AFR Americans for Financial Reform

March 9, 2017

Dear Representative,

On behalf of Americans for Financial Reform, we are writing concerning the six securities-related bills in today's markup.[1] AFR supports H.R. 1366, the "U.S. Territories Investor Protection Act". We oppose H.R. 910, "The Fair Access To Investment Research Act". We have not taken a positon on the other bills being marked up today, although some raise concerns.

More generally, we feel that as a whole the legislative package under discussion today is too heavily weighted toward deregulation of the promotion and sales of securities, and does not contain enough pro-investor elements. We thus recommend a vote against the package as a whole, unless issues with H.R. 910 are addressed and more pro-investor provisions are added.

For example, H.R. 1257, "The SEC Overpayment Credit Act", is not in itself objectionable. But it seems inappropriate for Congress to take action to return some $10 million to highly profitable exchanges, while failing to address the much larger sums in unpaid arbitration awards that are owed to wronged middle class investors.[2]

To take another example, H.R. 1219, "The Supporting America's Innovators Act", expands the number of accredited investors who can participate in unregistered private venture funds from 100 to 250. In itself this is not a major change. However, from a capital formation perspective, the need for this bill is questionable, as venture capital investments have hit new highs in recent years.[3] Indeed, many are warning of a valuation bubble in technology startups due to the high levels of venture investment.[4] Despite the lack of an apparent need for this deregulation, it may still increase risks to investors in light of the new ability to do mass solicitations under Regulation D and the possibility that the accredited investor definition will be loosened to permit more middle-class families to invest in such solicitations.

We expand further below on H.R. 1366, which we support, and also on the specific risks to investors presented by H.R. 910, the most problematic bill in the package.

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[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

[2] Estimates are that between 15% and 25% of FINRA arbitration awards to investors are never paid. Osterland, Andrew, "Wronged Investors Win Cases Over Brokers But Never Collect", CNBC, March 7, 2016; available at http://www.cnbc.com/2016/03/07/wronged-investors-win-cases-over-brokers-but-never-collect.html. Public Investors Arbitration Bar Association, "One out of Three Investor Awards In FINRA Arbitration Go Unpaid", February 26, 2016; available at https://piaba.org/piaba-newsroom/piaba-press-release-one-out-three-investor-awards-finra-arbitration-go-unpaid-nationa

[3] Venture capital investments set new records in 2014 and 2015 and then stabilized at a high level in 2016. See National Venture Capital Association, "After Peaking in 2015, Venture Investment Activity Normalizes in 2016", January 11, 2017; available at http://nvca.org/pressreleases/peaking-2015-venture-investment-activity-normalizes-2016-according-pitchbook-nvca-venture-monitor/

[4] https://www.wsj.com/articles/this-tech-bubble-is-bursting-1462161662

AFR supports H.R. 1366, the U.S. Territories Investor Protection Act. The Investment Company Act of 1940 requires investment companies to register with the SEC and follow a range of disclosure and other rules designed to protect investors. However the Act excludes funds located in and sold to residents of U.S. territories from these requirements. At the time the Act was passed legislators were concerned that it would be too difficult to visit U.S. territories to monitor such investment companies.

The motivation for this exemption is clearly obsolete given today's communication technologies, and the sweeping exemption has created significant harm to investors. Most recently, UBS inappropriately invested funds from a UBS pension bond issuance into UBS mutual funds that were exempted from the Act, leading to over a billion dollars in investor damage claims.[5] This action would have been forbidden under Investment Company Act requirements.

H.R. 1366 would end the exemption from the Investment Company Act for funds in U.S. territories. This is a long overdue reform and one we strongly support.

AFR opposes H.R. 910, "The Fair Access to Investment Research Act", and we urge a vote against this bill. H.R. 910 would create major new exemptions to rules governing broker-dealer research reports on exchange traded funds (ETFs). These exemptions would permit ETF sponsors to release research designed to promote their funds, without being covered by legal liability for false or misleading content or other standards designed to ensure accurate information for investors.

Past experience shows that misleading research reports can be used as a tool of market manipulation. During the dot-com bubble of the late 1990s, stock analysts at numerous investment banks contributed to highly inflated valuations for internet stocks by issuing "research reports" that touted unlimited growth prospects for these securities. Because the investment banks that employed them benefited from increased trading demand for these stocks, analysts faced major conflicts of interest that led them to minimize investor risks. The Securities and Exchange Commission eventually won $1.4 billion in settlements against ten different investment banks for these practices.[6]

Broker-dealers can currently distribute research on securities either through a prospectus, or as a non-prospectus research report subject to specified restrictions outlined under SEC Rules 137, 138, or 139. These restrictions generally permit the issuance of such research reports only for securities issued by operating companies and not for funds such as ETFs.[7] However, broker-dealers also can and do issue ETF research as marketing and sales material under SEC Rule 482.

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[5] Evans, David, "How UBS Spread the Pain Of Puerto Rico Debt Crisis To Clients", Bloomberg Markets, September 25, 2016; available at https://www.bloomberg.com/news/articles/2015-09-22/how-ubs-spread-the-pain-of-puerto-rico-s-debt-crisis-to-clients

[6] Labaton, Stephen, "Wall Street Settlement, The Overview: 10 Wall Street Firms Reach Settlement in Analyst Inquiry", New York Times, April 29, 2003.

[7] The restrictions are conditions for safe harbors from prospectus liability included in SEC Rules 137, 138, and 139. They generally would not cover broker-dealers connected to an ETFs since ETFs are in continuous distribution and broker-dealers are involved in share distribution.

Importantly, Rule 482 includes standards that prevent broker-dealers from using selective, misleading, or false data to promote a fund, and broker-dealers are legally liable for misstatements or omissions.

H.R. 910 would create a statutory requirement for the SEC and FINRA to exempt ETF research reports from classification as a prospectus, despite not meeting the restrictions ordinarily placed on such non-prospectus reports. The bill places numerous limits on the freedom of the SEC and FINRA to regulate these research reports. Such reports would not be subject to the accuracy standards and legal liability that exists for marketing materials issued under Rule 482, or to the legal liability attaching to a prospectus.

This broad exemption is particularly dangerous in the case of ETFs, which are different from securities issued by operating companies in important ways that contribute to broker-dealer conflicts of interest and incentives to create possibly misleading research. Because ETFs are entirely financial constructs created and issued by their sponsor, which is usually either the broker-dealer or closely affiliated with them, the broker-dealer faces a particularly acute conflict of interest that is even greater than the conflict involved with promoting securities from an unrelated operating company. Because ETFs are in a state of continuous distribution the exemption could be used to make what are in effect prospectus offers to retail investors without the legal liability that attaches to a prospectus.

Not only does this bill pose a threat to investors, it is unclear why any such deregulation is needed. The ETF sector is one of the most rapidly growing of all financial markets, with annual growth rates of 21.5% over the last decade to reach its current level of $3.4 trillion in assets under management. According to a recent report from Ernest & Young, continued rapid growth up to $6 trillion is predicted through 2020, and inflows to ETFs are expected to be double those to mutual funds over that time.[8] Broker-dealers already have an avenue to provide research to clients through the provision of sales and marketing materials that are required to meet disclosure and accuracy standards. Finally, since ETFs are funds and not operating companies, additional ETF investment does not directly contribute to capital formation.

If changes to current SEC rules are called for to accommodate the ETF market, these changes should be made by the SEC through rules. Congress should not use statute eliminate the SEC's flexibility in dealing with this large market and protecting investors from possibly misleading information concerning these investments. We urge you to vote against H.R. 910.

For more information please contact AFR's Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

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[8] Ernest and Young, "Integrated Innovation, The Key To Sustainable Growth: Global ETF Survey 2016", August, 2016; available at http://www.ey.com/Publication/vwLUAssetsPI/ey-integrated-innovation-the-key-to-sustainable-growth-global-etf-survey-2016/$FILE/ey-integrated-innovation-the-key-to-sustainable-growth-global-etf-survey-2016.pdf