AFR Americans for Financial Reform

CFA Consumer Federation of America

July 11, 2018

Dear Representative:

On behalf of Americans for Financial Reform (AFR) and the Consumer Federation of America (CFA), we are writing to oppose four of the bills under consideration at today's markup, HR 3555, HR 6021, HR 6177, and the "Expanding Investment in Small Businesses Act".[1]

We also support four of the bills under consideration at the markup, the "Enhancing Multi-Class Stock Disclosures" (Meeks), the "Market IPO Underwriting Cost Act" (Himes), the "Promoting Transparent Standards for Corporate Insiders Act", and the "National Senior Investor Initiative Act of 2018" (Gottheimer). In the case of the "Promoting Transparent Standards for Corporate Insiders Act", while we support the bill, we would also urge the Committee to take stronger action than a mandated study.

Below, we offer specific comments on each bill. We address the bills we oppose first, and then the bills we support.

BILLS AFR AND CFA OPPOSE

H.R. 3555, the Exchange Regulatory Improvement Act: The original version of this bill amends Section 3(a) of the 1934 Act to change the definition of an exchange "facility" to exclude any premises or property that are not involved in effecting or reporting a transaction on an exchange. Since key SEC jurisdiction over exchanges is limited to "facilities", this change would effectively eliminate SEC regulatory jurisdiction over ancillary exchange services such as the use of market data and related information services. Losing this SEC authority would make it much easier for exchanges to charge inflated monopoly prices to the general public, and to discriminate in access to key trading data.

A substitute amendment to the original instead instructs the SEC to do a new rulemaking that revises its definition of "facility" and sets forth the specific facts and circumstances that lead to a determination that any property or premises of the exchange are a "facility" subject to SEC oversight. The amendment mandates that these facts and circumstances be used to determine if an exchange rule may be reviewed by the SEC and falls under SEC regulatory jurisdiction.

While the substitute amendment is an improvement on the original, it still implies that the current expansive SEC definition of "facility" is problematic and should be changed in a way that makes it narrower (more specific) and therefore reduces SEC jurisdiction over exchange actions. We do

[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/

not believe that it is appropriate to ask the SEC to narrow its broad authority over exchange rules and pricing. We instead have the opposite concern – that the regulatory powers granted to for profit exchanges as Self Regulatory Organizations (SROs) create significant conflicts of interest that can allow them to abuse their regulatory privileges to charge excessive fees to other actors in the market, fees that in the end will be paid by investors. In a recent letter expressing concerns about this legislation, the Securities Industry and Financial Markets Association (SIFMA) states:

> "Despite transitioning from member-owned, not-for-profit, public utilities to for-profit, publicly-traded commercial enterprises, the exchanges retain the benefits of this special SRO status and we again urge the Committee to address that fundamental issue."

AFR and CFA agree with SIFMA that the core issue and concern should be the grant of regulatory power to for-profit companies and the resulting potential for abuse of other market participants. It is this issue which the Committee should address. HR 3555 should be rejected to avoid creating any pressure on the SEC to limit their needed regulatory oversight of for-profit exchanges.

H.R. 6021 would amend the Sarbanes-Oxley Act to create a statutory exemption for certain non-custody brokers or dealers from the requirement to have their financial reports audited by a firm registered with the Public Company Accounting Oversight Board (PCAOB). The PCAOB was created in the wake of the pervasive accounting scandals in the late 1990s and early 2000s to establish rules, accounting standards and to oversee the audits of public companies. It was later expanded, under Dodd-Frank, to include annual audits of all broker and dealers registered with the SEC. The lack of impartial external audits of his brokerage firm was a major factor enabling Bernie Madoff to engage in a multi-decade multi-billion dollar investor fraud.

The exemption from audit requirements contained in HR 6021 is unnecessary and also would endanger investors. It is unnecessary since the PCAOB already has the power to tailor audit requirements based on firm size. It endangers investors because it does not include adequate protections and because smaller brokers are hardly immune to accounting abuses or other forms of malfeasance that may endanger investors.

The exemption in HR 6021 would apply to all brokers with fewer than 150 representatives, a category that includes the great majority of the market. While it requires exempted firms to be in "good standing", the definition of good standing rests mainly on whether the firm has been convicted of a felony or barred by regulators from registration. It would apparently grant the exemption to firms subject to a judicial restraining order or an SEC disciplinary order that fell short of a ban. It also appears that the exclusion would be available to broker-dealers that employ representatives with felony fraud convictions, so long as the firm itself was not convicted. In short, HR 6021 would exempt many of the kinds of firms for which the auditing requirement was originally imposed. This legislation should be rejected.

HR 6177 would expand exemptions from SEC registration for advisors to venture capital funds. To qualify for the venture capital fund exemption from SEC registration, venture funds are currently required to invest 80% of their capital commitments in primary securities offerings from small private startups. This ensures that the exemption is tied to the basic purpose of venture capital funds, which is to allow sophisticated investors to provide capital directly to startup companies. HR 6177 would expand permissible investments for exempted venture capital funds to include the purchase of existing shares in Emerging Growth Companies (EGCs), which are companies with up to $1 billion in revenues, $700 million in public float, and $1 billion in nonconvertible debt. This would allow venture capital firms to invest all of their capital in public companies and not start-ups, while still qualifying for the venture capital exemption. (Note that venture capital firms are already permitted to qualify for the exemption while investing up to 20% of their capital in any public company including EGCs).

These changes would expand the venture capital fund exemption from SEC registration far beyond the common sense meaning of venture capital, to include what would basically be secondary market mutual funds trading shares in a wide variety of midsize public companies. In such cases the investor protections and transparency accompanying SEC registration would be lost, and funds would be diverted from early stage companies. HR 6177 should be rejected.

We understand that there may be a substitute amendment to HR 6177 which would change the exemption in a more limited way, to permit venture capital companies to qualify for the exemption while holding a much larger share of their investments in secondary market shares of private startup companies (i.e. shares purchased on the secondary market rather than offered directly by the company). We have not yet completed study of the implications of this amendment and hence are taking no position on the substitute at this time. However, we are concerned that permitting increased venture fund investment in secondary market shares would channel funding away from direct primary investments in startup companies. We are also concerned that the change could encourage excessive secondary market trading in early stage startups, especially in combination with the venture exchange bill passed by the Committee.

The "Expanding Investments in Small Businesses Act" requires the SEC to perform a study of current diversification requirements for mutual fund investments, and to perform a rulemaking changing such requirements if the study determines it would be appropriate to do so.

We are concerned that the bill mandates that the SEC consider only the effects of the diversification requirements on fund investments in small business, and not the benefits to investors of having more diversified mutual funds, specifically the reduction in risk of loss and avoidance of conflicts of interest. The current framing of this study and its mandated considerations do not adequately weight the core purpose of diversification requirements, which is to protect investors. In light of this, we oppose the bill in its current form.

BILLS AFR AND CFA SUPPORT

The Enhancing Multi-Class Stock Disclosures Act would require public companies with multi-class stock structures to clearly disclose the amount of equity interest and voting power held by any director or executive of the company who holds more than 5 percent of the voting power of the company.

The Investor Advisory Committee (IAC) of the SEC has strongly criticized current SEC disclosures of ownership information as confusing and inconsistent in the case of multi-class stock structures.[2] Multi-class structures inherently obfuscate corporate governance voting systems, and it is important that investors fully understand their implications. This bill provides a clear, direct solution that executes on the considered recommendations of the IAC. We urge the committee to pass this bill.

The Market IPO Underwriting Cost Act requires the SEC to study the direct and indirect underwriting fees for mid-sized public offerings and report recommendations to Congress. This legislation builds on several years of previous work by Representative Himes and others highlighting this issue. It also draws on a recent speech by SEC Commissioner Robert Jackson regarding underwriting fees charged to mid-sized firms by investment banks, as well as other indirect costs of going public for mid-sized IPOs.[3] Commissioner Jackson found that underwriting costs for mid-sized firms were very high at 7% and had remained remarkably consistent for a period of decades, even as technology and markets had changed radically. He also found evidence that larger firms were able to negotiate lower IPO costs while IPO fees for mid-sized firms rarely varied, indicating that the underwriting market for these firms was not competitive. An SEC investigation of the issue of excessive fees charged to mid-sized companies and investment bank pricing power in the IPO market is overdue and this bill would ensure it takes place. The Committee should support this legislation.

The Promoting Transparent Standards for Corporate Insiders Act would require the SEC to carry out a detailed study of insider trading by corporate executives and whether the SEC's current Rule 10b5-1 adequately protects against such abuses. This is especially timely given the multi-trillion dollar wave of company share buybacks that have been occurring in the current low interest rate environment and in response to the enormous corporate tax cuts recently passed by

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[2] *See* "Recommendation of the Investor as Owner Subcommittee: Dual-Class and Other Entrenching Governance Structures in Public Companies" (Feb. 27, 2018), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac030818-investor-as-owner-subcommittee-recommendation.pdf.

[3] https://www.sec.gov/news/speech/jackson-middle-market-ipo-tax.

Congress.[4] Insiders can make large profits by selling directly into such share buybacks. The combination of share buybacks and insider trading represents a direct diversion of corporate revenues from investment in the broader economy to private payments for top executives. It constitutes a major incentive for corporate decision makers to inappropriately favor share buybacks over other uses of funds such as investment and hiring.

Evidence has been available for many years that corporate executives take advantage of their knowledge of buyback plans to make additional profits selling their own stock. This evidence was recently summarized by SEC Commissioner Robert Jackson.[5] It appears that the SEC's current rule 10b5-1 facilitates such profiteering by providing an overly broad safe harbor against insider trading prohibitions. Over the past five years the Council of Institutional Investors (CII) has repeatedly urged the SEC to take action to prevent these abuses.[6]

This bill would require the SEC to study whether Rule 10b5-1 is providing adequate protection against insider trading and whether it should be changed in accordance with the recommendations of the CII. The specificity of the directives for this study should be useful in driving action by the SEC. We urge the Committee to pass this bill.

At the same time, there is already ample evidence that action is needed in this area and such action is particularly urgent given the high current rate of corporate stock buybacks. If the SEC does not act quickly, we urge the Committee to legislate directly to narrow the inappropriately broad safe harbor in Rule 10b5-1 and stop the current diversion of revenues to corporate insiders and away from investment and hiring.

The National Senior Investor Initiative Act of 2018 would create a new task force at the SEC to coordinate policy and activities related to protecting senior investors and to report regularly to Congress on issues affecting senior investors, including recommendations for relevant policy and

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[4] Talib Visram, *Tax Cut Fuels Record $200 Billion Stock Buyback Bonanza*, CNN.com (June 5, 2018); *see also* William Lazonick, *Stock Buybacks: From Retain-and-Reinvest to Downsize-and-Distribute*, Brookings Initiative on 21st Century Capitalism (April 2015),

[5] https://www.sec.gov/news/speech/speech-jackson-061118

[6] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission (Jan. 18, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%2018%202018%20Rule%2010b5-1%20(finalI).pdf; Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Elisse B. Walter, Chairman, U.S. Securities and Exchange Commission 3 (Dec. 28, 2012), http://www.cii.org/files/issues_and_advocacy/correspondence/2012/12_28_12_cii_letter_to_sec_rule%20_10b5- 1_trading_plans.pdf; Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Mary Jo White, Chairman, U.S. Securities and Exchange Commission 1-2 (May 9, 2013), http://www.cii.org/files/issues_and_advocacy/correspondence/2013/05_09_13_cii_letter_to_sec_rule_10b5- 1_trading_plans.pdf.

regulatory changes. We support this initiative. Senior citizens are among the most vulnerable to abusive and exploitative practices, not only because of health issues but because they may have amassed significant savings to support their retirement and therefore be targeted by unscrupulous financial actors.

In addition to the other valuable functions of the task force laid out in this legislation, we would recommend that the new task force investigate whether the current wealth thresholds for the accredited investor definition are adequate to protect seniors from financial exploitation through solicitation for inappropriate investments.

If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672. Thank you for your attention to these voting recommendations.

Sincerely,

Americans for Financial Reform

Consumer Federation of America