framework for electronic trading. We commented on an International Organization of Securities Commissions (IOSCO) consultation examining the challenges posed by technological developments to effective market surveillance. And we offered our views to the U.S. Securities and Exchange Commission (SEC) on issues raised at a roundtable held last month to discuss ways to promote stability in markets that rely on highly automated trading systems.

In all those jurisdictions, we have supported establishing principles and requirements for intermediaries regarding electronic trading and improving surveillance capabilities on a cross-market and cross-asset basis. We want to make the data collected for surveillance purposes more useful to regulators. And we advocate the examination of several recommendations set forth in the United States to address market risk, including the establishment of "kill switches" that would allow limits to be placed on either overall activity by market participants, or on specific categories of activity.

And this just scratches the surface of regulatory efforts underway to address issues relating to technology and automated trading. We continue to follow efforts in Europe to reform the Markets in Financial Instruments Directive, or MiFID, which would create a new regulatory structure for automated trading, high-frequency trading firms, and electronic trading venues. We also are monitoring efforts in Canada, Australia, and of course, in Asia that would address technology and related risks.

As with all regulation, finding the right balance is difficult—and yet critical. If regulations are too restrictive, they may unintentionally limit the use of evolving practices and technological developments, impeding the use of new and innovative trading tools. If regulations are too onerous or costly for some market participants, those participants may decide not to offer certain products or services to investors, or the cost of trading may increase as market participants shift the burden of compliance with new requirements to investors. We therefore urge a careful balance of these potential costs with the benefits that any new or amended regulations would provide to investors.

We also believe it is critical for regulators and market participants alike not to lose sight of the need to examine possible contributing factors to market infrastructure disruptions and the need for a fresh look at market structure in general. The current structure of the global markets has evolved significantly, and consideration should be given to whether it has evolved in the best interests of investors.

ICI and ICI Global have, on several occasions, questioned whether certain developments have benefited investors. Many of these questions surround the proliferation of automated trading and high-frequency trading. One such issue is the increasing amount and complexity of order types that exchanges and other trading venues continue to create to cater to certain market participants. Many of these order types facilitate strategies that can lead to disorderly markets or that can benefit market participants at the expense of long-term investors.

Another issue is the increasing number of order cancellations in the markets, particularly those that are cancelled shortly after submission. Orders sent to the market with no intention of being executed can strain a market's technological infrastructure, and under the right circumstances, could interrupt the ability to process trades in an orderly fashion. Our members also report that certain of the practices and strategies surrounding cancellations often are designed to detect fund trading of large blocks of securities and to trade with or ahead of those blocks to the detriment of investors.

Finally, we believe that regulators need to examine the complexity in the current structure of the markets attributable to the sheer number of execution venues. Requiring connectivity to these venues can take a toll on market participants—and adds to the risks of increased market disruption events.

Before I conclude, I would be remiss if I did not make a few comments on the impact last week of Hurricane Sandy on the U.S. East Coast. As you know, Hurricane Sandy caused the U.S. markets to close on Monday and Tuesday, October 29 and 30. ICI was actively involved in discussions relating to efforts to keep the securities markets open, and to reopen the markets after the two-day market close.

The decision to close the markets was definitely the right one given the potential danger to those who would have had to brave the weather to support the markets.

Going forward, however, there is no doubt that questions will be raised about the readiness of the exchanges' disaster recovery programs and the ability of the exchanges and the broker-dealer community to work together to ensure that the markets can remain open after a catastrophic event. I would anticipate that regulators will closely examine the need for reforms in this area.

At the outset, I said it was time to take stock of our markets…our regulatory structures…and the impact of changes on investors. I hope that my own stocktaking has helped clarify the issues, particularly on issues where regulations may have unintended or overreaching effects.

This is not an academic exercise or simply a matter for trade associations. This analysis matters to everyone in this room—indeed, to everyone in our markets.

In particular, I would implore those on the buyside to actively engage regulators and policymakers on the issues. It is in our investors' best interests to ensure that regulators recognize the implications of their activities on them. From our experience, regulators are eager to understand those implications. Investors need and deserve a seat at the table when decisions are made on the structure and operation of financial institutions and markets.

Thank you again for inviting me to speak at TradeTech Asia and I look forward to the rest of the conference.

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