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Promoting the Buyside Voice on Market Structure

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2016 ICI Capital Markets Conference

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As prepared for delivery.

Good afternoon, everyone.

This is our Sweet 16—our 16th conference devoted to the structure and operation of the U.S capital markets. Each year, it has ranked among our most important events. It gives us the opportunity to hit pause on some other top stories—like the Department of Labor's proposed fiduciary rule, and the debate around financial stability and asset management—and focus on the critically important issues dictating how our markets are functioning.

Today, I would like to talk with you about three questions facing ICI's work on market structure issues:

- First, how is ICI engaging with the regulators, especially the SEC, to enhance the equity markets?
- Second, what big challenge are the fixed-income markets facing?
- Third, how should we on the buyside be engaging in discussions about market structure going forward?

Let me begin with the equity markets.

Investors and the markets benefit when the regulations governing the operation of the equity markets are carefully tailored to promote fairness, efficiency, and competition—and when those regulations incorporate the views of the buyside. To that end, ICI has several initiatives under way.

One involves “maker-taker” pricing—the fee model commonly employed by exchanges and other equity market trading venues. Under this model, trading venues charge a fee to market participants that remove liquidity from the market—those are the “takers”—and pay a rebate to those who add liquidity by posting limit orders on the venue—those are the “makers.”

In our view, this model incentivizes brokers to route orders based on the levels of fees charged and rebates offered by trading venues—and reduces price transparency, impairs the quality of execution of fund orders, and needlessly increases market complexity. The benefits to investors of the rebates are far from clear. Especially for the most liquid stocks, we question whether rebates provide any benefit to investors.

In this light, we believe that the effects of fees and rebates on order-routing decisions warrant further examination. We have urged the SEC to work with the exchanges and other market participants to study how reducing fees and eliminating rebates for the most liquid stocks would affect investors. Just last month, we asked the SEC Equity Market Structure Advisory Committee to help establish a narrow pilot program that would generate data in this area to inform the SEC’s policy agenda. We hope the SEC and the Advisory Committee will show leadership in this area and conduct the study we recommend, so that we can learn more definitively about the impact of these fees and rebates.

Another initiative for the equity markets involves transparency and disclosure.

We are engaging with the SEC on its recently proposed rules to provide funds and other investors with more information about the operations and conflicts of interest of alternative trading systems. You all know these trading systems as “dark pools.”

Implemented effectively, these rules would require that dark pools disclose to funds and other investors information about how orders are submitted, matched, and executed on their trading systems. This information would then enable investors to understand whether their orders are treated fairly inside a dark pool’s matching engine—and could enable them to avoid unfair trading venues and evaluate the performance of their broker-dealers.

Transparency and disclosure are just as important for the order-routing practices of broker-dealers. Together with SIFMA and the Managed Funds Association, we submitted to the SEC a template for the minimum disclosure of information on order routing and execution quality that broker-dealers would have to provide to their institutional investor clients, including funds and their managers.

The template information would be standardized—it would provide funds with data to allow analysis and comparison, and it would help them begin a dialogue with their broker-dealers about order-routing practices and managing conflicts of interest. We are encouraging the SEC to use this template, and to make transparency in order-routing and execution practices a priority. We are hopeful that the SEC will propose and adopt this template in 2016.

A third initiative for the equity markets involves ensuring that they can respond effectively to market events.

On August 24 of last year, severe price moves in hundreds of securities—including ETFs and other exchange-traded products—triggered more than 1,300 trading halts. In some cases, these halts occurred less than a minute from the commencement or reopening of trading.

The trading halts exposed a crucial, and surely unintended, flaw in the limit up–limit down rules implemented after the May 2010 “flash crash.” The limit up–limit down rules were adopted to prevent a security from trading at a price outside specified price bands, but they rely on the rules of the individual exchanges to reopen trading after a halt.

This is a problem—because each exchange employs a different process to restart trading. These varied processes add to confusion and uncertainty during times of stress—exactly when clarity and certainty are most important.

Based on our analysis of the market volatility on August 24, and in close consultation with our members, we have urged SEC Chair White to direct the equity exchanges to work together to establish a harmonized process for reopening trading following a limit up–limit down trading halt.

We also have encouraged the SEC to ensure that the buyside has a meaningful voice in these efforts. As it stands now, the industry committee that administers the limit up–limit down rules—as well as other bodies that oversee other critical components of equity market structure—includes no fund representation, even though the events of August 24 deeply affected funds in many ways. Funds would add a much-needed industry perspective to the work of these committees, and we will continue to advocate for formal buyside representation on them.

Let me turn now to our second question—what big challenge are the fixed-income markets facing?

Reaching consensus on potential reforms, even on whether there is a need for any reform, has been no easy task. But if there’s one thing I’m sure we all agree on, it’s that we must always be looking out for anything that could jeopardize the liquidity in these markets.

Unfortunately, a recent rule proposal threatens to do just that. The SEC’s liquidity risk management proposal threatens to deprive the market of needed sources of liquidity, and could even induce herding behavior and cliff events.

One aspect of the proposal would require each fund to determine a “three-day liquid asset minimum,” and to manage its portfolio in accordance with it. A fund that falls below its minimum would be precluded from purchasing less-liquid assets until it once again exceeded the minimum.

If the proposal is adopted with this provision as proposed, increased demand for more liquid assets would come at the expense of other types of assets, depressing demand for them and making them less liquid. This could increase illiquidity in various market segments or security types and make them less desirable as fund holdings. Herding behavior of this type could become especially pronounced and problematic during stressed periods.

So what does this mean for fixed income, specifically?

Because the SEC would require funds to evaluate position size and quantitative measures that are particularly unsuitable for instruments that trade over-the-counter, larger funds would be more likely to have lower percentages invested in three-day liquid assets than smaller funds holding similar instruments. This could induce larger bond funds, in an attempt to compensate, to concentrate their portfolios in more liquid securities and avoid smaller, less-liquid securities. And that, in turn, could harm small and medium-size enterprises’ ability to obtain financing through the bond market, or else could increase their borrowing costs.

Markets in general also could be adversely affected. The three-day liquid asset minimum would potentially undermine, rather than bolster, market liquidity during stressed conditions. During market corrections, the assets falling the most in value are often the least liquid. Funds that fall below their minimums won’t have the flexibility to invest countercyclically and purchase undervalued and temporarily less-liquid assets, and so won’t be able to support market liquidity and prices by directing capital toward market segments under stress.

Notwithstanding the SEC’s good intentions, and the benefits of a more risk-focused approach to a liquidity management program rule, the prescriptive aspects of the rulemaking run a high risk of harming capital formation, other market participants, and markets generally, in foreseeable ways. At a minimum, and consistent with its mission, the SEC should be mindful of alternatives that advance investor protection without posing risks to the efficient functioning of the markets and to capital formation.

Let me turn now to my final question—how should we on the buyside be guiding discussions about market structure going forward?

Where once our capital markets interacted with only the SEC and the exchanges, we now have a veritable alphabet soup to contend with—the FRB, the CFTC, the FDIC, you name it.

With the ever-increasing globalization of our markets, this trend will not slow down—you can count on that. Our markets are no longer domestic on either the buyside or the sellside. Quite a large number of our members now have global operations and are highly active in international securities markets. This means yet more regulators—the Financial Conduct Authority in London … the European Securities and Markets Authority in Paris … the China Securities Regulatory Commission in Beijing.

This evolving regulatory landscape calls for diversity in our thinking. We must be nimble in how we think about and talk about our capital markets. Each of the regulatory agencies I mentioned—along with the many others I didn’t—should have investors’ interests and sound markets in mind. Yet each has a slightly different mandate, and so a slightly different perspective on the capital markets.

Take banking regulators as an example. They look at some capital markets activities as “shadow banking”—as though the markets are somehow unregulated, and hiding in the shadows.

Now, I don’t need to explain to this crowd the nuances of that misguided view, but I would like to point out one thing: it is imperative that, as we work with these regulators to preserve the benefits of the capital markets for investors, we recognize their view of the industry. Where they go wrong, we must quickly and forcefully rebut them, but we’d be making a huge mistake not to understand the thinking that informs their view.

Through understanding their perspective, we can better explain how capital markets regulation addresses their concerns or how their concerns don't apply to our industry. Doing so will enable us to engage more effectively with these regulators to ensure the continued safe and efficient functioning of the markets.

Central to each of the three questions I've just run through are basic principles on which we must continue to build our capital markets—principles that promote market structure policy that is fair to investors. These include robust price discovery … competition that fosters innovation and efficiencies for the benefit of investors … a high level of transparency … sensible regulation with diligent oversight and enforcement … and broad and diverse participation, especially the participation of long-term, retail investors.

All these principles are critical to the markets and to ICI members. They have infused and informed our work in this area for decades—and, as I see it, will continue to do so for years to come.

Thank you so much for joining us here in New York. In doing so, you're recognizing the importance of sound, efficient capital markets for regulated funds and their investors. You're recognizing that deep knowledge—shared both across the industry and with the regulatory community—is key to ensuring that the markets are working as best they can.

I hope you've found today's discussions so far to be engaging and enlightening. The second half of our program promises to be equally so, if not more. Thank you for your time and attention this afternoon.
