Remarks of Richard H. Baker, President and CEO of the Managed Funds Association at the European Union Financial Services Conference

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As prepared for delivery

Good morning and thank you so much for being here at the 16th Annual European Financial Services Conference. This marks the seventh year in which the Managed Funds Association has been a supporter of the conference, the third as a co-host.

Before I joined the Managed Funds Association as President and CEO more than ten years ago I had the honor of representing Louisiana for 20 years in the U.S. House of Representatives, where I was the Chair of the Subcommittee on Capital Markets. It's safe to say, I've seen my fair share of ups and downs in the financial sector.

MFA is the leading voice of the global alternative investment industry. It is a Member-driven organization –our Membership and our work is global.

Our mission is to help hedge fund managers and managed futures firms around the world engage with stakeholders on issues that affect them, share best practices, and communicate our industry's value to the global economy. We promote public policies that foster efficient, transparent and fair capital markets.

As a representative of the financial services industry, MFA shares the view underpinning the Capital Markets Union project that European businesses, from start-ups to small and medium-sized enterprises and multinationals, need access to a wide range of funding sources. We fully agree with the European Commission that more diversity in funding and investment opportunities for European businesses and investors will help drive European economic growth.

The free flow of capital from a wide variety of sources is healthy and necessary in an integrated and mutually reliant international economy. Regardless of where they are based, our Members and investors view themselves as participants in an interconnected market stretching across Europe, Asia, and elsewhere.

We work to ensure capital markets operate efficiently – and that all participants have equal access to those markets and are treated fairly.

I've been invited to speak today on the specific challenges and opportunities of investing in Europe from the perspective of the alternative investor industry.

First, it's important to stress that hedge funds have evolved dramatically over the last decade. Our industry is subject to authorization, regulation, and taxation and has progressively become a core feature of advanced capital markets.

Our Members vary in size and employ a wide range of investing strategies and they are increasingly investing on behalf of large institutions like pension plans and charitable organizations.

One of the largest sources of institutional allocations to hedge funds in Europe are public pensions –our Members are proud to help those pension funds in Europe and around the world to meet their investment objectives.

The data show that public pension funds have increasingly turned to alternative investors to help them meet their goals – between 2010 and 2017, worldwide pension allocations to hedge funds increased by more than 65 percent.

That means our Members are responsible for managing part of the retirement security of teachers, public servants, and households.

Pension funds turn to our industry because we help provide stable returns over time and reduce volatility in their portfolios – which, ultimately, helps ensure safe retirements for the pensioners they serve.

According to estimates, our industry had more assets under management than ever in 2017 – we have every reason to believe 2018 will be even better.

Our Membership and our work is global. Many of our Members have long track records of investing in Europe and managing money for European institutional investors – many more are eager to access Europe's capital markets.

They recognize the significant opportunities Europe has to offer, and the value they can deliver to Europe: helping protect pensioners' retirements and giving companies access to new funding sources.

Any firm – regardless of the nature of its business – considers a numbers of factors before deciding where to operate. One of the most important is the regulatory environment. Our Members are no different.

And MFA is committed to helping our Member firms and policy officials in the EU, the UK, the U.S., and elsewhere collaborate constructively to promote a safe and efficient regulatory landscape.

I am speaking to you here in Brussels this morning and I'll say the same thing in London tonight: Managed Funds Association strongly supports the goal of creating open, predictable, and level playing fields in Europe's capital markets.

One of the reasons we hope MFA has credibility with policymakers is because we do not simply and reflexively oppose regulation – instead, we think it's in everyone's interest to work to support regulators' efforts to safeguard our financial markets.

MFA has sought to bring that same constructive approach to Europe.

MFA and our Members are all-in on Europe – and we're eager to continue working with policymakers as they update the regulations that govern markets here, and as they navigate the post-Brexit world.

Our Members' interest in Europe is reflected in MFA's own organizational chart.

I recently created a standalone International Affairs department at MFA.

I hired Michael Pedroni to run that department – many of you probably know Mike and some of you may have worked with him. He's the former U.S. Treasury Representative in Brussels, founder of the U.S. Treasury Markets Room, and a seasoned international policy expert from his years at the IMF, Federal Reserve, and the White House. Michael works with, and is supported by, the MFA legal team, which has been active with EU and other regulators for years.

If you don't already know him, I hope you get to meet him here today. You'll also get to hear him speak – he's participating in the panel discussion immediately following my remarks. And if he's better than me, you can be sure he'll hear about it in his next performance review.

MFA is very supportive of the strides EU officials have made towards building deeper and more efficient capital markets – and for their call for more diverse sources of capital to complement the banking sector.

Last April, when we had the honor of hosting European Commission Vice-President Dombrovskis at our Global Finance Forum in Washington, he discussed the need to attract additional sources of capital to complement bank lending and help strengthen the European economy.

We are also appreciative of the Commission's recognition of the value our industry offers. As they said in their recently released proposals on prudential rules for investment firms, "Investment firms provide a range of services that give investors access to securities and derivatives markets … and form a vital cog in a well-functioning Capital Markets Union."

You won't be surprised to hear me say that I could not agree more that our Members are vital.

One specific pending initiative, of course, is the development of the framework for the Capital Markets Union.

Developing the framework for the CMU is a substantial process, involving a number of pieces of legislation and regulatory reviews. MFA believes that with the necessary public and private support it will help efficiently and effectively allocate capital to provide businesses with increased access to financing and create jobs.

We also believe it will provide opportunities for investors – like pension plan beneficiaries – to generate wealth for retirement or other financial goals.

To take advantage of those opportunities, we believe a successful Capital Market Union should be governed by a couple key principles:

Markets should promote fair competition and access – putting all participants on a level playing field and eliminating tiered markets that only benefit a few. In addition, well-designed clearing and settlement systems will minimize risks to markets and to market participants.

And just as our Members employ diverse investment strategies, we believe effective markets should draw on a diverse array of resources to provide capital. While banks are the primary source of capital in Europe right now, many small and medium sized businesses get off the ground with the help of non-bank financing. As Vice President Dombrovskis has said, we believe the EU should draw on sources of capital that complement bank lending – and one way to grow that pool of capital is to allow for smooth cross-border capital flows.

Underlying these principles is the need for consistency and predictability. And here we believe Europe still has room to improve, and so I will turn to some of the "challenges" we perceive for our industry. These challenges are not insurmountable – in fact they're similar to challenges we are working to address with regulators in the U.S. and elsewhere – and we offer our views in a constructive spirit.

We've welcomed the opportunity to submit comments to regulators and have conversations with European policymakers on several policy priorities MFA members have identified for 2018.

One priority – also a challenge – is the Commission's work to develop a new Prudential Regime for Investment Firms.

We fully understand and appreciate the objective of developing a regime tailored for investment firms – one size does not fit all when it comes to financial institutions.

That's why we encourage policymakers to take their time in ensuring that the proposal truly addresses the unique nature of investment firms.

For example, we hope they consider that the use of assets under management is not a good metric for determining the level of systemic risk posed by an asset management firm.

We start from the premise that no hedge fund is, or should ever be, too big to fail.

Because hedge funds are not systemically important, we strongly encourage a cap on capital equal to the size of the cap in the UCITS and Alternative Investment Fund Manager Directives. Predictable rules and level playing fields are themes we return to again and again.

Second, we are closely following the European Supervisory Authorities Review - the ESA Review.

The ESA Review is a wide-ranging regulation – but MFA is focused on a few specific provisions in the proposal that could impact alternative fund managers, including those based in third countries.

Portfolio delegation rules are a real concern. Our Members are concerned that any significant changes to the ability of EU investment managers to outsource or delegate the management of certain funds could harm the very investors who rely on the alternative asset management and UCITS industries.

Let me explain. Just as a factory outsources the manufacturing of some parts of its supply chain to third countries, an investment vehicle in Europe outsources some of its management strategy to third-country investment professionals.

For example, a UCITS fund manager may wish to provide EU investors access to emerging market investments. Rather than manage that portfolio entirely on its own, it contracts out the management to experts sitting in London, Hong Kong, New York, or Sao Paolo. That is a model that has worked well for decades, and we do not think it is in anyone's interest to change it.

On a related note, not specific to the ESA Review, but to the openness of Europe's markets to external capital, MFA stands ready to serve as a constructive partner to policymakers that need to balance delicate decisions on the investment climate, including screening of FDI while also preserving the bedrock of openness to investors.

Another priority is the central clearing of derivatives.

In short – we're for it, and we've been for it from the start.

We believe central clearing has increased transparency in the derivatives market and greatly reduced risks to investors and to the market as a whole.

We also support efforts to ensure that any clearinghouse that could have a significant impact on financial stability is subject to scrutiny and supervision.

As EU policymakers discuss this important topic, we want to stress a few key points:

First, we want to ensure any changes to CCP supervision don't reduce liquidity or make clearing prohibitively expensive.

Second, we support effective regulatory oversight and coordination among competent authorities.

Third, we also want to ensure any new measures adopted don't conflict with existing third country equivalence decisions.

And fourth, we believe that policymakers should seek input from clearing clients, including our Members, before they finalize any requirements to ensure they have a good understanding of how clients may be impacted and whether there may be unintended consequences.

There is an issue of great importance to our Members: data security and the protection of confidential and proprietary information.

Over the past decade, regulators and policymakers in the EU and the U.S. have begun collecting much more information from hedge funds. And we fully understand that regulators need to collect information – sometimes confidential information – to do their jobs.

I want to underline, though, just how sensitive some of this information is. We're talking about things like a fund's entire trading book, or the algorithms and white papers that guide its strategy.

In many cases this is their secret sauce, their competitive advantage – I've heard our Members talk at length about the measures they've put in place to protect their own networks. They are substantial.

We have seen that hackers are growing more sophisticated and aggressive – you can't go a day without hearing about a hack at some large institution or regulator.

To our minds, it's not a matter of if there's going to be a significant breach at a regulator, but when. As you know, the U.S. has already seen breaches at the highest levels of the U.S. government.

So we have four simple recommendations for policymakers in the EU and the U.S. we believe are logical that we think would help mitigate the risks of a potential breach.

First, we think regulators should consider the scope of the information requested and narrow it to ensure they're only asking for data that is actually necessary to achieve their core mission.

Second, we think regulators can build protections into their forms and reporting systems, including alphanumeric identifier rather than names.

Third – regulators' protections and security requirements should be tiered based on the level of sensitivity of the data they possess.

And fourth, we think regulators should return or destroy sensitive, confidential firm-specific data once they are through using it.

Europe has developed the GDPR to protect personal data of individuals. To further protect individuals, we believe it should incorporate the principles from our recommendations into financial regulation.

For example, we believe some of the MiFID II regulatory requirements concerning the collection of personal data is unnecessary to achieve the objectives of MiFID II.

As with GDPR, we hope the EU will show leadership by implementing regulatory protections for proprietary intellectual property, business methods, and information.

Let me say a word about MiFID II. We know EU authorities have been working diligently since 2011 to implement this, especially over the past couple years.

MFA has worked closely with our Membership to assist with compliance, and to understand where they may be experiencing abrasions in the implementation process. This is not unexpected – it's similar to challenges U.S. regulators face in implementing complex regulations.

We are communicating our findings to the relevant regulators.

Let me just cite one example where we think, with relatively little effort, policymakers could facilitate the objectives of MiFID II and enhance transparency and the accuracy of market data reported to regulators.

With respect to transaction and trade reporting, we call on EU authorities to: direct both parties to a transaction to provide their LEI number to their counterpart in conjunction with a transaction to ensure consistent and accurate transaction reports; and to make public an official list of systematic internalizers per product to avoid under- or over-reporting to regulators.

This is an exciting time in Europe – along with that excitement inevitably comes some uncertainty, which poses a real challenge to our Members.

If you take one thing away from my remarks today, I hope it's this: throughout Europe, countries are working to enhance economic growth and remove impediments to investment. To put even more capital to work for Europe's economies, policymakers should keep intact regulations that work well, fine tune those that do not, and ensure new ones recognize the unique nature of investment firms.

Our Members are well-aware of the vast opportunities Europe has to offer – that's why so many of them already operate here, will continue to do so, and why so many more are looking to jump in.

We also believe our Members offer real and meaningful value to Europe's financial markets – and the EU economy as a whole.

We are committed to helping them address any challenges that may make them hesitant – whether they involve the priorities I just identified, or the uncertainties UK-based firms are facing post-Brexit.

MFA will continue our constructive engagement with European policymakers.

Our focus remains on offering reasonable suggestions to streamline and simplify regulations and legislation and giving helpful analysis and feedback where appropriate – all with an eye towards helping policymakers ensure fair, transparent, and efficient markets.

That is the charge given to us by our Members – and the investors they serve.

Thank you very much.