Columbia Law School

Millstein Center for Global Markets
and Corporate Ownership

Session Brief No. 2

Future of Finance Colloquium

About the Millstein Center for Global Markets and Corporate Ownership

Building on Columbia Law School's longstanding strength in corporate and securities law, the mission of the Millstein Center for Global Markets and Corporate Ownership is to bring world class scholarship, research and academic rigor to the vital task of restoring and strengthening long-term financing of innovative and durable public corporations, which are the underpinning of economic growth.

This mission is essential given today's capital markets which are global, complex and volatile, and bring consequences and uncertainties to those who rely on them: companies, investors, and ultimately the wider economy.

The Center's research on the capital market and its impact on corporate governance and performance builds upon the work of the earlier successful "Institutional Investor Project" at Columbia University (1986-94), as well as the successes of the Millstein Center for Corporate Governance and Performance at the Yale School of Management (2005-12). The value of the Center's research is enhanced through active engagement with practitioners.

This paper provides a brief summary of discussion points, presentations, and findings from the "Future of Finance" Colloquium held in April 2014.

The Center's Session Briefings are framed as concise summaries of events or reports designed to promote policy discussion or further research. They strive to encompass a diversity of perspectives and are based on a combination of presentations, independent research, and the experiences of market leaders and thought leaders who participate in Center events or workshops. Participants generally include corporate board members and managers, institutional investors, advisors, leading academics, regulators, and other thought leaders.

Marcel Bucsescu, Executive Director of the Millstein Center served as lead editor. Jonathan Kim, former Senior Vice President, General Counsel and Secretary of Montpelier Re Holdings Ltd., and Rosemary Dodemaide, Operations Coordinator of the Millstein Center, served as secondary editors. Allison Mitkowski of Little Foot Communications served as the reporter.

The Millstein Center is extraordinarily grateful to all of its sponsors and partners, which provide support on an ongoing basis (a list of supporters can be found on the Center's website).

We would also like to extend a special Thank You to the CFA Institute for their collaboration, contributions, and participation in this event.

Views or positions presented in this briefing do not necessarily reflect the position of the Center, the Law School, University, or any supporters or particular participants.

On April 25, 2014, the Ira M. Millstein Center for Global Markets and Corporate Ownership and the CFA Institute hosted the *Future of Finance Colloquium*. The following is a summary of the panel discussions.

It should come as no surprise to insiders that the financial industry remains under siege—even though seven years have passed since the 2008 market crash. Surveys and polls consistently track the negative attitudes towards the sector held by the general public.[1] At the same time, movies and media reports depicting and describing the outrageous behavior of Wall Street professionals continue to fan the flames. The personal transgressions and the abuse of fiduciary responsibility and power, while often anecdotal and even fictitious, have left a strong impression on people. After all, this is the industry that engineered a way to chop up debt in the form of mortgages and sell off the pieces to unsuspecting investors who either didn't know or didn't understand the risks associated with such investments. Many have asked how such a house of cards was ever granted a building permit. Yet the industry now appears to be at it again with Collateralized Loan Obligations (CLOs). Is it any wonder, then, why the industry is still under siege? To the general public, it would appear that the financial sector has failed to learn from its mistakes. The past is indeed prologue.

Debating substantive issues—such as practical and acceptable degrees of regulation to ensure investor protection and maintain market integrity—becomes difficult in such a highly-charged, emotional environment. Historically, government has been called upon to provide stability and accountability for investors. Unfortunately, there are neither sufficient resources in the regulatory realm nor appropriate levels of cooperation and collaboration among regulatory agencies to ensure the desired outcomes. As such, the financial industry has stepped up and adopted a model of supervised self-regulation. This model places the onus on individual securities firms rather than regulators to ensure compliance with industry rules.

Whether or not this is the most suitable industry model is a topic of ongoing debate. Namely, how much regulation is needed to strike the correct balance between innovation and abuse, between growth and stability? The apparent consensus is that total regulation from without is not the answer, nor is total self-regulation from within. Thus the industry is left with the current hybrid paradigm of *"self-regulation with supervision."* Panelists at the *Future of Finance Colloquium* explored the pros and cons of this model as part of a broader discussion on what the future holds for this ever-changing industry.

[1] See, e.g. Edelman, The 2014 Edelman Trust Barometer. Financial Services Industry Results (New York, 2014).

Collateralized Loan Obligations

Early on in the panel discussion, the topic of CLOs emerged as a conduit for panelists to question how the industry could market and sell a product cast in a mold similar to the now-banned Collateralized Debt Obligations (CDOs). *"Whatever we regulate will become unregulated after a while, and somebody is going to come up with another idea that is just as good as the old one,"* one panelist stated. *"It's constantly changing—that's what capitalism is all about. That's why we're under siege."*

The question of how the industry is able to offer CLOs is an interesting one, considering that CDOs had a heavy hand in the market crash of 2008. A CLO, by definition, is a security backed by a pool of debt, typically in the form of low-rated corporate loans. CLOs are similar to CDOs except for the difference in the underlying loans. In a CLO, the investor receives scheduled debt payments from the underlying loans. The upside of investing in CLOs is the potential for above-average returns and greater diversity. As with CDOs, however, CLO investors assume the majority of the risk if the borrower defaults.

CLOs fall at the intersection of securitization and leveraged loans, and both these asset classes have been subjected to increased regulatory scrutiny in recent years. Regulators have introduced additional requirements through Basel III and indirectly through Dodd-Frank. Basel III resulted in higher capital requirements and increased due diligence for banks that invest in CLOs. Additionally, banks acting as loan sponsors or originators may now be required under the Supervisory Formula Approach (SFA) to hold capital on the entire group of underlying assets.

Banks that invest in CLOs will also be subject to the Volcker Rule after the Rule's conformance period expires in July 2017. Regulators granted an extension of the period after determining that CLOs would not be grandfathered under the Rule. The extension provides banks with more time to restructure CLOs to exclude securities from the underlying assets—a move that would exempt CLOs from Volcker. It is this type of maneuvering that demonstrates how the industry will always seek an end-run around regulations in order to continue to offer products that are both innovative and venturesome. However, in this new, post-market-crash world, the industry can count on increased regulation and continued scrutiny, making it more difficult to introduce products that could potentially tank the market yet again. As one industry report on CLOs concluded: *"The combined effect of these regulations, together with heightened regulatory expectations and ambiguities, will have the impact of limiting banks' participation in CLO structures. As an unintended consequence, non-banking (or shadow banking) entities that are outside of such regulatory constraints are expected to fill the gap."*

Self-Regulation With Supervision: A "Nice Hybrid" Model

Under the current arrangement, independent agencies provide regulatory oversight of the industry. The panel focused on the Financial Industry Regulatory Authority (FINRA) as an example of self-regulation with supervision. FINRA, itself a hybrid as a semi-public private entity, is owned and funded by member brokerage firms and exchange markets but not governed by them. FINRA's dual mission is to protect investors and preserve market integrity. Through this mission, FINRA strives to increase the trustworthiness of the markets and their intermediaries so the public can invest with confidence. With surveys reporting varying percentages of investor faith in the markets, FINRA is focused on the singular mission of ensuring that such markets are truly trustworthy—regardless of any public opinion to the contrary.

FINRA issues rules to govern the conduct of member firms and enforces those rules through fines, suspensions, or debarment from the industry. FINRA is also held accountable for its actions by a higher power: the federal Securities and Exchange Commission (SEC). The SEC has the authority to bring actions against FINRA; to remove officers and directors; and to levy fines and issue censures. In this manner, FINRA has been characterized by corporate governance watchdogs as a *"nice hybrid"* of self-regulation with supervision.

The panelists discussed how the general public benefits from this hybrid model since FINRA is not funded by taxpayer dollars. Were the SEC to take on FINRA's role in addition to its own, it would require a budget increase to fund its expanded remit, the cost of which would be shouldered by taxpayers. The panelists acknowledged that securities firms are also more willing engage with FINRA than with the SEC, mainly because there are fewer communication obstacles. Additionally, member firms trust FINRA because they understand that the organization is working toward a mutually beneficial mission of ensuring investor confidence. When investors are confident, they will continue to invest, thereby preserving overall market integrity by ensuring that various markets within the industry are continually infused with capital. A dearth of investor confidence is damaging to markets, so it is in the best interest of FINRA *and* its members to work collaboratively to ensure such confidence.

A Firm's Eye View

The panelists concurred that the current hybrid model of self-regulation with supervision appears to strike an appropriate balance between total regulation and total self-regulation. But how do businesses and investors feel about the model? The panel included a firm with over $2 trillion in assets under management—a large portion of which is on behalf of pension funds. This firm runs a diverse and global business, with operations in 27 countries world-wide.

The firm's representative said he believes that investment managers generally appreciate that some degree of regulation is necessary, and that most firms try to play by the rules to the best of their capabilities. However, he further noted that the paper trail generated by Dodd-Frank is hefty, not to mention burdensome, and paradoxically fails to provide the type of transparency that investors deserve and for which the legislation was intended. After conducting an investor survey on regulation, the panelist's firm found that 64% of those surveyed had no confidence that rules promulgated under Dodd-Frank would fix the industry's ongoing problems. Additionally, the majority of investors surveyed believed that the increased cost of regulation would be passed on to them rather than absorbed by the industry. As the panelist stated: *"The numbers are dismal, and the real question is: Where do we go from here?"*

With such a confounding question hanging in the air, firms like the one represented on the panel are doing their best to make progress toward a solution. The journey begins with the proposition that the rules are here to stay and are unlikely to be simplified in the near- or long-term. Consequently, the panelist's firm continues to rely on surveys to assess investor sentiment. In one such survey, which was evenly divided between retail and institutional investors, the firm found that trust in the industry was finally on the upswing after the nosedive that accompanied the 2008 market crash. Survey results like these feed the ongoing debate about how to prove both the value and integrity of the industry to investors—particularly when clients are investing in passive strategies with efficient price-points and market exposure, and realizing as good—if not better—returns than they might under active fee-based money management.

In Regulation We Trust?

Adding even more uncertainty to the mix when it comes to investor sentiment, the numbers vary from survey-to-survey, making it nearly impossible to pinpoint precise percentages. Some surveys show that investor trust is running high despite the 2008 market crash. One panelist discussed a Center for Audit Quality (CAQ) survey of investors that revealed how confidence quickly rebounded post-crash, with 69% of investors surveyed expressing faith in the U.S. capital markets. Confidence in U.S. publically- traded companies was even higher at 79%.[2] Yet, when asked *why* they trusted the markets and publically-traded companies, many mainstream investors were unable to provide a specific rationale. Simply put, investor trust is running high without any particular rhyme or

[2] The Center for Audit Auality. The CAQ's Seventh Annual Main Street Investor Survey (Washington, D.C., 2013).

reason, leading the panelists to wonder if investors are placing blind faith in the avenues available to them since they lack alternatives if their goal is to grow savings into substantive retirement nest eggs. Then again, perhaps investors believe the overall market has recouped enough stability since 2008 to be considered trustworthy again.

The industry has also questioned why, to date, Dodd-Frank has yet to emerge as the financial industry's panacea in the same manner that Sarbanes-Oxley (SoX) addressed the accounting scandals that rocked the corporate world in the early 2000s. SoX arguably cleaned up an industry that was in desperate need of a housekeeper post-Enron/Worldcom, so by analogy Dodd-Frank should be capable of doing the same in the present context. Corporate governance experts, however, contend that Dodd-Frank cannot be expected to make a clean sweep of ongoing problems within the financial industry since such problems are deeper and more complex than cut-and-dried accounting scandals. Additionally, many industry insiders consider Dodd-Frank to be over-the-top, providing more regulation than needed.

Again, the starting proposition is that some level of regulation is necessary, since the consensus is that the so-called *"market"* cannot be trusted to police itself. While panelists concurred that the market is generally accountable, they agreed that obvious pockets within remain beyond the trust of insiders or the public generally. There are too many eyes on the market, they reasoned, for it to be anything other than beyond reproach. At the same time, the challenge with the current hybrid model of self-regulation with supervision is that Dodd-Frank created an environment where too many agencies with overlapping authority and jurisdiction are fighting to define and protect their own turf. The panelists discussed how these agencies are not working together in a way that is conducive to the industry responding intelligently and thoughtfully to the current regulations. Suggestions to merge the SEC and Commodity Futures Trading Commission (CFTC) have been soundly rejected because each agency has its own agenda and its own well-funded champions in Congress. The SEC has dampened expectations for inter-agency cooperation in the near-term. Nor should investors or the general public expect consensus-building or clarity of regulations among agencies on the horizon. The panelists noted that this forecast is deflating for firms that are trying to play by the rules, and are left chasing their tails in an attempt to answer a plethora of regulatory questions that are often inconsistent, contradictory, or communicated inefficiently. Accordingly, the industry has looked to organizations such as FINRA and the CAQ to take the lead on building trust with investors.

The panel felt that simplifying the regulations would undoubtedly help increase levels of transparency and trust while fostering cooperation and collaboration among regulatory agencies. At some point down the road, panelists expect that the industry will see a normalization of regulations in the Dodd-Frank era. The pendulum may never swing back to its previous center, but it may eventually come to rest at a new center—a new normal, if you will. For now, the Dodd-Frank rubric stands, and some argue that only time will bring the system back to equilibrium.

Where Are We Headed Next?

Despite the trials that continue to plague the industry, the panelists conceded that we are better off now than we used to be. Nevertheless, there are still broad challenges facing our economy now and in the future. Over the next few decades, our economy will be fueled by a multitude of participants ranging from social security beneficiaries, to retirees living on modest retirement plans, to high-net-worth investors. Given this setting, the panelists concluded that firms will need to adopt a more client-centric model in order to best serve unique subsets of investors.

The panelists also agreed that suitability of investments and fiduciary responsibility should remain of paramount importance, particularly as the industry evolves to serve a broader range of clients who are not considered rich by traditional investment standards, but who have enough money and confidence to participate in the market. The panelists felt that the industry would gravitate toward services that appeal to the masses of retail investors who fall into this *"rich enough to invest"* category. They also predicted that the wave of the future would ride on passive investing versus active money management. In some cases, after accounting for fees, investors are already realizing equal if not better returns via passive investment strategies than they might via active money management. The only question on the panelists' minds was why this so-called *"shift to passive investment strategies"* is not already self-evident.

The panelists agreed that the focus will gravitate toward serving individual client needs vs. treating clients as consumers of financial products. Market segmentation will place investors into a number of discrete baskets, with investors in each basket thinking and acting quite differently from one another. High-net-worth investors will seek deeper guidance and education from advisors, who will be paid a premium for their knowledge and skill in addition to the basic services they provide. One panelist compared this relationship to that of a patient and a physician, building trust and commitment over the long term as the physician demonstrates knowledge and skill in relation to the patient's varying needs. Those who can afford this avenue will receive an education in addition to a potential return on investment. And yet, perhaps the largest basket of investors will be the masses, unable to retire at age 65, or even 70, and in need of a suitable investment strategy to see them through their golden years.

As the market diversifies in this manner, the panelists called for simplicity in regulations, in addition to full and transparent disclosures of services, fees and conflicts of interest. The topic of pension funds investing in alternative investments, such as private equity, raised concerns about investors who may not understand or even know about the risks associated with such strategies. Thus, the burden will fall on brokers and advisors to uphold their fiduciary responsibilities to their clients by matching clients only with investment strategies that are suitable for their long-term investment goals and risk tolerances.

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