The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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ICI Testimony for Congressional Hearing on Impact of Dodd-Frank Act

[26288]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 39-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 28-12
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 24-12
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MONEY MARKET FUNDS ADVISORY COMMITTEE No. 44-12
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 29-12
SEC RULES MEMBERS No. 59-12
SMALL FUNDS COMMITTEE No. 19-12 RE: ICI TESTIMONY FOR CONGRESSIONAL HEARING ON IMPACT OF DODD-FRANK ACT

On July 10, Thomas Lemke, General Counsel and Executive Vice President, Legg Mason & Co., LLC, testified on behalf of ICI at a hearing held by the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Financial Services Committee. Titled "The Impact of Dodd-Frank on Customers, Credit, and Job Creators," the hearing featured a panel of witnesses representing various sectors of the financial services industry and several other stakeholders. [1]

Summary of ICI Testimony

ICI's written testimony begins by noting that mutual funds and other registered investment companies ("registered funds"), which operate under a remarkably comprehensive regulatory framework, help over 90 million shareholders to achieve their financial goals. It states that Congress did not direct the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at these funds, because they were not a cause of the financial crisis. Nonetheless, the statute and rules implementing it will have important implications for all market participants, including registered funds and their advisers.

The testimony then makes the points outlined below.

- Certain provisions of the Dodd-Frank Act are intended to promote bank safety and soundness and financial stability, but care must be taken to ensure that their implementation does not have unintended adverse consequences—for registered funds and their shareholders, the financial markets, or the broader economy.
    - Volcker Rule. The regulatory proposal to implement the Volcker Rule reaches much farther than Congress intended, inappropriately capturing some U.S. registered funds and virtually all non-U.S. retail funds. Any final rule should expressly exclude these funds from the definitions of "covered fund" and "banking entity." The proposal also could impair the financial markets and limit investment opportunities for registered funds and their shareholders. ICI has provided recommendations for addressing these concerns in its comments to regulators.
    - Designation of Systemically Important Nonbank Financial Companies ("SIFIs"). It is important that the Financial Stability Oversight Council ("FSOC") act deliberatively in exercising its authority to designate nonbank SIFIs for heightened regulation and consolidated supervision by the Federal Reserve Board. SIFI designation is neither warranted nor appropriate for registered funds or their advisers because, among other things, they do not present the risks such designation is intended to address. While ICI welcomes the study of asset management companies the Office of Financial Research is undertaking on behalf of the FSOC, we feel strongly that: (1) it would be premature to evaluate such companies under the existing SIFI designation framework before completion of this analysis; and (2) the FSOC should publish the study (and any future material changes to its SIFI designation guidance) for public comment.
    - Enhanced Prudential Standards for Nonbank SIFIs and Large Bank Holding Companies. The Federal Reserve Board's proposal to implement enhanced prudential standards under Section 165 of the Dodd-Frank Act is premature as applied to nonbank SIFIs, because the FSOC has not yet designated any such SIFIs. Without knowing which entities will be designated, the Federal Reserve Board cannot comply with its statutory obligations regarding nonbank SIFIs. The Federal Reserve Board therefore should exclude nonbank SIFIs and separately propose a process for prescribing the enhanced standards that will be applied to them.
    - Unlimited Insurance for Noninterest-Bearing Transaction Accounts. In the Dodd-Frank Act, Congress granted circumscribed authority for the Federal Deposit Insurance Corporation to provide unlimited deposit insurance only to specified accounts and only for a two-year period. Congress should reject calls to extend this program beyond its statutory expiration date, because the program has the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for noninterest-bearing transaction accounts.
- In addition to the Volcker Rule, Dodd-Frank Act provisions on asset-backed securities ("ABS") and derivatives have implications for registered funds as investors in the financial markets.
    - Asset-Backed Securities. As investors in ABS, registered funds have a strong interest in ABS markets that function fairly and in the interests of investors.
        - Risk Retention. ICI generally supports the goal of the joint regulatory proposal to implement the credit risk retention requirements imposed by the Dodd-Frank Act. We believe that the proposed standards for risk retention may not be appropriate or necessary for certain classes of ABS in which registered funds invest—in particular, notes issued by asset-backed

commercial paper programs and securities issued by municipal tender option bond programs.
        - Prohibition Against ABS Conflict of Interests. ICI also supports the rule the Securities and Exchange Commission ("SEC") has proposed to implement the prohibition under the Dodd-Frank Act against material conflicts of interest in connection with certain securitizations. The SEC should clarify, however, that the proposed rule excludes actions taken in connection with investing in an ABS by a registered fund that is an affiliate of an entity that structures or distributes an ABS. In addition, the proposed rule's exception for liquidity commitments should not be viewed as inconsistent with the restrictions under the regulatory proposal to implement the Volcker Rule.
    - Derivatives. Registered funds are participants in the derivatives markets and use these instruments in a variety of ways. Accordingly, ICI and its members have encouraged reform efforts in the derivatives markets.
        - Implementation of Title VII. It is crucial for implementation of the new regulatory framework for derivatives to follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies. Specifically, the implementation periods should: (1) afford adequate time for the SEC and the Commodity Futures Trading Commission ("CFTC") to gather additional market data to inform future rulemaking; (2) allow market participants to build market infrastructures, modify business operations, complete testing, and perform outreach and education of customers; and (3) phase in rule requirements by type of market participant and asset class.
        - The Status of Non-Deliverable Foreign Exchange Forwards. Under the Dodd-Frank Act, foreign exchange ("FX") swaps and forwards are considered swaps unless the Secretary of the Treasury makes a written determination that either or both should not be regulated as swaps. The Treasury has issued a proposed determination that would exempt FX swaps and forwards from the definition of swap, but would not include non-deliverable FX forwards ("NDFs") within the exemption. ICI has consistently supported Treasury's proposed exemption of FX swaps and forwards, and strongly believes that the exemption should extend to NDFs, which are functionally and economically identical to FX forwards. Treasury, in coordination with the CFTC or, if necessary, Congress, should clarify that FX forwards include both deliverable FX forwards and NDFs.
        - The Process for Making a Swap "Available to Trade." Late last year, the CFTC, pursuant to the Dodd-Frank Act, proposed a process to establish which swaps will be subject to mandatory trading, or will be made "available to trade" on a designated contract market ("DCM") or swap execution facility ("SEF") for purposes of the Commodity Exchange Act. The CFTC's proposed process would grant the DCMs and SEFs a significant role in making these determinations. To address the incentives a DCM or SEF may have to require that a swap be subject to mandatory trading, even in the absence of a liquid trading market for the swap, the CFTC should require DCMs and SEFs to consider objective standards or thresholds as part of the make "available to trade" determination process, and should make consideration of each standard/threshold mandatory.
        - The Determination of Block Trades. Pursuant to the Dodd-Frank Act, both

the SEC and CFTC have issued proposals relating to block trades. Market transparency is a key element to ensuring the integrity and quality of the swaps markets, but that must be balanced against adequately protecting information regarding a registered fund's block trades. It is critical that the SEC and CFTC adopt block thresholds that account for the liquidity in each unique category of swaps, calculate the thresholds regularly, and establish thresholds that are low enough to encourage the use of block trades.

- ICI wishes to make the Subcommittee aware of an agency's troubling use of the Dodd-Frank Act as a pretext for expanding its authority through unjustified regulation.
  - For almost thirty years, the CFTC has provided a uniform exclusion through its Rule 4.5 from regulations applicable to commodity pool operators for entities already subject to another regulatory scheme. Invoking its supposed "more robust mandate" to "manage systemic risk" under Dodd-Frank, the CFTC has sharply curtailed this exclusion, but only for registered funds and not for other entities covered by the rule.

In actuality, the CFTC's amendments to Rule 4.5 were neither required nor even contemplated by the Dodd-Frank Act. The additional regulation that amended Rule 4.5 will impose on registered funds is redundant of the comprehensive regulation to which registered funds and their advisers are already subject by the SEC. The CFTC has not justified the need for these additional regulatory burdens, nor the significant costs they will impose on registered funds and their shareholders. Nor has the agency adequately explained how registered fund shareholders, which already enjoy comprehensive protections under the federal securities laws, will benefit from this additional, redundant layer of regulation.

Frances M. Stadler
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endnotes

[1] In addition to Mr. Lemke, these witnesses were: Kenneth E. Bentsen, Jr., Executive Vice President for Public Policy and Advocacy, SIFMA; Thomas C. Deas, Jr., Vice President and Treasurer, FMC Corporation, on behalf of the National Association of Corporate Treasurers and the U.S. Chamber of Commerce; Tom Deutsch, Executive Director, American Securitization Forum; Dennis M. Kelleher, President & CEO, Better Markets, Inc.; Anne Simpson, Senior Portfolio Manager, CalPERS; and Paul Vanderslice, President, Commercial Real Estate Finance Council. ICI's testimony and that of the other witnesses is available at http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=301909.

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