TESTIMONY OF

MARCUS M STANLEY

Policy Director, Americans for Financial Reform

On behalf of

AMERICANS FOR FINANCIAL REFORM

Re

"CAPITAL FORMATION AND REDUCING SMALL BUSINESS BURDENS"

Before the

SECURITIES, INSURANCE, AND INVESTMENT SUBCOMMITTEE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

Tuesday, March 24, 2015, 2:30 pm

538 Dirksen Senate Office Building

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

Mr. Chairman and members of the committee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, state and local groups who have come together to advocate for strong and effective financial regulation. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.

Before turning to the specific bills under consideration today, I would like to make some general points regarding the topic of the hearing. Today's hearing addresses 'capital formation,' which is of course a central part of the SEC's mission. However, AFR does not believe that the agency's capital formation mandate conflicts with its mission of investor protection. Effective capital formation requires that investors entrust their capital to the market without demanding prohibitive risk premiums.Perhaps even more critically, it requires that markets channel investor capital to its highest and best use. When investors put their money into a pump-and-dump penny stock scheme, that money was not effectively used in capital formation. When investors purchased securities on the basis of fraudulent accounting, or on the basis of misleading descriptions of the true risks of the 'toxic' mortgage assets at the heart of the financial crisis, their capital was misallocated and economic harm was done. Furthermore, after these scandals came to light, they contributed to loss of faith in our financial markets and to a potential rise in the future risk premium demanded by investors in order to supply capital, or even an unwillingness to supply capital for risky projects at all. In sum, then, a failure to place a high priority on the SEC's investor protection mission will also harm its mission of ensuring effective capital formation.

This perspective shapes our views on the bills under consideration today. I will now turn to discussing those bills in detail. I will discuss five of the nine bills under consideration. AFR supports the legislation eliminating swaps data indemnification requirements (HR 742 from the 113th Congress). We oppose three bills:

- Legislation exempting mergers and acquisition brokers from broker-dealer registration (HR 2274 from the 113th Congress).

- Legislation that would expand exemptions from Dodd-Frank derivatives clearing requirements for financial affiliates of commercial entities (HR 5471 from the 113th Congress).

- Legislation that would expand exemptions from adviser registration for advisers to certain funds that combine monies from small business investment companies (SBICs) and private equity or venture capital. (HR 4200 from the 113th Congress).

Although we do not have a formal position on legislation requiring the SEC to modify Reg SK disclosures (HR 4569 in the 113th Congress), I will briefly speak on that bill as well.

Eliminating Swaps Data Indemnification Requirements: AFR SUPPORTS

For some years AFR has been concerned with the slow pace at which domestic and international regulators are implementing derivatives data reporting mandates under the Dodd-Frank Act. The requirement that derivatives data be reported to regulators in a form that can be aggregated and used to measure total risk exposures across the financial system is an important part of the improved capacity to monitor systemic risk that should be created by new financial regulations. Clear, consistent, and usable derivatives data would be extremely beneficial to both banking and market regulators in controlling risk, and could create important indirect benefits for financial institutions themselves, many of which still face issues in their own internal systems for aggregating risk exposures.

Unfortunately, progress in derivatives data reporting has been slow, and much of the data collected does not appear to be in a form that can be aggregated. There are many reasons for this slow progress, but it is clear that the ability to share derivatives data between different national regulators and data repositories is crucial for effective data reporting. It appears that the indemnification requirements in Dodd-Frank are creating a barrier to such information sharing. The replacement of these indemnification requirements with a simpler confidentiality agreement, as proposed in HR 742, would be beneficial in encouraging needed sharing of derivatives data between different jurisdictions and entities. We thus favor this legislation.

Exemption of Merger and Acquisition Brokers From Dealer Registration: AFR OPPOSES

This legislation (HR 2274 from the 113th Congress) would eliminate SEC broker-dealer registration requirements for merger and acquisition brokers. While a much narrower version of this legislation could be acceptable, AFR opposes this bill, since it has multiple flaws:

- It lacks needed investor protections such as provisions to prevent bad actors from taking advantage of exemptions from registration to evade enforcement of securities laws.[1]

- The legislation applies the M&A broker exemption far too broadly, to any acquisition of a company with gross revenues of $250 million or less. This goes far beyond transactions involving the purchase of local small businesses, and would permit numerous deals involving companies of significant size to avoid broker-dealer oversight.

---

[1] North American Securities Administrators Association, "NASAA Letter to Senators Manchin and Vitter Re S 1923", September 8, 2014

- The lack of an effective provision to prevent transfer to a shell company means that the broker could effectively also take control of the transferred company in a private-equity type transaction.

The potential application to private equity is concerning, as the exemption from broker-dealer registration would restrict the SEC in policing this complex area and interfere with ongoing SEC investigation of potential abuses in private equity involving unregistered broker-dealer activities.[2]

This legislation is also unnecessary, as the SEC has already taken administrative action to exempt merger and acquisition brokers from broker-dealer registration, while preserving capacity to enforce needed investor protections.[3]

Finally, we would also point out that numerous registered broker-dealers who comply fully with SEC broker-dealer conduct requirements are active in arranging deals to sell companies, and this overly broad legislation would expose them to competition from unregulated entities that would not have to comply with important investor protection requirements such as suitability standards. We believe this is inappropriate.

Expanding Exemptions From Derivatives Clearing Requirements: AFR OPPOSES

The requirement that standardized derivatives transactions be cleared through a central counterparty is a fundamental financial system safeguard established by the Dodd-Frank Act.

While commercial entities using derivatives to hedge legitimate commercial risk are already exempted from clearing requirements, financial entities can only qualify if they are hedging risk on behalf of an affiliated commercial company and are acting as the agent of the commercial affiliate. This legislation (HR 5471 from the 113th Congress) would remove these limitations and leave in place only a requirement that the financial entity is somehow hedging or mitigating the risks of a commercial affiliate. As many purely financial trades can be interpreted to somehow 'mitigate the risks' of the broader corporate group, including commercial affiliates, this limitation is vague and non-specific.

This seemingly technical change could have far-reaching implications. There are numerous major financial entities that have commercial affiliates and could claim that there was some relationship between their derivatives activities and mitigating risk for some commercial affiliate. For example, the Senate Permanent Subcommittee on Investigations has recently documented that the major Wall Street banks often combine commodity production and trading activities, and that these "financial companies often traded in both the physical and financial markets at the same time, with respect to the same commodities, frequently using the same

[2] Buccacio, Katherine, "Republicans Look to Ease PE Regulatory Burden", Private Equity Manager, January 13, 2015; Morgenson, Gretchen, "Private Equity's Free Pass", New York Times, September 27, 2014.
[3] Securities and Exchange Commission, "No-Action Letter Re M&A Brokers", January 31, 2014 [Revised February 4, 2014].

traders on the same trading desk."[4] This legislative change would significantly reduce the ability of the CFTC to police risk management for this kind of co-mingling of commercial and financial activities, both at major banks and at commercial companies like General Electric that have large financial subsidiaries such as GE Capital. As the non-partisan Congressional Research Service stated in an analysis of this bill, it "could potentially allow large banks to trade swaps with other large banks and not be subject to the clearing or exchange-trading requirements as long as one of the banks had a nonfinancial affiliate."[5]

There are cases in which financial affiliates of commercial entities may genuinely be hedging the production-related risks of commercial affiliates but may not in a narrow sense be acting 'as an agent' of the commercial affiliate. Through administrative action, the CFTC has already permitted such affiliated 'central treasury units' (CTUs) to make use of the clearing exemption in a wide range of cases.[6] The agency has thus made clear that it is taking a broad interpretation of what it means to hedge 'on behalf of the [commercial affiliate] and as an agent', and is eager to accommodate legitimate hedging needs. But if this restriction were eliminated entirely, as this legislation would do, then the CFTC would be dramatically limited in its ability to address attempts by financial entities to evade risk management requirements by claiming that they were mitigating the risk of commercial affiliates, an evasion that would be invited by this legislation.

We oppose this legislation and believe statutory change is unnecessary. If Congress wishes to make some statutory change in this area, it should be limited to clarifying the CFTC's discretionary authority to accommodate the CTU model on a carefully controlled basis. There should be no general reduction in CFTC authority to manage this complex area of derivatives regulation.

Expand Exemptions From Advisor Registration For SBIC Funds: AFR OPPOSES

An important change made by the Dodd-Frank Act was the new requirement that most advisors to private funds such as hedge and private equity (PE) funds must register with the Commission under the '40 Act. We are strong supporters of this provision, both for its investor protection benefits and its systemic risk benefits in creating greater financial system transparency. This new requirement has already begun to create improvements in investor protection, as initial SEC inspections of newly registered PE fund managers found violations of law or material weaknesses in controls at over half of advisors examined.[7]

---

[4] United States Permanent Subcommittee on Investigations, "Wall Street Bank Involvement With Physical Commodities, Majority and Minority Staff Report", Permanent Subcommittee on Investigations, United States Senate, November 20, 2014.

[5] Congressional Research Service, "CRS In Focus: HR 37 Derivatives Provision May Create Broader Exemption", January 26, 2015.

[6] Commodity Futures Trading Commission, Division of Clearing And Risk, "No-Action Relief For Swaps Entered Into By Eligible Treasury Affiliates", CFTC No-Action Letter 13-22, June 14, 2013; Commodity Futures Trading Commission, Division of Clearing And Risk, "Further No-Action Relief For Swaps Entered Into By Eligible Treasury Affiliates", CFTC No-Action Letter 14-44, November 26, 2014.

[7] Bowden, Andrew, "Spreading Sunshine in Private Equity", SEC Office of Compliance Inspections and Examinations, Speech at Private Equity International (PEI), Private Fund Compliance Forum 2014 New York, NY, May 6, 2014

Currently, fund advisors who manage less than $150 million in combined assets are exempted from this registration provision. Combined assets are defined as private equity or hedge fund assets plus assets from Small Business Investment Companies (SBICs) and venture capital (VC). However, advisors who manage solely SBIC or VC money are completely exempted.

This legislation (HR 4200) alters these provisions so that only private equity or hedge fund assets would be counted toward the $150 million line. Advisors combining SBIC with PE money would be exempted even if their total funds exceeded $150 million, so long as total PE assets were under $150 million. It is likely that this change would affect only a relatively small number of advisors. However, we object on principle to carving more advisors out of these new registration requirements, especially given what we have learned over the last year about the potential for widespread investor abuses in private equity markets. We are also concerned that the legislation would weaken state investor protection oversight of SBIC funds.

AFR does not at this time have positions on the other bills under consideration by the Committee. But I would like to briefly comment on "The Disclosure Modernization and Simplification Act of 2014," legislation that requires the SEC to modify Reg SK disclosures. There is no issue in principle with updating or simplifying investor disclosures as long as no material information is lost. The SEC has ample authority to do this, and was last required to examine the issue in 2013 under the JOBS Act. It has a current task force working on this issue, marking the fifth time a task force or initiative has studied this issue over the past two decades.

Given the large amount of SEC work on this issue that has already taken place and continues to take place, as well as the numerous other critical priorities for the agency, including the completion of the roughly 40% of Dodd-Frank rules that remain incomplete, we question whether this is an appropriate priority for agency resources. We are also concerned that the legislation instructs the agency to 'eliminate' disclosure requirements under Reg SK when important parts of Reg SK – notably the disclosures for asset-backed securities – were recently shown to be inadequate during the financial crisis and are being strengthened under the Dodd-Frank Act. A sensible review of disclosures should ask what needs to be improved, not simply what needs to be eliminated.

This is not the only issue with the bill. As currently written, this bill requires rulemaking after six months, although the study to determine what if any rule changes are necessary or appropriate takes place over 12 months. This seems inappropriate.

Finally, on the issue of disclosures, we believe that greater investment in implementing machine-readable disclosures would be of much greater benefit to investors and possibly issuers than any reasonable 'simplification' or 'scaling' of disclosures could possibly be. There is significant private sector interest in assisting investors in analyzing machine-readable data, and likely also assisting issuers to generate and file such data. But the potential benefits here cannot be fully realized until the SEC has transformed its disclosure system from disconnected documents into searchable open data.

Thank you for the opportunity to testify. I am happy to answer further questions, and in the future can be contacted at marcus@ourfinancialsecurity.org or (202) 466-3672.