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**STATEMENT**

**OF**

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**BEFORE THE**

**US HOUSE OF REPRESENTATIVES**

**COMMITTEE ON FINANCIAL SERVICES**

**SUBCOMMITTEE ON  
CAPITAL MARKETS, SECURITIES AND INVESTMENT**

**ON**

**EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES,  
INVESTORS AND JOB CREATION**

**MARCH 29, 2017**

## EXECUTIVE SUMMARY

- Congress enacted the Volcker Rule to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain bank transactions. The Volcker Rule was *not* directed at registered funds—that is, mutual funds, exchange-traded funds, or other US investment companies that are subject to comprehensive regulation under the Investment Company Act of 1940—or at similar non-US funds. Unfortunately, the final regulations implementing the Volcker Rule nonetheless resulted in a number of concerns for these funds and their investment advisers. Our testimony highlights three areas of concern. It also provides ICI’s views on structural changes in the secondary corporate bond markets and expresses support for the Subcommittee’s examination of the Volcker Rule and its consideration of the capital markets more broadly.
- A first area of concern stems from the fact that the five agencies implementing the Volcker Rule (“Agencies”) failed to provide a complete carve-out for registered funds. As a result, many such funds found themselves treated as “banking entities.” This could happen, for example, in the case of a newly-launched fund whose investment adviser was affiliated with a bank. Solely by reason of the adviser’s investment of start-up capital (so-called “seed money”), the fund itself would be subject to the Volcker Rule’s trading and investment limits as if it were a bank. It is clear that Congress did not intend such a result.
- The Agencies ultimately provided some relief—only days before the July 21, 2015 compliance date—after months of effort from ICI and other stakeholders. The task of obtaining this relief was particularly burdensome because:
  - the problem was apparent, and had been brought to the Agencies’ attention *three years earlier* during the comment period on the proposed implementing regulations, and
  - the Byzantine multi-agency process adopted by the Agencies was never transparent, involving repeated meetings and calls with Agency staffs without any clear indication as to their thinking, progress or deliberations.
- A second area of concern involves competitive inequalities. For example, the final regulations appropriately exclude “foreign public funds”—the foreign equivalents to registered funds—from the Volcker Rule’s restrictions. The Agencies, however, placed requirements on US firms and their affiliates that rely on this foreign public fund exclusion that do not apply to foreign firms offering the same types of funds.
- A third area of concern is that the Volcker Rule has disrupted the market for certain securities in which registered funds invest. To illustrate, we discuss the restructuring and contraction that has occurred in the tender option bond (“TOB”) market and the implications for banks, investors (including registered funds), and municipalities. It is our understanding that the size of the total

outstanding TOB market has decreased significantly since before the financial crisis, due in part to the Volcker Rule, and that the demand for these securities consistently exceeds the supply.

- The Subcommittee has expressed interest in the impact of the Volcker Rule on the US capital markets, with particular focus on liquidity in the fixed income markets. Our testimony underscores the importance of market liquidity to registered funds and the continuing complexity of the market making exception in the final implementing regulations. It then discusses the significant structural transformations that are occurring in the secondary corporate bond markets, and what these mean for liquidity in those markets.
- To reiterate, ICI supports the Subcommittee's examination of the Volcker Rule and its consideration of the capital markets more broadly. Market dynamics and factors relevant to trade execution affect a registered fund's ability to deliver on its investment mandate and, in turn, fund investors' ability to achieve their financial investment goals.

## I. INTRODUCTION

My name is David Blass. I am General Counsel of the Investment Company Institute (“ICI”) a leading global association of regulated funds, including mutual funds, exchange-traded funds (“ETFs”), closed-end funds, and unit investment trusts in the United States (“registered funds”), and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. As of March 1, 2017, ICI’s members manage total assets of US\$18.9 trillion in the United States, serving more than 95 million US shareholders, and US\$1.6 trillion in assets in other jurisdictions. Thank you, Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee for inviting me to testify.

ICI appreciates the opportunity to speak to the Subcommittee regarding the effect of the Volcker Rule on registered funds and, more broadly, capital markets, capital formation, and investors. We previously have had the opportunity to appear before the full Committee on Financial Services and to make known some of our concerns about Section 13 of the Bank Holding Company Act—commonly known as the Volcker Rule—which was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>1</sup> As we stated then and reiterate today, the registered fund industry has a unique perspective on Volcker Rule issues because funds are both issuers that, in some circumstances, may be subject to the Volcker Rule and “buy-side” investors in domestic and international financial markets that may be affected by the Volcker Rule.

By all acknowledgements, the Volcker Rule was never intended to apply to registered funds. Nonetheless, ICI members have been affected by the complexities and consequences of the Volcker Rule, and some have had to navigate its complicated implementing regulations and the Byzantine multi-agency process for obtaining guidance and interpretations under those regulations. The regulations implementing the Volcker Rule introduced particular uncertainties about the treatment of certain registered funds and similar funds organized outside the United States. Although the agencies charged with implementing the Volcker Rule ultimately issued guidance to try to ameliorate some of these issues, they never have been resolved through a transparent rulemaking process and, more importantly, some registered funds are now subject to an unnecessary compliance burden as a result.<sup>2</sup> Further, the Volcker Rule has disrupted the market for certain securities in which registered funds invest. And it is one of many factors contributing to structural changes in the fixed income markets.

In the sections that follow, we first provide background information on registered funds and their comprehensive regulatory framework (Section II). We then discuss some of the unintended

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<sup>1</sup> Paul Schott Stevens, ICI’s President and CEO, testified before the U.S. House of Representatives’ Committee on Financial Services during the 112<sup>th</sup> Congress. His written testimony is available at [https://www.ici.org/pdf/12\\_house\\_impact\\_volcker2\\_written.pdf](https://www.ici.org/pdf/12_house_impact_volcker2_written.pdf).

<sup>2</sup> The Volcker Rule implementing agencies (the “Agencies”) are: the Federal Reserve Board, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Securities and Exchange Commission.

consequences and complexities of the Volcker Rule that affect registered funds and their foreign counterparts (Section III). Finally, we provide ICI's views on structural changes in the secondary corporate bond markets and express support for the Subcommittee's examination of the Volcker Rule and its consideration of the capital markets more broadly (Section IV).

## II. BACKGROUND ON REGISTERED FUNDS

Registered funds and their investment advisers operate under a comprehensive framework of regulation, including the Investment Company Act of 1940 ("Investment Company Act"), the Investment Advisers Act of 1940, and other federal securities laws. This framework has been enhanced over the years, including most recently in the Dodd-Frank Act, by Congress and the Securities and Exchange Commission ("SEC"), the primary regulator for registered funds and the asset management industry more generally. Notably, the regulatory framework serves both to protect investors and to mitigate risks to the financial system.

The applicable laws encompass not only disclosure and anti-fraud requirements but also substantive requirements and restrictions on funds' structures and day-to-day operations. Fund investment advisers likewise must register with the SEC and are subject to SEC oversight and disclosure requirements. All investment advisers owe a fiduciary duty to each fund they advise, meaning that they have a fundamental legal obligation to act in the best interests of the fund pursuant to a duty of undivided loyalty and utmost good faith. Actions taken on behalf of a fund by its adviser and other service providers are subject to broad oversight by the fund's board of directors (typically comprising at least a majority of independent members) and the fund's chief compliance officer. Funds must have written compliance programs designed to prevent violations of the federal securities laws. Fund directors, fund and adviser officers, and other employees all must adhere to codes of ethics.

It is important to note that the Investment Company Act was developed in direct response to overreaching and self-dealing by fund sponsors in the 1920s, which caused significant losses for investors. That Act seeks to minimize risk for fund shareholders by, among other things, ensuring that the fund and its investments are easily understood, its investment portfolio is managed for the benefit of its investors and not for the benefit of its investment adviser, and fund assets will not be misappropriated. Among the most significant of these protections are the following:

- Transactions with affiliates: The Investment Company Act contains a number of strong and detailed prohibitions on transactions between the fund and fund insiders or affiliated organizations, such as the corporate parent of the fund's investment adviser.
- Leverage: The Investment Company Act constrains funds' ability to borrow or issue any "senior security" that would take priority over the fund's shares.
- Custody of assets: The Investment Company Act requires all funds to maintain strict custody of fund assets, separate from the assets of the adviser. Nearly all funds use a bank custodian for

domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients.

- **Transparency:** Under the Investment Company Act and applicable SEC regulations, funds are subject to extensive disclosure requirements. Funds provide a vast array of information about their operations, financial conditions, contractual relationships with their advisers and other matters to the investing public, regulators, media, and vendors such as Morningstar, and other interested parties—far more information than is available for other types of investments.
- **Mark-to-market valuation of fund assets:** All mutual funds provide market-based valuations of their shares at least daily. The valuation process results in a net asset value for the fund, which is the price used for all transactions in mutual fund shares.

In recognition of the comprehensive framework that applies to registered funds, Congress deliberately determined to exclude registered funds from the scope of the Volcker Rule. Rather, the Rule is intended to apply only to certain privately offered funds that are structured in a manner that avoids registration and regulation under the Investment Company Act.

### **III. UNINTENDED CONSEQUENCES AND COMPLEXITIES AFFECTING REGISTERED FUNDS**

Congress enacted the Volcker Rule to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain transactions or relationships. To accomplish these goals, the Volcker Rule prohibits banks and their affiliates and subsidiaries (referred to as “banking entities”) from engaging in “proprietary trading.”<sup>3</sup> The Volcker Rule also generally prohibits banking entities from sponsoring or investing in hedge funds, private equity funds, or other similar funds (referred to as “covered funds”). Despite the Agencies’ recognition that the Volcker Rule was *not* directed at registered funds, the final regulations implementing the Rule nonetheless resulted in a number of concerns for the registered fund industry.

#### **A. Hampering Organization and Sponsorship of Registered Funds**

Most significantly, many registered funds and their advisers found themselves within the definition of a “banking entity” under the final regulations and, thus, subject to the Volcker Rule’s trading and investment limits as if they were banks. For some ICI member firms, this treatment arose because the fund adviser is affiliated with an insured depository institution, even though that institution is not directly involved in the fund or asset management business.

As a consequence, these investment advisers found some of their common practices, such as “seeding” new funds, subject to restrictions under the final regulations, even though these practices had been

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<sup>3</sup> There are exclusions for “permitted activities,” such as market making, as defined in the statute and implementing regulations.

longstanding and, to our knowledge, had never raised any regulatory concerns in the past. Seeding is a primary way for an investment adviser to launch a new fund. The adviser, during an initial seeding period, will own all or nearly all of the shares of a fund, as the adviser attempts to establish the fund, to test the investment thesis of the fund, and to develop an investment record that will attract investors—with the goal being to reduce the adviser’s relative ownership of the fund as investors buy fund shares. As a result of the adviser’s initial ownership stake, a newly seeded fund would be considered an affiliate of a “banking entity” and thereby captured (albeit needlessly so) by the final regulations implementing the Volcker Rule.

ICI and other interested parties communicated this concern to the Agencies during the comment period on the proposed regulations to implement the Volcker Rule, but the final regulations offered only limited relief. The Agencies allowed that a sponsoring banking entity may hold 25% or more of a registered fund during a one-year seeding period and permitted the banking entity to apply to the Federal Reserve Board for an extension of the seeding period up to two additional years. This narrow seeding exception did not account for prevailing industry practices and did not address seeding practices in a variety of contexts.

This was a significant issue for ICI members, potentially placing affected funds at a competitive disadvantage. To begin with, multi-year seeding periods are common for (and necessary to) the successful launch of registered funds in the United States; investors generally expect a demonstrated track record before investing in a new registered fund. The immediate effect of the rule was two-fold.

- First, because banking entities require certainty that they will be able to avail these funds of a sufficient seeding period, some considered refraining from launching new funds, the consequence of which would be to decrease investor options with respect to investment vehicles that the Volcker Rule was never designed to affect. That end result would diminish innovation and development of new funds that are important to retail investors to meet their retirement, education, and other needs.
- Second, and more immediate, existing funds—those that already have been formed and currently are in their seeding period, many of which have investors who are unaffiliated with the sponsoring banking entity—required additional time to meet the compliance deadline and avoid being deemed to be “banking entities” under the Volcker Rule. Absent relief, the banking entities would be forced to restructure the funds by selling off their stakes or by liquidating the funds. Either course would require advance planning and have evident adverse consequences for the third-party investors in the funds, which, again, were never intended to be reached by the Volcker Rule.

Upon the Agencies’ release of the final regulations implementing the Volcker Rule, ICI and its members sought to engage the Agencies on these issues. To our surprise and our members’ consternation, addressing the issues—which were apparent and brought to the Agencies’ attention from the outset—took many months and required working through the Byzantine multi-agency process adopted by the Agencies to implement the Volcker Rule. The process proved particularly

frustrating because it took so long, because it was never transparent (with ICI and other stakeholders writing to and meeting repeatedly with Agency staffs without any clear indication as to their thinking, progress, or deliberations), and because the ultimate resolution proved, in many ways, incomplete.

Agency action on the seeding issue came in July 2015, only days before the deadline by which compliance with the Volcker Rule was mandated. At that time, the Agencies published fund seeding guidance in the form of a “frequently asked question,” found on the Agencies’ websites. This guidance provided much-needed immediate relief, in that it recognized that banking entities, during the seeding period, may hold more than 25% of a registered fund’s shares for longer than one year without the fund itself being viewed as a banking entity and subject to the Volcker Rule’s restrictions.

The “guidance,” although greatly welcomed, was disappointing for several reasons. First, it interprets but does not alter the legal requirements of the final regulations—such piecemeal approaches create needless confusion. Second, the guidance introduces other vagaries and complexities because it could be read to suggest that, in the ordinary course, a three-year seeding period may be the maximum allowed. This phraseology has left some industry participants uncertain about longer seeding strategies, which may be necessary and common for certain types of funds.

To us, this process demonstrates that the complexity of the Volcker Rule is nearly unmanageable not only for financial entities with obligations to comply with the Rule’s myriad requirements but also the Agencies themselves—they seem to struggle to administer, interpret, and implement the very regulation they have adopted and impose restrictions that appear untethered from the widely acknowledged underlying policy objectives of the Rule. Moreover, as noted, the end result leaves registered funds with an unexpected and unnecessary compliance burden, despite the fact that registered funds should have been outside of the scope of the Volcker Rule from the beginning.

Similar challenges have been encountered by funds that are publicly offered (by both US and foreign banking organizations) and substantively regulated outside of the United States—essentially, the foreign counterparts to registered funds—despite Congressional intent to limit the extraterritorial impact of the Volcker Rule. The final implementing regulations appropriately provided an exclusion for so-called “foreign public funds” from the Volcker Rule’s restrictions. Yet in much the same way as registered funds, these funds faced uncertainty as to what would be considered a permissible seeding period, such that the fund would not become subject to the trading and investment limits in the Volcker Rule. And, like registered funds, foreign public funds did not obtain needed guidance from the Agencies until days before the July 2015 compliance date. In addition, foreign public funds organized differently from their US counterparts (for example, without a separate fund board of directors) faced an added layer of complexity. Without specific guidance from the Agencies, those funds might have been deemed to be “controlled” by their bank-affiliated adviser and thus subject to the Volcker Rule, despite being organized in a manner permitted under the laws of their home jurisdiction. The Agencies ultimately issued the needed guidance but only after the same protracted process used to issue seeding guidance.



Finally, the Volcker Rule and its implementing regulations create competitive inequalities that deserve to be reviewed and addressed. Take, for example, the foreign public funds described above, which are excluded from the Volcker Rule's restrictions. Unfortunately, the Agencies placed requirements on US firms and their affiliates seeking to rely on this foreign public fund exclusion that do not apply to their foreign competitors. In particular, US firms must ensure that fund interests are sold "predominantly" (a term that is undefined in the final regulations) to third-party retail investors, but excluding their affiliated persons. This restriction on sales to affiliated persons creates monitoring and other compliance challenges for US firms and, for no apparent reason, puts US sponsors of foreign public funds at a competitive disadvantage to their foreign competitors.

## **B. Hampering Investment Opportunities for Registered Funds**

In addition to the challenges described above that some of our members must grapple with, the Volcker Rule also has had unanticipated implications for certain securities in which many registered funds invest. Like many investors, our members value predictability in the structure and nature of their investments, a predictability that has been undermined in many ways by the overzealous application of the Volcker Rule to activities that Congress did not intend to regulate when the Volcker Rule was enacted. One example of this disruption can be seen in the case of the tender option bond ("TOB") market.

In a traditional TOB program, a bank deposits one or more investment grade municipal bonds into a trust that issues two classes of tax-exempt securities: a short-term security (the "floater") that is supported by a liquidity facility, and a residual floating rate security (the "residual"). The floater is a variable-rate demand security that bears interest at a rate adjusted at specified intervals. The liquidity facility provides a "put" or conditional demand feature, allowing the floater holder to tender the floater, with specified notice, and receive face value plus accrued interest.

Floater holders (typically shorter-term investors) bear limited and well-defined insolvency and default risks associated with the underlying bonds and rely upon their largely unfettered put right to manage these risks. Holders of residuals (typically longer-term investors) receive all cash flows from the underlying bonds that are not needed to pay interest on the floaters and expenses of the trust. Residual holders bear all of the market risk and share the credit risk with the floater holders with respect to the underlying municipal bonds.

Prior to the Volcker Rule, a bank typically performed the traditional functions of a TOB program sponsor. Since the enactment of the Volcker Rule, however, a TOB trust is very likely to be considered a covered fund. Therefore, banks have been forced to restructure TOB trusts to avoid sponsoring a covered fund, which is prohibited under the Volcker Rule and, even when permitted under certain exemptions, subjects the fund to a variety of restrictions and limits (such as a prohibition on receiving credit support from the sponsor).

There is no indication that Congress ever intended for the Volcker Rule to limit banks' ability to sponsor TOB trusts. In fact, Congress sought to avoid interfering in traditional banking activities such as this one. We pointed this out to the Agencies prior to the finalization of the regulations

implementing the Volcker Rule, but the Agencies failed to exclude these programs from the final regulations' definition of a covered fund. Though the worst fear of TOB investors and sponsors—that TOBs would cease to exist after the Volcker Rule—has not materialized, the Volcker Rule has played a role in the contraction of the supply of TOBs.<sup>4</sup> Our members report that the demand for these securities—which can increase the diversification and liquidity of fund portfolios—consistently exceeds supply, with new deals sometimes oversubscribed by three to four times.

As a result of the Volcker Rule, banks have been forced to change their role from sponsors to liquidity providers and to cede the role of sponsor to one of the trust's residual interest holders. The uncertainty caused by this seemingly unnecessary regulatory shift led to disruption in the TOB market, to the detriment of banks and investors alike. The shrinkage of the TOB market also has implications for municipalities in that TOBs provide an important source of demand for municipal bonds, which benefits municipalities with funding needs.

#### **IV. STRUCTURAL CHANGES IN THE SECONDARY CORPORATE BOND MARKETS**

The Subcommittee has expressed interest in the impact of the Volcker Rule on the US capital markets, with particular focus on liquidity in the fixed income markets. We address this topic below.

##### **A. Importance of Market Liquidity to Registered Funds**

For registered funds, the availability of liquidity is a critical element of efficient markets. Many banking entities are key participants in providing this liquidity, promoting the orderly functioning of the markets and committing capital when needed by investors to facilitate trading.

Liquidity is particularly important in the everyday operations of mutual funds, which typically offer their shares on a continuing basis and are required by the Investment Company Act to issue “redeemable securities.”<sup>5</sup> To invest cash they receive when investors purchase fund shares as well as to meet investor redemption requests on a daily basis, mutual funds must have efficient, orderly markets.

Registered funds also rely on adequate liquidity when making investment decisions and when trading the instruments in which they invest. Important investment criteria analyzed by portfolio managers at registered funds include a security's liquidity, *i.e.*, whether a position can be sold in a timely and cost efficient manner. And, if registered funds are concerned about the possibility that the liquidity of particular instruments could become impaired in the future, they may be reluctant to invest in those instruments altogether.

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<sup>4</sup> It is our understanding that the size of the total outstanding TOB market has decreased significantly from its size before the financial crisis.

<sup>5</sup> See Section 2(a)(32) of the Investment Company Act (generally defining “redeemable security” as “any security . . . under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.”).

## B. Development of Implementing Regulations and Concerns About Market Impacts

In our December 2012 testimony, we explained that much of the concern about market liquidity arose from the complexities of the proposed regulations to implement the Volcker Rule. We took issue, for example, with the proposal's presumption that short-term principal trading is proprietary trading, unless a banking entity is able to demonstrate otherwise. Concerned that such a presumption would fundamentally prejudice the analysis of a banking entity's trading activity from the outset, we observed that a banking entity in this position would have to worry about hindsight interpretations and second-guessing about key compliance decisions with respect to each financial position. Registered funds and other investors, in turn, would have to worry about any chilling effect this might have on a banking entity's ability or willingness to engage in market making activity.

The final regulations, regrettably, generally follow the same structure as the proposed regulations, broadly defining "proprietary trading" and retaining the rebuttable presumption. The Agencies did revise the exemption for permitted market making, so that its applicability is determined based on the general market making activities of a bank's trading desk and not on a transaction- by- transaction basis. Nevertheless, it requires, among other things, that the amount, types and risks of the financial instruments in the trading desk's "market maker inventory" must be designed not to exceed, on an ongoing basis, the "reasonably expected near term demands of clients, customers and counterparties." To rely on this exception, banks must maintain a robust set of risk controls for their market making activities, in addition to the compliance requirements generally applicable to banks under the final regulations. The market making exception thus remains an area of considerable complexity.<sup>6</sup>

The final rule addressed another of registered funds' most pressing concerns about the proprietary trading prohibition and its potential impact on the capital markets, as outlined in our December 2012 testimony. It did this by ensuring that banking entities' activities with respect to all municipal securities (in addition to Treasury and federal agency securities, which were carved out from the beginning) would not be impaired. As our testimony indicated, we were concerned that failure to exclude these securities would have posed liquidity challenges for registered funds, which are significant investors in securities issued by state and local government entities, and made it difficult for states and localities to raise capital.

Not excluded from the Volcker Rule—and of particular interest to this Committee—are the fixed income markets, including the corporate bond markets, in which registered funds are steady investors.

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<sup>6</sup> See, e.g., Michael Bright, Jackson Mueller and Phillip Swagel, *FinReg21: Modernizing Financial Regulation for the 21<sup>st</sup> Century*, Milken Institute Center for Financial Markets (March 24, 2017) at 3, available at <http://www.milkeninstitute.org/publications/view/853> ("For example, if a trader buys a 10-year corporate bond from a client, but cannot easily re-sell that bond and instead sells a 10-year Treasury—meaning the trader is long a corporate note and short the 10-year Treasury note. Is this a 'prop trade,' or is it simply appropriate risk management in a rapidly moving market? How long can the trader hold this position before it becomes a 'prop trade?' This is a simple trade but not a simple question in the context of the Volcker Rule. And yet it seems obvious that this series of events should constitute allowable market-making—the normal activity of a broker-dealer in carrying out trades for customers and offsetting the resulting risks on its own books—in today's financial markets.")

Funds are investment vehicles through which millions of Americans gain access to corporate bonds, so ICI and its members have a strong interest in ensuring the quality and integrity of these markets. With this in mind, we recently weighed in on an examination of liquidity in secondary corporate bond markets conducted by the Board of the International Organization of Securities Commissions (“IOSCO”).<sup>7</sup>

### **C. Secondary Corporate Bond Markets: A Shifting Landscape**

There is considerable consensus that the secondary corporate bond markets are undergoing significant structural transformations caused in part by regulatory reform in the aftermath of the financial crisis as well as by changing economics and technology.<sup>8</sup>

Historically, most trading in US corporate bond markets has been over-the-counter, either between a dealer and a customer or between two dealers. This trading generally occurred over the telephone or through electronic systems that allow a customer to negotiate or trade with particular dealers. Often, dealers traded with their customers on a principal basis, using their capital to carry a large inventory of bonds on their books.

After the financial crisis and the ensuing regulatory reform, the role of dealers in these markets has changed, with dealers reducing inventory and acting more often in an agency capacity for their customers. A number of factors may explain why dealers have chosen to reduce their holdings of corporate bonds. These include the Volcker Rule and other regulatory requirements that limit the ability of banks to use their balance sheets to engage in market making activities, as well as increased costs associated with holding corporate debt in inventory. Given the central role that dealers have played in corporate bond markets, it is not surprising that many participants that had become accustomed to dealers providing liquidity in a principal capacity now must navigate their way through this evolving market environment.

Further, our members’ experience suggests that the nature of trading is changing, as new technology has introduced trading protocols that did not exist in the fixed income markets even a few years ago. These new technologies and innovations provide market participants with additional means to trade corporate bonds, and will be a factor both in altering the structure of the bond markets and in influencing the ability of market participants to adapt to dealers’ changing role in these markets.<sup>9</sup>

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<sup>7</sup> See Letter to IOSCO from Dan Waters, Managing Director, ICI Global, dated September 30, 2016, available at <https://www.ici.org/pdf/30289.pdf> (commenting on IOSCO Board, *Examination of Liquidity of the Secondary Corporate Bond Markets, Consultation Report* (August 2016)).

<sup>8</sup> For greater detail, see generally IOSCO Board, *Examination of Liquidity of the Secondary Corporate Bond Markets, Final Report* (February 2017) (“IOSCO Report”), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD558.pdf>.

<sup>9</sup> See also IOSCO Report at 15-16.

#### **D. What About Liquidity in the Secondary Corporate Bond Markets?**

The shifting landscape does not necessarily mean that there is a lack of liquidity in the secondary corporate bond markets. Indeed, liquidity is not an “it’s there or it’s not” proposition. In a recent letter to IOSCO, Vanguard—a global investment management firm offering more than 190 mutual funds in the United States—explained it this way:

[L]iquidity is dynamic, subjective, and hard to define. It can change in response to shifts in investor risk preferences, dealer financing costs and profit opportunities, or any of the other variables that influence capital market activity.

Liquidity has, in effect, a price. That price corresponds to changes in the supply of and demand for liquidity. Or to put it another way, liquidity is obtained along a cost continuum.<sup>10</sup>

Another facet of liquidity to bear in mind is that market participants—based on their particular trading or investment strategies, time horizons, risk tolerances and the like—place different values on and have different perceptions of liquidity. As part of its recent examination of the secondary corporate bond markets, IOSCO surveyed market participants including funds, dealers, electronic trading venues and others. As their responses indicated, industry perceptions of the development of bond market liquidity over the past decade are mixed. The majority of both buy-side and sell-side respondents to the survey perceive market liquidity to have decreased. These perceptions were generally based on personal experience and not on data analysis.<sup>11</sup>

In addition, there is no single metric that reliably can measure bond market liquidity. Rather, a variety of metrics are commonly used as indicators of liquidity. These include trading volume, turnover ratio, bid-ask spreads, trade size, immediacy (in other words, the time it takes to trade a bond), price impact measures and statistics related to market making.

Some metrics, such as trading volume, indicate that liquidity has increased in recent years. Others, such as turnover ratio, suggest a modest decrease in liquidity. Still others suggest potentially important changes in the US bond market. According to a December 2015 report by the Financial Industry Regulatory Authority (“FINRA”), market participants appear to have executed more trades in smaller

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<sup>10</sup> Letter to IOSCO from Tim Buckley, Managing Director and Chief Investment Officer, The Vanguard Group, Inc., and John Hollyer, Principal and Head of Risk Management Group, The Vanguard Group, Inc., dated 30 September 2016, available at <https://www.iosco.org/library/pubdocs/537/pdf/Vanguard.pdf>, at 2.

<sup>11</sup> IOSCO Report at 4.

size.<sup>12</sup> The data set forth in the FINRA report are consistent with viewpoints expressed by some market participants that it requires more time and trades to transact in larger sizes in the US bond market.<sup>13</sup>

### **E. What Does All of This Mean?**

Many variables affect capital markets activity and the liquidity in those markets.<sup>14</sup> Clearly, however, friction created by regulatory requirements that are overbroad or insufficiently tailored to achieve the desired objective is one such variable that can and does influence the ways in which various entities—including dealers and their trading partners such as funds—participate in the capital markets.

ICI supports the Subcommittee’s examination of the Volcker Rule and its consideration of the capital markets more broadly. As noted earlier, factors such as increased cost and delays in trade execution affect a fund’s ability to deliver on its investment mandate and, in turn, on fund investors’ ability to achieve their financial investment goals.

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I appreciate the opportunity to share these views with the Subcommittee. ICI looks forward to continued engagement with Congress on matters of importance to registered funds and their investors.

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<sup>12</sup> FINRA, *Analysis of Corporate Bond Liquidity*, Research Note (December 2015), available at [https://www.finra.org/sites/default/files/OCE\\_researchnote\\_liquidity\\_2015\\_12.pdf](https://www.finra.org/sites/default/files/OCE_researchnote_liquidity_2015_12.pdf).

<sup>13</sup> See also IOSCO Report at 1, 24-45 (describing IOSCO’s analysis of a variety of metrics relevant to the liquidity of the secondary corporate bond markets).

<sup>14</sup> For additional discussion of how the corporate bond markets are evolving, including the mixed evidence concerning changes in market liquidity, see Viewpoints, *Addressing Market Liquidity: A Broader Perspective on Today’s Bond Markets*, BlackRock (Nov. 2016), available at <https://www.blackrock.com/corporate/en-lm/literature/whitepaper/viewpoint-liquidity-bond-markets-broader-perspective-february-2016.pdf>.