

**TESTIMONY OF HEATHER SLAVKIN CORZO**  
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**SENIOR FELLOW, AMERICANS FOR FINANCIAL REFORM**  
**TO THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**  
**ON LEGISLATIVE PROPOSALS ON CAPITAL FORMATION AND CORPORATE GOVERNANCE**  
**February 28, 2019**

Chairman Crapo, Ranking Member Brown, and members of the committee, thank you for inviting me to testify. My name is Heather Slavkin Corzo, and I am the Director of Capital Markets Policy for the AFL-CIO and a Senior Fellow at Americans for Financial Reform (AFR). The AFL-CIO is America's labor federation representing 55 national and international labor unions and more than 12 million working people. AFR is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry.

The AFL-CIO and AFR both work on behalf of millions of American workers, consumers and retirees to promote policies that create a safe, sound and stable economy that helps all Americans achieve economic security. Working people, consumer and retirees need a healthy and fair financial system to provide financing for business and allow access to safe, affordable credit to buy homes or make other major purchases. And, we need a safe place to invest our retirement savings.

The AFL-CIO has, since its founding, seen ensuring the retirement security of working people as a central mission of the labor movement—both through our advocacy for Social Security and Medicare and through collective bargaining with employers. Today, collectively bargained retirement plans account for more than \$7 trillion of invested capital in this country. While the ownership of stocks and bonds remains predominantly in the hands of the wealthiest Americans, working people are major investors through our benefit funds, and our retirement security is bound up with the health of the financial system. For these reasons the labor movement has been actively engaged for decades in promoting effective, common sense regulation of our capital markets.

The 2008 financial crisis was a stark reminder of the fact that inadequate financial regulation can devastate working families. The crisis caused \$19.2 trillion in lost household wealth;<sup>1</sup> 2.6 million working people lost their jobs in 2008 alone;<sup>2</sup> and 7.8 million Americans lost their

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<sup>1</sup> US Department of the Treasury, *The Financial Crisis Response In Charts*, Apr. 2012 available at [https://www.treasury.gov/resource-center/data-chart-center/Documents/20120413\\_FinancialCrisisResponse.pdf](https://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf).

<sup>2</sup> David Goldman, *Worst year for jobs since '45*, CNNMoney.com, Jan. 9, 2009 available at [https://money.cnn.com/2009/01/09/news/economy/jobs\\_december/](https://money.cnn.com/2009/01/09/news/economy/jobs_december/).

homes.<sup>3</sup> Furthermore, the white families fared better in the recovery than families of color – put another way, the racial wealth gap has widened due the Great Recession.<sup>4</sup>

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 made major improvements to the financial regulatory architecture in the United States, especially in the area of consumer financial protection. The AFL-CIO and AFR supported Dodd-Frank during the legislative process and continue to fight for strong implementation. It was, however, a compromise. It was only the first step towards the creation of a safe and sound financial system that serves the interests of the real economy. Today, I will talk about a number of additional steps that need to be taken.

## **1. Legislative Proposals on Capital Formation and Corporate Governance**

At today's hearing, the Committee will consider more than two dozen bills related to securities markets regulation. It would be impossible to discuss each one. Instead, I will say that, as a general principal, public policy should promote fair, transparent and stable markets; facilitate regulatory efforts to police against fraud and provide remuneration for victims; and encourage shareholders to engage with companies on topics investors deem important. One set of bills being considered today moves away from that standard, a few are neutral, and a handful are modest positive steps.

I would like to refer the Committee to the letters attached to this testimony that were sent by AFR over the past year. These letters lay out specific objections to twelve of the bills under consideration in today's hearing.<sup>5</sup>

Many of the bills being considered at today's hearing represent major deregulatory efforts that would undermine investor protection in significant ways by allowing firms to attract capital through deceptive or unfair practices, harming people saving and investing for their families' futures, and distorting the markets. For example, the Helping Angels Lead Our Startups (HALOS) Act, would create an exception to the prohibition against general solicitation and advertising, allowing issuers to advertise securities offerings without complying with the registration requirements in the securities laws and permitting non-accredited investors to purchase stock in unregistered companies.

The Consumer Financial Choice and Protecting our Capital Markets Act, would reverse a key post-crisis systemic risk reform by permitting prime money market mutual funds to once again report inaccurate valuations in a way that encourages investors to view these instruments as similar to bank deposits. As detailed in the attached letter, this risks a repeat of the bailout of these instruments during the 2008 financial crisis.

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<sup>3</sup> Kari Paul and Jacob Passi, *A decade after the housing crisis, foreclosures still haunt homeowners*, MarketWatch, Sep. 30, 2018 available at <https://www.marketwatch.com/story/a-decade-after-the-housing-crisis-foreclosures-still-haunt-homeowners-2018-09-27>.

<sup>4</sup> Rackesh Kochhar and Richard Fry, *Wealth inequality has widened along racial, ethnic lines since end of Great Recession*, Dec. 12, 2014, Factank, Pew Research Center available at <http://www.pewresearch.org/fact-tank/2014/12/12/racial-wealth-gaps-great-recession/>.

<sup>5</sup> The twelve bills in question are S. 588, S. 2765, S. 3518, S. 3723, "The Exchange Regulatory Improvement Act", the "International Insurance Standards Act", S. 1117, S. 2126, S. 2953, S. 3575, S. 3576, and the "Expanding Investment in Small Business Act".

The Fair Investment Opportunities for Professional Investors Act, would freeze in place outdated income and wealth thresholds to qualify individuals as accredited investors, preventing the SEC from establishing better protections for senior citizens targeted for inappropriately complex and risky investments. In addition to AFR, both the SEC's Investor Advisory Committee and the North American Association of Securities Administrators (NASAA) oppose this idea.

Another bill, the Exchange Regulatory Improvement Act, would interfere with ongoing regulatory action by directing the SEC to propose a rule to define the "facility of an exchange." Anything outside the definition would not be subject to direct SEC oversight. This could result in the elimination of a significant set of existing regulations that protect investors. This bill is being considered just as the SEC is—for the first time—examining how the for-profit exchanges inhibit competition and charge unreasonable fees. Congress should allow the Commission to finish its work.

With that said, many of the bills under consideration today are not objectionable. Some represent small deregulatory changes that would not, on net, pose serious threats to investors or the financial system. Others would make positive changes to the existing regulatory framework. The Brokaw Act, for example, requires more timely disclosure when an investor acquires a 5% stake in any class of securities of an issuer and closes loopholes that have allowed investors to avoid existing disclosure requirements. The Compensation for Cheated Investors Act directs FINRA to establish a compensation fund, financed by fines assessed by FINRA on regulated entities, to help compensate cheated investors who have suffered losses. The AFL-CIO and AFR support additional transparency in the securities markets and efforts to provide remuneration for victims of fraud.

None of the pieces of legislation under consideration today, however, represents the type of far-reaching change that is needed to create an economy that works for working people. This Committee has the ability to end predatory financial activities that undermine the well-being of everyday Americans -- to stop private equity firms from sucking wealth out of businesses, destroying jobs and extracting exorbitant fees from pension funds; to address short-termism in our financial markets by taking on activities like stock buybacks and efforts to silence the voices of long-term investors seeking to encourage companies to address environmental, social and governance concerns; to end too-big-to-fail so that taxpayers never again have to bail out Wall Street banks; and to put finance in its proper role as servant to the real economy instead of its master, so that it no longer has the ability to dominate the economy and the political process.

## **2. Private Equity**

Private equity investment strategies have a growing and underappreciated impact on the US economy. Assets held by private equity (PE) firms have grown from \$1 trillion prior to the financial crisis to a new record of \$3.1 trillion in 2017, with another \$1 trillion in committed capital waiting to be invested.<sup>6</sup> Today, PE-owned companies employ nearly 5 million

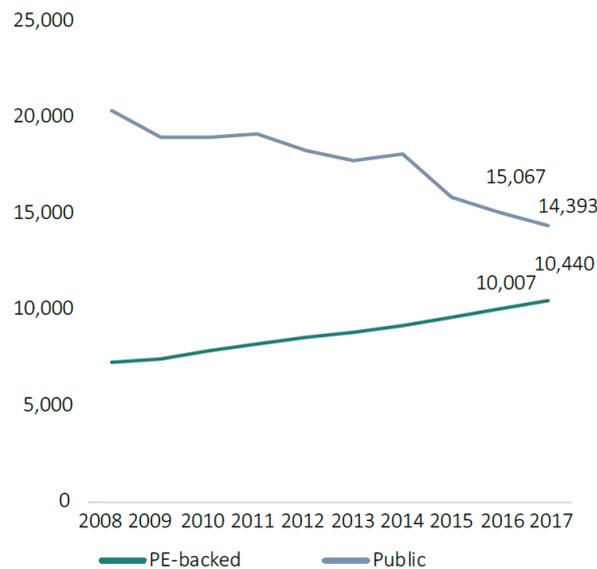
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<sup>6</sup> Press Release: *Private Equity Industry Grows to More Than \$3tn in Assets*, Preqin, Jul. 24, 2018 available at <http://docs.preqin.com/press/PE-Assets-Jul-18.pdf>.

American workers.<sup>7</sup> We have seen a steep decline in the number of publicly-traded companies over the last decade, while at the same time, the number of PE-backed companies has grown rapidly.

### Convergence between public and PE-backed companies continues

North American and European companies (#) by backing status



Source: PitchBook

Note: Due to a lag in the reported data, this data is presented through full-year 2017.

Comment by Eileen Appelbaum to FTC on Proposed Consent Agreement in the Matter of Staples/Essendant, Inc.

The PE model often serves as a vehicle to allow wealthy PE managers (PE general partners or GPs) to take control of real economy businesses, which provide goods and services of value to the public, and extract wealth from the businesses. This is accomplished using cash provided by outside investors, many of which are pension plans who pay exorbitant fees to the GPs for the privilege of investing.

‘Private equity’ is often the modern term used to refer to leveraged buyouts, which gained notoriety in the 1980s. PE owners typically use large amounts of debt in their acquisitions, which result in lower tax bills for the companies but greater risk. Companies are often forced to cut workers’ wages and benefits to keep up with debt payments and frequently end up in bankruptcy, at which point workers, suppliers, and other creditors all suffer losses. Now, the size of the market for risky corporate debt has reached a point at which global regulators are raising concerns that an economic downturn could lead to a wave of defaults and systemic risk.

<sup>7</sup> American Investment Council: Private Equity Invests and Supports Jobs In New Members’ States and Districts, Jan. 9, 2019 available at <https://www.investmentcouncil.org/wp-content/uploads/new-member-jobs-and-investment-report.pdf>.

## a. Private Equity and Workers

Private equity observers have long been concerned that the strategy, due to its reliance on high levels of leverage and the resulting cash constraints the leverage creates for companies, can result in lower wages and benefits for workers. Increasing amounts of empirical evidence supports this belief. One independent analyst has concluded that more than 60% of the retail jobs loss in 2016 and 2017, around 130,000 jobs, were at companies owned by PE.<sup>8</sup>

Toy 'R' Us is a recent example of a PE-owned company that ended up in bankruptcy. The toy store was purchased by a consortium of PE firms in 2005 for \$6.6 billion. Despite \$11 billion in annual sales, Toys 'R' Us struggled to service the \$5 billion debt put on the companies by the PE owners and filed for bankruptcy in 2018.<sup>9</sup> When the company entered liquidation, it left 31,000 employees out of work.<sup>10</sup>

Toys 'R' Us's PE owners have blamed its failure on competition from online retail providers, like Amazon, and other market forces. Multiple analysts, however, have said the blame rests with the company's unsustainable debt and warned that other retail chains could fail in a similar fashion due to high-risk private equity investments.<sup>11</sup>

Eileen Appelbaum and Rosemary Batt recently concluded an analysis of the supermarket industry that compared the performance of supermarket chains owned by private equity firms to those with other ownership structures.<sup>12</sup>

The research conducted by Batt and Appelbaum into the supermarket industry confirms that the PE ownership model and financial engineering that is often employed by PE owners leads to riskier capital structures at portfolio companies, makes it more difficult for them to withstand outside pressures - whether economic or from evolution in consumer preferences and technology - and can lead to worse outcomes for employees.

Since 2015 seven major grocery chains, employing more than 125,000 workers, have filed for bankruptcy. Some of the blame for these bankruptcies can be placed on competition: low-cost competitors like Walmart and Whole Foods (owned by Amazon). But another significant factor in many of these cases was the PE owners who were behind all seven bankruptcies.<sup>13</sup>

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<sup>8</sup> Steve LeVine, *Vulture capitalists are killing off retail jobs*, Axios, Jan. 10, 2018 available at <https://www.axios.com/private-equity-1515603080-efd39541-a9fb-474b-8c24-04623ee518fd.html>.

<sup>9</sup> Jessica DiNapoli and Tracy Rucinski, *How \$5 billion of debt caught up with Toys 'R' Us*, Reuters, Sept. 17, 2017 available at <https://www.reuters.com/article/us-toys-r-us-bankruptcy-timeline/how-5-billion-of-debt-caught-up-with-toys-r-us-idUSKCN1BV0FQ>.

<sup>10</sup> Chris Isidore, *31,000 Toys 'R' Us employees: No job and no severance*, CNN, Mar. 16, 2018 available at <https://money.cnn.com/2018/03/16/news/companies/toys-r-us-employees/index.html>.

<sup>11</sup> Dave Dayen, *The Cause and Consequences of the Retail Apocalypse*, The New Republic, Nov. 14, 2017 available at <https://newrepublic.com/article/145813/cause-consequences-retail-apocalypse>.

<sup>12</sup> Rosemary Batt and Eileen Appelbaum, *Private Equity Pillage: Grocery Stores and Workers At Risk*, American Prospect, Oct. 26, 2018 available at <https://prospect.org/article/private-equity-pillage-grocery-stores-and-workers-risk>.

<sup>13</sup> *Id.*

## PRIVATE EQUITY–BACKED CHAINS THAT WENT BANKRUPT

GROCERY CHAIN	P.E. SPONSORS	NUMBER OF STORES	NUMBER OF EMPLOYEES	BANKRUPTCY DATE
A&P (Food Basics, Food Emporium, Pathmark, Super Fresh, Waldbaum's)	Yucaipa Partners	296	28,500	July 2015
Fairway Market	Sterling Investment Partners	15	4,000	May 2016
Fresh & Easy	Yucaipa Partners	150	4,000	Oct. 2015
Haggen Food Grocery Store	Comvest Group	164	10,000	Sep. 2015
Marsh Supermarkets	Sun Capital	116	14,000	May 2017
Southeastern Grocers (BI-LO, Bruno's, Fresco y Más, Harveys, Winn-Dixie)	Lone Star Funds	>730	>50,000	Mar. 2009, Mar. 2018
Tops Markets LLC	Morgan Stanley	170	14,800	Feb. 2018

*Batt & Appelbaum, Private Equity Pillage: Grocery Stores and Workers at Risk*

Batt and Appelbaum found that, “private equity owners have extracted millions from grocery stores in the last five years—funds that could have been used to upgrade stores, enhance products and services, and invest in employee training and higher wages.”<sup>14</sup>

The performance of supermarket chains owned by PE was often characterized by struggles to pay down excessive debt, financial engineering tactics to enrich PE owners at the expense of the businesses, and ultimately bankruptcy that left workers, suppliers, and other creditors taking hits. Employees were often thrown out of work and/or forced to take cuts to their retirement benefits.<sup>15</sup>

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

In September 2015 Haggen, Inc, a west coast grocery chain owned by Comvest Partners, declared bankruptcy after a failed expansion. According to Applebaum and Batt:

Workers, vendors, suppliers, and landlords were losers in this story, but not Comvest... At the time that the P.E. firm agreed to buy the 146 stores, securities filings show it also reached a deal to sell the real estate underlying 20 of the new store locations for \$224 million—and lease them back under a sale-leaseback agreement. It later engaged in sale-leaseback transactions for additional stores—for a total of 39 stores. Through these sales, Haggen made an estimated total of \$300 million according to regulatory filings and real-estate documents—roughly equal to what it paid for the 146 stores... The unsecured creditors meanwhile—mainly laid-off workers, suppliers, and landlords—were owed roughly \$100 million.

And in February 2018 Tops Markets declared bankruptcy:

The northeastern chain of 170 grocery stores was bought out by Morgan Stanley Private Equity and Graycliff Partners in an LBO worth \$310 million in 2007. Morgan Stanley pursued a number of LBO add-ons between 2007 and 2012, and then financed the buyout of the company, including all of its debt, by Tops management in December 2013. By that time, Morgan Stanley had loaded the company with \$724 million in debt—more than twice the original purchase price. That included some \$377 million in dividends that Morgan Stanley paid to itself and its investors—equal to 55 percent of the total debt that had accrued. This does not include advisory fees charged by Morgan Stanley nor the future interest payments that Tops had to shoulder...

[T]he debt overhang left Tops with little wiggle room to reduce prices or resources to invest in store upgrades, new products, and online services needed to be competitive, as it reported itself in its bankruptcy filing. At the time of the bankruptcy, it had 14,800 employees... The company used the bankruptcy process to substantially

## b. Excessive leverage

Leveraged buyouts (LBOs) are a traditional strategy employed by PE. An LBO can be thought of as a financing technique used to acquire an operating company using a small amount of cash and a large amount of debt that resides on the books of the target company. PE GPs usually put a small amount of their own money towards the down payment, 1-3%. The remainder of the equity investment is provided by investors such as pension funds and wealthy individuals. In a typical buyout, around 30% of the purchase price is paid as equity, or cash, and 70% is debt financing.<sup>16</sup>

When a PE fund buys a company, the company is responsible for paying down loans, not the GP or the investors. Loan payments are paid out of the company's earnings and if the company cannot make the payments, the PE fund is not responsible for the company's debts. It is common practice for a company acquired in an LBO to take out additional loans shortly after the acquisition to reimburse the PE GP for a portion of the down payment or pay a dividend in what's called a 'dividend recapitalization.'

As discussed above, the debt servicing burden that excessive leverage imposes on a company often forces the company to forego investments to make the company more competitive and provide family-sustaining wages and benefits to its workforce.

Recent increases in the issuance of leveraged loans, which are often used to finance LBOs, are raising concerns among regulators domestically and globally.<sup>17</sup> In the past five years, the value of outstanding leveraged loans has nearly doubled to \$1.15 trillion.<sup>18</sup> Late last year, the Federal Reserve issued a Financial Stability Report which raised concerns about high levels of corporate debt and the increase in risky lending practices.<sup>19</sup> The report stated, 'lenders have become more willing to extend loans with fewer credit protections to higher-risk borrowers. Moody's Loan Covenant Quality Indicator suggests that loan covenants are at their weakest levels since the index began in 2012...'<sup>20</sup>

In October 2018, Former Federal Reserve Chair Janet Yellen raised concerns that the leveraged lending market could create systemic risks. She said, "I am worried about the systemic risks associated with these loans... There has been a huge deterioration in standards; covenants have been loosened in leveraged lending."<sup>21</sup>

## c. Investors in Private Equity

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reduce the pension benefits for [employees] by withdrawing from [union] defined benefit pension plans and replacing them with 401(k) plans.

<sup>16</sup> *Id.*

<sup>17</sup> Jim Puzanghera, *Remember the subprime mortgage mess? \$1.2 trillion in risky corporate debt is flashing similar warning signs*, LA Times, Jan 20, 2019, available at <https://www.latimes.com/business/la-fi-corporate-debt-risks-20190120-story.html>.

<sup>18</sup> *Id.*

<sup>19</sup> Board of Governors of the Federal Reserve System, *Financial Stability Report*, Nov. 2018, available at <https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf>.

<sup>20</sup> *Id.* at 12.

<sup>21</sup> Sam Felming, *Janet Yellen sounds alarm over plunging loan standards*, Financial Times, Oct. 25, 2018, available at <https://www.ft.com/content/04352e76-d792-11e8-a854-33d6f82e62f8>.

US pension funds have an average target allocation to private equity of 8.6% of total assets.<sup>22</sup> In many situations, pension plans are under pressure to make up for insufficient employer contributions by chasing riskier investments that could produce greater returns. PE funds advertise that they have the ability to provide those returns. Unfortunately, the opacity, illiquidity and high fees associated with PE add to the risks of the investment and the difficulty in achieving returns sufficient to justify those risks.

The lack of transparency into PE makes it difficult to analyze the accuracy of claims that PE investments outperform other asset classes. In addition, PE managers do not use traditional metrics to report returns. The CFA Institute has explained that typical methods for comparing performance “work well (at least from a statistical perspective) only for those instruments that are publicly traded and are highly liquid. This is a major problem for private equity (PE) investments as they are not only “private” and illiquid but also exhibit serious smoothing issues because of subjective appraisals and valuation lags.”<sup>23</sup>

In December 2018, the CFA Institute published, ‘Private Equity: The Emperor Has No Clothes.’ The piece examined different models of private equity returns and concluded, ‘Exposure to small caps likely explains private equity returns. Liquid alternatives to private equity can be created simply by buying small, cheap, and levered stocks... [Locked-up capital] keeps investors from redeeming their funds at market lows and helps private equity firms weather storms like the global financial crisis. But the same fund structure can be replicated through public equities at a fraction of private equity fees.’<sup>24</sup>

PE is characterized by high fees that take away from investors’ returns. The fee structure, known as ‘2 and 20,’ means that the fund manager gets 2% annually of the total amount of assets under manager plus 20% of the return on any investment.

PE investments are illiquid, and therefore pose greater risks for investors. The average life of a fund is 10 to 13 years.<sup>25</sup> The secondary market for interests in PE funds is very limited. The total transaction volume in the secondary market in 2018 was estimated at \$72 billion.<sup>26</sup> To put that in perspective the industry has around \$4.1 trillion in committed capital – less than a 2% turnover rate.<sup>27</sup> Once an investor buys into a fund, it is very difficult to get out before the fund sells off all the companies in the portfolio.

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<sup>22</sup> American Investment Council, Public Pension Study, May 2018 available at <https://www.investmentcouncil.org/wp-content/uploads/2018-public-pension-study-final3.pdf>.

<sup>23</sup> Prasad Ramani, *Evaluating Private Equity Performance: PME vs. Direct Alpha*, Enterprising Investor, CFA Institute, Jul. 23, 2014 available at <http://blogs.cfainstitute.org/investor/2014/07/23/evaluating-private-equity-performance-pme-vs-direct-alpha/>.

<sup>24</sup> Nicolas Rabener, *Private Equity: The Emperor Has No Clothes*, Enterprising Investor, CFA Institute, Dec. 3, 2018 available at <https://blogs.cfainstitute.org/investor/2018/12/03/private-equity-the-emperor-has-no-clothes/>.

<sup>25</sup> Robert Harris, Tim Jenkinson and Steve Kaplan, *Private Equity Performance: What Do We Know?* Available at <http://faculty.chicagobooth.edu/steven.kaplan/research/kpe.pdf>

<sup>26</sup> Collier Capital, *The Private Equity Secondary Market*, Collier Capital Ltd. 2019 available at [https://www.colliercapital.com/sites/default/files/Collier%20Capital%20%E2%80%93%20the%20private%20equity%20secondary%20market\\_0.pdf](https://www.colliercapital.com/sites/default/files/Collier%20Capital%20%E2%80%93%20the%20private%20equity%20secondary%20market_0.pdf).

<sup>27</sup> Press Release: *Private Equity Industry Grows to More Than \$3tn in Assets*, Preqin, Jul. 24, 2018 available at <http://docs.preqin.com/press/PE-Assets-Jul-18.pdf>.

The Dodd-Frank Act required PE fund managers to register with the SEC for the first time and submit to periodic examinations. After the first round of exams, the then SEC Director of the Office of Compliance Inspections and Examinations Andrew J. Bowden revealed that extensive abuses had been uncovered. Bowden said in a 2014 speech, “When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.”<sup>28</sup>

The minimal reporting and examination requirements instituted by Dodd-Frank revealed an industry where abusive practices towards investors were common practice. More must be done to rein in these abuses.

#### **d. PE solutions**

The private equity model exists and is remarkably profitable for the GPs who run the funds due to a series of loopholes and carveouts in securities, bankruptcy and tax law. Exemptions in the securities laws allow PE firms to avoid the disclosure requirements and SEC oversight applicable to other pooled investment vehicles, like mutual funds, of a similar size and impact in terms of the number and relative wealth of the individuals whose retirements and job security depend on their performance. The bankruptcy laws allow GPs to load companies with debt, pay themselves dividends, and walk away without any responsibility if the company ends up in bankruptcy. And, PE GPs take advantage of tax loopholes such as the carried interest tax loophole and tax benefits for monitoring fee abuse.

There is no public interest reason to provide incentives that encourage and reward private equity buyouts. In fact, I would argue, that the public interest demands that policymakers eliminate loopholes carveouts and privileges that feed abusive leveraged buyouts and strongly encourage the Committee to consider this set of issues.

### **3. Short-termism**

Increasing public attention has focused on how financial markets actors pressure businesses to focus on short-term returns instead of long-term competitiveness and contribution to the real economy. The most egregious examples of short-termism come from automated trading strategies that rely on extreme speed and interconnection to, essentially, skim from investors whose technological resources cannot compete with those of high-frequency traders.<sup>29</sup>

A true long-term focus would require companies to invest in workers, products and services of value to the markets, and paying taxes to develop the infrastructure - both physical and human - to be successful.

The focus on quarterly stock performance instead of long-term performance puts pressure on companies to prioritize financial engineering over investments in research and development, growth, and good jobs. It also disincentivizes attention to long-term but potentially

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<sup>28</sup> Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Spreading Sunshine in Private Equity, May 6, 2014 available at <https://www.sec.gov/news/speech/2014--spch05062014ab.html>.

<sup>29</sup> The Financial Transaction Tax would go a long way toward mitigating abusive high frequency trading. It could help to refocus investors on long-term, buy-and-hold strategies while raising hundreds of billions of dollars that could be investing into the real economy.

catastrophic implications of their activities such as climate change and economic inequality which are, in fact, key to financial performance. Long-term, diversified investors can only obtain sustainable positive returns if the economy is growing and economic actors are taking the necessary steps to prevent or mitigate systemic threats. I will discuss a few major opportunities to address short-termism.

### **a. Stock buybacks**

In recent decades, companies have spent exorbitant sums buying back their own stock. The 2017 Tax Cuts and Jobs Act hyper-charged the practice. In 2018, companies spent more than \$1 trillion buying back their own stock and are on pace to surpass that level in 2019.<sup>30</sup>

Company's excessive spending on buybacks has prompted concerns that they are prioritizing short-term stock price jumps over long-term investments that would make their businesses more competitive. According to *The Economist* magazine, "If firms are overdoing buy-backs and starving themselves of investment, artificially propped-up share prices will eventually tumble."<sup>31</sup> Large stock buybacks send "a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term," Laurence Fink, chairman and CEO of Blackrock, wrote in an April 14, 2015 letter to S&P 500 companies.

Company executives whose compensation is primarily comprised of stock-based awards, gain the most from short-term maneuvers to boost stock prices. As is so often the case with financial engineering, workers and long-term investment in business improvements suffer. For example, if Wal-Mart had chosen to invest the \$10 billion allocated for stock buybacks in 2018 to raising workers' wages, it could have paid each worker an additional \$5.66 per hour.<sup>32</sup>

SEC policy changes in the early 1980s opened the door for the proliferation of stock buybacks. Prior to the issuance of Rule 10b-18, it was generally thought that stock repurchases would be considered stock price manipulation by the SEC. 10b-18, however, created a safeharbor that gave companies comfort that they would not be charged by the Commission with manipulation and buybacks took off.

Multiple policy changes have been put forward to limit buybacks. Senator Baldwin's Reward Work Act would eliminate the 10b-18 safeharbor and require companies to include worker representatives on the boards of directors. Senators Schumer and Sanders have announced plans to introduce a bill that would condition the ability of companies to buy back their stock on adherence to a \$15 minimum wage. A bi-partisan House bill introduced by Representatives Maxine Waters and Patrick McHenry, the Promoting Transparent Standards for Corporate Insiders Act, requires an SEC study and rulemaking on executive trading plans

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<sup>30</sup> Ben Walsh, *Stock Buybacks Are on Track for Another Record Year*, *Barron's*, Feb. 20, 2019 available at [https://www.barrons.com/articles/stock-buybacks-are-on-track-for-another-record-year-51550682106?mod=article\\_inline](https://www.barrons.com/articles/stock-buybacks-are-on-track-for-another-record-year-51550682106?mod=article_inline).

<sup>31</sup> *Share buybacks: Corporate Cocaine*, *The Economist*, Sep. 13, 2014 available at <https://www.economist.com/leaders/2014/09/13/corporate-cocaine>.

<sup>32</sup> Lenore Palladino, *Rewriting the Rules to Take Aim at Stock Buybacks and Force Companies to Invest in Their Workers: The STOP Walmart Act*, *Medium*, Nov. 14, 2018 available at <https://medium.com/@lenorepalladino/rewriting-the-rules-to-take-aim-at-stock-buybacks-and-force-companies-to-invest-in-their-workers-7463680414c5>.

that would help to prevent insiders from taking advantage of stock buybacks to cash out their equity. These bills would help to limit abusive buybacks and improve outcomes for working people and long-term investors.

### **b. Promoting investor engagement**

Investors must be empowered to engage with companies and encourage them to consider long-term factors. Unfortunately, the Chamber of Commerce and other business interests have been pressuring Congress and the SEC to make it more difficult for investors to engage with companies through the shareholder proposal process. These efforts to raise the ownership requirements that investors must meet to be eligible to submit shareholder proposals, increase the minimum vote a proposal must receive in order to be eligible for resubmission, and eliminate the ability of proxy advisors to provide recommendations on shareholder votes without first receiving input from issuers are all aimed at preventing long-term investors from pressuring companies to respond to investors concerns about environmental, social and governance (ESG) concerns.

Policymakers interested in promoting long-term investing must ignore these demands to limit shareholders' rights. Instead, the focus should be on finding ways to encourage long-term investing. For example, mandatory corporate disclosure of ESG factors in a standardized way that analysts could use to compare ESG performance in an apples-to-apples way among issuers would go a long way towards advancing long-term investment strategies.

### **c. Workers on boards**

The single-most effective way to improve workers' wages and benefits is to empower workers. In the corporate governance context, that means putting workers on corporate boards. The worker representatives must be selected by the workers themselves through a democratic election process. It also must be made clear that worker representatives should be included in all board-level decisions that impact workers interests.

Senator Baldwin and Senator Warren have both introduced legislation that require worker representation on boards. The AFL-CIO and AFR strongly support both bills and encourage the Committee to put them on the agenda for formal consideration.

## **4. Too-big-to-fail**

The largest banks in the US have gotten larger since the 2008 financial crisis. At the end of 2007, the six largest US banks had a total of \$8.2 trillion in assets.<sup>33</sup> Now, these same banks have a combined \$10.6 trillion in assets.<sup>34</sup>

<b>Rank</b>	<b>Bank name</b>	<b>Total assets</b>
1	JPMorgan Chase & Co.	\$2.62 trillion
2	Bank of America Corp.	\$2.34 trillion
3	Citigroup Inc.	\$1.93 trillion

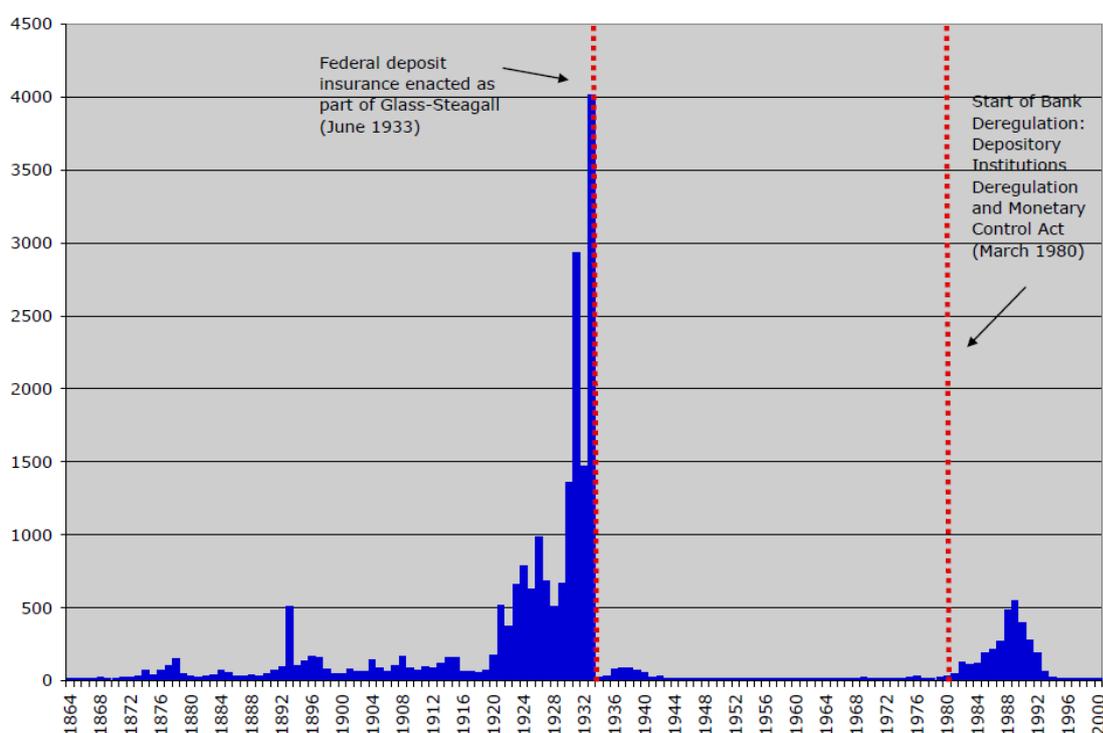
<sup>33</sup> *The World's Biggest Banks 2008*, Global Finance, Aug. 4, 2009 available at <https://www.gfmag.com/awards-rankings/best-banks-and-financial-rankings/the-worlds-biggest-banks-2008->

<sup>34</sup> Amanda Dixon, *America's Largest Banks*, Bankrate.com, Feb 20, 2019 available at <https://www.bankrate.com/banking/americas-top-10-biggest-banks/#slide=1>.

Rank	Bank name	Total assets
4	Wells Fargo & Co.	\$1.87 trillion
5	Goldman Sachs Group Inc.	\$957.19 billion
6	Morgan Stanley	\$865.52 billion

S&P Global Market Intelligence

Aspects of Dodd-Frank were aimed at limiting risks within these institutions and preventing the need for future bailouts. Unfortunately, it remains very difficult to envision how one or more of these institutions could fail without threatening US, and global, economic stability. It does not have to be this way. For many years, US bank regulations restricted interstate banking and prevented federally insured commercial banks from engaging in speculative activities. The period in which those laws remained in place marked a particularly stable time for the US banking industry during which bank failures were exceedingly rare.



Source: David Moss, "An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System," 2009.

In the early 1980s, policymakers in Washington began rolling back laws and regulations that had kept the system safe for decades. The Riegle-Neal Interstate Banking Act of 1994 paved the way for the reemergence of interstate banking and allowed the largest US banks to grow dramatically.<sup>35</sup> In 1994, the six largest banks had assets equal to 17 percent of Gross Domestic Product (GDP). They now have assets estimated to be 55% percent of GDP.

<sup>35</sup> Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Federal Reserve History, Sep. 1994 available at [https://www.federalreservehistory.org/essays/riegle\\_neal\\_act\\_of\\_1994](https://www.federalreservehistory.org/essays/riegle_neal_act_of_1994). See also Roisin McCord, Edward Simpson Prescott, and Tim Sablik, *Explaining the Decline in the Number of Banks Since the Great Recession*, Richmond Federal Reserve Economic Brief, Mar. 2015 available at

The Federal Reserve began chipping away at the Glass-Steagall Act's separation of banking and securities activities in 1987. Over 10 years, the Fed issued a series of regulations that allowed bank subsidiaries to underwrite and deal corporate debt and equity securities. In 1987, bank subsidiaries were limited to transactions in commercial paper and a small range of securities as long as these activities did not account for more than 5% of the subsidiary's gross revenues. By 1997, however, the Fed had broadened the types of securities transactions that could be undertaken by bank subsidiaries, the revenue limit was increased to 25% of the subsidiaries' gross revenues and rules had been lifted that barred banks from marketing the securities services provided by their subsidiaries.<sup>36</sup> This allowed regulated commercial banks to enter the securitization markets in a substantial way and also exposed regulated financial institutions to these unregulated loan pools.

The final nail in the coffin for the Glass-Steagall Act's prohibition of merging the provision of banking and securities services within a single entity came in 1998 when the Federal Reserve authorized the merger of Citicorp, a commercial bank, with Travelers Group, Inc, an insurance company that had securities firm Salomon Smith Barney as a subsidiary, to form Citigroup, the first universal bank in the US.<sup>37</sup>

In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA), which repealed restrictions on financial institutions' business operations that had been in place since 1933 when Congress passed the Glass-Steagall Act. Glass-Steagall was intended to address conflicts of interest and systemic risk issues that arose from the operation of commercial and investment banking within the same firm. GLBA dismantled the barriers between commercial and investment banking, insurance, and mortgage lending. Once commercial banks were permitted to enter the riskier and more lucrative businesses previously reserved for investment banks, which did not take FDIC-insured consumer deposits, bank holding companies shifted away from consumer lending.

Dodd-Frank took some useful steps towards addressing the problem of too-big-to-fail. The Volcker Rule, stress testing, and orderly liquidation authority that were created by Dodd-Frank could, if implemented appropriately, mitigate excessive risk taking by too-big-to-fail banks, allow regulators to work with banks in advance of financial crises to ensure that they maintain strong balance sheets, and allow for the liquidation of an insolvent bank without setting off a systemic crisis.

Even perfect implementation of these provisions would not end the too-big-to-fail problem. Implementation, however, has been far from perfect and regulatory changes by the current Administration are seriously weakening an already flawed system.

Congress must pass legislation to bring our largest banks down to a size that they could fail without threatening economic stability. Legislation introduced in past Congresses and sponsored by Ranking Member Brown would do just that. For example, the Brown-Kaufman

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[https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic\\_brief/2015/pdf/eb\\_15-03.pdf](https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf).

<sup>36</sup> Arthur E. Wilmarth, *The Transformation of the US Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks*, University of Illinois Law Review, Vol. 2002, No. 2 at 318-320, 2002. Available at SSRN: <http://ssrn.com/abstract=315345>. Internal citation omitted.

<sup>37</sup> Federal Reserve Bulletin, Volume 84 Federal Reserve Bulletin Number 11; Pg. 985 (Nov. 1998).

Act that was proposed as an amendment to Dodd-Frank would have imposed a strict size cap on banks; limited both non-deposit and overall liabilities; and instituted a statutory leverage ratio. The Terminating Bailouts for Taxpayer Fairness Act introduced by Senator Brown and Senator Vitter would have increased capital requirements, especially for the too-big-to-fail banks. These are the types of policy changes needed to bring banks down to size and eliminate too-big-to-fail.

In addition, Congress should pass Senator Warren's 21<sup>st</sup> Century Glass-Steagall Act, which would break up the too-big-to-fail banks by separating commercial banking, taking deposits and making loans for consumers and businesses, and investment banking, which entails more risky and speculative activity. Risky investment banking activities must not be permitted within commercial banks, which are insured by the government. This is exactly what Congress did when it passed the Glass-Steagall Act during the Great Depression. And for 50 years after Glass-Steagall went into effect, bank failures were rare and our economy generated the longest period of broad-based prosperity in US history.

When a handful of banks hold such vast sums of money, it places our entire financial system at greater risk. It also increases the likelihood that the government will bail out Wall Street banks again in the future. The best way to prevent future government bailouts of too-big-to-fail financial institutions is to end too-big-to-fail once and for all.

## **5. Conclusion**

In conclusion, while there are some legislative proposals on the agenda today that represent minor improvements to our current financial regulatory architecture, none of them come close to the scale or scope necessary to create an economy that truly works for working people.

This Committee has the ability to end predatory financial activities that undermine the well-being of everyday Americans - to stop private equity firms from sucking wealth out of businesses, destroying jobs and extracting exorbitant fees from pension funds; to address short-termism in our financial markets by taking on activities like stock buybacks and efforts to silence the voices of long-term investors seeking to encourage companies to address environmental, social and governance concerns; and to end too-big-to-fail.

Of course, this is not the job of Congress alone. We need strong financial regulatory agencies to implement legislative changes. And, we need to fill the empty commission slots at the SEC and other financial regulatory agencies to bring credibility to the regulatory process.

# APPENDIX A

Letter dated October 11, 2018 from the AFL-CIO and Americans for Financial Reform to the U.S. Senate regarding S. 488, the “JOBS and Investor Confidence Act of 2018.” This letter discusses:

- S. 588, the “Helping Angels Lead Our Startups (HALOS) Act” (see discussion of Title 1)
- S. 2756, the “Fair Investment Opportunities for Professional Experts Act” (see discussion of Title 4)
- S. 3518, the “Small Business Mergers, Acquisitions, Sales & Brokerage Simplification Act” (see discussion of Title 3)
- S. 3723, the “Main Street Growth Act” (see discussion of Title 20)
- The “Exchange Regulatory Improvement Act” (see discussion of Title 8)
- The “International Insurance Standards Act” (see discussion of Title 14)

October 11, 2018

Dear Senator,

On behalf of the AFL-CIO and Americans for Financial Reform (AFR), we are writing to state our opposition to S 488 (the “JOBS and Investor Confidence Act of 2018”) which has been passed by the House. We understand that many industry lobbyists are pressing for adoption of some or all of this legislation by the Senate. In our view, S 488 contains a number of harmful deregulatory provisions that make it a bad tradeoff for the public. We are concerned that parts of S 488 meaningfully weaken important investor protections and change the structure of securities markets in damaging ways.

Not all of the provisions in S 488 are misguided. AFR has opposed eleven and supported four of the thirty-two provisions in S 488, and takes no position on the other seventeen.<sup>1</sup> The pro-investor portions of the bill in Titles 27, 29, 30, and 31 do have value, and would shine a light on exploitation of investors and issuers, as well as improper patterns of insider trading tied to stock buybacks. However, these positive provisions are informational measures like studies and advisory provisions. In contrast, other provisions in the bill take much more active steps to deregulate securities markets in ways that could harm investors.

Overall, the package is a net negative for investors and the public interest. It would expose investors to greater danger of fraud, and it would undermine the public equities markets by inappropriately expanding the scope for private fundraising. Some examples of provisions in S 488 that we are concerned about include the following (in order of the titles in the bill):

**Title 1 of S. 488, the “HALOS Act”, eliminates prohibitions on general solicitation and advertising for Rule 506(b) private securities offerings at “demo days” pitch events sponsored by trade associations and a wide variety of other organizations.** After the JOBS Act already vastly expanded the ability to engage in public offerings of private securities, this legislation would expand it even further, permitting large-scale public meetings to pitch private securities to ordinary investors. As University of Mississippi securities law professor Mercer Bullard stated in his recent testimony:<sup>2</sup>

“The Act will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering. ... The HALOS Act represents the de facto repeal of offering regulation.”

SEC Rule 506(c) already permits the types of meetings and solicitations authorized by the HALOS Act, but it requires the seller to make a reasonable effort to verify that any purchasers of the offerings are accredited investors. The sole purpose of the HALOS Act seems to be to expand the scope for general solicitation and sales to ordinary retail investors who do not qualify as accredited investors. There is no reason for Congress to act to further deregulate private

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<sup>1</sup> AFR has previously opposed Titles 1, 3, 4, 5, 8, 14, 15, 20, and 26 of S 488 as stand alone bills. We opposed a somewhat different version of Title 25 and oppose the version in S 488 due to its interaction with Title 20 (venture exchanges). We opposed a somewhat different version of Title 32 and are still examining the version in S 488. We have previously supported Titles 27, 29, 30, and 31. We take no current position on other provisions.

<sup>2</sup> Bullard, Mercer, “Testimony of Mercer Bullard Before the Committee on Banking, Housing, and Urban Affairs”, June 26, 2018. <https://bit.ly/2NBXrB9>

securities offerings. Such actions only expose investors to increased risk of fraud and loss while adding to the factors that discourage companies from making public offerings and shrink the public equities market.

**Title 3 of the bill creates an “M&A Broker” exception from SEC registration and oversight for firms that assist in buying and selling privately held companies with gross annual revenues of up to \$250 million.** While a carefully crafted exception for intermediaries in the sale of local small businesses could be appropriate for smaller deals, the \$250 million revenue limit in this section far exceeds the size of businesses that are actually local and small. Businesses of this size are better characterized as medium sized to large private businesses with a regional or national footprint. It is unfair to ask brokers who register with the SEC and comply with requirements, including anti-money laundering rules, to compete with unregistered and unregulated competitors in buying and selling private companies of significant size. This legislation could also be harmful to business owners who would sell their businesses through unregistered advisors who are not subject to the codes of ethics that bind registered dealers.

**Title 4 cements in statute a definition of “accredited investor” based on income and wealth thresholds that have not changed since 1982 and are far outdated today.** In view of the tremendous risk inherent in investing in private securities offerings, the securities laws generally require that persons investing in such offerings be “accredited investors.” The current standard, which would be codified by this bill, defines an accredited investor as anyone with a net worth in excess of \$1 million excluding their primary residence, or an income in excess of \$200,000 (individuals) or \$300,000 (couples). This outdated definition effectively removes many Main Street retirees from key transparency and disclosure protections available in the public markets, rendering them more vulnerable to exploitation.<sup>3</sup>

While Title 4 would update the current outdated thresholds for inflation going forward, freezing the current thresholds in statute as the starting point would permanently lock in a dangerously low standard.<sup>4</sup> The accredited investor definition should be revisited but this provision does so in an ill-considered way that would tie the SEC’s hands in making needed reforms. Both the SEC’s Investor Advisory Committee (IAC) and the North American Association of Securities Administrators (NASAA) oppose this provision and the general idea of placing the current threshold in statute.<sup>5</sup>

**Title 8 would require the SEC to rewrite its oversight rules for trading exchanges in ways that would narrow its current authority over exchange pricing practices.** Specifically, this section requires the SEC to conduct a new rulemaking that revises its definition of “facility” and

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<sup>3</sup> An estimated one-third of all accredited investors are retirees.

<sup>4</sup> When SEC adopted the current definition of “accredited investor” in 1982 an estimated 1.5 million U.S. households met its requirements. Today, more than 16 million U.S. households—or about one in eight—qualify for accredited status. If the 1982 definition was adjusted to keep pace with inflation, an accredited investor today would need an annual income of \$515,000 — well more than double the present \$200,000 limit— or a net worth of more than \$2.5 million. (<https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023>)

<sup>5</sup> See: Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014). Available at <http://bit.ly/22HoUHw>. North American Securities Administrators Association, “Letter from NASAA President and Alabama Securities Director Joseph P. Borg to the HFSC Chair and Ranking Member regarding markup of H.R. 3758, H.R. 477, H.R. 3857, H.R. 2201, and H.R. 1585”, October 11, 2017. Available at <http://bit.ly/2xK1Lag>.

sets forth the specific facts and circumstances that lead to a determination that any elements or activities 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. Since the definition of “facility” is the key statutory element that gives the SEC jurisdiction over exchanges, the clear goal here is to narrow SEC jurisdiction over trading exchanges.

As officially recognized Self-Regulatory Organizations (SROs), exchanges are granted broad powers by government, which give them significant pricing power and monopoly control over trading information generated on the exchange. Exchanges themselves also have very concentrated ownership, with 12 out of the 13 public stock exchanges owned by just three large corporations. In recent years, these exchanges have become for-profit private corporations and have exercised their regulatory powers aggressively to maximize profits, often at the expense of consumers and investors.<sup>6</sup> In this environment, Congress should avoid taking actions to deregulate these exchanges still further.

**Title 14 on international insurance standards would place significant new restrictions on executive branch negotiations of international insurance standards addressing systemic risks posed by international insurance conglomerates.** The large insurance conglomerates that dominate the U.S. and global insurance market today are active far beyond the boundaries of any individual state. The Dodd-Frank Act recognizes the importance of state-based insurance regulation and state regulators are currently given a very substantial consultative role in international insurance negotiations. Title 14 increases this role and also puts in place major new barriers to action in this area, including a Congressional fast track veto process for covered agreements that address risk protections for the financial activities of large insurance companies. The Trump White House has already expressed serious concerns about previous measures to restrict international insurance regulatory agreements as contravening executive branch authority.<sup>7</sup> While we do not necessarily agree with this perspective in all cases, we concur that the limitations in Title 14 are excessive and inappropriate.

**Title 20 on venture exchanges would dictate an alternative regulatory framework for securities exchanges that list shares of early-stage private startups.** A threshold question concerning such venture exchanges is why they are needed. The market for venture capital is already extremely healthy both in the U.S. and globally, reaching new records of approximately \$200 billion annually in venture capital funding, with over half in the U.S.<sup>8</sup> Ownership stakes in early stage non-public companies, including venture-funded companies, are already broadly available through over the counter markets to sophisticated individual investors, institutional investors, asset managers, and pension funds that can perform the needed due diligence. Even for these sophisticated investors, the returns from venture investments are highly uncertain and

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<sup>6</sup> <https://www.sec.gov/news/speech/jackson-unfair-exchange-state-americas-stock-markets>

<sup>7</sup> See Presidential Signing Statement for S 2155, asserting “exclusive Constitutional authority to determine the time, scope, and objectives of international negotiations”. Available at <http://www.presidency.ucsb.edu/ws/index.php?pid=129721>

<sup>8</sup> See KPMG, Venture Pulse: Q1 2018 Global analysis of venture funding, available at: <https://home.kpmg.com/xx/en/home/insights/2018/04/venture-pulse-q1-18-global-analysis-of-venture-funding.html>

mixed, with venture capital as an asset class generally underperforming the public markets over the long term.<sup>9</sup>

Venture shares tend to be unsuitable for many retail investors due to their risk, and un conducive to exchange listing because they tend to be illiquid and opaque. Increasing liquidity for venture stage investments should not be seen as an end in itself, but should only occur if it serves a real public policy purpose. Greater liquidity might for example be used as a vehicle for informed venture company insiders to exit and sell their investments before bad news about their company reaches the broader public. It would not, for example, have been beneficial if early stage investments in Theranos had been more liquid and company insiders had been able to sell out before the massive fraud at the company had been revealed.

The U.S. public markets are the broadest, deepest, and most liquid in the world, and the success of public markets is most likely to be sustained if companies seeking liquidity are encouraged to go public. Venture exchanges would discourage this. They also risk creating the appearance but not the reality of liquidity, as shares in early stage venture companies with limited information and disclosure are always likely to be thinly traded.

**Title 25 on venture capital funds** would further encourage excessive secondary market trading in venture shares by permitting companies to qualify for venture capital exemptions from SEC rules by trading secondary stakes in venture capital companies. This would effectively allow venture capital funds to become quasi-mutual funds made up of secondary shares in venture capital companies. The public purpose that would be served by this provision is unclear.

Again, the pro-investor studies and advisory bodies in Titles 27, 29, 30, and 31 of S 488 do have value. However, they do not outweigh the harm that would be done by the provisions cited above, which would actively change securities laws in significant ways. On balance, there is simply no reason for Congress to act to grant the benefits to industry contained in this bill.

Thank you for your attention. For more information please contact AFR's Policy Director, Marcus Stanley, at [marcus@ourfinancialsecurity.org](mailto:marcus@ourfinancialsecurity.org) or 202-466-3672.

Sincerely,

Americans for Financial Reform

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<sup>9</sup> Mulcahy, Diane and Weeks, Bill and Bradley, Harold S, "We Have Met the Enemy...and He is Us: Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope Over Experience", Kauffman Foundation, May 2012. Available at SSRN: <https://ssrn.com/abstract=2053258>

# APPENDIX B

Statement by Americans for Financial Reform regarding a House Financial Services Capital Markets Subcommittee Hearing on November 3, 2017. This statement discusses:

- S. 1117, the “Consumer Financial Choice and Capital Markets Protection Act of 2017” (see discussion of H.R. 2319)



AFR Statement on 11/3 House Financial Services Capital Markets Subcommittee Hearing

On behalf of Americans for Financial Reform (AFR), thank you for the opportunity to submit this statement to the Subcommittee today. 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.<sup>1</sup>

We are disturbed that the Committee is once again choosing to consider deregulatory bills which will roll back needed protections for investors and for the broader economy, rather than turning its attention to the weaknesses in our regulatory system revealed by scandals at Equifax and Wells Fargo, or the financing needs of millions of Americans impacted by natural disasters across the country. Several of the bills under consideration today by the Subcommittee raise especially grave concerns.

**H.R.2319: Consumer Financial Choice and Capital Markets Protection Act of 2017:**

HR 2319 would reverse an important post-financial crisis reform and allow money market funds to present their share value to investors as stable, even though shares in money market funds are investment products that carry market risk to investors. By doing so, it will contribute to restoring the misperception that money market funds are similar to insured bank deposits and have an implicit government backstop. This misperception was reinforced during the 2008 financial crisis, when, in the face of a massive run on prime money market funds, the Treasury Department provided a public taxpayer guarantee of the entire sector, over \$3 trillion in assets.

The run on money market funds in the 2008 crisis, and the resulting massive public bailout, definitively demonstrated the dangers of allowing investors to perceive an investment product like money market funds as free of risk. In order to reinforce clarity on the true valuation of money market fund shares, regulators reversed a 1982 regulation that permitted prime institutional money market funds to report valuations to their investors through an approximation method which generally permits them to report each share as worth one dollar, even if the actual market value of shares differs from a dollar. This change did not apply to government funds or retail funds. In response to this more accurate “floating net asset value (NAV)” method of valuation, which makes market risk clear, some institutional investors have withdrawn their funds from prime funds and re-allocated them to government funds, which have less market risk.

HR 2319 would reverse this change and once again permit prime money market funds to present themselves to investors as having a stable share value of \$1. This change would again contribute to a misperception that money market funds have an implicit backstop from the government. While HR 2319 claims to prohibit further government bailouts of money market funds, it does not in fact do so. ***HR 2319 includes an explicit loophole that would permit the government to again provide public assistance to bail out money market funds in time of crisis.*** The definition

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<sup>1</sup> A list of AFR coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

of “covered Federal assistance” that would be prohibited by HR 2319 is carefully phrased to exclude any Federal Reserve program that is “part of a program or facility with broad-based eligibility established in unusual or exigent circumstances.”<sup>2</sup> This language mirrors the language of Section 1101 of the Dodd-Frank Act, which permits the Federal Reserve to provide emergency lending assistance under Section 13(3) of the Bank Holding Company Act so long as such lending is provided as “in unusual or exigent circumstances...in any program or facility with broad based eligibility”.<sup>3</sup> Section 13(3) of the Bank Holding Company Act is the same provision that was used to extend trillions of dollars in credit to major Wall Street banks for a period of years during the 2007-09 financial crisis. HR 2319 would leave this provision open for use by money market funds.

Thus, HR 2319 would at the same time restore the ability of prime money market funds to falsely present themselves to institutional investors as a stable value product akin to a bank deposit, while also permitting such funds to receive government support through the Federal Reserve during periods of financial stress. We believe that this type of deregulation will only reinforce misperceptions about the risk involved in money market fund investments and will increase dangers to the stability of the financial system.

**H.R. \_\_\_\_\_, The Small Business Credit Availability Act:** AFR previously opposed a broader version of this bill, which expanded permissible leverage and investments for business development companies (BDCs).<sup>4</sup>

The new version of this bill would still greatly expand the amount that BDCs are permitted to borrow. Specifically, the bill would double BDC leverage limits from the current 1-1 level (one dollar of borrowed money for each dollar of investor equity) to 2-1. In contrast, conventional closed-end mutual funds can only leverage 1-2, or borrow one dollar per two dollars of investor equity. Note that this fund-level leverage is in addition to the leverage that already exists in BDC portfolio holdings, due to investments in risky subordinated debt and structured products. For example, research from Wells Fargo shows that effective leverage at many large BDCs is already 5-1 or greater.<sup>5</sup> This means that a doubling of permitted regulatory leverage could lead to effective leverage of up to 10-1, or ten dollars in debt for each dollar in equity.

These high leverage ratios expose retail investors and retirees to a significantly greater risk of investment losses. As outlined by Professor Mercer Bullard in his testimony today, BDCs already charge much greater fees to investors than comparable investment products. It would add insult to injury to permit BDCs to also increase the risk of investment losses by significantly boosting their leverage.

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<sup>2</sup> See Section 66(a)(2)(C) of the Investment Company Act as added by Section 2 of HR 2319.

<sup>3</sup> See Section 13(3)(A) of the Bank Holding Company Act.

<sup>4</sup> Americans for Financial Reform, “Opposition Letter to HR 3868”, November 3, 2015. <http://bit.ly/2iZfXK9>

<sup>5</sup> Bock, Jonathan, Finian O’Shea and Joseph Mazzoli, “Equity Research: The Q4 2015 BDC Scorecard”, Wells Fargo Securities, September 10, 2015.

Nor is there any evidence that this increase in permitted leverage is needed to serve the public policy goals of the BDC structure, which is channeling funds to small and mid-market operating companies. It would be much more effective for BDCs to attract additional capital by offering a better deal and lower fees to investors, rather than increasing the risk to investors and to the companies they support by increasing their borrowing. Furthermore, as Professor Bullard documents in his testimony, BDCs are currently investing a large fraction of their funds in other financial companies and securitization structures, rather than directly supporting operating companies.

**H.R. \_\_\_\_\_, Expanding Investment Opportunities Act:** We have not yet completed our review of this legislation, which would allow Closed End Funds (CEFs) to take advantage of many registration exemptions created by the SEC for offerings issued by operating companies. However, we share the concerns that Professor Bullard expresses in his testimony that there are significant differences between CEFs and actual operating companies that could render these exemptions inappropriate for CEFs.

# APPENDIX C

Letter dated February 13, 2018 from Americans for Financial Reform to the U.S. House of Representatives regarding the “TRID Improvement Act of 2017” (H.R. 3978). This letter discusses:

- S. 2126, the “Fostering Innovation Act of 2017” (see discussion of Title III)



February 13, 2018

Dear Representative,

On behalf of Americans for Financial Reform, we are writing to urge you to vote in opposition to H.R. 3978, which is being considered on the House floor today.<sup>1</sup> This legislation is a grab bag of bad legislative ideas that should never have advanced through the House Financial Services Committee. Especially notable given the recent wild swings in stock prices, Title II of this bill would sharply limit the ability of the Securities and Exchange Commission (SEC) to investigate high-frequency automated trading strategies that can disrupt markets. But that is hardly the only harmful bill in this package. There are several other provisions that would weaken consumer and investor protections.

**Title I**, “TRID Improvement,” would amend the TILA/RESPA Integrated Disclosure Rule (also known as TRID) to change how title insurance fees are disclosed, in a manner that would increase confusion and potentially misinform consumers as to the final cost of these important fees. The title insurance market already lacks transparency and fairness; fees are grossly inflated in relation to the value of the insurance. The Consumer Financial Protection Bureau (CFPB) carefully studied this issue in its rulemaking to determine the clearest and most accurate way to disclose fees in light of varying state laws on title insurance and differences in practices by different companies.<sup>2</sup> The changes in the statutory language here would limit the CFPB’s authority to create a consistent method of disclosure across different companies and different states, and to reflect ways in which title insurance costs can change at closing. Further refinement in title insurance disclosures can be addressed through rulemaking by the CFPB itself in consultation with stakeholders.

**Title II**, “Protection of Source Code,” would severely restrict the ability of the SEC to examine the detailed trading strategies of high-frequency traders or automated traders, even in cases where such traders posed a risk to markets or the financial system. Title II would prevent regulators from inspecting not only the raw source code used in automated trading, but also any related intellectual property that “forms the basis for the design of” source code. Examination of such intellectual property would only be possible in an enforcement context pursuant to a subpoena. This implies that the SEC would have to wait until the damage was done through a

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<sup>1</sup> 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 coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>.

<sup>2</sup> See CFPB, *Final Rule: Amendments to Federal Mortgage Disclosure Requirements under the Truth in Lending Act (Regulation Z)*. Available at <http://bit.ly/2t6xtvb>.

“flash crash” or similar market disruption before taking any action, which would have to be retrospective.

In light of the significance of automated trading to modern markets, and the potential risks of high frequency trading, it makes no sense to tie the hands of regulators in examining detailed trading strategies and methods of high frequency traders. At any brokerage, trading instructions to a human trader, including the conditions under which such a trade would be carried out (e.g., a limit order) are part of the books and records routinely open to inspection by FINRA or the SEC. Trading instructions must not be exempt from inspection simply because they are automated. They should be part of the books and records of the organization, just as other order-related documents are. Intellectual property related to source code clearly involves trading strategies, which have always been a subject for regulatory inspection and oversight.

The continued high volatility on Wall Street is giving evidence of the potential systemic dangers of high-frequency automated trading.<sup>3</sup> Now is not the time to tie the SEC’s hands in doing oversight of such trading.

**Title III**, “Fostering Innovation,” would double the time for which certain new public companies are exempt from key financial reporting controls, most notably attestation by an auditor that their earnings and accounting are accurate. It grants this exemption to a class of companies, newly public companies with low revenue growth, which have a particular strong incentive to manipulate their financial statements and deceive investors. This piece of the legislation would both harm investors and undermine the integrity of our capital markets.

**Title IV**, “National Securities Exchange Regulatory Parity,” would dangerously expand Federal pre-emption from state securities laws designed to protect investors from securities fraud. Under current law, a national securities exchange needs to meet listing standards similar to those of a major national exchange—e.g., the New York Stock Exchange, NASDAQ—for its securities to be deemed “covered securities.” Under this classification, securities enjoy the advantages of exemptions from state-level regulations.

Title IV in H.R. 3978 would amend the Securities Act of 1933 to remove the requirement that companies meet listing standards rigorous enough to be considered similar to those of major exchanges, effectively allowing riskier, less liquid securities to qualify as “covered securities” and avoid state securities laws designed to protect investors and financial markets. Under this section of H.R. 3978, a security would be exempt from state-level fraud protections as long as it is traded on a national exchange that is a member of the National Market System. This would mean that securities could be pre-empted from the oversight of state securities regulators without

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<sup>3</sup> Harwell, Drew, “A Down Day on the Markets? Analysts Say Blame the Machines,” *Washington Post*, February 6, 2018. Available at <http://wapo.st/2BTxBXL>.

meeting the strong standards that the SEC has laid out for individual securities to qualify for pre-emption under Section 18 of the Securities Act.

Both the North American Securities Administrators Association (NASAA), the main body of state securities regulators, and the chief securities regulator for the Commonwealth of Massachusetts have made the dangers of this legislation clear in strongly worded opposition letters.<sup>4</sup> In these letters, they advocated for fair and rigorous listing standards as essential to protect retail investors and savers, to maintain high standards for corporate governance, and to avoid conflicts of interests that harm investors. Title IV of H.R. 3978 unacceptably weakens these listing standards.

The sections of H.R. 3978 discussed above are, individually, bad bills for consumers and investors rights and protections. Packaging them together only worsens the harm. We urge you to reject H.R. 3978.

Thank you for your attention to this matter. For more information please contact AFR's Policy Director, Marcus Stanley, at [marcus@ourfinancialsecurity.org](mailto:marcus@ourfinancialsecurity.org) or 202-466-3672.

Sincerely,

Americans for Financial Reform

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<sup>4</sup> North American Securities Administrators Association (NASAA), "Letter from NASAA President and Alabama Securities Director Joseph P. Borg to the Senate Committee on Banking, Housing and Urban Affairs Chair regarding Section 212 of S. 2155 (National Securities Exchange Parity)," December 5, 2017, Available at <http://bit.ly/2C1y5II>; The Commonwealth of Massachusetts, "Letter from the Secretary of the Commonwealth William F. Galvin to Senator Elizabeth Warren regarding Opposition to Section 212 of S. 2155, the 'Economic Growth, Regulatory Relief, and Consumer Protection Act.'" December 4, 2017.

# APPENDIX D

Letter dated September 13, 2018 from Americans for Financial Reform to the House Financial Services Committee regarding six bills under consideration at a Committee markup. This letter discusses:

- S. 2953, the “Small Business Audit Correction Act of 2018” (see discussion of H.R. 6021)



September 13, 2018

Dear Representative,

On behalf of Americans for Financial Reform (AFR), we are writing to urge you to vote against six of the bills under consideration in today's Financial Services Committee markup.<sup>1</sup> As has generally been the case over the past year, this markup features a significant number of bills that reduce protections for consumers, investors and the public, counterbalanced by no serious efforts to strengthen regulation of Wall Street. On the tenth anniversary of the global financial crisis, it is disturbing that the House is continuing to prioritize Wall Street's agenda over the public interest.

Due to the brief advance notice provided for this hearing, we are continuing to examine this legislation and may take a position later on bills not discussed here. Below, we list the bills we currently oppose and describe reasons for opposing them. The bills are listed in numerical order.

**HR 2128, the “Due Process Restoration Act”**, would permit parties to SEC enforcement actions to force the SEC to drop the administrative proceeding and pursue the case as a civil action in Federal court. It would also significantly raise the standard of proof in SEC administrative actions.

Joseph Borg, the President of the North American Securities Administrator Association (NASAA) and the Director of the Alabama Securities Commission, testified that this bill would be a “potential death knell for SEC administrative practice”.<sup>2</sup> His testimony also describes the ways in which HR 2128, by blocking effective disposition of cases through the administrative process and encouraging wrongdoers to remove their cases to more time-consuming and cumbersome Federal court actions, would disrupt both our securities markets and the functioning of the Federal courts. We agree with NASAA's concerns about this bill and urge you to reject it.

**HR 5534, the “Give Useful Information to Define Effective (GUIDE) Compliance Act”** would require the Consumer Financial Protection Bureau (CFPB) to conduct a new rulemaking that defines a formal process for issuing guidance. The sweeping definition of guidance in the Duffy Amendment goes far beyond guidance bulletins and covers potentially most CFPB communications, including news releases, blog posts, and frequently asked questions. Requiring the CFPB to establish this type of formal procedure for issuing guidance takes away the Consumer Bureau's ability to rapidly respond to evolving forms of consumer harm. It also prevents the CFPB from responding to requests for guidance and clarification as they arise in an ever changing marketplace. This bill conflicts with the general guidance practice of federal agencies, which is intended to preserve their ability to address problems in a timely manner

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<sup>1</sup> 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 coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

<sup>2</sup> <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-jborg-20180613.pdf>

within the scope of existing rules and practices. By making it more difficult for the CFPB to issue guidance and to address concerns from both industry and the public, this bill will weaken the CFPB's ability to carry out its Congressional mandate to protect consumers.

The bill also requires the CFPB to issue a civil penalty matrix that would determine in advance the permissible size of civil monetary penalties. Binding the CFPB to a civil penalty matrix will restrict the flexibility the CFPB needs to hold scammers and corporate wrongdoers accountable when they develop new ways to abuse consumers.

**HR 6021, the “Small Business Audit Correction Act of 2018”**, 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 and 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 not 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, regardless of the total financial activities of the brokerage firm. This is a category that includes the great majority of the market. While it requires exempted firms to currently be in “good standing”, this is inadequate protection to replace sound auditing standards and requirements. This legislation should be rejected.

**HR 6741, “The Federal Reserve Reform Act of 2018”**, contains numerous provisions affecting the operations of the Federal Reserve. Some of these provisions affect areas of monetary policy which AFR does not typically weigh in on, and there are other provisions we would not necessarily oppose. However, we strongly oppose Section 7 of the bill, which would bring funding for the Federal Reserve's regulatory activities under the Congressional appropriations process. Banking regulators have traditionally been independently funded in order to reduce opportunities for short-term and inappropriate political pressures on regulatory supervision and decisions. Today, the Federal Reserve is arguably the single most important banking and financial system regulator. While Congress is always free to pass legislation changing financial regulatory rules and procedures, the day-to-day funding of regulatory activities should be independent of the appropriations process.

**HR 6743, “The Consumer Information Notification Requirement Act”**, would protect companies such as Equifax that fail to protect consumer data. Section 3 of the bill would preempt all state data breach, data security and other privacy laws as they apply to both “financial institutions and their affiliates.” “Financial institution” is a term that includes numerous non-banks including Equifax and the other consumer reporting agencies, as well as debt collectors and payday lenders. This is unacceptable.

State protections are particularly critical since current Federal privacy protections, as restated in Section 2 of HR 6743, only require corporations to inform consumers of a privacy breach if the breached firm determines that the privacy violation is “reasonably likely” to result in certain economic harms. State privacy laws are significantly broader and more protective of consumer privacy rights. Section 3 of HR 6743 replaces the narrow preemption provision in the existing law with a far broader preemption provision that could not only eliminate all state data breach notice, data security and other privacy laws as they apply to financial institutions, but forestall further state innovation to protect their citizens from future privacy and data security threats. By replacing the existing notice standard in the overwhelming majority of states with a weaker preemptive federal standard, this bill would cause consumers to stop receiving notifications about breaches that they currently have a right to hear about — breaches that could lead to physical, financial, or emotional harm. The bill would also prevent states from responding to new threats with new protections, which is particularly dangerous since many States have moved more quickly to protect the public than Congress has.

**HR 6745, “The ACCESS Rural America Act”** would raise the number of non-accredited investors rural telecommunications companies may have before the firm must register equity securities with the SEC from the current 500 to 1,200. This would tend to undermine the public equities markets in favor of private market fundraising with inadequate disclosure requirements and investor protections. To address the lack of public disclosure the bill also requires the SEC to design a new disclosure form for companies that use the exclusion in this bill. However the elements in the new disclosure form are far less comprehensive and informative than current disclosures required upon registration of public securities.

Thank you for your attention to this matter. For more information please contact AFR’s Policy Director, Marcus Stanley, at [marcus@ourfinancialsecurity.org](mailto:marcus@ourfinancialsecurity.org) or 202-466-3672.

Sincerely,  
Americans for Financial Reform

# APPENDIX E

Letter dated June 21, 2018 from Americans for Financial Reform to the House Financial Services Committee regarding two bills under consideration at a Committee markup. This letter discusses:

- S. 3575, the “Modernizing Disclosures for Investors Act” (see discussion of H.R. 5970)



June 21, 2018

Dear Representative,

On behalf of Americans for Financial Reform (AFR), we are writing to urge you to vote against H.R. 5970 and H.R. 6130, two of the bills under consideration in today's Financial Services Committee markup.<sup>1</sup> H.R. 5970 would eliminate the traditional quarterly disclosures of detailed financial information by public companies, information that investors need to evaluate the financial position of companies in which they have invested. H.R. 6130 would grant certain former "emerging growth companies" an additional five years of reduced disclosure and registration requirements.

These two bills should be rejected in order to protect transparency and disclosure that are important to promote robust capital markets and to ensure that timely information is available to investors to make informed decisions.

**H.R. 5970**, the so-called "Simplifying Disclosures for Investors Act," would require the Securities and Exchange Commission (SEC) to amend its quarterly financial disclosure requirements to allow publicly traded companies to elect not to disclose information through Form 10-Q.

Under current rules, public companies are required to file Form 10-Q with the SEC for each of the first three quarters of the firm's fiscal year. Three times a year, the information in Form 10-Q offers investors a snapshot of the company's performance. This information includes detailed financial statements and discussions about market and liquidity risks. These periodic reports provide investors with an ongoing comprehensive view of the firm throughout the year, helping them evaluate firms and better decide in which companies to invest.

Based on the greatly reduced statutory requirements in H.R. 5970, these disclosures could shrink to a press release in which only "a quarterly income statement, a balance sheet as of the last day of the quarter, and a statement of operations" would be required.<sup>2</sup> This would unjustifiably eliminate a broad range of relevant information about a particular firm currently provided in Form 10-Q. It would also make it far more difficult, perhaps impossible, for investors and regulators to make cross-company comparisons. Additionally, H.R. 5970 would allow companies to submit their reports in non-standardized formats that might not be suitable to be automatically uploaded and analyzed by a computer. H.R. 5970 is opposed by CalPERS and the Council of Institutional Investors, and should be rejected.

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<sup>2</sup> H.R. 5970—115<sup>th</sup> Congress: "Simplifying Disclosures for Investors Act," available at: <https://www.congress.gov/bill/115th-congress/house-bill/5970/text>.

We understand it is possible that a substitute amendment to HR 5970 may be advanced which mandates a study on the costs and benefits of 10-Q disclosures. Such an amendment would only be appropriate if it does not direct the SEC to weaken or eliminate quarterly disclosures, and the study instructions clearly direct the SEC to assess the benefits of detailed quarterly financial disclosures to investors and the markets.

**H.R. 6130**, the “Helping Startups Continue to Grow Act,” would extend for an additional five years the exemption from important registration and disclosure requirements for so-called “emerging growth companies” (EGC). Currently, among other disqualifying thresholds concerning revenues and debt issued, public companies can only maintain the EGC status for up to five years after the initial public offering (IPO). H.R. 6130 would grant an additional five year exemption to the subset of companies that ceased to be EGCs within the last five years because they exhausted the current five year limit. The bill would thus create a ten-year registration and disclosure exemption for current, future, and many former EGCs.

There is no evidence supporting the claim that exemptions and reduced compliance for EGCs has or will significantly increase the number of public offerings.<sup>3</sup> Instead, this bill would just give EGCs and recent EGCs ten years of reduced compliance with key provisions in core financial regulations. These include exemptions from Dodd-Frank Act executive compensation disclosure requirements like the pay ratio disclosure rule, which shows the ratio of CEO compensation to the median compensation of the employees, and the pay versus performance disclosure, which allows investors to understand how executive compensation relates to the financial performance of the company. H.R. 6130 would also grant a ten-year exemption from the Sarbanes-Oxley Act requirement that companies include in their annual financial reports a management and auditor certification of internal controls over financial reporting.

In the five years after the enactment of the JOBS Act in 2012, EGCs accounted for 85 percent of all IPOs.<sup>4</sup> In the first quarter of 2018, 87 percent of IPOs registered as EGCs.<sup>5</sup> This means that the exemption in H.R. 6130 would extend to the vast majority of all companies that went public in the last five years.

H.R. 5970 and H.R. 6130 assume that reducing registration and financial disclosure requirements are the only means to revive the public offering market. However, as Tyler Gellasch, Executive Director of the Healthy Markets Association, stated in a Committee hearing, “these proposals also largely ignore the other side of the markets: the investors. Investors are of course an essential party in capital formation ... if a company, its executives, or its early investors want to

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<sup>3</sup> See: Steven Davidoff Solomon, “A Dearth of I.P.O.s, but It’s Not the Fault of Red Tape,” *The New York Times*, March 28, 2017, available at <https://nyti.ms/2nhPeK0>.

<sup>4</sup> Lia Der Marderosian, Brian Johnson, Erika Robinson, and David Westenberg, “2017 IPO Report,” Harvard Law School Forum on Corporate Governance and Financial Regulation, May 25, 2017, available at: <https://bit.ly/2JWtHSn>.

<sup>5</sup> Jessica Hotham, “Q1 2018 IPOs: Auditor Market Share and Stats,” Audit Analytics Blog, April 25, 2018, available at: <https://bit.ly/2yunzeM>.

sell their securities, they need investors who will purchase their securities. Without investors, there is no capital formation.”<sup>6</sup> Instead of promoting healthy capital markets, these two bills would leave Main Street investors in the dark about their investments and potential investments for significant periods of time—until comprehensive reports are published at the end of the year and until the 10-year handout for recent ECG expires. These bills should be rejected.

Thank you for your attention to this matter. For more information please contact AFR’s Policy Director, Marcus Stanley, at [marcus@ourfinancialsecurity.org](mailto:marcus@ourfinancialsecurity.org) or 202-466-3672.

Sincerely,  
Americans for Financial Reform

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<sup>6</sup> Testimony of Tyler Gellasch at the Hearing on Legislative Proposals to Help Fuel Capital and Growth on Main Street Before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment, May 23, 2018, available at: <https://bit.ly/2MIb6e>.

# APPENDIX F

Letter dated July 11, 2018 from the Consumer Federation of America and Americans for Financial Reform to the U.S. House of Representatives regarding four bills under consideration at a Committee markup. This letter discusses:

- S. 3576, the “Developing and Empowering our Aspiring Leaders Act” (see discussion of H.R. 6177)
- The “Expanding Investment in Small Business Act”

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".<sup>1</sup>

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

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<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> 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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<sup>2</sup> 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>.

<sup>3</sup> <https://www.sec.gov/news/speech/jackson-middle-market-ipo-tax>.

Congress.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup>

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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<sup>4</sup> 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),

<sup>5</sup> <https://www.sec.gov/news/speech/speech-jackson-061118>

<sup>6</sup> 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%202018%20Rule%2010b5-1%20\(final\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%202018%20Rule%2010b5-1%20(final).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](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](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](mailto: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