

## **SPEECH**

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# **Clouds Overhead: Financial Regulation After the Crisis**

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## **General Counsel's Address Mutual Funds and Investment Management Conference Karrie McMillan General Counsel Investment Company Institute**

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As prepared for delivery

Good morning to all of you, and thank you for joining us.

Thank you, Jack [Lockridge, executive director, Federal Bar Association], for that introduction, and thanks to you and to Frank Nasta for your invaluable assistance in assembling another outstanding program.

I haven't been coming to the Mutual Funds Conference as long as Frank has—and it certainly hasn't changed my life the way it has his!

I also especially want to acknowledge the many, many hours that ICI staff have devoted to creating one of the best learning experiences that you can find for our industry and its counsel.

As Frank told you, we have a full program—one that reflects the incredibly full regulatory agenda that our funds face today.

Let me just run through the highlights:

First, there's Dodd-Frank implementation—including swaps and derivatives, systemically important financial institutions, and a wide range of studies and reports.

Then there's the Volcker Rule—a part of Dodd-Frank that...well, we all know it holds a special place in our hearts.

We have the Commodity Futures Trading Commission's amendments to Rule 4.5, which bring a bonus—a proposal to “harmonize” 4.5 with SEC regulations, in which the term “harmonize” is more like a cruel joke.

On the retirement policy front, we have a full agenda of proposals and anticipated re-proposals.

Then there's the long-running saga of money market funds. It's been three and a half years since Reserve Primary Fund broke the dollar, and more than two years since the Securities and Exchange Commission adopted the post-crisis amendments to Rule 2a-7. But we're still waiting for the promised “Round Two” changes.

And that's just the domestic agenda. Overseas, we have many of these same issues, plus financial transaction taxes, market structure initiatives, the mysterious world of “shadow banking,” and an ever-growing list of other matters.

Now, I'm not complaining about regulation per se. The fund industry has long recognized that our business is built on a foundation of sound, investor-oriented regulation. That's backed up by the fiduciary duty of advisers and directors to funds and their shareholders—the highest duty under the law.

Throughout our 72-year history, ICI has sought to work with the SEC and other regulators. Our goal has always been to help them craft rules that are effective, efficient, and equitable. Time after time, working together, we've reached that goal.

And in the wake of the worst financial crisis since the Great Depression, we understand that Congress and the American people want a vigorous response. 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—on Capitol Hill and now in the agencies.

Last year at this time, I said that I saw sunlight peeking through the clouds of the financial crisis. Markets had stabilized and were improving. The Dodd-Frank Act had been passed. Investors maintained their confidence in funds, in defined contribution retirement plans, and in investing. Lawmakers on Capitol Hill clearly understood how the services our funds provide to Main Street separate us from other financial industries. Heck, Congress even passed a bipartisan tax bill to modernize the tax code in ways that benefit mutual fund investors.

Perhaps my most hopeful observation last year was that regulators were taking a thoughtful approach to their rulemaking duties. Despite the crushing workload dictated by Dodd-Frank, the SEC and other regulators were taking their time, offering longer comment periods, and working hard to find the right approaches. For the most part, their priority has been on getting the rules right—not on meeting due dates.

As a result, lots of deadlines have been missed—which reflects both the difficulties of turning legislative concepts into rule text and the fact that, in general, regulators are not rushing the process.

That's the bright side of our busy, busy agenda.

Unfortunately, there's a dark side as well.

Generally when I'm in Phoenix or Palm Desert, I prefer to focus on the sunshine. But this year—sadly, in keeping with the weather—I have to take note of three clouds that are looming over us. Big, threatening, dangerous clouds. Clouds that could do grave damage to funds and their investors.

The three threatening issues that are hanging over us are the Volcker Rule...more money market fund regulation...and the CFTC's amendments to Rule 4.5.

Let's take them one at a time.

It's been more than a month since we filed our comment letter on the Volcker Rule implementation. I still haven't gotten over the fact that we filed a 51-page response to a proposal that wasn't even supposed to affect registered investment companies.

As you know, Congress enacted the Volcker Rule to limit "proprietary trading" by banks. The Rule also prohibits banks from sponsoring or investing in hedge or private equity funds. Mutual funds and other investment companies were not the Rule's target.

But when it came time to implement the Rule, five regulators had to coordinate. And the proposal spills over into nearly every corner of finance.

Funds are not immune.

Under the proposed Volcker Rule, banks could be prevented 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 funds and their investors, less liquidity means wider spreads and higher trading costs.

The proposal is especially troubling because it calls into question banks' ability to act as authorized participants for exchange-traded funds, and to conduct related activities. These activities are critical to ensuring that ETFs keep the market price of their shares close to the net asset value. Shrinking the number of firms eligible to act as authorized participants and market makers will create bad outcomes for ETF investors.

The Volcker proposal is so broadly written that it would treat some U.S. registered funds—and virtually all non-U.S. funds—as hedge funds. Yes—hedge funds. That would bar banks from sponsoring or investing in any of these funds. But its exemption for foreign trading activity is so narrow that U.S. registered funds could find it difficult to find foreign counterparties for trading.

The bottom line—the proposal to implement the Volcker Rule could impair liquidity and trading in U.S. markets; prevent U.S.-related global funds from competing with similarly situated foreign-sponsored funds; impede the organization, sponsorship, and normal activities of U.S. funds; and limit funds' investment opportunities.

That's quite a lot of damage.

Now, despite all that, I do have one hopeful chord to strike. Congress never intended for the Volcker Rule to directly affect registered investment companies. I don't think our funds were intended to be "covered funds" or "banking entities." So I think that some of the

spillover damage that the Rule could inflict on registered funds is an inadvertent side effect—and could easily be fixed.

I can't say the same about the second dark cloud—the SEC's push for "structural changes" in money market funds.

We'll have a panel this afternoon on money market funds, where we hope to gain a better understanding of the SEC's plans and proposals.

However, there have been enough leaks and enough public commentary that we all have a pretty good handle on where Chairman Schapiro and the staff are going.

Let me cut through all the details—all the rhetoric—all the arguments.

Let me just state something that should be obvious to us all:

What the SEC is considering doing to money market fund investors is outrageous.

Outrageous.

No other mainstream financial product in this country has a regulator-imposed freeze on assets. No other mainstream financial product has been ordered to routinely tell its customers, "You can put your money in—but you can't get it all back when you want it."

This is not a minimum account balance, where depositors pay higher fees or sacrifice interest if their balances fall. No—this is Washington saying to investors: "You can't have your own money back" without an arbitrary delay. Not just in a crisis—but in good times and bad.

For more than 70 years, mutual funds have operated on the opposite idea—the principle that funds will redeem their shares—in full—on any day that the markets are open.

Yet the staff of the SEC now appears to be ready to say that this core principle does not apply for money market fund investors. Investors who depend on the stability, convenience, and liquidity of money market funds—all the features the SEC's proposals would take away.

Now, mix a redemption freeze that will lock up investors' assets with a capital buffer that will deprive them of yield, and you have one of the reported SEC proposals.

The other is that old chestnut—floating the value of money market funds.

We've been batting that idea down for three years now. And we've won some important converts. Not among the banking regulators—I'll grant you that. But we've certainly created doubts among many at the SEC.

The record is clear that floating the NAV of money market funds won't change investor attitudes or behavior; won't prevent redemptions in a crisis; and won't reduce systemic risk.

What it will do is destroy the value of money market funds for investors—and for the economy. If they're listening to investors, the staff and leadership at the SEC should have gotten that message loud and clear.

We've looked at what happened to money market funds' mark-to-market values last

summer, at the height of the eurozone crisis. We looked at the prime funds with the greatest exposure to European financial institutions. We found that their “floating” value dropped by nine-tenths of a basis point.

On a \$1 share, that’s a dollar sign followed by: 0.00009.

If you’re trying to follow along, that’s nine one-thousandths of a penny.

That kind of “float” is not going to move a share priced at \$1, and it’s not going to move a \$10 share. It might—in extreme conditions like the eurozone crisis—move the price of a \$100 share. Forget about “breaking the buck”—funds will have to “break the Benjamin.”

If the SEC really wants money market funds to float, our research suggests they’re going to have to reprice them to \$1,000 a share. Otherwise, they’re going to force investors to swallow all the legal, tax, and accounting burdens of floating funds—only to discover that whatever funds are left won’t actually float at all.

I said earlier that I thought the potential damage of the Volcker Rule is inadvertent. Here, however, the damage is no accident.

Money market funds are one of the great success stories of modern financial regulation. Throughout the history of these funds, the SEC has carefully crafted rules that balance these funds’ competing objectives of stability of principal, liquidity, and yield. These rules have enabled money market funds to flourish and innovate—to the great benefit of investors and the economy.

The 2010 amendments to Rule 2a-7 built upon that success. They raised the bar for what it means to be a money market fund—and the new model is far stronger. These reforms were tested and proven last summer, when they made money market funds more resilient in the face of crisis. They have made investors more secure, at a reasonable price. They have reduced systemic risk. They are a success.

But the SEC’s “Round Two” proposals could easily destroy its “Round One” gains. Think about it—the 2010 amendments reduced portfolio risks; increased liquidity; empowered boards to make sure investors are treated fairly; and made these funds more transparent.

By contrast, Round Two would drive billions of dollars away from money market funds and into unregistered cash products that have no risk-limiting regulations, no required liquidity, no board governance, and no transparency.

Round Two would undo Round One—and then some.

It’s time for the SEC to recognize the success of its 2010 reforms—and move on.

And now we arrive at a subject that really gets me worked up.

Last month, the Commodity Futures Trading Commission enacted its amendments to Rule 4.5. If you’re not familiar with Rule 4.5, my panel later this morning is your must-attend event of the week, because your funds may soon be answering to two regulators—two regulators with requirements that are at once duplicative and fundamentally inconsistent.

As you well know, funds’ use of derivatives brings enormous benefits to fund investors. Some mutual funds use options, futures, swaps, and other derivatives to provide exposure

to the commodity markets for those shareholders who seek that diversification. But they also use financial derivatives to efficiently manage their portfolios—hedging currency or credit risks, fine-tuning bond portfolios, and gaining access to asset classes that are too difficult or costly to trade directly.

For more than eight years, mutual funds operated comfortably under the 4.5 exclusion—without incident. But in January 2011, the CFTC decided it needed to target a small number of what it called “futures-only investment products” that it maintained were evading CFTC regulation.

Instead of covering only these few products, however, 4.5 sweeps in thousands of equity, bond, and hybrid mutual funds—funds that aren’t by any stretch of the imagination “futures-only” investments— and unnecessarily subjects them to a brand new regulator.

There are many curious facts in this tale that I find very puzzling.

First, the CFTC has been very vocal on Capitol Hill about its lack of resources to keep up with its Dodd-Frank rulemaking duties. Dodd-Frank didn’t call on the agency to re-examine 4.5—and the CFTC has never demonstrated why the amendments are necessary now. But the agency piled 4.5 on top of its allegedly crushing workload anyway—because, in their words, the amendments are “consistent with the tenor” of Dodd-Frank.

Second, for some reason, the CFTC saw fit to make these amendments while the rules for swaps trading are still unsettled. We don’t know which swaps will fall under their regulation or how funds’ use of these swaps will be affected. All we know is that advisers to many funds that use swaps will be forced into CPO registration. At best, you can say these amendments are premature.

Third, the CFTC has never explained what regulatory gap it’s filling. Think about it—mutual funds are the only investment product regulated under all four of the major federal securities laws. Yet the CFTC claims that overlaying its rules on top of the SEC’s comprehensive regulation of mutual funds will somehow help fund investors.

Come on. Really?

Oh, yes—did I mention that a CFTC commissioner tagged her own agency’s cost-benefit analysis as “sorely lacking”? Well, she did.

There’s only one explanation for the Rule 4.5 amendments that makes sense to me. The CFTC decided that the turmoil following Dodd-Frank created a perfect opening for a regulatory land grab. The result will either vastly expand the CFTC’s jurisdiction—or drive mutual funds out of the markets for futures, options, and swaps. Either way, investors lose.

I’ve described for you three major regulatory initiatives that could have dire consequences for funds and investors. All of them will raise costs, limit investment opportunities, and make markets less efficient. None can be justified by a rigorous cost-benefit analysis. And none of them will help protect investors.

Fortunately, the American system can be self-correcting. The enormity of the Volcker Rule proposal is so obvious that even the public has taken note. The financial industry’s massive resistance may—we hope—lead the agencies to withdraw the proposal and re-examine it.

The SEC’s money market proposals have hit massive resistance as well. Chairman Schapiro

may think that the “hue and cry” on this issue is coming from the fund industry—but what she’s really hearing are the voices of Main Street USA.

Look at the lineup of groups that have told the SEC that its proposals will undermine the stability, convenience, and liquidity they need—businesses, state and local governments, colleges and universities, nonprofits, financial advisers, and individual investors.

Issuers of commercial paper and municipal securities have spelled out the economic damage that will follow if money market funds’ financing of their operations is disrupted.

Those messages seem to be getting through—at least to some at the Commission. I certainly hope so.

As for the CFTC— the extensive damage that Rule 4.5 may cause still needs to be fully evaluated. We can’t tell in part because their actions are so premature, and the comment period for the harmonization proposal is still open.

We will file a strong comment letter on that, with a vigorous cost-benefit analysis that will clearly demonstrate the rule’s excessive costs to fund shareholders.

I know that you’re all asking the same question that I am: “What do we have to be optimistic about?”

We have our core values.

We have our fiduciary culture.

Our industry remains strong.

Most importantly, our shareholders are with us.

We can weather these regulatory clouds, just as we came through the market storms of the financial crisis.

I hope you share that optimism, and I thank you for your time and attention.