Questions for the Record from Representative Keith Ellison

The Honorable Mary Jo White, Chair, Securities and Exchange Commission

April 29, 2014
Hearing

Question 1: Extensible Business Reporting Language (XBRL)

Is the SEC the only financial regulator that still collects two versions of every financial statement: one in plain text and another in a structured searchable database? If not, which other regulators collect both paper documents and a searchable database.

How long does the SEC intend to keep this duplicative requirement to file the same information twice?

<u>Response:</u> When the Commission proposed in 2008 to require financial statement information in structured data format – specifically XBRL – it also proposed to continue to require that information in traditional format so it could monitor the usefulness of, and cost and ease of providing, structured data before attempting further integration of the structured data format. It noted, however, that after evaluating the use of new structured data technologies, software and lists of electronic tags, it might consider proposing rules to eliminate financial statement reporting in traditional format or require a filing format that integrates the traditional format with the structured data format.

The vast majority of commenters that addressed the dual format issue stated that the Commission should continue to require financial statements in traditional format even if it required structured data format as well. Most of these commenters also stated that the Commission should monitor the development of technology that could enable companies to file information in a manner that provides the processing benefits of structured data and the visual clarity of the traditional format. These commenters reasoned that when such technology is developed, it would be appropriate to require only the single resulting format. In light of these comments, in 2009, the Commission adopted rules that require financial statement information in structured format in addition to the traditional format. In so doing, the Commission stated its belief that investors and analysts may wish to use the traditional format to obtain an electronic or printed copy of the entire registration statement or report either in addition to or instead of disclosure formatted using structured data.

Staff is now considering how the use of an "inline" method for providing structured data might improve the filing of financial information in a structured data format. Such a method of filing would allow companies to integrate structured data into their filings containing financial statements, such as the Form 10-K, rather than present it in an exhibit. Eliminating the requirement to file certain structured data in an exhibit separate from the company's traditional format financial statements may ease filer burden and enhance the quality of the structured data submissions.

Other regulators may collect and store financial information in ways that differ from the Commission's requirements. We are not, however, aware of all the formats they use or their reasons for using them.

In July 2013, the SEC's Investor Advisory Committee asked the SEC to adopt structured data formats, like XML and XBRL, for everything it collects. Today, most of the SEC's 800+ forms are just documents, not structured data. When will the SEC respond to the Investor Advisory Committee's recommendation that the agency adopt structured data formats for its whole reporting regime, to make all of the information fully downloadable and searchable? What will the response be?

Response: The Commission has a longstanding commitment to make information contained in filings more usable and accessible to investors and the Commission. For example, the Commission and its staff have incorporated considerations of structured data into the rulemaking process. The Commission recently adopted rules to require loan-level disclosure for asset-backed securities in XML format so that investors may more easily access and analyze data about the asset pool. In the rule proposal relating to crowdfunding, the Commission proposed rules that would require filing of certain information in a structured format so that the Commission can collect key information about offerings and investors can compare investment opportunities. In addition, consistent with the Advisory Committee's recommendation that the Commission take steps designed to reduce the costs of providing structured data, the staff is considering whether the "inline" method of filing structured data described above might improve the filing of structured data and reduce the costs associated with current filing requirements.

When the Commission is considering new disclosure requirements or updating existing requirements, the Commission also considers what information is most usefully disclosed and then considers whether that information can and should be structured. It is important to keep in mind that not all information may be usefully tagged.

How is the SEC enforcing data quality in XBRL? Has the SEC sent out letters to any firm asking them to fix their data in XBRL? Will the SEC step up efforts to increase compliance?

Response: The staff continues to work on ways to improve the quality of structured data in company filings. When the Commission adopted rules to require companies to submit financial information in a structured format using XBRL in an exhibit to their filings, it provided a phase-in period for companies to adjust to the requirement. Throughout the phase-in period, the staff provided guidance on how to comply with the rules to enhance the quality of the data and updated the taxonomies – the dictionaries of financial terms with associated data tags – to enhance comparability across companies and filings.

That work continues today. For example, the staff recently posted to the SEC's website an assessment of custom tag use. The staff also is examining whether further enhancements to the filing requirements could enhance the quality of the structured data submissions and is considering how the use of the "inline" method described above might improve the quality of structured data.

In addition, as you know, the Division of Corporation Finance staff selectively reviews annual and periodic filings to monitor and enhance compliance with applicable disclosure and accounting requirements, consistent with the review mandate of Section 408(c) of the Sarbanes-Oxley Act of 2002. These reviews involve an evaluation of company disclosure. If the staff becomes aware of an error in the structured data in connection with these reviews, it would treat the error the same as other filing errors. If the error appears to cause the filing to be materially non-compliant or deficient, the staff would request, via letter or telephone, that the company amend the filing to correct the error regardless of the company's size or whether the filing was otherwise subject to staff review. In addition, the Division of Corporation Finance also will address filing errors that it sees broadly across filings to make registrants aware of review findings. For example, in July 2014, the staff posted to the SEC's website a sample letter it sent to companies that failed to include certain required calculation relationships in their filings.

As you know, this Committee considered The Small Company Disclosure Simplification Act (H.R. 4164) which would exempt many firms from compliance. Do you have any concerns about that bill?

Response: The Commission is committed to using developments in technology and electronic data communications to facilitate greater transparency in the form of easier access to, and analysis of, information. I believe that requiring financial statement information in structured data format enables investors and others to search and analyze the financial information dynamically and facilitates comparison of financial and business performance across companies, reporting periods and industries. To the extent companies would be exempt from this requirement, the structured financial data available to the SEC and public would be less complete and, as a result, the exemption could reduce the extent to which these benefits are realized.

Access to significant amounts and types of data, both structured and unstructured, also is vital to the Commission's work of regulating the U.S. capital markets. Using structured data, the staff can systematically and efficiently analyze, and draw conclusions from, large quantities of information. Nearly all of the data analyses the staff performs in support of rulemaking and risk assessment activities depend on structured data, as these activities require the staff to scrutinize and compare large amounts of information. A less complete set of structured financial data could reduce the staff's ability to conduct its work.

Question 2: Mandatory Arbitration

Last week, FINRA stopped Charles Schwab from requiring its investors sign contracts that took away their rights to join a class action lawsuit. This is a positive step for

investor protection. However, the mandatory arbitration provisions in agreements between investors and their investment advisors and broker-dealers remain. When will the Commission exercise its authority under Section 921 of the Wall Street Reform Act to ban or limit the use of these clauses?

> **Response:** The use of pre-dispute mandatory arbitration agreements by broker-dealers and investment advisers is a very important issue and has long been the subject of vigorous debate. Through various past requests for comment, the Commission has received a number of comment letters reflecting disparate views with respect to the mandatory arbitration of securities disputes. While the Commission has not yet determined whether to exercise its Section 921 authority, the Commission staff continues to explore issues related to pre-dispute mandatory arbitration agreements, including the costs to investors and other market participants, as well as fairness in arbitration forums.

Question 3: CEO Pay Ratio

This month, Demos published the report "Fast Food Failure." This report found that the CEO to average worker pay ratios in the fast food industry routinely are greater than 1,000 to one.

Furthermore the report finds that companies that fail to pay their employees a living wage are often less efficient than firms that pay their workers more fairly. Other studies have found that firms with high CEO: median employee pay ratios are led in a more risky manner. CEO pay ratios are relevant to investment decisions.

When will the SEC move to finalize its rule under Dodd-Frank 953(b), which provides for disclosure of the CEOs pay as a multiple of the median-paid employee?

> **Response:** The Commission has proposed rules to implement Section 953(b), and completing this rulemaking, as with all of our congressionally mandated rulemakings, is a priority for me. As evidenced by the voluminous public comment file on the Commission's website, this rulemaking requires careful consideration of a number of significant issues. We have received more than 128,000 comment letters, including over 950 unique letters from a variety of stakeholders. These letters reflect a wide range of views concerning the proposed rules and the potential costs and benefits associated with their requirements. The staff is carefully reviewing and analyzing all comments as it develops final rule recommendations for the Commission's consideration.

Question 4: Funding for the SEC

I remain concerned that the Securities Exchange Commission lacks adequate funding. I have read a number of books and articles about SEC enforcement actions. Many of these report SEC enforcement staff tediously picking through phone logs or emails. Yet, Wall Street has access to software that makes this work more efficient.

What are recent technological purchases made by the SEC that have made enforcement actions more effective and efficient? If the SEC received a 20% funding increase, can you give me two examples of technology that the SEC would like to acquire to make investigations more efficient and accurate?

Response: It is a high priority for me to continue the agency's investments in the technologies needed to keep pace with today's high-tech, high-speed markets.

The Commission's information technology (IT) investments are designed to provide staff with the tools necessary to efficiently and effectively protect investors. Our IT investments represent a broad effort that ranges from the basic, such as periodic software and hardware upgrades, to the complex, such as developing and purchasing advanced analytical tools designed to prospectively detect fraud. By improving the entire spectrum of tools, our IT investments amplify the staff's ability to spot individual instances of misconduct and identify macro-level, systemic concerns.

For example, the Division of Enforcement has made large investments in upgrading its IT Forensics Lab capabilities as well as moving its investigations to a modern, comprehensive e-Discovery platform. The Forensics Lab routinely assists the investigative staff in retrieving digital evidence and can help establish links between wrongdoers engaged in insider trading and other misconduct. Additionally, the e-Discovery platform provides staff with more comprehensive search capabilities and a quicker, more robust method to review documents and conduct investigations.

In addition, the Office of Compliance Inspections and Examinations (OCIE) recently introduced the National Exam Analytics Tool, which empowers examiners across the National Exam Program to access and systematically analyze large volumes of trading data through a series of standard reports and analytics. The ability to flag certain transactions and anomalies in trading data helps identify potential misconduct and trends in the market. OCIE's Risk Analysis Examination team – which leverages technology to conduct cross-firm review involving large quantities of data from clearing firms – also collected and analyzed hundreds of millions of trading records, identifying a wide range of problematic behavior.

The Commission also has initiated the implementation of a centralized data analysis platform to receive, house, transmit, and analyze the huge quantities of data we receive. The data analysis platform is a basic, but crucial, element of the IT improvements at the Commission. It provides a state-of-the-art foundation for the new tools we have implemented to detect potential misconduct. The platform gives staff the ability to make connections that are not otherwise apparent in the data and more easily identify market trends and aberrant behavior, which is often indicative of potential misconduct.

The Commission recently invested in innovative systemic risk detection technologies. These tools harness the breadth of data that the Commission receives and helps synthesize that data into actionable information. They also automate tasks that otherwise would be completed manually using slower methods and tools, thereby making our limited staff more effective and efficient.

In terms of how we might enhance our technological capabilities with respect to investigations if we received a funding increase, the Division of Enforcement is evaluating new technologies that would make it more efficient to assess large volumes of information, including early case assessment, financial statement processing and other analytical tools, as well as text and audio search capabilities. By way of example, the Division has been assessing an analytical platform that provides advanced search and discovery capabilities, integrates structured and unstructured data, provides for quantitative analytics and helps to visualize connections within large data sets to enable investigative attorneys and staff to quickly and efficiently identify securities frauds. Additionally, the Division is preparing to modernize its "bluesheet" technology system, which collects and analyzes stock trading data from market participants. The current system was designed more than a decade ago, and is inefficient and slow to process the larger data sets now commonly seen in high-frequency trading. Additional funding could better ensure that these and other important technology projects are fully implemented.

More broadly, our ability to continue using the Reserve Fund established under the Dodd-Frank Act is important to the SEC's future IT investments. The SEC has dedicated the Reserve Fund to critical IT upgrades, and, if funding permits, plans to continue investing in areas such as data analysis, EDGAR and sec.gov modernization, enforcement and examinations technologies, and business process improvements.

If the SEC does not receive sufficient additional resources, the agency will be unable to build out its technology and hire the industry experts and other staff needed to oversee and police our areas of responsibility, especially in light of the expanding size and complexity of our overall regulatory space.

Question 5: Response to public statements

There remain strongly held views in some quarters that the SEC is not willing to take on the most powerful titans on Wall Street when it matters. I entered a recent speech of former SEC attorney employee James Kidney who said:

The SEC has become "an agency that polices the broken windows on the street level and rarely goes to the penthouse floors…On the rare occasions when enforcement does go to the penthouse, good manners are paramount. Tough enforcement, risky enforcement, is subject to extensive negotiation and weakening… superiors were more focused on getting high-paying jobs after their government service than on bringing difficult cases."

This accusation that *Rolling Stone* reporter, Matt Taibbi continues to make about SEC being afraid of punishing Wall Street.

What is your response to these concerns that the SEC does not hold bad actors on Wall Street accountable? Are some executives and firms "too big to bar?

> **<u>Response:</u>** I agree that it is critical for the SEC to pursue wrongdoers at every level, including Wall Street senior executives and officers. No executives or officers are "too big to bar." The SEC has a proud history of holding bad actors accountable, including those of every seniority on Wall Street. Our success pursuing misconduct related to the financial crisis is a case in point. To date, we have charged 169 individuals and entities with wrongdoing stemming from the financial crisis, including prominent Wall Street firms such as Goldman Sachs, JPMorgan, and Bank of America. That tally includes bars or suspensions against 40 individuals from working in the securities industry, serving as officers or directors of public companies, or practicing before the Commission, as well as over $3 billion in disgorgement, penalties, and other monetary relief ordered.
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> The SEC also has amassed a strong record pursuing top officials as we have brought actions against 70 CEOs, CFOs, and other senior executives for wrongdoing related to the financial crisis. Where we have had evidence to charge bad actors who occupied significant positions of authority at prominent financial institutions, we have done so, including, for example, the two top executives at Countrywide Financial for deliberately misleading investors about its credit risks and the CFO of Citigroup for causing the bank to make misleading statements about its subprime exposure.
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> As these actions make clear, the Commission seeks to hold all wrongdoers accountable for their misconduct, regardless of size or status, and is willing to employ powerful remedies to protect the public from future harm, including significant monetary penalties and barring wrongdoers from the industry or appearing before the Commission.

Question 6: Waiver for Royal Bank of Scotland Group Plc

Under federal securities laws and regulations, criminal convictions automatically preclude financial institutions from eligibility as a Well-Known Seasoned Issuer ("WKSI"). WKSI confers numerous benefits to filers. Considering this requirement, why did you vote to approve a waiver to let Royal Bank of Scotland Group Plc continue doing business as usual despite the recent criminal conviction of the bank's Japanese subsidiary for manipulating the London interbank offered rate? The Royal Bank paid a $100 million fine and agreed to a deferred-prosecution agreement for the parent company. The SEC vote to approve the waiver was 3-2, with dissenting votes by Stein and Commissioner Luis Aguilar.

Should a fraud violation, whether criminal or civil, result in the disqualification of a company from receiving the designation of a "Well-Known Seasoned Issuer"?

> **<u>Response:</u>** While it would not be appropriate to discuss the Commission's internal decision making in a particular matter, I can assure you that the staff and each Commissioner in every case presented carefully considers the applicable standards and

policies in the context of all the relevant facts and circumstances presented before arriving at a recommendation or decision to grant or deny a waiver.

Under the Commission's rules, a well-known seasoned issuer (WKSI) is an issuer that is current and timely in its reports filed pursuant to the Securities Exchange Act of 1934 for at least one year and has either $700 million of publicly-held shares or has issued $1 billion of non-convertible securities, other than common equity, in registered offerings for cash in the preceding three years. The WKSI regime is intended to facilitate access to the capital markets by eligible issuers who are comparatively well-known to the marketplace. An issuer can lose its WKSI status by becoming an "ineligible issuer" if the issuer (or its subsidiary) is convicted of certain felonies or misdemeanors specified in Section 15(b) under the Exchange Act; violates the anti-fraud provisions of the federal securities laws; or is the subject of a judicial or administrative decree or order (including a settled claim or order) prohibiting certain conduct or activities regarding the anti-fraud provisions of the federal securities laws. Rule 405 of the Securities Act of 1933 allows the Commission to grant a waiver from ineligible issuer status (WKSI waiver) upon a showing of "good cause" and a determination by the Commission that the disqualification "is not necessary under the circumstances."

In my view, waivers of WKSI disqualifications should be granted only after a thorough analysis of the specific conduct triggering the disqualification, an analysis of other relevant facts and circumstances, and a rigorous application of the applicable standards. Waivers should not be granted to either "soften" the impact of an enforcement action nor should they be used to add additional penalties if disqualification is not warranted or necessary under the applicable standards and the facts and circumstances at issue. The burden to demonstrate that the standards are met is the responsibility of the applicant seeking a waiver.

The Division of Corporation Finance recently revised its written policy statement about WKSI waivers, which was first posted on the Commission's website in 2011 ("Revised Statement"). The Revised Statement provides clarity, consistency, and greater certainty as to the factors that are considered by the Division in determining whether or not to grant a WKSI waiver to an issuer that has become an ineligible issuer and would lose its WKSI status absent a waiver.

Why should companies with clearly fraudulent activity be allowed to speed up the process for registering their securities offerings?

Response: In adopting the rules that created WKSI status, the Commission broadly drafted the disqualification provisions and then provided a process by which it could evaluate, based on the specific facts and circumstances, whether the disqualification was necessary in a particular case. The standard that is applied in connection with a review of an application for a WKSI waiver is whether the nature of the violation or conviction involved disclosure for which the issuer or any of its subsidiaries was responsible or calls into question the ability of the issuer to produce reliable disclosure currently and in the future. As stated in the Revised Statement, "Where there is a criminal conviction or a scienter based violation involving disclosure for which the issuer or any of its subsidiaries was responsible, the issuer's burden to show "good cause" that a waiver is justified would be significantly greater." Each of the factors noted in the Revised Statement is analyzed with the facts and circumstances surrounding the WKSI waiver prior to making a final determination.

Are you concerned that such actions create a culture of impunity where wrong doing is only lightly punished?

Response: The level of punishment assessed for the underlying violation is a separate matter that is determined either by prosecution or settlement of the relevant enforcement action. In the case of an SEC enforcement action, the Commission has a wide range of sanctions available to provide for an appropriate level of deterrence. In the case of a criminal action brought by the Department of Justice for which there is no parallel Commission civil action, the level of punishment imposed in the criminal action is not something that the Commission controls.

How many WKSI waivers has the SEC granted to institutions that were convicted of improprieties but allowed to continue as seasoned issuers in 2011, 2012 and 2013? Has the SEC granted waivers to any large financial firm after repeated violations? If so, which ones and how many waivers?

Response: In 2011 and 2012, no WKSI waivers were granted for criminal convictions. In 2013, one WKSI waiver was granted for a criminal conviction. All WKSI waivers that have been granted are posted on the Commission's website at: http://www.sec.gov/divisions/corpfin/cf-noaction.shtml#405.

In the past five years, how many institutions and broker dealers lost their WKSI status? Which ones?

Response: The staff does not track when issuers, including financial institutions and brokers dealers, lose WKSI status. There are a number of ways that an issuer can lose WKSI status, including by becoming an "ineligible issuer" resulting from a conviction for certain felonies or misdemeanors specified in Section 15(b) under the Exchange Act; violating the anti-fraud provisions of the federal securities laws; or becoming the subject of a judicial or administrative decree or order prohibiting certain conduct or activities regarding the anti-fraud provisions of the federal securities laws. In addition, an issuer can lose WKSI status in other circumstances. For example, any issuer can lose WKSI status for failure to file reports pursuant to section 13 or 15(d) of the Exchange Act during the preceding 12 months or failing to have a market value of its outstanding equity securities of $700 million or more. As the triggers for a loss of WKSI status are not solely limited to enforcement actions brought by the Commission, the staff does not and is not able to track the issuers that lose WKSI status. The staff is notified of a loss or a potential loss of WKSI status when an issuer inquires about a waiver, which is usually in connection with a conviction, violation, decree or order noted above. These inquiries, however, may be on a no-names or hypothetical basis, so the staff may not know the name of the issuer that is making the inquiry. Further, after a review of the staff policy statement outlining the factors that the staff would assess in connection with a consideration of a waiver request, some issuers may determine that a waiver would not be forthcoming and not make a request. As a result, the staff is not able to track in any systematic or complete manner the companies, including financial institutions and broker dealers, that lose WKSI status.

Questions for Record (QFRs) for "Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request"
April 29, 2014

Rep. Michael Fitzpatrick

Chairman White, four years ago, the SEC was given authority in the Dodd Frank Act to adopt rules imposing a mandatory fiduciary duty for broker-dealers and investment advisers. The SEC asked for comments on the issue, then wrote a report, and then asked for more comments and data. And, based on what I have heard, you are having a tough time coming up with a formula that works for both investment advisers and broker-dealers.

I would like to suggest to you that, perhaps the reason it is so hard to write a rule that works for everyone is that there really are a lot of different business models, and *"one* size fits all" just may not work for everyone. And, just to take that a step further, why not just make sure all securities professionals 'disclose conflicts of interest and disclose what their obligations are, and then let investors make a choice as to who they want to deal with? I would ask you to consider that approach."

Response: I appreciate your suggestion. The question of whether and, if so, how to use its authority under Section 913 of the Dodd-Frank Act is very important to the Commission and to investors. As you know, last year the Commission issued a public Request for Data and Other Information (Request) relating to the provision of retail investment advice and regulatory alternatives. As the Commission said at the time, it sought data "to assist us in determining whether to engage in rulemaking, and if so, what the nature of that rulemaking ought to be." The Request sought comment on several alternative approaches to a uniform fiduciary standard, including expressly imposing certain uniform disclosure requirements with respect to a broker-dealer's and investment adviser's material conflicts of interest with its retail customers. Feedback on that approach and other approaches is an important consideration in determining whether and, if so, how to use the Commission's authority under Section 913.

Questions for Record (QFRs) for "Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request"
April 29, 2014

Rep. Scott Garrett

Asset Management SIFI Designation

On July 18, 2013, the Financial Stability Board issued a release designating 9 insurance companies including U.S. based insurer, MetLife, as a Global Systemically Important Insurer. The release states:

> **[T]he FSB, in consultation with the International Association of Insurance Supervisors and *national authorities*, have identified an initial list of nine G-SIIs**

As you are aware, the FSB is also currently examining the asset management industry for potential global designations. As they move forward with their process, it is important to identify precisely who the National Authority in the U.S. is as it relates to the asset management industry.

1. Who is the National Authority of the asset management industry in the U.S.?

Response: In January 2014 the FSB and IOSCO published a Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions. That document proposes that the "national authority" for purposes of identifying any non-bank, non-insurer financial entities would be "a regulator or other appropriate government agency with the authority to engage in the assessment process." The Consultative Document provides flexibility with regard to the determination of the "national authority" to take into account different regulatory structures in different jurisdictions (*i.e.*, some jurisdictions have one prudential regulator with authority over the banking, insurance, and securities sectors while others have multiple regulatory authorities). As this process is still in the consultative phase, national authorities have not been identified.

2. Will this National Authority be consulted by the FSB prior to the FSB making any determinations to designate asset managers?

Response: Under the proposed methodology of the Consultative Document, the "national authority" would have a great deal of involvement in any determination to identify a non-bank, non-insurer financial entity as a SIFI. In particular, the Consultative Document proposes that the FSB and IOSCO would first need to finalize applicable sectoral methodologies for market intermediaries, finance companies, and asset management entities as well as a "guiding methodology" for all other non-bank, non-insurer financial entities. The FSB and IOSCO would then form an international oversight group (the "IOG"), consisting of representatives from FSB and IOSCO member jurisdictions and other relevant standard-setting bodies, as well as the FSB and IOSCO Secretariat. The IOG would compile a confidential "reference" list of entities that equal or exceed the materiality threshold(s) set by the finalized sectoral methodologies. The IOG would assign any entities to the "national authority or authorities" to conduct an assessment using the methodology as a guide.

The Consultative Document recognizes that, with regard to non-bank, non-insurer financial entities, "authorities will need to rely more on supervisory judgment in assessing the global systemic importance" of any identified entities. The "national authority or authorities" will conduct such as assessment and provide to the IOG a confidential "narrative assessment" and recommendation as to whether any entity identified should be designated. The IOG may follow up with the "national authority or authorities" with questions or comments. The "national authority or authorities" will consider the feedback from the IOG and communicate a preliminary determination to the IOG (including the reasons for non-designation should that be the case). Under the framework adopted by the FSB and endorsed by the G-20 leaders in November 2010, the FSB and the national authorities together will determine the final list of designated non-bank, non-insurer financial entities.

3. What will be the formal way for the National Authority to agree to any determinations by the FSB to designate any asset managers?

Response: Under the framework adopted by the FSB and endorsed by the G-20 leaders in November 2010, the "national authority or authorities" together with the FSB will determine the final list of designated entities.

Examination of Advisers to Private Funds

It was recently reported that the SEC Office of Compliance, Inspections, and Examinations (OCIE) has determined that private equity funds are charging inappropriate fees and expenses to their clients. While I do not condone the any inappropriate charging of fees, I question whether using valuable and limited SEC staff resources to examine private equity funds that cater to more sophisticated and wealthier investors instead of examining additional uninspected investors advisers with a largely retail investor client base is appropriate.

1. Can you please provide me the hours and money spent on the investigations and examinations that uncovered the concerns surrounding fees and expenses being charge by private equity funds?

Response: While the SEC staff does not track examination information in the format that you have requested, it does compile the number of "presence exams" of private equity advisers. Since October 2012, OCIE has completed approximately 150 "presence exams" of private equity advisers, representing approximately 10% of the 1,500 examinations of all advisers conducted over that period. The presence exams of private equity advisers generally have been more narrowly focused and used fewer resources than other adviser exams.

OCIE has also observed that private equity advisers provide advice to a wide spectrum of investors. The Private Equity Growth Capital Council, an industry organization, has stated, "Private equity investment provides financial security for millions of Americans from all walks of life. The biggest investors in private equity include public and private pension funds, endowments and foundations, which account for 64% of all investment in private equity in 2012." Thus, to the extent private equity advisers are engaged in improper conduct, it could potentially adversely affect the retirement savings of many Americans beyond the wealthy individuals who are generally viewed as making private equity investments.

2. Using that information, can you please share with me how many additional investor advisers your examination staff would have been able to examine and investigate had those resources been used on that instead?

<u>Response:</u> Due to the many variables that impact the time and length of examinations, the staff cannot determine the number of additional advisers OCIE would have been able to examine if it did not examine advisers to private equity funds. Among the many items that impact the length of a particular examination are the type and scope of the examination, the size and complexity of the firm being examined, and the risk factors present at each particular firm. While examinations conducted are risk-based, some are very focused on just one or two high-risk areas (*e.g.*, presence exams) and others may focus on a host of higher risk areas (*e.g.*, risk priority exams). This scoping has a significant impact on the time needed to conduct an examination.

As noted above, many of the examinations of advisers to private equity funds were conducted as presence exams, which are designed to be more targeted than typical risk priority examinations. Presence exams generally take less time than standard risk-based exams. If the examination resources used to examine the advisers to private equity funds were redirected elsewhere, that staff likely would have conducted examinations of advisers with similar risk profiles. The scope of such exams and time needed to conduct these reviews would be entirely dependent on the specific facts and circumstances of each exam.

Derivatives

In the SEC's 2012 guidance memorandum outlining a new approach to cost-benefit analysis, the SEC affirmed that "high-quality economic analysis is an essential part of SEC rulemaking" and that the SEC "has long recognized that a rule's potential benefits and costs should be considered."

I would like a better understanding on the way in which the SEC may be applying the cost-benefit analysis to the SEC's proposal of rules governing cross-border security-based swap activities. I understand that these rules, in their proposed form, would apply to security-based swap activities transacted between two non-U.S. entities if such activities are conducted within the United States.

1. Would you be able to advise the Committee about the benefits of applying the SEC's security-based swap regulatory regime in this context?

Response: As part of the SEC's cross-border proposing release in May 2013, the SEC proposed to apply certain Title VII requirements to transactions between two non-U.S. persons that involve conduct within the United States by one or both counterparties to the transaction. The SEC proposed this requirement in order to address a number of economic and regulatory concerns.

First, consistent with our statutory obligations to consider the effects of our rules on competition, efficiency, and capital formation, the SEC considered the potential impact of disparate regulatory treatment where the scope of regulation depends on whether a non-U.S. person counterparty is dealing with a non-U.S. person or U.S. person, both of whose operations are located in the United States. For example, the SEC's proposing release suggests that this disparity could result in fragmented markets by potentially making it more difficult for U.S. firms to access liquidity from non-U.S. counterparties.

Second, the proposed approach was designed to ensure that market participants engaging in security-based swap activity through operations in the United States would be subject to appropriate regulatory requirements. For example, our experience with our anti-fraud and anti-manipulation authority before the Dodd-Frank Act underscored the importance of, among other things, having prompt access to books and records in order to maintain fair, orderly, and efficient markets. The proposed conduct approach sought to ensure that access, thereby facilitating our ability to police U.S. markets for fraudulent and manipulative behavior.

Although the SEC adopted rules governing the application of the security-based swap dealer and major security-based swap participant definitions in the cross-border context in June 2014, the SEC did not adopt the element of the proposal that would have required dealing transactions between two non-U.S. persons to be counted for purposes of the dealer *de minimis* thresholds if the security-based swap transaction is a "transaction conducted within the United States." Instead, in light of the complex and important issues raised by the proposed requirement, including those you raise, the SEC anticipates soliciting additional comment regarding when a transaction between two non-U.S. persons should be included in the relevant *de minimis* thresholds when one or both counterparties are engaged in security-based swap activity within the United States.

2. Is the Commission actively considering the possibility that one potential outcome is that

non-U.S. institutions would move high-paying US jobs abroad to stay outside of the SEC's conduct based security-based swap rules and that is potentially already happening?"

Response: In our cross-border proposal and in subsequent evaluation of comments and interactions with market participants, the SEC carefully considered the potential impact of our proposed regime, including the possibility that certain market participants may restructure their business operations, including by moving some or all of their operations (or agents that transact on their behalf) outside the United States. In our cross-border proposal, we sought comment on a wide range of issues related specifically to the proposed conduct-based application of Title VII.

The SEC received several comments in response, including comments relating to the possibility that firms would restructure their business or move personnel overseas in response to the proposal. As noted above, the cross-border rules recently adopted by the Commission did not include this aspect of the cross-border proposal but rather indicated that the Commission's intent is to seek further comment on this issue.

3. You have mentioned in previous statements that the SEC will focus this year on finalizing the rules for securities-based swaps under Title VII of the Dodd-Frank Act. What is the SEC's timeline for finalizing these rules?

Response: I expect the next steps to be the adoption of regulatory reporting and post-trade public transparency for security-based swaps. The SEC will also consider the application of mandatory clearing requirements to single-name credit default swaps, starting with those that were first cleared prior to the enactment of the Dodd-Frank Act. Our overall goal at this point is to move as quickly as possible to get the substantive rules, along with relevant cross-border guidance relating to those rules, in place.

To date, the Commission has proposed all of the rules required to implement the new regulatory regime for derivatives under Title VII and has begun the process of adopting these rules. Most recently, with the cross-border rules adopted in June 2014, the SEC completed regulations regarding application of the security-based swap dealer and major security-based swap participant definitions in the cross-border context. These final rules include definitions of several key terms are necessary to the application of Title VII in the cross-border context, including the definition of "U.S. person."

Given the global nature of the market for OTC derivatives, these final rules were a necessary foundational step in the SEC's implementation of Title VII. Because of the importance and complexity of the overall framework of Title VII, the SEC took the time to adopt rules via the full notice and comment process, and engaged in time-intensive and critical economic analysis. Having adopted these initial cross-border rules, the SEC has now turned to consideration of the cross-border application of the substantive requirements imposed by Title VII in conjunction with the final rules that will implement those requirements.

4. The SEC has also committed to thoughtful implementation sequencing and phasing in of the new requirements. Would you please share your current thoughts on this important element of minimizing market disruption?

Response: The Dodd-Frank Act directs the Commission to create and implement a new regime for the vast, global market for security-based swaps that developed over many years. Earlier in the process, the Commission released a Title VII implementation policy statement setting out the Commission's views on how it would sequence the rules required by Title VII and requesting comment. The aim of this sequencing release was to prevent the disruption and cost that could result if the rules adopted under Title VII were to go into effect simultaneously or in a haphazard fashion and to give security-based swap market participants clarity as to how the Commission, in general, is seeking to order the compliance dates of these rules.

The SEC remains committed to implementing these important reforms while avoiding unnecessary implementation costs to the security-based swap markets. This commitment informed the SEC's decision to adopt an initial set of cross-border rules addressing the application of the security-based swap dealer and major security-based swap participant definitions rather than a comprehensive set of cross-border rules addressing the full range of issues that were addressed in our proposal. This approach allows the SEC to consider the cross-border aspects of each rule in the context of the related substantive rule, and to provide market participants with a comprehensive guide to "domestic" and cross-border requirements in a particular area before requiring compliance, which should help reduce implementation costs versus a piecemeal approach to implementation.

A key principle articulated in the implementation policy statement was that persons and entities regulated pursuant to Title VII must be given adequate time to come into full compliance with the final rules applicable to them, which includes having an appropriate amount of time to properly understand the rules and prepare themselves to comply with the new requirements arising from those rules. Therefore, those subject to the new regulatory requirements must be given a reasonable, but not excessive, amount of time to come into compliance with the new rules applicable to security-based swaps. This view continues to inform our process.

The implementation policy statement proposed that, following the adoption of definitional rules (*i.e.*, rules further defining the terms "security-based swap," "security-based swap agreement," and "mixed swap" and the rules further defining "security-based swap dealer," and "major security-based swap participant") and the proposal of cross-border rules, the registration of swap data repositories and the reporting of security-based swap data should be the next step in implementation. I continue to believe that those rules are the next logical step, and we are working diligently towards adopting those rules.

5. As you are aware, the CFTC has mostly completed their rulemakings which are currently being implemented across the industry, and rulemaking in major foreign jurisdictions is also well underway. For market participants, including end users who use OTC derivatives for

crucial risk management purposes, it will be important that the SEC and CFTC's rules are coordinated and will not be in conflict with each other. Is the SEC prioritizing the workability of its regime with that of the CFTC?

> **<u>Response:</u>** Since the Dodd-Frank Act was passed in July 2010, the staffs of the SEC and the CFTC have consulted and coordinated with each other regularly in the development and implementation of our respective rules. The objective has been to establish consistent and comparable requirements. However, there are differences in some of the agencies' proposed rules, and in the agencies' recently adopted cross-border rules. In certain areas, it may be appropriate for the Dodd-Frank Act's application to security-based swaps to be different from its application to the swaps that will be regulated by the CFTC, as the relevant products, entities, and markets themselves are different, or because the relevant statutory provisions are different. Given this, differing approaches to the regulation of swaps and security-based swaps may be warranted in some instances.
>
> Nevertheless, the Commission is mindful of the costs associated with having different sets of rules, and will be sensitive to those burdens as we move to adoption in various areas. For example, since 2010 we and the CFTC have discussed and compared our respective approaches to the registration and regulation of foreign entities engaged in cross-border swap and security-based swap transactions involving U.S. persons to determine where those approaches converge and diverge. The results are reflected in the final cross-border rules and interpretive guidance we adopted in June, which brought the Commission's cross-border framework to the same place as the CFTC in key respects. I believe the Commission's approach represents a careful balancing of the regulatory goals of Title VII, the practical needs of market participants, and workability with the existing CFTC regime.

Credit Rating Agencies

Chair White, in 2011, pursuant to Dodd-Frank, the SEC proposed an extensive and demanding set of new regulatory requirements for the credit rating industry. The proposed rules, when adopted, will supplement the robust regulatory regime that the SEC has implemented under the Credit Rating Agency Reform Act of 2006.

The SEC should be commended for having taken a very deliberate approach to regulating the credit rating industry. I commend the Commission for moving forward on proposals to remove the references to NRSRO's from its regulation. This was an important bipartisan reform contained in Dodd-Frank that seeks to address core issue surrounding the role that ratings played in the financial crisis, namely the overreliance by investors on a rating because of the requirement in federal regulation and statute.

Notwithstanding this important progress, I think it is time for the SEC to finalize, in a sensible way supported by rigorous cost-benefit analysis, the Dodd-Frank rulemaking that it initiated in 2011. However, I would like to reiterate my concerns about moving forward on the government assignment system for ratings under Section 939F of Dodd-Frank. In my view, such an assignment system would be contradictory to detangling the government

from the ratings process and reducing investor overreliance on ratings.

1. Can you describe the steps that the SEC has taken since 2009 to further regulate and oversee the credit rating industry?

Response: The Credit Rating Agency Reform Act of 2006 (the "CRA Reform Act") provided the Commission with explicit oversight authority over credit rating agencies registered as nationally recognized statistical rating organizations, or NRSROs. Thereafter, in 2007 and 2009, the Commission adopted rules that require NRSROs to, among other things, publish information about their activities, make and maintain certain records, file annual reports with the Commission, and establish and enforce procedures to manage conflicts of interest. The rules also prohibit NRSROs from having certain conflicts of interest and from engaging in unfair, coercive, and abusive practices.

Pursuant to the CRA Reform Act, the Commission publishes an Annual Report to Congress on NRSROs that identifies applicants for registration as NRSROs, specifies the actions taken on such applications, and specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs. The fifth annual report was published in December 2013.

The Dodd-Frank Act expanded the Commission's NRSRO oversight authority and required the Commission to establish an Office of Credit Ratings, with the Director of the office reporting to the Chair of the SEC. The Office of Credit Ratings was established in June 2012 with the hiring of its Director. The office monitors the activities and conducts examinations of NRSROs to assess and promote compliance with statutory and Commission requirements. The office is staffed with examiners, attorneys, and accountants with expertise in structured finance, corporate finance, municipal finance, financial institutions, insurance companies, and credit rating agencies.

The Dodd-Frank Act mandated annual examinations of each NRSRO, covering eight specified review areas. The results of these examinations are made available to the public in an annual report that summarizes the essential findings and indicates whether the NRSROs have appropriately addressed the recommendations contained in prior reports. Commission staff completed the third cycle of the examinations and in December 2013 issued the third annual report. The fourth cycle of the examinations currently is underway.

The Dodd-Frank Act also required that the SEC undertake several studies related to the credit rating industry. All of the studies are completed and the related reports have been published as follows:

- Report to Congress on Review of Reliance on Credit Ratings, as required by section 939A(c) of the Dodd-Frank Act, July 2011;

- Report to Congress on Credit Ratings Standardization Study, as required by section 939(h) of the Dodd-Frank Act, September 2012;

- Report to Congress on Assigned Credit Ratings, as required by section 939F of the Dodd-Frank Act, December 2012; and

- Report to Congress on Credit Rating Agency Independence Study, as required by section 939C of the Dodd-Frank Act, November 2013.

In addition, The Dodd-Frank Act mandated a number of rulemakings to enhance the regulation, accountability and transparency of NRSROs. The Commission began the process of implementing these mandates with the adoption of Exchange Act Rule 17g-7 in January 2011, requiring NRSROs to provide a description of the representations, warranties and enforcement mechanisms available to investors in an offering of asset-backed securities as well as how those representations, warranties and enforcement mechanisms differ from those of similar offerings.

Most recently, on August 27, 2014, the Commission completed its required rulemakings for NRSROs by adopting rules requiring NRSROs to, among other things: (1) report on internal controls; (2) protect against potential conflicts of interest; (3) establish professional standards for credit analysts; (4) publicly provide – along with the publication of a credit rating – disclosure about the credit rating and the methodology used to determine it; and (5) enhance their public disclosures about the performance of their credit ratings. These rules create an extensive framework of robust reforms and will significantly strengthen the governance of NRSROs. The reforms will also significantly enhance the transparency of NRSRO activities and thereby promote greater scrutiny and accountability of NRSROs. Together, this package of reforms should improve the overall quality of NRSRO credit ratings and protect against the re-emergence of practices that contributed to the recent financial crisis.

The Dodd-Frank Act also required the SEC, to the extent applicable, to review its regulations that require use of credit ratings as an assessment of the credit-worthiness of a security, remove these references, and replace them with appropriate standards of credit-worthiness. The Commission has adopted final amendments that remove references to credit ratings from most of its rules and forms that contained such references, including rules adopted in December 2013 removing references to credit ratings in certain provisions applicable to investment companies and broker-dealers, and in August 2014 new requirements to replace the credit rating references in shelf eligibility criteria for asset-backed security offerings with new shelf eligibility criteria. In addition, in July 2014, the Commission re-proposed to remove credit rating references from rule 2a-7, the rule that governs money market funds, and the comment period on that re-proposal ended October 14, 2014. I expect that the Commission will consider final amendments removing credit rating references from rule 2a-7 in the near future.

2. Can you describe the additional regulation and SEC oversight that the 2011 proposal would, if adopted, bring to the credit rating industry?

<u>Response:</u> As discussed above, the rules adopted in August 2014 aim to improve the governance and management of NRSROs by requiring them to, among other things, (1) report on internal controls; (2) protect against potential conflicts of interest; (3) establish professional standards for credit analysts; (4) publicly provide – along with the publication of a credit rating – disclosure about the credit rating and the methodology used to determine it; and (5) enhance their public disclosures about the performance of their credit ratings.

3. You have mentioned previously that finalizing the rulemaking that the SEC proposed in 2011 is one of your priorities. Will you reaffirm that finalizing this particular rulemaking remains a priority? Can you give us an estimated time by which this rulemaking will be finalized?

<u>Response:</u> Finalizing these rules was an important priority, and the Commission finalized these rules on August 27, 2014.

Enforcement

On July 13, 2008, the Securities and Exchange Commission (SEC) announced that the SEC and other securities regulators will immediately conduct examinations aimed at the prevention of the intentional spread of false information intended to manipulate securities prices. The SEC's announcement stated the examinations were to be conducted by the SEC's Office of Compliance Inspections and Examinations, as well as the Financial Industry Regulatory Authority (FINRA) and New York Stock Exchange Regulation. Understanding that these examinations would be fact-intensive and potentially lengthy examinations, it has been almost six years since the SEC announced the examination.

1. How many examinations did the SEC, FINRA and NYSE Regulation complete?

2. What were the results of these examinations?

3. Did the SEC, FINRA or NYSE Regulation file one or more enforcement actions against any entities or individuals that engaged in the intentional spreading of false information? If yes, please provide the specifics of these enforcement actions and the results of the action. If no, please provide the reasons that the SEC, FINRA and NYSE Regulation did not file any enforcement actions?

<u>Response to Questions 1-3:</u> SEC staff has informed me that in August 2008, the SEC's Office of Compliance Inspections and Examinations (OCIE), in conjunction with FINRA's Market Regulation Department and NYSE Regulation's Market Surveillance Division (collectively the SROs), conducted approximately 40 investment adviser or broker-dealer examinations, which generally were closed by or before February 2010, related to the topic you identified. In 2009, OCIE and the SROs conducted follow-up inquiries reviewing changes initiated by certain of the firms as a result of the original examinations in 2008.

Consistent with Commission policy, the results of these limited scope examinations conducted by SEC staff are non-public. Generally speaking, however, examinations that do not identify significant violations nevertheless often result in enhancements by firms to their policies, procedures, or systems subsequent to the examinations.

Securities Investor Protection Corporation

Will you please provide all related documents, emails, or other types of communications (drafts or otherwise) from the years of 2009 to 2011 between the Madoff Trustee, the Securities and Investor Protection Corporation and the SEC's General Counsel's office as it relates to deliberations and discussions as to the specific Net Investment Method (NIM) that would be used to determine victims' eligibility for restitution in the Madoff liquidation?

Response: I understand SEC staff has discussed production of these documents with your staff and relayed the process by which they may be requested by the Committee.

Securities Class Action Opt-Outs by Issuers

As you are aware, in securities class actions payments to the injured class generally come from innocent shareholders, and are subject to substantial attorneys' fees that reduce any recovery. Further, many investors that hold a diversified portfolio of securities will be on the plaintiffs' side of some securities class actions, and on the defendant's side in others; as a result, any purported financial benefits to diversified institutional investors are often cancelled out in the long-run.

The deterrent effect of securities class actions on managerial misconduct is debatable and, at a minimum, diluted, as innocent investors pay the vast majority of any settlements. A recent study by Navigant Consulting found that securities class actions are a net cost to investors.[1] It found that investors lose an average of $39 billion per year as a result of collateral damage to their investments from the filing of a case against the firm in which they are invested. When measured against the average investor recovery of $5 billion per year, investors are estimated to lose, on net, $34 billion in value per year as a result of the securities class action system.

Nevertheless plaintiff attorneys receive a net windfall of an average of $1 billion per year from filing these cases.[2] When considered in this context, it is not surprising that issuers and shareholders both may seek to avoid this form of civil liability. It is also not surprising that interest groups associated with the securities class action trial bar would place pressure on the Commission to support the existing system.

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[1] U.S. Chamber Institute for Legal Reform, *Economic Consequences - The Real Costs of U.S. Securities Class Action Litigation* p. 3 (February 2014) *available at* http://www.instituteforlegalreform.com/uploads/sites/1/EconomicConsequences_Web.pdf

[2] *Id*.

In early 2012, Carlyle Group LP ("Carlyle"), as part of a public offering, sought to include a provision in its organizational documents that would prohibit shareholders from filing securities class action lawsuits against it.

In response to Carlyle's attempt to prohibit its shareholders from filing securities class actions, in a letter dated February 3, 2012, Senators Al Franken, Richard Blumenthal and Robert Menendez opposed Carlyle's securities class action provision and "urged the SEC to deny the acceleration of registration statements that would unlawfully deprive investors of their ability to vindicate their statutory rights through inclusion of provisions requiring individual, confidential arbitration of all shareholder disputes."

The Senators endorsed an argument put forward by the Commission in 1990 that the provision would violate Section 29(a) of the Securities Exchange Act of 1934, which provides that "any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void."

That argument ignores the fact that the right to participate in a private securities class action was not created nor intended by the drafters of the Securities Exchange Act of 1934. The Supreme Court has endorsed this statutory interpretation of the Exchange Act, as the majority opinion in *Blue Chip Stamps*, authored by former Chief Justice Rehnquist, held that in the context of the private right of action under 10(b) and Rule 10b-5, "[t]he courts already have inferred a private cause of action that was not authorized by the legislation."[3] The Securities Exchange Act does not provide for a right to join a securities class action, and thus a waiver of that right is thus clearly not prohibited by Section 29(a).

I am troubled that the Commission pressured an issuer to remove a provision in its organizational documents that by all indications was clearly permitted by federal and state law. In a staff letter to the Carlyle Group, Assistant Director Pamela Long wrote:[4]

> ***We note that you have amended your limited partnership agreement to require individual arbitration of any disputes relating to the agreement or the common units, including disputes arising under the federal securities laws. We have also reviewed the supplemental information counsel provided to us regarding this issue. In a phone call on February 1, 2012, we advised counsel that the Division of Corporation Finance does not anticipate that it will exercise its delegated authority to accelerate the effective date of your registration statement if your limited partnership agreement includes such a provision, so that the Commission would need to make any decision on a request for acceleration. Based on an article published today by Bloomberg, we understand that you have announced that you have decided to withdraw the proposed arbitration provision. Please***

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[3] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 759 (1975)

[4] Letter from Pamela Long, Assistant Director, Division of Corporation Finance, Sec. & Exch. Comm'n, to Jeffrey Ferguson, General Counsel, The Carlyle Group L.P. (February 3, 2012) *available at* https://www.sec.gov/Archives/edgar/data/1527166/000000000012006433/filename1.pdf

confirm to us whether you intend to amend your limited partnership agreement to remove the mandatory individual arbitration provision.

I can find no reasonable basis for the Commission to continue to restrict issuers from including such provisions or for the Division of Corporation Finance to fail to utilize its delegated authority to accelerate the effective date of a registration statement on the grounds that the organizational documents of an issuer contains a provision prohibiting investors from joining or bringing a securities class action claim against the issuer.

Similarly, I can find no support for the proposition contained in a letter from the Commission's Office of Chief Counsel, Division of Corporation Finance asserting that a shareholder proposal to institute a similar provision into Pfizer's bylaws may be excluded from the corporate ballot on the grounds that "implementation of the proposal would cause the company to violate the federal securities laws."[5]

Accordingly, I request that you answer each of the following questions individually and provide the requested documents:

1. Did the Commission or its staff evaluate the legality of the securities class action provision in the Carlyle offering documents? If so, please provide all records, communications and documents relating to that analysis.

Response: Yes. As part of its review of Carlyle's registration statement, I understand that staff of the Division of Corporation Finance carefully considered the issue of the legality of the mandatory arbitration provision in Carlyle's organizational documents. I also understand SEC staff has discussed the production of documents with your staff and relayed the process by which they may be requested by the Committee.

2. If the reluctance on the part of the Division of Corporation Finance to accelerate the registration statement's effective date did not stem from uncertainty about the legality of the provision, then what was the reason for that reluctance?

Response: The federal securities laws provide a number of specific remedies for investors who purchase securities. Section 14 of the Securities Act provides that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of [the Securities Act]…shall be void." In addition, when deciding whether to exercise its delegated authority to accelerate the effective date of a Securities Act registration statement, the staff of the Division of Corporation Finance is required to specifically consider, among other things, the public interest and the protection of investors.

While it would be inappropriate to discuss individual matters, generally speaking the staff's

[5] Letter from Ted Yu, Senior Special Counsel, Division of Corporation Finance, Sec. & Exch. Comm'n, to Matthew Lepore, Pfizer Inc. (February 22, 2012) *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/donaldvuchetich022212-14a8.pdf

evaluation of a registration statement would include a focus on whether provisions of the entity's organizational documents would have effectively forced shareholders to waive important rights granted to them under the Securities Act. This could include considering carefully the degree to which provisions would have interfered with the investor protections afforded by the express private right of action provided in Section 11 of the Securities Act for false and misleading statements contained in registration statements, as well as the deterrent effect on issuer misstatements provided by Section 11 actions. The staff is not able to accelerate the effective date of an entity's registration statement without making the required public interest and investor protection findings.

3. Does any provision in the federal securities laws currently prohibit, or enable the Commission to prohibit, issuers from requiring investors to pursue claims against the issuer through an arbitration proceeding instead of a securities class action?

Response: While there are no provisions in the federal securities laws that expressly prohibit companies from including provisions in their organizational documents that would require mandatory arbitration of any claims arising under these laws, as noted above, the staff's consideration of a provision in the context of a review of registration statements may focus on whether such provisions would adversely affect shareholders' ability to exercise important rights granted to them under the Securities Act and interfere with the investor protections afforded by Section 11 of the Securities Act. Such an analysis would be part of the Division of Corporation Finance's evaluation of whether it is able to make the required public interest and investor protection findings needed to exercise its delegated authority and accelerate the effective date of an issuer's Securities Act registration statement.

4. Please provide an exhaustive description of supporting arguments relevant to the staff's position in a no-action letter regarding a shareholder proposal to include a class action opt-out on the ballot of Pfizer, Inc of February 22, 2012, in which the staff asserted that "We note there appears to be some basis for your view that implementation of the proposal would cause the company to violate the federal securities laws."[6]

Response: Rule 14a-8 of the Securities Act provides shareholders with the opportunity to submit proposals for inclusion in a company's proxy materials for a shareholder meeting. Generally, a company must include the proposals in its proxy materials, unless it is able to demonstrate that a proposal may be excluded pursuant to one of the procedural or substantive bases provided in the rule.

In Pfizer's case, the shareholder proposal would have amended the company's bylaws to prohibit generally any present or former shareholders from bringing any controversies or claims against the company, its directors, or its officers in court and, instead, would have required such persons to arbitrate these controversies or claims.

[6] *Id.*

In seeking "no-action" relief from the staff to omit this proposal from its proxy materials, Pfizer argued that the proposal was excludable under Rule 14a-8(i)(2), which permits omission of a proposal that, if implemented, would cause the company to violate federal law. The staff concluded that Pfizer's request presented some basis for the company's view that the proposal, if implemented, would violate the anti-waiver provisions of the federal securities laws. It is important to recognize that the staff's no-action response reflects an informal, non-binding view as to whether the company has met the burden required under Rule 14a-8 for the staff to not recommend enforcement action if the proposal is excluded from the company's proxy materials.

5. In a letter in August 5, 2011, the SEC conducted an estimate of the cost of staff time in drafting the "proxy access rule."[7] Utilizing the same methodology, please provide an estimate of the cost the Commission has incurred though its participation in private actions by filing amicus briefs over the last five years.

Response: Over the past five years, the Commission itself filed 26 briefs as *amicus curiae* on a variety of issues in private actions in federal district court and federal courts of appeals. For purposes of the requested estimate, we have selected what we believe to be an average case and assumed that the amount of staff time devoted to preparing the brief in that case was spent on the briefs for each of the others, recognizing that because the matters varied somewhat in terms of complexity, some required more staff hours and some fewer. Subject to those limitations, we estimate that over the past five years approximately 4,732 staff hours were spent in preparing the 26 *amicus curiae* filings at an estimated labor cost of approximately $918,580. The labor cost reflects salary as well as other components of the Commission's labor cost, such as healthcare and other benefits, and an allocation of administrative support and overhead cost.

Proxy Advisory Firms

Members of the Securities and Exchange's Investor Advisory Committee have expressed concern about the influence that proxy advisors wield and the preferential regulatory treatment they enjoy. I appreciate that the Commission held a roundtable last year on this issue and continues to consider appropriate reforms.

1. Will you commit to rescind the *Egan-Jones* Staff No Action Letter, provided by the staff in response to a request from Kent S. Hughes on May 27, 2004, pending an interpretive release by the Commission which makes the obligations of proxy advisors clear?

Response: Proxy advisory firms play an important role in the proxy process by, among other things, assisting investors in analyzing and considering how to vote the investors'

[7] *See* Letter from Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, to Scott Garrett, Representative, U.S. House of Representatives (Aug. 5, 2011).

shares. The proxy process lies at the center of the ongoing and important dialogue between companies and investors. The role of proxy advisory firms, including their use by institutional investors, has been a continuing area of focus at the Commission. In 2010, the Commission issued a comprehensive concept release on the U.S. proxy system that sought comment as to whether the U.S. proxy system as a whole operates with accuracy, reliability, transparency, accountability, and integrity that investors and issuers should expect.

More recently, as you note, the SEC held a roundtable in December 2013 on proxy advisory firm issues, including proxy advisory firms' disclosure of conflicts of interest and the use of proxy advisory firms by institutional managers, among other things. I believe that the roundtable discussion was very productive and provided a variety of perspectives, including those of proxy advisory firms, investors, corporate issuers, and institutional managers.

Following the roundtable, in June 2014, the Division of Investment Management and the Division of Corporation Finance issued Staff Legal Bulletin No. 20 to provide guidance about proxy voting responsibilities of investment advisers and the availability of exemptions from the proxy rules for proxy advisory firms. The Staff Legal Bulletin provides guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. It also provides guidance on the availability and requirements of two exemptions to the federal proxy rules that often are relied upon by proxy advisory firms, and clarifies that advisers and their clients do not have to agree that the adviser vote all of the client's proxies. In particular, the Staff Legal Bulletin cites to the staff's Egan-Jones letter for two reasons: to describe an investment adviser's duties when retaining or continuing to retain any particular proxy advisory firm to provide proxy voting recommendations, and to demonstrate that investment advisers should establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis. There are no plans to rescind the letter.

2. Have you consulted with the Department of Labor to determine in what instances the use of proxy advisors, who can become conflicted when they receive consulting fees from the issuers about whom they are advising ERISA fiduciaries concerning their investments in the issuers, may expose institutional investors regulated under ERISA to fiduciary liability? Will you conduct a similar inquiry with respect to regulated mutual funds?

Response: The DOL's rules apply to the voting of proxies held in employee benefit investment portfolios by fiduciaries in accordance with ERISA. As such, the rules applicable to registered investment advisers (which may include certain institutional investors), under the Investment Advisers Act of 1940, are different. Therefore, the staff has not consulted with the DOL with respect to how the DOL's regulations affect ERISA fiduciaries.

3. Are mutual funds currently free to adopt a policy that actively voting shares is not cost-effective, and instead to adopt a policy of voting with the recommendation of company

management unless red flags suggest a need for further attention? If there is any ambiguity in the Commission staff's current interpretations of its rules, will you commit to clear up that ambiguity?

> **Response:** As the Commission stated in 2003 when it adopted requirements regarding proxy voting by open-end and closed-end funds, proxy voting decisions by funds can play an important role in maximizing the value of the funds' investments, thereby having an enormous impact on the financial livelihood of millions of Americans.
>
> Mutual funds are formed as corporations or business trusts under state law and, as in the case of other corporations and trusts, must be operated for the benefit of their shareholders. Because a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities. Boards generally delegate this function to the fund's investment adviser as part of the adviser's general management of fund assets, subject to the board's continuing oversight. The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of "utmost good faith, and full and fair disclosure." This fiduciary duty extends to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.

Cost-Benefit Economic Analysis

Chair White, during your Senate confirmation hearing, you testified that improving the SEC's economic analysis function was one of your top three priorities, and you noted "the SEC should seek to assess, from the outset, the economic impacts of its contemplated rulemaking. Such transparent and robust analysis, including consideration of the costs and benefits, will help ensure that effective and optimal solutions are achieved without unnecessary burdens or competitive harm."

I share your concern that this priority has received insufficient attention at the Commission. I believe this problem stems from the fact that the Division of Economic and Risk Analysis, unlike the other operating divisions of the Commission, is not delegated any meaningful authority in the Commission's operating rules.

A meaningful step in the right direction would be to place for a vote by the Commission a proposal to add the following language to Section 200.23a of the Commission's internal operating rules:

> **"The Office of Economic Analysis shall be led by the Director of Economic and Risk Analysis. The Office may suspend any authority delegated to any staff of the Commission with respect to a particular matter upon a finding that the Director cannot determine that the benefits of the action exceed its costs. In that instance, the Director shall submit an analysis of the decision**

to the Commission. In that instance, the delegated authority will remain suspended with respect to that particular matter until such time as it is renewed by an act of the Commission."

Will you commit to putting that rule amendment to a Commission vote?

Response: As you note, I am committed to supporting and strengthening our Division of Economic and Risk Analysis (DERA), which has been the Commission's most rapidly growing division. DERA's expansion has greatly enhanced the Commission's ability to perform high-quality economic analysis in support of rulemaking and policy development. Importantly, DERA staff also routinely contributes substantively to a broad range of other Commission initiatives and activities, such as assisting with enforcement actions and developing risk assessment tools and metrics to help focus scarce resources on investigations and examinations.

I would not, however, support the above rule amendment. While it is critical that SEC staff exercising delegated authority consult and coordinate as appropriate with all other relevant divisions and offices, including DERA, the Commission has determined that the SEC staff in receipt of delegated authority is qualified and equipped to exercise it. As such, vesting any one division or office with the plenary authority described in the above amendment would in my view not be appropriate or optimal.

<u>Questions for SEC Chair Mary Jo White submitted by Chairman Hensarling</u>

1. How many times has the Volcker Rule inter-agency working group met since you and your fellow regulators announced its creation at our February 5 Full Committee hearing? How many times have the principals of the five agencies met to discuss Volcker Rule implementation?

> **<u>Response:</u>** The full interagency working group holds weekly calls to discuss implementation of the final rule. Separately, a specialized group within the working group also meets regularly to discuss issues related to the metrics reporting requirement. I also have had discussions with principals of the other Volcker Rule agencies to discuss implementation of the rule.

2. Please describe the specific involvement of the Secretary of the Treasury in the deliberations of the Volcker Rule inter-agency working group.

> **<u>Response:</u>** The Dodd-Frank Act provides a coordinating role for the Chairperson of the FSOC (the Secretary of the Treasury) with respect to the rulemaking process. The Department of the Treasury was involved in the regular meetings held by the interagency group and played a coordinating role throughout the rulemaking process. Further, following adoption of the final rule, the Secretary of the Treasury held a meeting of principals to discuss implementation of the rule.
>
> Currently, the interagency working group is an informal working group comprised of staff of the agencies responsible for implementing and enforcing the Volcker Rule. It is a consultative, collaborative body that enables staff from each of the agencies to communicate on a regular basis on questions from market participants, on technical issues, and on supervision and examination approaches.

3. Thank you for responding to my March 11, 2014 letter about the Volcker Rule's impact on the liquidity of the U.S. corporate bond market. When do the five regulators expect to provide the first quarterly report about corporate bond market liquidity and the Volcker Rule? As the SEC is the regulator with the most expertise on corporate bonds, what will the SEC do to modify or alter the Volcker Rule if the agencies determine that liquidity for corporate bonds is decreasing?

> **<u>Response:</u>** In response to your request, we provided an initial report on corporate bond market liquidity on June 26, 2014. As you know, many factors may affect liquidity in the U.S. corporate bond market. The report is intended to set out some historical trends in this market and provide a baseline for monitoring changes in the market. The agencies also provided a subsequent report on November 3, 2014, and I expect will provide further periodic updates of this information in the future. To the extent that the final rule has unintended impacts on banking entities or the U.S. financial system, the agencies would seek to evaluate and, as appropriate, address those impacts within the parameters of the

Comment [CC1]: Tim to doublecheck.

statute.

4. The extension for CLOs provided by the regulators on April 8, 2014, did not provide any more certainty to the CLO market. Were CLOs created for proprietary trading purposes? If not, for whom were CLOs created?

Response: In light of the Federal Reserve Board of Governors' statement on April 7, 2014 of its intent to extend the conformance period for certain CLOs, and based on the staff's discussions with industry representatives and a review of data provided by market participants, it appears that the current volume of new CLO issuances is higher as compared to CLOs issued prior to the agencies' adoption of final rules implementing the Volcker Rule, with U.S. CLO issuances increasing to a post-crisis high of approximately $12 billion in April 2014, which was the third highest monthly total on record. Consistent with this data, it was recently reported that CLO issuance has increased each month this year, with year-to-date issuance increasing by nearly 29% as compared to the same period of 2013.

A CLO is an asset-backed security that is typically collateralized by portions of tranches of senior, secured commercial loans or similar obligations of borrowers who are of lower credit quality or that do not have a third-party evaluation of the likelihood of timely payment of interest and repayment of principal. CLOs thus generally provide a means for investors to obtain an investment collateralized by these loans or similar obligations. Investment managers form CLOs to provide investors with these investment opportunities. CLOs are managed vehicles for which investment managers receive management fees and performance-based compensation.

5. The five agencies charged with implementing the Volcker Rule took action on April 8 on CLOs but the action did not resolve the uncertainty to a market for business loans and they are a critical part of the capital markets in the United States. A market which came through the crisis without incident, has a default rate of 0.41%, over 20 years, only 25 tranches have defaulted and serves to help finance such companies as J CREW, Delta Airlines, Michael's Craft Stores, Tempurpedic, American Airlines, TXU, Dollar General, and Rite Aid. Did the regulators ignore the facts about the CLO market before taking action that has made this market, a market for business loans, less attractive?

Response: As noted above, following the Federal Reserve Board's action on April 7, the CLO market has expanded to post-crisis highs and, based on public data, the corporate loan market and the CLO market have in fact increased in size after the last year.

Section 619 of the Dodd-Frank Act generally required the agencies to prohibit banking entities from investing in hedge funds and private equity funds, collectively defined as "covered funds" in the agencies' final rules. At the same time, the statute provides that it shall not be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Federal Reserve Board to sell or securitize loans. The agencies gave effect to these statutory provisions by prohibiting banking entities from investing in covered funds while also excluding from the definition of covered fund certain loan securitizations. In the adopting release, the agencies were careful not to expand the definition of excluded loan securitizations to vehicles holding both loans and securities, noting that such an expansion would not be consistent with the provision of the Dodd-Frank Act that specifically only protected the "sale and securitization of loans" by banking entities. The agencies also noted in the adopting release that excluded loan securitizations that meet the conditions of the rule do not raise the same type of concerns as other types of securitization vehicles that could be used to circumvent the restrictions on proprietary trading.

6. Shortly after the Volcker Rule was approved one Washington, DC attorney stated "The Volcker rule is going to keep a lot of people at this firm occupied for a long time." Given the massive compliance burden and the need for regulators to look over the shoulders of traders to make sure they stay on the right side of the blurred line between prop trading and market-making, there will clearly be more jobs for compliance officers and government regulators. But that is not what most Americans consider sustainable job growth. How will sharply increased borrowing costs and less liquid capital markets translate into fewer job opportunities for those Americans not fortunate enough to have a government regulatory job, a job in the compliance department of a Wall Street bank or for one of their lawyers?

Response: The final Volcker rule includes workable exemptions for market making and underwriting activities, which should reduce the potential for increased borrowing costs or less liquid capital markets. Staffs of the agencies are monitoring liquidity in the corporate bond market and expect to provide periodic updates of their findings to the Committee. To the extent that the final rule has unintended impacts on banking entities or the U.S. financial system, the agencies would seek to evaluate and, as appropriate, address those impacts within the parameters of the statute.

7. With respect to the apparent liquidity crunch occurring in the corporate bond market, Professor Andrew Lo of MIT noted "Corporates face the risk of higher borrowing costs if liquidity continues declining." Given that part of the SEC's mission is to facilitate capital formation, isn't it incumbent upon the SEC to conduct a comprehensive analysis of the Volcker Rule's impact on the ability of businesses to issue debt through the U.S. markets?

Response: Because banking entities are not required to comply with the trading restrictions of the final Volcker rule until July 21, 2015, it is too soon to determine whether the rule will impact liquidity in the corporate bond market. Notably, the rule provides exemptions for activities that are core to the functioning of this market, including underwriting and market making-related activities, and does not impact trading by firms that are not banking entities. We have provided two staff reports on corporate bond market liquidity and will continue to monitor liquidity in the corporate bond market.

8. During our first Volcker Rule hearing in January, one of our witnesses stated, "There

are five enforcers [of the Volcker rule], and maybe six if you add FINRA to the mix, which I think ultimately the SEC will look to FINRA to do." As many bank holding companies conduct much of their trading in SEC-regulated entities, do you see your agency as taking the lead in terms of implementation and enforcement of the Volcker Rule?

Response: Within the United States, securities underwriting and market making activities generally are conducted in SEC-registered broker-dealers. In this regard, the SEC will have a significant role to play in implementing the Volcker Rule and examining for compliance with these provisions of the final rule. At the same time, the Volcker Rule's application is not limited to U.S. securities markets, as it applies to markets for commodity futures and derivatives, as well as U.S. banking entities' trading activities in foreign markets. Further, banking organizations tend to structure their activities based on operational functionality rather than legal status, as recognized by the final rule's definition of "trading desk." Thus, a banking organization's activities often span more than one legal entity. For example, a trading desk that makes a market in corporate bonds may book its corporate bond positions in an SEC-registered broker-dealer and may book index CDS positions acquired for hedging purposes in a different banking entity that has a different primary regulatory authority. As a result, the SEC is coordinating implementation of the final rule with the other rulemaking agencies through a consultative, collaborative process.

9. Some have argued that the banking regulators, by virtue of prudential regulations, statutory confidentiality protections and the presence of embedded bank examiners, have more discretion and flexibility concerning whether and how to enforce the Volcker Rule compared to the SEC, which because of its rule-based regulations cannot simply decline to report Volcker Rule violations when it sees fit. Do you agree with this critique? If you disagree with this critique, do you believe the SEC has the authority to waive clear violations of the Volcker Rule? If so, how would this work in practice? What criteria would you and your fellow Commissioner use to make this determination?

Response: Section 13(e)(2) of the Bank Holding Company Act (BHC Act) mandates that each agency enforce compliance of section 13 with respect to a banking entity under the respective agency's jurisdiction. Accordingly, the final rule provides each agency with the authority to take any action permitted by law to enforce compliance with section 13 or the final rule, including ordering a banking entity to terminate activities or investments that violate the rule. The banking agencies also retain inherent authority to conduct examinations or otherwise inspect banking entities to ensure compliance with the final rule.

At the Commission, the Office of Compliance Inspections and Examinations (OCIE) promotes compliance with the federal securities laws through outreach, publications, and examinations, and where appropriate, referrals to the Commission's Division of Enforcement for consideration of further action against the entity. During inspections and examinations, OCIE staff will assess compliance with regulatory requirements based on a risk-based selection process. An examination may include an on-site visit, interviews with appropriate personnel, and document reviews, in order to analyze the relevant portion of the entity's operations.

Following the end of the conformance period, if examiners identify potential failures by a regulated banking entity to comply with the Volcker Rule or section 13 of the BHC Act, examiners will confer with other SEC staff concerning the application of the requirements to the banking entity's activities. SEC staff will then consider appropriate next steps, including coordinating with the interagency group. A violation may result in an examination summary letter being issued to the registrant that identifies the non-compliant activities and requires that the registrant identify what actions it will take to address the concerns identified. Where the violations found are serious, SEC staff will consider additional actions, which may include a referral of the matter to the Division of Enforcement for their consideration as to appropriate action.

10. The firms that were subject to oversight by the SEC under the now-shuttered Consolidated Supervised Entities (CSE) program had onsite SEC examiners reviewing their trading and other activities in the run-up to the crisis. Did any SEC examiners embedded in one of those CSE firms identify proprietary trading or investments in hedge funds or private equity funds as a concern?

Response: The CSE program was a voluntary Commission program that involved actively monitoring certain large investment bank holding companies that were not otherwise subject to regulatory supervision. One of the primary purposes of the program was to monitor the financial and operational condition of the holding company and its potential impact on the registered broker-dealer, and to verify that the risk control system was functioning effectively.

Commission staff members monitoring CSE firms were not embedded at the firms. Instead, a multi-disciplinary team of Commission staff, including economists, financial engineers, and accountants, met regularly with senior risk managers, financial controllers, treasury personnel, and internal auditors of the CSE firms to discuss financial and operational issues. A key theme throughout these discussions was risk concentration, and how the control functions collectively managed concentrated exposures of various types. In its review of CSE firms, Commission staff generally focused on firms' risk exposures, rather than the particular type of trading activity giving rise to the risks.

11. Are investors harmed when they cannot buy or sell securities because of illiquid, inefficient or disorderly markets? Does the Volcker Rule have the potential to actually harm investors, particularly those investors invested in fixed income securities?

Response: Liquidity provides important benefits to the financial system, and market makers play an important role in providing and maintaining liquidity throughout market cycles. Further, restrictions on market-making activity can result in reduced liquidity, and the effects of diminished liquidity can be concentrated in markets where trading is already infrequent, such as the fixed income market. By exempting the market-making related activity of banking entities, the rule recognizes the importance of these activities to the financial system. Certain provisions of the market-making exemption are designed to recognize differences across markets and asset classes by accounting for the liquidity, maturity, and depth of the market for the type of financial instrument in which a market is made. As a result, banking entities will continue to be able to engage in market-making related activities across markets and asset classes.

Questions for Record (QFRs) for "Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request" April 29, 2014

Rep. Robert Hurt

How would the SEC view a short-seller who allegedly compensates third parties to attack the shorted publicly- traded company, while concealing the payments?

How would the SEC view a short-seller who knowingly puts into the marketplace false and misleading information concerning the shorted company in order to drive down the stock price? Is such conduct unlawful?

Response: The SEC enforces a variety of provisions of the securities laws that may come into play in the context of short sales. Whether certain conduct violates these laws is highly dependent on the facts and circumstances of a particular case. Some of the provisions aimed at addressing abusive short sale practices include: (1) Section 9(a) of the Exchange Act, which contains several provisions prohibiting manipulation of security prices; (2) Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5, which prohibit fraudulent conduct in connection with the purchase, sale, or offering of securities; (3) Regulation M, which is a set of anti-manipulation rules that govern activities in connection with securities offerings; and (4) Regulation SHO and Exchange Act Rule 10b-21, which are aimed at preventing potentially manipulative or abusive "naked" short selling.

The SEC has brought cases in each of these areas to address problematic short sale conduct. For example, the SEC has charged short sellers with fraud in cases where they are linked to false statements made for the purpose of negatively impacting the price of the shorted stock. In one case, the SEC charged a broker with fraud and manipulation for recklessly spreading false rumors about a company while at the same time profiting from short sales of that company's stock. The SEC also filed fraud charges against a corporate employee who caused the issuance of a false press release so that he could profit from a short position.

In addition to these fraud cases, the SEC has made other types of abusive short selling practices an enforcement priority. For example, last year the SEC announced an initiative to enhance enforcement of-Rule 105 of Regulation M, which prohibits firms from improperly participating in public offerings soon after short selling those same stocks. The rule is intended to protect a stock offering from potential manipulation by short sellers who artificially depress market prices and, in the process, guarantee themselves a profit while reducing the company's offering proceeds and diluting shareholder value. The enforcement of Rule 105 promotes offering prices that are set by natural forces rather than manipulative short sale activity. As part of the initiative, we have charged over 40 firms with violations of the rule, resulting in more than $23 million in monetary sanctions. In another case filed earlier this year, the SEC charged two individuals with fraud and violations of a short sale rule for perpetrating a complex scheme in which they engaged in sham transactions to evade delivering the securities underlying their short positions in over 20 different issuers.

If the SEC was provided evidence of such alleged activities by a short-seller, would the SEC investigate?

Response: Determinations as to whether to open an SEC enforcement investigation turn on the specific facts and circumstances of the particular matter. Every tip, complaint, or referral the SEC receives is carefully reviewed for reliability, detail, and potential violations of the federal securities laws. In determining whether to open an investigation, the staff considers whether it would have the potential to substantively and effectively address the alleged violative conduct. The staff analyzes a variety of threshold issues, including whether the facts suggest a possible violation of the federal securities laws involving fraud or other serious misconduct, the magnitude or nature of the violation including the number of victims, and the amount of profits or losses at issue. The staff may also consider whether there is a need for immediate action to prevent investor harm, whether the alleged conduct undermines the fairness or liquidity of the U.S. securities markets, whether the alleged conduct involves a recidivist, and whether the investigation would involve a possibly widespread industry practice that should be addressed.

Representative Patrick E. Murphy
Questions for the Record
April 29, 2014
"Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request"

Chair White, releasing the OFR study on asset management for comment gave key stakeholders and academics the opportunity to weigh in.

1. How will these comments be incorporated into the FSOC's continued examination of the asset management industry?

Response: When OFR published its report in September 2013, the Commission provided a place on the Commission's website to collect public responses and comments. Approximately 55 comment letters were submitted on the OFR Study, "Asset Management and Financial Stability." The commenters – which include industry representatives, academics, and public interest groups – provided a variety of views on issues related to the asset management industry and its potential risks.

The comment letters are publicly available on the SEC's website. They can be accessed from the following link: http://www.sec.gov/comments/am-1/am-1.shtml. In addition, SEC staff provided staff of FSOC members with an overview of the comments that were received by the November 1, 2013 comment period closing date. SEC staff continues to review and analyze the various views expressed in these comments as well as in comments submitted more recently.

The public comments provided useful insights on issues related to asset managers and potential systemic risk and have helped inform the overall review of those issues.

The insights and ideas raised in the comment letters have been discussed at FSOC meetings, both at the principal and at the staff level, and the comment letters are informing the work of the Council in its continued examination of the asset management industry.

I recently joined 40 of my colleagues in a letter to Secretary Lew urging the FSOC to perform and publish additional analysis beyond the OFR study before taking steps to designate any asset management firms as systemically important financial institutions (SIFI). I am concerned with recent reports that the FSOC has moved a few asset management firms into stage two of the examination process before the FSOC has determined appropriate risk criteria and publicly explained how any identified risk would be mitigated by designating an asset management firm.

2. I understand the FSOC has scheduled a May 19th public forum on the asset management industry, which is a great first step, but what additional steps will the FSOC

take to perform a robust analysis, seek input from experts to fully understand the industry, and explain why designation of an individual firm or firms would be a better solution for mitigating any identified systemic risk than industry-wide activity-based regulation by the primary regulator?

Response: As you indicated, FSOC held a public Conference on Asset Management on May 19, 2014. The Conference featured three panels titled, "Investment Risk Management by Asset Management Firms," "Asset Management and Risks Across the Broader Financial System," and "Operational Issues and Resolvability" that included industry speakers, academics, and other stakeholders

At the conference, the Director of the Commission's Division of Investment Management presented an "Overview of the Asset Management Industry" to provide background and context. Among other things, the presentation included an overview of the regulatory regime applicable to investment advisers and mutual funds and other SEC-registered investment companies; background on the growth of investment advisers and funds; a description of data availability with respect to investment advisers and funds; background on the use of third-party service providers to perform operational functions; and a summary of how investment advisers operate in the financial markets as agents on behalf of clients.

At a subsequent July 31, 2014 Council meeting, FSOC "directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry." I will continue to collaborate with my fellow FSOC financial regulators to help inform FSOC's understanding of the asset management industry and its potential risks.

As a CPA, I was surprised to read that the Financial Accounting Foundation (FAF) unexpectedly contributed $3 million of fees paid by U.S. public companies to the International Financial Reporting Standards Foundation after consultation with SEC officials. It concerns me to think that SEC would pressure FAF to make this contribution without first consulting this committee and Congress.

3. How will this contribution benefit U.S. companies?

Response: As I indicated at the time of FAF's announcement, I am gratified that the FAF indicated it will provide a substantial contribution to the IFRS Foundation. The contribution is intended to support the IASB during the period that it is completing work on four joint accounting standards projects underway with the FASB. The joint projects involve accounting for revenue recognition, leasing, financial instruments, and insurance. Completing these joint projects will further the goal of convergence of U.S. and international accounting standards, which will benefit companies by promoting increased comparability of their financial reporting with their foreign peers. Under the Commission's rules, foreign private issuers are permitted to file financial statements in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP.

Today, over 500 companies, representing trillions of dollars of market capitalization, file reports with the Commission as foreign private issuers using IFRS, availing themselves of this method of reporting. As such, high-quality IFRS standards are critically important to the U.S. markets and American investors.

4. Would allowing U.S. companies the option to use international accounting standards cause confusion for investors and simply create a race to the bottom in terms of accounting standards?

Response: The FASB and IASB have been working together to more closely converge U.S. GAAP and IFRS since 2002. The FASB's ongoing work with the IASB on convergence projects has helped to eliminate many significant differences between U.S. GAAP and IFRS, thereby furthering the objective of a single set of high quality international accounting standards. The Commission continues to monitor the progress of the remaining convergence projects.

As discussed above, over 500 companies, representing trillions of dollars of market capitalization, today file reports with the Commission as foreign private issuers using IFRS.

The Commission has not yet made any determinations as to whether there would be any further incorporation of IFRS into the U.S. financial reporting system. I believe it is important for the Commission to continue to consider the potential benefits and challenges of further incorporating IFRS into the U.S. financial reporting system. The needs of U.S. investors will continue to remain front and center as we think about this issue.

COMMITTEE ON FINANCIAL SERVICES

Committee on Financial Services

Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request

May 27, 2014

Rep. Bill Posey (FL-8)

On December 23, 2013, FINRA issued a concept proposal to develop a Comprehensive Automated Risk Data System (a.k.a – CARDS).

CARDS is a far reaching system that will permit FINRA to collect and store, in an automated, standardized format, highly detailed and very specific financial and personal information about retail customers from securities broker-dealers. This information will be collected on a regular basis and will permit FINRA (and potentially the SEC and other regulators) to have a complete picture of an individual person's financial life.

We are concerned about the personal privacy and information security issues raised by the proposed CARDS system. Personal privacy and security of personal information has never been more important. Millions of customers recently had their personal financial information compromised by a data beach at Target.

The CARDS system sounds similar to CFPB programs that collect information regarding every American's entire financial life, and the collection of the this information raises important Constitutional rights and personal privacy issues. In addition, securing such sensitive information from possible security breaches is immensely important.

It is my understanding that FINRA currently maintains various systems, such as InSite, OATS, Blue Sheets, that collect information very similar to that contemplated by CARDS. I also understand that CARDS is being proposed at the same time the Securities and Exchange Commission ("SEC") and the securities industry self-regulatory organizations, including FINRA, are considering a Consolidated Audit Trail ("CAT") that will collect and store vast amounts of financial information similar to the information that a CARDS system will collect. I am concerned that the SEC and FINRA have not considered the cost-benefit aspects of the CARDS proposal, in particular in light of these already existing systems and the proposed CAT system.

Since the SEC is the regulator of FINRA under Section 15A of the Securities Exchange Act of 1934 and is responsible for approving all FINRA rule changes, we would like to know:

1. What does the SEC know about the CARDS system?

> **<u>Response:</u>** In its December 2013 request for comment from its members and others on a concept proposal to develop the Comprehensive Automated Risk Data System (CARDS), FINRA indicated that CARDS is intended to facilitate more focused and streamlined examinations and should reduce requests for information from firms as well as result in shorter on-site examinations.
>
> According to FINRA, CARDS would accomplish these objectives by automating the collection of certain information that is maintained by member firms as part of their books and records. FINRA proposes to use the information collected through CARDS as a surveillance tool to run analytics that should help focus examinations by identifying potential sales practice misconduct as well as potential business conduct problems with member firms, branches, and registered representatives.
>
> The Commission staff understands that FINRA received over 800 comment letters in response to the concept proposal on which it solicited comment. After considering the comments raised by the commenters, on September 30, 2014, FINRA issued a Regulatory Notice seeking comment on a specific proposal to implement CARDS. FINRA's proposal is available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p600964.pdf and is subject to a 60-day comment period. Once it prepares a formal submission, FINRA will have to file the proposal with the Commission for review and approval pursuant to Section 19(b) of the Exchange Act.

2. Is the SEC is collaborating with FINRA on CARDS?

> **<u>Response:</u>** The SEC is not collaborating with FINRA in the development of CARDS. FINRA staff has discussed the CARDS concept proposal generally with the staff of the Commission.

3. What are the SEC's and FINRA's positions on the personal privacy and Constitutional rights issues raised by CARDS?

> **<u>Response:</u>** It would be premature for the SEC to express a position on the issues raised by the commenters on the CARDS concept proposal published by FINRA. I expect that FINRA will review and consider any comments received in formulating any proposal that it may consider filing with the Commission. The Commission would then consider whatever concerns are raised by the commenters on the CARDS proposal when and if FINRA files a rule change with the Commission.

4. Will the SEC review and approve the CARDS system prior to FINRA implementing the system?

> **Response:** To establish CARDS, FINRA would have to file a proposed rule change with the Commission pursuant to Section 19(b) of the Securities Exchange Act. FINRA would not be able to implement the system prior to SEC approval of the proposed rule change.

5. Will the CARDS proposal be published in the Federal Register so that all American citizens will have the opportunity to review the proposal and provide comments?

> **Response:** Yes. All proposed rule changes filed pursuant to Section 19(b) of the Securities Exchange Act are published for comment in the Federal Register.

6. Have the SEC and FINRA considered the costs and benefits of the CARDS system and how CARDS relates to already existing SEC and FINRA systems and the proposed CAT system?

> **Response:** FINRA has indicated that it is considering the costs and benefits of CARDS and how the system relates to existing FINRA systems, as well as the proposed CAT system. FINRA has not yet filed a proposed rule change with the SEC that would require formal review and approval by the SEC.

Suggested Questions

Regarding Office of Financial Research Study on Asset Managers and Potential Designation as SIFIs by the Financial Stability Oversight Council:

1. It has been widely reported that the SEC had significant concerns that the OFR report viewed mutual funds through a 'bank lens,' even though they operate on a fundamentally different business model from banks. Does the SEC believe the final OFR report corrected the lens, or is the final study still based on a misguided perspective?

Response: While the Commission did not participate in or take a position on the OFR Asset Manager Study, SEC staff provided comments, technical input and shared expertise with the OFR as OFR drafted and revised the study. Since OFR's publication of the Study, the public has provided input on the issues through comments on the Study, and the FSOC held a conference on asset management, which have added to FSOC's understanding of asset managers and their distinct role in the financial markets.

In addition, at the July 31, 2014 Council meeting, FSOC "directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry." As a member of FSOC, I will continue to collaborate with my fellow FSOC financial regulators to help inform FSOC's understanding of the asset management industry and its potential risks.

2. How do leverage ratios indicate riskiness of an institution and how do the leverage ratios of banks and mutual funds differ?

Response: The leverage amounts of registered investment companies can vary depending on the derivatives and other senior securities used, and the cover methods utilized. The Commission has stated that "[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return." The Commission also has stated that leveraging of a fund's portfolio "magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities." In short, leverage amplifies both negative and positive portfolio performance, and may significantly impact the overall risk/reward profile of a fund.

As a general matter, registered investment companies (both closed-end and mutual funds) are limited in their use of leverage. Specifically, registered investment companies are subject to Section 18 of the Investment Company Act of 1940, which protects investors against the potentially adverse effects of a fund's issuance of "senior securities." Congress' concerns underlying the limitations in Section 18 included, among others, (i) potential abuse of the purchasers of senior securities; (ii) excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities; and (iii) funds operating without adequate assets and reserves. To address these concerns, Section 18 of the Investment Company Act requires open-end funds (e.g., mutual funds) to limit their senior securities to bank borrowings with 300% "asset coverage," and closed-end funds to have 300% asset coverage of senior securities representing indebtedness. "Asset coverage" for these purposes means the ratio of (i) a fund's total assets, less all non-senior security liabilities and indebtedness, to (ii) the fund's aggregate amount of senior securities representing indebtedness.

Notwithstanding Section 18's asset coverage requirements, the Commission has stated that, instead of complying with the statutory 300% asset coverage requirement, funds could cover certain derivative positions by segregating liquid assets equal to the fund's future potential liability. Subsequently, in no-action letters and other more informal contexts, the staff applied this asset segregation cover approach to additional derivative transactions, and explained that the amounts to be segregated depend on the instrument. It is also important to note that fund investors receive significant disclosure regarding the investment program and any attendant risks.

3. Earlier this year, former Federal Reserve Board Chairman Ben Bernanke said that equity mutual funds are "not runnable", or subject to a run on deposits like banks. Do you agree with Mr. Bernanke?

Response: I agree with former Chairman Bernanke that a run on deposits at a bank is a very different event, with very different outcomes, than investors redeeming money from an equity mutual fund, even in large volumes. Pursuant to section 22(e) of the Investment Company Act of 1940, equity mutual funds, like all other mutual funds registered with the SEC, are required to provide shareholders a right of redeemability, and the fund cannot postpone the date of payment of the proceeds of a shareholder redemption request for more than seven days. As such, investors in an equity mutual fund theoretically could redeem their securities en masse over a very short period of time. In the case of an equity mutual fund, however, such redemptions would be satisfied by cash on hand at the fund and by the fund's selling a portion of the equity securities it holds. Those securities would be sold in the equity markets at a market-based price. Unlike a bank, a redeeming shareholder of an equity mutual fund is not guaranteed to receive his or her principal, but has a right to receive only his or her proportionate share of the value of the fund based on the fund's valuation next-computed following the shareholder's redemption. Additionally, the main trigger for run on a bank is a concern about potential insolvency, and one of the main negative outcomes of a run on a bank is the bank could become an insolvent institution, thereby spreading risk to its counterparties. Equity mutual funds, on the other hand, do not pose insolvency risk and do not serve as lenders or traditional counterparties to other financial institutions.

4. In a free market, we accept that firms might fail and investors in those firms may incur losses. SIFI designation essentially marks an institution as "cannot be allowed to fail." In the comments to the OFR study, many experts stated they do not believe asset managers

pose a systemic risk—or a risk to the entire financial system. Should the federal government seek to insure a firm can't fail simply because it is large, even if a failure would not cause any systemic financial distress?

> **Response:** The size of a nonbank financial institution is one of many factors the FSOC may consider in designating a firm for supervision by the Board of Governors of the Federal Reserve System. Under Section 113 of the Dodd-Frank Act, the FSOC may designate a nonbank financial company, "if the Council determines that material financial distress at the US nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the US nonbank financial company could pose a threat to the financial stability of the United States." The statute further lists ten statutory factors that the Council "shall consider" in making such a determination. In addition, in a final rule and interpretative guidance issued by FSOC on April 11, 2012, the Council further explained how it would make these determinations. In assessing the risk to financial stability posed by a nonbank financial institution, the Council will consider six categories that subsume the ten statutory factors. Those categories guide the designation process, and are (1) interconnectedness; (2) substitutability; (3) size; (4) leverage; (5) liquidity risk and maturity mismatch; and (6) existing regulatory scrutiny. An important step of the designation process is an assessment of whether an entity could pose a threat to the financial stability of the United States. As part of this process, the Council looks at a number of factors in connection with this assessment, with size of an entity being only one. Thus, while size alone may not lead to designation, an entity that FSOC determines does not pose a threat to the financial stability of the United States will not be designated.

5. I understand the SEC is planning to test certain mutual funds over the next several months to judge the riskiness of some newer, alternative strategies. It seems to me this is a logical move to monitor risk and innovations in the industry. Would you agree that the SEC, as the agency of jurisdiction and the most expertise, should be the primary voice in addressing potentially risky practices across the asset management industry?
As a member of FSOC, have you shared your concerns with your fellow members on the Council?

> **Response:** Pursuant to the Investment Advisers Act and the Investment Company Act, the SEC has been regulating investment advisers and mutual funds and other investment companies since 1940, and therefore has nearly 75 years of institutional expertise and knowledge of asset management entities.
>
> I have shared my view that we as a Council need to be open to relevant expertise, whether that expertise comes from FSOC members themselves or from outside sources. I also believe that the SEC, as the primary regulator of asset managers, should have a leading role in further informing the FSOC on asset managers and analyzing issues related to asset managers.

Why did FSOC move forward with its review of Fidelity and BlackRock, when the baseline study by OFR has been widely discredited, and FSOC has yet to hold its May 19th Conference on the asset management industry?

> **<u>Response:</u>** I cannot speak on any firm-specific reviews. When analyzing the role of asset managers and the potential for systemic risk, it is important to obtain a variety of perspectives. The public comment letters submitted on the OFR Asset Manager Study have been informative to the overall discourse on asset management. In addition, as you indicated, FSOC held a public conference on Asset Management on May 19, 2014. The Conference featured three panels titled "Investment Risk Management by Asset Management Firms," "Asset Management and Risks Across the Broader Financial System," and "Operational Issues and Resolvability". Following the conference, and at the July 31, 2014 Council meeting, FSOC "directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."

If FSOC decides to move forward with SIFI designations for asset managers, I am very concerned that the required additional regulatory oversight will be constructed though a 'bank lens', similar to the OFR study. Can you commit to advocating for industry appropriate metrics from your position on FSOC?

> **<u>Response:</u>** Upon determining that a non-bank financial institution could pose a threat to financial stability of the United States under one of the two statutory determination standards articulated in Section 113 of the Dodd-Frank Act – whether that company is an asset manager, an insurance company, or any other type of non-bank financial institution – I believe it is important for FSOC and the primary regulators of such company to consider standards that are relevant and appropriate for that particular type of company and the types of risks that it could pose to financial stability. In addition, I believe the FSOC and the primary regulators of any designated company should work with the Board of Governors of the Federal Reserve System, as appropriate, to provide for standards that are tailored in a reasonable and effective manner.

<u>Regarding Equity Market Structure:</u>

1. High-frequency trading is now a hot topic among commentators and the media. As we have seen in our past hearings on market structure, it's one of the numerous issues the SEC's is grappling with as our markets are changing and adjusting to new technology. In your testimony, you indicate that the SEC will conduct a thorough, data-driven review of market structure. Can you provide some examples of how you are looking into the potential costs and benefits of high-frequency trading, specifically?

> **<u>Response:</u>** The SEC uses a variety of tools to analyze high frequency trading. Examples include our Market Information Data Analytics System, or MIDAS, and the economic literature on high-frequency trading (HFT).

MIDAS is an externally hosted market information and data analysis system which combines advanced technologies with empirical data to promote better understanding of markets. Research with MIDAS shows, for example, that the speed of those taking liquidity seems to keep pace with the speed of those canceling quotes, suggesting that slowing the ability of liquidity-providers to cancel their quotes without similarly slowing the ability of liquidity-takers to access those quotes would not necessarily slow the market itself, but could disadvantage those who provide liquidity compared to those who take liquidity. MIDAS data also show that the cancel-to-trade ratio for exchange-traded products (ETPs) is significantly higher than for corporate stocks. This could be a result of the structural differences between how stocks and ETPs trade.

The SEC also recently released on its equity market structure website a staff review of recent empirical economic literature on HFT and its impact on the markets. In general, this review illustrates that primarily passive HFT strategies appear to have beneficial effects on market quality, such as by reducing spreads and reducing average intraday volatility. In contrast, primarily aggressive HFT strategies can raise potential concerns, particularly with respect to their impact on market volatility and institutional execution costs.

Questions for the Record – Full Committee
From: Congresswoman Kyrsten Sinema
Date: Tuesday, April 29, 2014
Title: "Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request"
Questions for SEC Chairwoman Mary Joe White:

1.) You mentioned in your testimony that the Commission is currently conducting the review of the accredited investor definition as it relates to natural persons, as mandated by the Dodd-Frank Act. Can you provide any additional information as to where the Commission is on this matter?

Response: Commission staff, including staff from the Division of Corporation Finance and the Division of Economic and Risk Analysis, are currently engaged in a comprehensive review of the accredited investor definition. As part of this review, the staff is evaluating the impact that any change in the income and net worth thresholds would have on capital formation and investor protection. In addition, the staff is considering and independently evaluating alternative, non-financial criteria for the accredited investor definition, such as professional or educational background, experience in private placement investments or reliance on registered brokers or investment advisers. The results of this review will help to inform the Commission's consideration of whether to change the definition of accredited investor. Any possible changes to the definition would subsequently occur through the notice and comment rulemaking process, which would involve a thorough economic analysis.

2.) I understand the SEC is examining whether the existing net worth and income tests are appropriate measures that should continue to be used. Are you aware of any studies that correlate net worth to investor sophistication?

Response: SEC staff has identified economic studies examining correlations between wealth and investor sophistication. The staff is evaluating whether the underlying data and ultimate conclusions of these studies provide insight into the characteristics of current U.S.-based investors. Among other issues being considered are the sample size, nature, and country of households utilized.

Wagner QFRs for SEC Chair Mary Jo White

1. Given the value of financial advice, would you be concerned by a regulatory action that threatened to cause lower and middle income investors to lose their ability to access affordable investment advice?

Response: The SEC has a three-part mission: to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation. I believe an important goal in pursuing the SEC's regulatory actions should be to make sure that investors, particularly retail investors, are appropriately protected and have access to the type of investment advice that they need and can afford. For example, the potential effects on investors, particularly retail investors, are a key consideration in considering whether to use the authority provided to the Commission under Section 913 of the Dodd-Frank Act.

2. Has the SEC been collaborating with Labor Secretary Thomas Perez on their fiduciary rulemaking. Please describe any and all discussions you, or other members of the SEC, have had and what was discussed. What actions do the SEC plan to take based on these discussions?

Response: I have met with Secretary Perez in person several times and we have spoken over the phone about the DOL's fiduciary rulemaking. The SEC staff has also met with DOL staff on a number of occasions, providing technical expertise regarding the Commissions' regulation of investment advisers and broker-dealers, including disclosure requirements and our approach to the conflicts that surround, among other things, principal trading, differential compensation, and receipt of commissions. Our economists and DOL economists have discussed cost-benefit related issues as well as relevant academic studies.

I recognize the concerns about consistency and the impact the DOL's rulemaking may have on Commission registrants, particularly broker-dealers. Of course, because the DOL has its own perspectives, jurisdiction, and statutory authority, any rules the agencies adopt may or may not differ. My goal and that of my staff is to continue to work together to coordinate our rules as much as is appropriate under our different statutory standards and mandates.

3. Have you and Secretary Perez discussed the situation in the U.K., where regulators implemented a rule banning commissions for financial advisors that resulted in a decrease in the ability of lower and middle income investors to access financial advice, a so-called "advice gap"? If so, did you discuss how to avoid similar adverse consequences for US investors?

Response: I am aware of the UK's Retail Distribution Review and the implementation of its adviser charging rules, and I understand that my staff has discussed with DOL representatives the potential impact on retail investors if they do not have access to affordable investment advice for their retirement savings. My consideration of any potential rulemaking by the Commission will certainly take into account the potential impact on retail investors' access to affordable investment advice. In addition, any Commission proposal would solicit public comments to better inform our efforts. I am committed to working with the Commission's economists in evaluating the costs and benefits of any potential approach so that we can further our goal of protecting investors without imposing unnecessary or unduly burdensome costs on them or the industry.

4. In recent testimony before the Oversight Subcommittee, OFR's director said that they participated in a meeting with the SEC regarding OFR's Asset Management Report. Would you please provide a comprehensive list of all meetings held between the OFR and the SEC regarding OFRs Asset Management Report?

Response: SEC staff met both in person and telephonically with OFR staff to discuss the study. Based on an informal review, SEC staff met with OFR staff approximately thirteen times between January 2013 and September 2013.

5. In recognition of the SEC's mission to facilitate capital formation, it has, in the past, taken action to expand access to capital for smaller companies. For example, in 2007, the SEC expanded access to the simpler, and more cost-effective, "shelf registration" on Form S-3 for SEC reporting companies with less than $75 million in public float. Has the SEC found any evidence of increased enforcement activity or cases of fraud it believes are a result of its 2007 expansion of shelf registration for smaller reporting companies on Form S-3?

Response: The staff does not specifically track enforcement activity related to the 2007 expansion of shelf registration, but generally is not aware of a significant increase in enforcement actions related to such change.

6. How many total Electronic Communications Privacy Act related subpoenas has the SEC issued in the last 8 calendar years? How many in each individual year for the past 8 years? How many were challenged? How many were quashed or modified?

Response: As part of the investigative process, SEC staff often issue subpoenas, which can number in the thousands over the course of any given year. The SEC does not, however, track the statutes related to each subpoena or the number of times its subpoenas are challenged, quashed, or modified. One exception to that practice is subpoenas issued to financial institutions covered by the Right to Financial Privacy Act, which imposes certain unique procedures and reporting requirements.

7. Does the SEC provide notice to the individual when the content of his or her emails is subpoenaed from an ISP? Why or why not?

Response: When the SEC has subpoenaed e-mail content from third-party ISPs, its practice has been to provide notice to the individual subscribers to give them the opportunity to challenge the subpoena in court pursuant to the Electronic Communications Privacy Act, 18 U.S.C. § 2703(b)(1)(B)(i).

8. In your letter of April 24, 2013 to Senator Leahy regarding your opposition to S. 607, the ECPA Amendments Act of 2013, you said the bill could have a significant negative impact on the SEC's enforcement efforts. As support, you cited a case in which the SEC obtained an email through an ECPA subpoena to the individual's internet service provider. What was the name of the case? Please describe why subpoenaing the email from the ISP was the only way to get evidence of the civil violation.

Response: The complaint referenced in the April 24, 2013 letter pertains to the matter of *SEC v. Len A. Familant and Paul Greene,* Civil Action No. 1:12-CV-00119-JEB (D.D.C. 2012). As noted in the letter, the e-mail evidence "was particularly important because, as alleged in the complaint, the defendants had carefully concealed their scheme. At the time the Commission subpoenaed the ISP, the individual had failed to produce his personal e-mail in response to a document subpoena the SEC had issued him almost a year earlier."

9. Mutual funds are currently subject to comprehensive regulation, like strict limits on leverage, diversification requirements and minimum standards for liquidity. Can you discuss how these regulations distinguish mutual funds from other financial institutions and reduce their potential to pose systemic risk?

Response: As you indicated, mutual funds and other investment companies registered with the SEC under the Investment Company Act of 1940 are subject to certain substantive restrictions on their investments. Among other things, mutual funds are limited in their use of leverage and may only borrow from banks, subject to a 300% asset coverage requirement on the amount of such borrowings. In addition, mutual funds may not invest more than 15% of their net assets in illiquid securities, which includes securities for which market quotations are not readily available, restricted securities and other investments that generally cannot be sold within seven days at approximately the price at which they are carried by the mutual fund. With respect to diversification, a mutual fund that identifies itself as diversified is limited, as to 75% of the value of its total assets, to investing no more than 5% of its assets in the securities of a single issuer.

In addition to these substantive investment restrictions, mutual funds and other SEC-registered investment companies are required to provide quarterly public reports (with a 60 day lag) of their portfolio holdings, are limited in their ability to transact with affiliates, and are subject to oversight by an independent board of directors.

Many other financial institutions, whether banks or non-banks, are not subject to the same level of investment restrictions, portfolio transparency, affiliated transaction prohibition, or independent board oversight. Together, these regulatory features of mutual funds are designed to address investor protection issues.

10. If a mutual fund is designated as a SIFI, one consequence is that investors in that fund could be assessed fees to bail out a distressed financial institution deemed systemically important, such as a large bank holding company. My constituents invest in mutual funds for their most important savings goals – such as saving for retirement, making a down payment on a first home and saving for their children's education. The prospect of their savings being tapped by the government to help bail out a failing financial institution is troubling to me. Can you discuss this consequence and the potential impact for investors?

Response: As your question indicates, mutual funds do not have excess capital. Each investor owns a pro-rata share of the mutual fund's assets, minus expenses. One impact, therefore, of any designation of a retail investment vehicle like a mutual fund, would be the economic effect such a designation would have on the investment return of the investors in the fund. Among other things that potentially would result from a designation are the imposition of capital standards as well as the imposition of fees that are charged to bank and non-bank systemically important financial institutions.

11. FSOC is considering whether asset managers or their activities pose risks to financial stability and, if so, whether an appropriate response is to designate managers or funds for prudential regulation and supervision by the Federal Reserve. Similar discussions are taking place in the global arena, as evidenced by a recent Financial Stability Board consultation. Fund managers invest as agents, not principals – which means that they do not take fund assets onto their balance sheets. Unlike banks, mutual funds don't need capital to absorb investment losses because fund investors understand that they are taking on risk when they invest in a fund.

Funds, after all, are simply conduits that allow my constituents to invest in the capital markets in a diversified and relatively cost-effective manner. Can you elaborate on how these and other aspects of the structure and regulation of mutual funds and their managers make it highly unlikely that they pose a systemic risk?

Response: As you indicate, mutual funds and other SEC-registered investment companies are investment vehicles. They invest primarily in the domestic and global securities markets. Unlike banks and certain other financial institutions such as insurance companies, funds do not promise to return principal or guarantee a prescribed return or a set payment by a specific date or upon a specific event. Investment losses are borne by a fund's investors and not by the asset manager. Asset managers function as agents for their principals, the funds to whom they owe a fiduciary duty. In addition, the assets under management are owned by the fund, so the financial strength of an asset manager does not pose potential harm to a fund for which they provide advisory services.

Mutual funds and other SEC-registered investment companies are required to provide disclosure to investors, and potential investors, detailing the nature of the investment risk they undertake. In addition, mutual funds are subject to substantive investment restrictions and also are required to provide quarterly public reports (with a 60 day lag) of their portfolio holdings, are limited in their ability to transact with affiliates, and are subject to oversight by an independent board of directors. Together, these structural and regulatory features of mutual funds are designed to address investor protection issues.

12. SIFI designation doesn't seem necessary for the asset management industry because the industry is already subject to SEC oversight. Can you discuss the SEC's current efforts with respect to regulating and monitoring the asset management industry?

Response: Pursuant to the Investment Advisers Act and the Investment Company Act, the SEC has been regulating investment advisers and mutual funds and other investment companies since 1940, and therefore has nearly 75 years of institutional expertise and knowledge of asset management entities. The Commission's efforts in administering these statutes is multi-faceted and focus on minimizing financial risks to investors from fraud, self-dealing and misleading or incomplete disclosure through rulemaking; registration, review and investor disclosure; risk assessment; examinations and enforcement. The SEC has approximately 650 professionals focused on the regulation, monitoring and on-site examination of investment advisers and funds.

One of the fundamental tenets of investment adviser regulation is that, as declared by the Supreme Court in 1964, investment advisers are fiduciaries. As such, asset managers must put their clients' interests before their own and mitigate and disclose any conflicts of interest, such as trading for their own account and arrangements with brokers.

In addition, asset managers with assets under management above $100 million are subject to an SEC-administered regulatory regime under the Investment Advisers Act. This regime includes custody and recordkeeping requirements; restrictions on frontrunning, principal trading and misuse of material non-public information; and an on-site examination program. Asset managers are subject to comprehensive public disclosure requirements, including disclosure of disciplinary history, business organization and personnel, conflicts of interest and private fund census information. Much of the asset manager regulatory regime has focused on establishing a fundamental separation between investment advisers, on the one hand, and the assets of their clients, on the other – whether those assets are in a fund or managed accounts.

In addition, mutual funds, exchange-traded funds, and other registered investment companies are operated pursuant to a comprehensive regulatory regime under the Investment Company Act. That regime imposes substantive limits on investments by the mutual funds, including leverage, liquidity, and diversification standards; mandates a minimum level of independence in governance; and prohibits most transactions with affiliates. In addition, mutual funds are subject to on-site examination by SEC examiners.

The SEC staff reviews fund and adviser disclosures; answers interpretive questions; conducts risk-based monitoring; prepares recommendations for new rules and rule amendments; meets with asset management executives to discuss issues such as firm growth, risk management, and market trends; and engages in rulewriting and policy analysis. The risk monitoring program includes monitoring trends in the asset management industry, analyzing industry data and carrying out targeted examinations.

The SEC also deploys staff from 12 field offices across the country to conduct on-site examinations of advisers and their funds. All of these regulatory efforts supplement the SEC's strong enforcement program, which includes the SEC's Asset Management Unit within the Division of Enforcement.

With respect to industry monitoring, the SEC also focuses on geo-political, natural disaster and market events that can have an impact on SEC-regulated funds and advisers. Regarding such events, we focus on maintaining communication with affected asset managers, reviewing disclosures to investors and assessing the impact on investors' ability to access funds or trade securities.

I have asked the Division of Investment Management staff for an "action plan" to enhance our asset manager risk management oversight program. Among the initiatives under near-term consideration are expanded stress testing, more robust data reporting, and increased oversight of the largest asset management firms.