LEGISLATIVE PROPOSALS TO PROMOTE JOB CREATION, CAPITAL FORMATION, AND MARKET CERTAINTY

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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U.S. HOUSE OF REPRESENTATIVES

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LEGISLATIVE PROPOSALS TO PROMOTE JOB CREATION, CAPITAL FORMATION, AND MARKET CERTAINTY

Wednesday, March 16, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:04 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Manzullo, Neugebauer, McCotter, Posey, Hayworth, Hurt, Grimm, Stivers; Sherman, Lynch, Miller of North Carolina, Donnelly, Himes, Peters, and Green.

Chairman GARRETT. This hearing of the Capital Markets Subcommittee will come to order. Today's hearing is entitled, "Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty." Each side will be limited to 10 minutes for opening statements.

And I will now yield myself 1 minute.

Basically, all I want to say during my time is I am pleased to chair today's hearing inasmuch as today is the first legislative hearing in which we are going to try to discuss real solutions that address several of the negative consequences that resulted from Dodd-Frank. And these are the areas as mentioned: job creation; capital formation; and market certainty.

I am also pleased that we have with us today the subcommittee's five freshmen. Basically, these freshmen have stepped up to the role of sponsoring the five pieces of legislation that we will be discussing from the panel shortly, which address the areas of promoting job creation and eliminating unnecessary government overreach. These are issues that they all engaged in during the campaign of last fall. And now that they are here in Washington, I would say that these freshmen are proving that they can get the job done and are doing something about these issues.

Throughout the debate over Dodd-Frank in the last Congress, I often spoke about the many negative consequences, both intended and unintended, that it has caused. Now, some of those negative consequences are being exacerbated by what? By the rulemaking process that we are going through right now.

So my hope is that the bills in front of us today will spur a productive discussion that will continue here in this subcommittee and throughout this Congress. They will focus on ways to—as I have already said—get capital, private capital off the sidelines, back into the marketplace and create those jobs that we so desperately need.

And with that, I will yield 3 minutes to the gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

Some say that all we worry about here is the next election. If you are only worried about the next election, you can achieve your purpose by passing statement bills, bills that might pass the House or committee, but have no chance in the other body. Hopefully, we are focusing on bills that will actually pass both bodies, be signed by the President and, hopefully, will focus on things that affect the capital markets, not just our own reelection chances.

Dodd-Frank needs technical correction and improvement. Those who voted for it acknowledged that it would need a technical corrections bill. And we are going to need to pass several. But if we pass nothing except on a purely partisan basis—as I believe almost every vote at the full committee in markup has been absolutely party line, and that is thousands of votes we have cast already this year, each of us casting a couple dozen.

And so, I hope that these bills will move forward and become bipartisan, both in content and in sponsorship. I am particularly concerned with the credit rating agencies. Senator Franken and I worked on an amendment that then got mangled in conference so that it is a little vague. And it gives a little too long to the SEC to act. What we need is to guarantee that we clarify that and that we expedite it and we make it clear to the SEC that within 2 years, we will not be in a circumstance where you get to pick your credit rating agencies when you are issuing a debt instrument.

If the pitcher picks the umpire, it is a strike. We know that. And hopefully, we won't be dealing with tactics that try to dissuade us from that by saying things like, "Well, just tell people not to rely on the credit rating agencies' rating," which begs the question, what social purpose do they serve, but also, how can you possibly not rely on it?

Even if you are investing in a mutual fund, you have to choose between several different mutual funds. Which one of those funds, both with a 5 percent rate of return, is investing in the safest instrument? I guess if you have $10,000 to invest and you want to spend a couple million dollars evaluating the portfolios on your own, you could reach a conclusion. Otherwise, you have to rely on the credit rating agency.

We do have one bill that deals with credit rating agencies, but it does not deal with the issue that we have to deal with, which is issuers selecting their own rater. And I hope that legislation that will drive this change forward may—on an expedited basis, will pass this committee on a bipartisan basis, whether that is through an amendment to the Stivers bill or as separate legislation.

I yield back.

Chairman GARRETT. And I thank the gentleman. I think we are on the same page, hoping to see these bills get through the process and to the White House and signed.

And with that, I will yield 1 minute and 20 seconds to the gentleman from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. One minute, 20 seconds. Okay. I am going to actually speak to H.R. 1070, which is the Small Company Capital Formation Act of 2011. And part of this, we have had a couple of the folks who are here to testify today have actually come and visited me in my office talking about what has gone on with Reg A.

If you take a look at the little charts—and we have a handful of charts we have mocked up, you see that nice, long, flat line on the right-hand side? That is where we have been now since 1992, 1993 where we have not raised the dollar amount that you can take a small company and go and put it out on the market.

If we truly care about creation of jobs, if we care about capital formation and getting that velocity of innovative ideas in the marketplace where you and I can buy and sell them in some type of stock or equity, I think this bill is simple. It directs the SEC to raise that limit up. We would like to raise it up to $50 million for initial offerings within those Reg A rules.

Thank you, Mr. Chairman.

Chairman GARRETT. I thank the gentleman.

Mr. Peters is recognized for 2 minutes.

Mr. PETERS. Thank you, Mr. Chairman, and thank you for holding a hearing on legislative proposals to promote job creation. I think there is bipartisan agreement that job creation should be our top priority. And some of the bills that we will be dealing with today are issues that were worked on in the last Congress in a bipartisan fashion.

For example, I worked with Chairman Garrett as well as Mr. Meeks on including a provision in Dodd-Frank that includes a $150 million exemption from the SEC registration requirement for private funds and also directs the SEC to come up with a registration scheme for larger firms that takes into account the amount of risk they pose for investors or for the larger economy. I think the amendment provides the SEC with the flexibility that they need to come up with a less burdensome registration scheme and I look forward to continuing to work with Chairman Garrett on this issue.

I also worked closely with many of my colleagues on both sides of the aisle and in both Houses of Congress on the derivatives title of Dodd-Frank. Bringing greater regulation and transparency to these markets is of critical importance. But I remain committed to making sure that end-users who are using derivatives to hedge actual risk are not required to post margins. It is important that as we revisit the end-user exemption, we keep in mind the important role that captive finance companies play in supporting the work that end-users do to create jobs and to grow our economy and also pension funds that provide retirement security to millions of workers and retirees.

Mr. Chairman, I yield back the balance of my time.

Chairman GARRETT. Thank you.

The gentleman from California for 1 minute and 20 seconds?

Mr. ROYCE. Yes, thank you, Mr. Chairman. I think the future of U.S. competitiveness is dependent upon us looking at three glaring impediments to capital formation: first, unnecessary and duplicative regulation; second, excessive litigation; and third, a convoluted Tax Code. We have the second highest corporate tax code in the world.

In terms of raising capital through IPOs, I have watched us go from a situation where half of the world's new public companies in the 1990s were here to one today where we have 13 percent. And, as Mr. Weild notes in his testimony, there has been a precipitous decline in the number of publicly listed companies in the United States on our exchanges.

We had 8,823 in 1997, and 5,091 at the end of last month. That is a 42 percent decline. And this is the definition of capital flight. When capital, both human and financial, can relocate anywhere around the globe with the type of ease that they have today, we have to reassess the business environment that we have created here.

The three problems I indicated are all problems that Congress has contributed to mightily. And I am grateful to the Chair for taking a critical step in this endeavor and I look forward to the testimony of our witnesses.

Thank you, Mr. Chairman.

Chairman GARRETT. I thank the gentleman.

To the gentlelady from New York for a minute and 20 seconds?

Dr. HAYWORTH. Thank you, Mr. Chairman.

And thank you to our witnesses for joining us. Congressman Royce's comment regarding the business environment could not be more apt. And vis-a-vis that, this week we have introduced the Burdensome Data Collection Relief Act, H.R. 1062. And that would repeal Section 953 of Dodd-Frank. There have been statements of support from both sides of our political aisle supporting this concept of repeal. And I appreciate that.

Existing law does, as you all know, require extensive disclosure regarding executive compensation. And all material information that a company that issues stock—is a public company—is required to be disclosed, material information that would affect a decision to invest or divest or vote for directors. The legislation that we have proposed in H.R. 1062 only applies to immaterial disclosures, which is, in fact, virtually all of that particular section.

One lesson of our financial crisis that started, as we know, in 2008, is the importance of risks and incentives associated with executive compensation. H.R. 1062 focuses disclosures regarding executive compensation on these risks and incentives by eliminating irrelevant and confusing, extraneous information.

The disclosure requirement, Section 953(b), as it now exists would be costly and time-consuming for employers, would serve no useful purpose for company shareholders, and most crucially, would divert resources from job creation. And that is our critical role here. So for these reasons, we need to repeal Section 953(b).

I thank you again for your testimony today.

And I thank the chairman. I yield back.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Virginia for a minute and 20 seconds?

Mr. HURT. Thank you, Mr. Chairman.

I want to thank you all for being here this afternoon.

Mr. Chairman, I want to thank you for holding today's hearing on these important legislative proposals that will facilitate job creation by increasing the flow of private capital to small businesses. As noted by Republican and Democrat Members in last week's hearing with the SEC, there is serious concern about the effects of the new government mandate for advisers to private equity included in Dodd-Frank. These unnecessary registration requirements, which do not make the financial system more stable or less risky, will impose an undue burden on small and mid-sized private equity firms and will decrease capital available to spur job growth.

This is why I have introduced H.R. 1082, the Small Business Capital Access and Job Preservation Act, with bipartisan support. If enacted, private equity advisers will be given the same exemption under Dodd-Frank that venture capital advisers receive. This will allow small businesses to access capital, expand, and get people back to work. With unemployment still unacceptably high in my district, Virginia's 5th District, and across the country, now is not the time to impose onerous and unnecessary regulatory requirements that force firms to divert essential capital from preserving and creating jobs.

I look forward to the testimony of our witnesses and thank them for their appearance before our subcommittee today.

Thank you, Mr. Chairman. And I yield back the balance of my time.

Chairman GARRETT. I thank the gentleman.

Now, the gentleman we have been waiting to hear from is recognized for a minute and 20 seconds.

Mr. STIVERS. Thank you, Mr. Chairman. You will always be waiting to hear from me because I am the most junior member of the committee. I would like to thank the chairman for calling this important hearing.

And the five bills we are going to talk about today are going to be addressing some of the most burdensome parts of the Dodd-Frank bill that are having a negative impact on jobs in our country. Specifically, the proposal that I have brought forward deals with the asset-backed securities market. It is the Asset-Backed Market Stabilization Act of 2011.

Last year, in Dodd-Frank, the credit rating agencies were basically held liable for potential shareholder lawsuits. And as a result of that, the Securities and Exchange Commission had to issue two no-action letters to get the asset-backed securities market moving again. And unfortunately, that is not a way to make things work.

We can't have laws on the book and have regulatory agencies saying we are not going to enforce this law. So I think there is a better way to move forward.

I know Mr. Sherman talked earlier about the conflict of interest. I think we need to deal with both of those things long-term. And we are looking at making some changes that may deal with a little more of that in this bill. But this bill will basically do away with Section 939(g) of the Dodd-Frank bill and go back to the old Section 436.

It will help folks like Ford, and like Honda, that employs about 4,400 people in my district and built 400,000 cars last year. This is a way to finance the creation of things and make sure that we continue to have jobs in this country.

I look forward to hearing the witnesses. And I appreciate the opportunity to bring this bill forward.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman yields back.

And at this point, I welcome again the entire panel for being with us here today. Without objection, your complete statements will be made a part of the record. And as those of you who have been on these panels before know that you will each be recognized for 5 minutes. And, of course, before you are the red, green, and yellow lights to advise you to keep you within that timeframe, if we can do so.

So with that, I begin with 5 minutes to Mr. Bertsch, please.

STATEMENT OF KENNETH A. BERTSCH, PRESIDENT AND CEO, SOCIETY OF CORPORATE SECRETARIES AND GOVERNANCE PROFESSIONALS

Mr. BERTSCH. Thanks. My name is Ken Bertsch, and I am the new executive head of the Society of Corporate Secretaries and Governance Professionals, which is an association of governance officers. We have 3,100 members.

Thank you for the opportunity to testify on the repeal of Section 953(b) of the Dodd-Frank Act, which requires company disclosure on the pay ratio, as Congresswoman Hayworth just mentioned, between the CEO and the medium-paid employees of the company. We acknowledge the public policy concern on widening pay gaps in the United States. However, we believe the required disclosure will not be material or meaningful to investors and that Section 953(b) as now written will be difficult and expensive to implement.

We note also, by the way, that the SEC faces challenges in implementing many Dodd-Frank reforms and is otherwise resource-constrained. The SEC must prioritize and focus on the most important issues facing investors in the securities market. Accordingly, we believe the provision should be repealed. If Congress wishes to move ahead on the concept of the pay ratio, a more workable legislation should be enacted.

We have two basic problems here. One, the pay ratio would not provide meaningful information to investors, in our view. Under existing SEC requirements, investors get extensive disclosure on executive compensation.

SEC disclosure documents are meant to contain information that a reasonable investor needs to make an investment decision. SEC disclosure documents are not meant to contain every item of information that any investor could possibly want to know. Proliferation of disclosure requirements not censored on a disciplined standard will make SEC disclosure documents unusable for the average investor.

The pay ratio will not provide meaningful, comparable data because it is not based on similarly situated employees. There is a great deal of noise around what constitutes a company employee with many firms contracting out work locally or globally and others not doing so. Some companies have overseas locations with lower pay levels where much of the work is done. They have outsourced.

These companies may have better pay ratios than those that have chosen to maintain their operations, call centers, for example, in the United States. Companies with franchisees rather than company staff stores will also likely have a better pay ratio. The pay ratio will not be a meaningful measure to compare the CEO's compensation or to compare the pay practices within a single industry.

We believe investors have indicated limited interest in obtaining such pay ratio information from companies. We are aware of votes last year on 10 shareholder proposals requesting reports on pay disparity. On average, the proposals were opposed by 93.9 percent of the shares voted. They received lower levels of support than many other shareholder proposals concerning executive compensation.

Finally, if investors are concerned that they need additional disclosure on pay equity, they can exert pressure through say-on-pay votes, votes on directors, and shareholder proposals.

The second major area of concern—the requirement as written is burdensome well beyond its benefit. Given the definition used in this provision, we fear that large, worldwide U.S. companies will not be able to calculate the median of the annual total compensation of all employees, as the law specifies, with the degree of precision and certainty required for information filed under U.S. securities laws.

Payroll systems are not set up to gather the kind of information required under this provision. This is especially the case for companies organized into multiple business operating units. Those business units keep records and have internal controls over what each employee is paid, but they report aggregate figures to the parent company for inclusion in consolidated financial reports for public filings.

A company would have to convert the pay of each employee globally into the elaborate pay formula applicable to the named executive officers in the summary compensation table. To our knowledge, no public company now calculates each employee's total compensation this way. For a company with tens of thousands of employees, this would be a very large and costly task, at best.

My written testimony lists some of the questions that corporate staff must answer in trying to comply. I would point to one in particular that—and there are really a lot of different questions that would have to be answered. One that is a little bit different than other understanding is that local privacy laws in some markets actually prevent the export of personal compensation information across borders without employee consent.

In summary, we believe the provision is simply unworkable and would produce information that is not meaningful to investors. Thank you.

[The prepared statement of Mr. Bertsch can be found on page 44 of the appendix.]

Chairman GARRETT. I thank the gentleman.

Mr. Deutsch for 5 minutes?

STATEMENT OF TOM DEUTSCH, EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM (ASF)

Mr. DEUTSCH. Thank you very much, Chairman Garrett, for inviting me to testify here on behalf of the American Securitization Forum. My name is Tom Deutsch. I am the executive director of the organization that represents over 330 member institutions who originate the collateral for most mortgage and asset-backed securitizations in America. That includes auto loans, student loan companies, mortgage originators, small banks, large banks, as well as lenders to small and medium-sized businesses.

Let me first just address a couple key points of the importance of the securitization markets to the overall global economy, in particular, the U.S. economy. Currently, there are over $11 trillion outstanding of securitized assets in America, of all these different asset classes: credit cards; student loans; asset-backed commercial paper, etc. In particular, 91 percent of all outstanding loans—at least currently, loans that are being originated to support auto loans to consumers, 91 percent of those are financed through the securitization process.

Finally, even talking about Government-Sponsored Enterprises. Although 95 percent of mortgages in America today are backed by the U.S. Government, Fannie Mae, Freddie Mac, and Ginnie Mae all securitize those loans into the secondary market and sell them to the institutional investors such as pension funds, mutual funds, insurance companies, and others who seek returns on those investments.

But as we saw in 2009, once the securitization market stopped working, the credit market stopped working. It is a very quick—and, unfortunately for American consumers, unfortunate that they wouldn't be able to access auto loans, credit cards, and student loans at many of the same levels, certainly not looking to go back to a 2006 credit availability, but we certainly don't want to go back to a 2009 credit availability, either.

As we saw strong consumer ABS demand uptick into 2010, we had significant issuance of auto and other asset-backed securitizations. We also saw credit availability expand for more lower-income borrowers and also at cheaper rates throughout the United States.

My purpose in testifying here today is to talk about two issues. In my written statement, I go into a great amount of detail about some key issues related to securitization that concerns the orderly liquidation authority provisions of the Dodd-Frank Act. There is a tremendous amount of detail, and I will leave that to your future reading.

But in my oral remarks today, I do want to focus on the ASF's strong support for Congressman Stivers' legislation to effectively repeal the repeal of 436(g). Although he has not introduced it yet, we have seen the draft that is available online.

In this testimony, I would like to provide a little bit of background of how 436(g) works and in particular, why it is important for the securitization markets that we have a long-term fix. As Congressman Stivers indicated, on July 22nd, the repeal of 436(g) went into effect. That was the day after President Obama signed

Dodd-Frank into law. That same day, the securitization markets completely shut down.

No issuer of auto loans, student loans, etc., was able to put a securitization in the market because of a peculiar SEC regulation, items 1103 and 1120, that specifically require that ratings be included in statutory prospectuses. The securitization markets are the only markets to be impacted by this.

Because of this, credit rating agencies were not willing to provide consent to include those ratings into the statutory prospectuses because at that point, they had become subject to strict Section 11 liability. That is in their ratings, when they are providing some forward-looking statements about the potential credit quality out of the underlying assets and what that performance may be over time, they are very concerned that with 20/20 hindsight 5 years down the road, you could look back and say, that assessment wasn't exactly right. We are going to bring litigation against you because you didn't have the right assumptions.

This is very different than existing parties that are subject to Section 11 liability under the Securities Act because they look at existing facts and things that they can actually verify as opposed to make forward-looking statements. That is why it is critical to distinguish between credit rating agencies being subject to this Section 11 strict liability and other potential actors that are currently subject to this liability.

But at this point, the markets have resumed under the SEC's no-action letter, which we certainly are very grateful for the SEC staff to be able to keep the securitization markets going. But a no-action letter is certainly not a long-term or permanent fix. So what we are proposing and what we are strongly supportive of is legislation that would ultimately repeal the repeal of Rule 436(g) so that the securitization markets can go back to normal and have the permanency associated with being able to understand the rules and not have this subject to change in the SEC's position.

I thank you very much for the time. And I look forward to answering any questions that committee members may have.

[The prepared statement of Mr. Deutsch can be found on page 50 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Ms. Hendrickson for 5 minutes?

STATEMENT OF PAMELA B. HENDRICKSON, CHIEF OPERATING OFFICER, THE RIVERSIDE COMPANY

Ms. HENDRICKSON. Chairman Garrett, members of the subcommittee—

Chairman GARRETT. Can you just pull your microphone up a little bit?

Ms. HENDRICKSON. Sorry.

Chairman GARRETT. And then you might want to even pull it up closer to you a little bit.

Ms. HENDRICKSON. Can you hear me now?

Chairman GARRETT. There you go.

Ms. HENDRICKSON. Chairman Garrett, members of the subcommittee, my name is Pam Hendrickson, and I am the chief operating officer of The Riverside Company.

Riverside is a private equity firm that manages $3.5 billion of investor funds. We use that money to buy and build small companies that, with our capital and guidance, will grow and create hundreds of jobs. Today, the 50 companies we own in the United States together employ more than 10,000 people.

There are more than 2,000 small and mid-market private equity firms like us in the United States. I am here today to support legislation introduced by Representative Hurt of Virginia that would eliminate the Dodd-Frank requirement that private equity firms register with and report to the Securities and Exchange Commission under the Investment Advisers Act of 1940.

Registration will not accomplish Dodd-Frank's stated purpose of helping identify and reduce systemic risk in the U.S. financial system. Let me begin by sharing a story. Commonwealth Laminating and Coating is a small company based in Martinsville, Virginia. It manufactures solar window films that help shield cars, houses, and commercial properties from the sun's heat.

Its products are sold all over the world, but they are all manufactured in Martinsville. In 2006, CEO Steve Phillips realized that he needed much more capital to continue to grow his company. Riverside was approached as a potential capital source and acquired a majority interest in CLC.

At the height of the recession, Riverside and CLC together invested an additional $16 million in capital to significantly boost the company's production capacity. Together, we grew jobs by 73 percent.

By the time Riverside sold CLC last summer, the company had grown its earnings by 277 percent. The teachers, firefighters, and government employees whose pension funds invested in Riverside received a significant return.

The bottom line is that with Riverside's help, this small company in Martinsville nearly quadrupled its earnings and significantly increased its employee base during our ownership period. This is what Riverside and firms like us do every day.

But suppose the CLC investment hadn't turned out so well. Could a failure there have created the type of cascading losses that caused the financial crisis? The answer is a resounding no.

Private equity investors commit capital over a 10-year period. They generally have no right to pull their money out of a fund. So there simply couldn't be a run on the bank.

Any financial loss would have been confined to this single investment. Private equity transactions are not interconnected with other financial market players. And they are not related to each other.

The failure of any one company cannot cause a ripple effect. Our world is not the Wild West. Our industry is closely watched and heavily scrutinized by a very sophisticated group of investors, generally large pension funds, foundations, and endowments who employ highly-trained consultants and experienced lawyers.

Private equity has been around for 50 years and has survived at least 3 cyclical downturns. In all those years, neither the SEC nor this committee have had to devote time to worrying about negative macroeconomic impacts or investor fraud in private equity. We invest in businesses and people, not publicly traded securities.

What happens to Riverside if the proposed registration and reporting requirements take effect? Let us look at just one issue, valuation. Valuing private companies where there is no publicly traded stock is an art, not a science. It is challenging, and it is expensive. While we develop quarterly valuations for our investors, they understand that the true value of an investment is known only when the acquired company is sold and profits are returned to them.

Under the proposed new rule, all private equity firms would be required to calculate the value and performance of each of their funds, and, therefore, each of their companies, on a monthly basis. You can do the math. Our 50 companies times 12 months means we would have to undertake 600 separate valuations each year to comply with the regulation.

Under the new rules, small firms might need to calculate 240,000 company values each year. That is for members of the Association for Corporate Growth, who represent about 20,000 small companies. According to comments filed with the SEC, estimated annual costs per firm of this exercise range from $500,000 to $1 million.

To conclude, private equity exists in large part because the public equity markets do not do a good job of serving the capital needs of small companies, the companies that generate the most job growth. Instead of imposing additional costs and regulatory burdens, we should be supporting a system that has steadily provided critical capital to small and growing businesses, thereby strengthening companies, communities, and creating more jobs.

Thank you for the opportunity.

[The prepared statement of Ms. Hendrickson can be found on page 83 of the appendix.]

Chairman GARRETT. Mr. Weild?

STATEMENT OF DAVID WEILD, SENIOR ADVISOR, GRANT THORNTON LLP

Mr. WEILD. Thank you. Chairman Garrett and members of the subcommittee, thank you for inviting me to testify this afternoon on job creation, capital formation, and market certainty, issues that are absolutely critical to our Nation's economic future. My name is David Weild, and I am a senior adviser for the Capital Markets Group of Grant Thornton, one of the six global audit tax and advisory organizations.

The United States stock market, once the envy of the world, has suffered a devastating decline in numbers of small initial public offerings. Our research and analysis of relevant data strongly demonstrates that small businesses and entrepreneurs cannot access the capital they need to grow jobs. The United States is losing more public companies from our listed stock exchanges than we are replacing with new IPOs.

When measured by number of listed companies, America's stock exchanges are declining while those of other developed nations are increasing. It is imperative that Congress, regulators, and stakeholders in the debate evaluate and take action to increase the number of U.S. publicly listed companies. An increase to the Regulation A ceiling will provide a less costly and more effective alternative for smaller entrepreneurial companies that want to access the public capital markets and may also enable smaller growth-oriented companies to access the public market at an earlier stage in their growth cycle.

We applaud the Small Company Capital Formation Act as the beginning of a campaign to bring back the small IPO, the U.S. economy and our stock markets. Regulation A was originally enacted during the Great Depression to help the economy by improving small-business access to equity capital. Huge startups and growth companies have the option to borrow money from a bank, and consequently, access equity risk capital is essential to drive entrepreneurship.

This bill does three things that are enormously beneficial for small companies' capital formation and in turn, the U.S. economy. First, it will drive down costs for issuers by permitting the use of a simpler offering circular for the SEC's review. Second, it opens up the Regulation A exemption to a size—this is important—that will allow companies to list on the New York Stock Exchange and NASDAQ and to avail themselves of the so-called "blue sky" exemption, thus avoiding extremely costly State-by-State filings.

And third, it will allow issuers to gauge the viability of an offering by meeting with investors before incurring the significant costs of an offering. This last so-called "testing the waters" provision may not seem like much, but there has been a steady increase in IPOs that are postponed, withdrawn, priced below the low end of the range of the IPO filing range, or that have broken the IPO issue price within 30 days of the completion of an offering. These so-called "busted deals" can be ruinous to small companies.

I fully endorse the passage of this bill to increase the cap on Regulation A from $5 million to $50 million with the following requirements: one, that issuers file audited statements with the Securities and Exchange Commission and distribute such statements to prospective investors; two, that issuers be required to submit their offering statements to the SEC electronically; three, that periodic disclosures be determined by the SEC—we recommend that they mimic those required of registered companies—and four, that the SEC stipulate so-called "bad boy" provisions to disqualify from participation in this market those individuals or entities with a disciplinary or criminal history.

I applaud the subcommittee for seeking solutions to the capital formation challenges that small-growth companies face. Passage of the Regulation A draft bill is a necessary first step in the campaign to bring back the small IPO, generate jobs, and revitalize the U.S. economy.

Please note, however, that this Regulation A draft bill alone is not going to be sufficient to get the IPO market back on track and to get America back on the path to prosperity. I encourage Congress to seek many solutions, including a congressional charter for a new stock market, one that focuses on providing the essential economic model that sustains the infrastructure needed to support small public companies and drive that long-term growth and prosperity that we all seek for all Americans. A market such as this would also drive tax revenues without costing the taxpayers a dime.

Thank you for this opportunity to present on such an incredibly important topic. I am pleased to answer any questions. Thank you.

[The prepared statement of Mr. Weild can be found on page 107 of the appendix.]

Chairman GARRETT. I appreciate your testimony. We will have questions in a moment.

Mr. Zubrod for 5 minutes?

STATEMENT OF LUKE ZUBROD, DIRECTOR, CHATHAM FINANCIAL

Mr. ZUBROD. Good afternoon, Chairman Garrett, and members of the subcommittee. I thank you for the opportunity to testify today regarding legislative proposals to promote job creation, capital formation, and market certainty. My name is Luke Zubrod, and I am a director at Chatham Financial.

Today, Chatham speaks on behalf of the Coalition for Derivatives End Users. The Coalition represents thousands of companies across the United States that utilize over-the-counter derivatives to manage day-to-day business risk. Chatham is an independent adviser to businesses that use derivatives to reduce risk. A global firm based in Pennsylvania, Chatham serves over 1,000 end-user clients, ranging from Fortune 100 companies to small businesses, including clients in 46 States and every State represented by members of this subcommittee.

The Coalition supports the efforts of this subcommittee to pass legislation aimed at reducing systemic risk and increasing transparency in the OTC derivatives market. The Coalition also appreciates the bipartisan nature of the present undertaking. The overwhelming and bipartisan support for end-users was made clear in the amendments adopted to the financial reform legislation that passed the House in December 2009.

Several amendments, including the Murphy-McMahon amendment which passed with 304 votes, were intended to ensure that the salient economic requirements of the Act were appropriately focused on those entities whose use of derivatives could jeopardize financial stability. In essence, they were intended to protect end-users from onerous bank-like regulation that would divert precious working capital from job-creating activities, including research and development and business expansion.

Let me turn to where things now stand in terms of implementing the derivatives title of the Dodd-Frank Act and point out where end-users have the greatest concern. The Coalition appreciates recent comments by Federal Reserve Chairman Ben Bernanke, CFTC Chairman Gary Gensler, and SEC Chairman Mary Schapiro indicating that margin requirements should not be imposed retroactively. Appropriately, the chairmen recognized that the retroactive imposition of a margin requirement would upset the reasonable expectations of market participants when they entered into preexisting contracts and could severely restrict economic growth.

The Coalition is concerned, however, by recent testimony provided by regulators concerning the imposition of margin requirements on end-user transactions used prudently for the purpose of risk management. Congress recognized that the imposition of margins on end-users would divert working capital from job-creating activities and hamper economic growth while offering no appreciable mitigation of systemic risk.

Indeed, following the conclusion of the conference committee, the chairmen of the four committees with primary jurisdiction over Title 7 took steps to make clear that regulators did not have the authority to impose margins on end-user hedges. However, in spite of congressional intent and the clear language of the statute, some regulators appear to have interpreted Title 7 as giving them authority to impose margin on end-user hedges and even worse, requiring swap dealers to impose margin requirements on all end-user hedges. We respectfully request that this committee provide end-users with certainty by clarifying that their hedges will not be subject to margin requirements.

The Coalition appreciates the hard work of the CFTC, the SEC, and prudential regulators in proposing more than half of the 150 or more expected rules to meet the 1-year rulemaking timeline mandated by Congress. The regulators have run an open and transparent process and have met with representatives of the Coalition approximately a dozen times. However, we are concerned that the statutory deadline for rulemaking does not allow regulators sufficient time to incorporate recommendations, craft thoughtful rules, and conduct adequate cost/benefit analyses.

The regulators have sufficient authority to adopt a phased-in approach to implementation of rules. We are eager to ensure the final rules strengthen the market and minimize unintended and unnecessary consequences.

We therefore, respectfully ask this committee to consider extending the date by which final derivatives regulations must be promulgated, which is now set at July 15, 2011. Additionally, I elaborate in my written testimony on two more issues, which I will briefly summarize.

First, though we strongly support the legislation's transparency objective, we are concerned that proposed real-time reporting rules could inadvertently jeopardize end-users' ability to secure efficient market pricing in certain situations. Second, the Coalition is concerned that capital adequacy guidelines finalized by the Basel Committee on banking supervision late last year could unnecessarily and substantially increase end-user costs incurred as they use derivatives to manage their business risk.

As regulators go about the important work of finalizing the rules intended to address problems revealed by the financial crisis, it is critical that well-functioning aspects of these markets not be harmed. We appreciate your attention to these concerns and look forward to continuing to support the subcommittee's efforts to ensure that derivatives regulations do not unnecessarily burden American businesses, jeopardize economic growth, or harm job creation.

Thank you for the opportunity to testify today.

[The prepared statement of Mr. Zubrod can be found on page 122 of the appendix.]

Chairman GARRETT. And I thank you.

Mr. Silvers for 5 minutes?

STATEMENT OF DAMON A. SILVERS, POLICY DIRECTOR AND SPECIAL COUNSEL, AFL-CIO

Mr. SILVERS. Thank you, Mr. Chairman. I am Damon Silvers. I am the policy director and special counsel for the AFL-CIO. I am testifying today on behalf of the Americans for Financial Reform and the Consumer Federation of America as well as for the AFL-CIO.

The 250 member organizations of Americans for Financial Reform represent well over 50 million Americans and their families. I should note I am also the Deputy Chair of the Congressional Oversight Panel for TARP, however, I am not here on behalf of either the panel or its staff.

The title of today's hearing is, "Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty." These are the very goals that the Dodd-Frank Wall Street Reform and Consumer Protection Act sought to achieve after the most traumatic financial crisis since the Great Depression cost our Nation 8 million jobs, left 13 million families facing home foreclosure, and destroyed $10 trillion in household wealth.

Well-regulated financial markets facilitate capital formation and help private companies obtain the financing they need to grow and create jobs. Poorly-regulated markets, such as we have seen over and over again in the last 15 years, lead to bubbles and panics and excess volatility, which destroy confidence and jobs. If we want well-regulated markets, Congress must first give regulators the opportunity to implement the Dodd-Frank Act and the financing necessary to do so effectively.

The American people are genuinely worried—I think that is an understatement—about unemployment and are frustrated that Congress is focused on side issues that will not help people get back to work. A tracking poll conducted by the Kaiser Foundation in February found that 71 percent of adults in this country feel that Congress is paying too little attention to the economy and jobs. Tragically, cynical exercises in financial deregulation, such as the bills under consideration today, are only going to intensify public frustration with this Congress.

If there was a truth-in-labeling act for Congress, the Business Risk Mitigation and Price Stabilization Act would be called the "Help Create Another AIG Act." The proposal would amend the definition of a major swap participant to prevent regulators from designating from special oversight undercapitalized and highly-leveraged financial institutions that maintain major derivatives positions that threaten U.S. financial stability.

I have here the Congressional Oversight Panel's 300-page unanimous bipartisan report on AIG that will hopefully help refresh the subcommittee's memory as to where this type of deregulation leads. The Burdensome Data Collection Relief Act, which would repeal the Dodd-Frank requirement that issuers disclose the ratio between CEO pay and median worker pay, should be called the "Promote CEO Pay Secrecy Act."

I have here the Congressional Oversight Panel's unanimous bipartisan report on executive compensation and the TARP, which, among other things, contains the testimony of the special master for executive pay that executives of our country's major financial firms "feathered their own nests to the tune of billions of dollars while their companies were receiving public money and laying off tens of thousands of Americans."

The Small Business Capital Access and Job Preservation Act, which would amend the Investment Advisers Act to provide a registration exemption for private equity fund advisers, should be called the "No Accountability for Leveraged Buy-Out Funds Act." I have here the special regulatory reform report of the Congressional Oversight Panel, which lays out the systemic risks associated with leveraged private pools of capital. And if one has an interest, one could take a look at tens of thousands of jobs lost through leveraged buy-outs over the last 2 decades in the United States.

The Small Company Capital Formation Act, which would allow offerings of up to $50 million to rely on the Regulation A exemption and seek capital from the investing public without audited financial statements should be called the "Promote Penny Stock Fraud Act." And finally, the Asset-Backed Market Stabilization Act, which would exempt the rating agencies from the same standards that apply to other experts giving an opinion in connection with offerings of asset-backed securities—remember asset-backed securities. They are, after all, the market that caused the collapse of our economy—would be called the "Illegal Immunity for the People who Brought You the Financial Panic Act."

In reality, these legislative proposals are not attempts to help put Americans back to work or to restore confidence in our financial markets. They are a systematic effort to chip away at the first meaningful steps toward reregulating our financial markets and restoring some level of stability after 30 years of deregulation led to the worst financial crisis, the worst unemployment, and the greatest economic suffering in our country since the Great Depression.

For these reasons, the Americans for Financial Reform, the AFL-CIO, and the Consumer Federation of America strongly oppose each of these efforts on behalf of Wall Street interests to weaken the Dodd-Frank Act and to further put our country in danger of repeating the experience of 2008. Thank you.

[The prepared statement of Mr. Silvers can be found on page 93 of the appendix.]

Chairman GARRETT. I thank the gentleman for his testimony. But if we rename all the bills, we won't continue to get the bipartisan support that we have been getting for all of them.

[laughter]

So with that, I thank the panel for all their testimony.

And we now go for questioning to the gentleman from Virginia for the first 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. And I appreciate you taking me out of order.

Mr. Silvers, I was particularly interested in your testimony. I assume that you would agree—it sounds like you have been around here long enough. It sounds like to me you would agree that there are significant costs to increased regulations to businesses—in this case, private equity funds—which have to comply with these new regulations. Do you agree with that?

Mr. SILVERS. I would compare that to telling you that every time you sneeze, there is a cost. The regulations that the Dodd-Frank Act subjects private equity funds to, which is registration under the Investment Company Act, I think is widely understood to be among the least onerous of the regulations that we apply to financial markets.

Mr. HURT. But you would agree there is a cost?

Mr. SILVERS. I think there is a—as I said, I think there is a cost to every act one takes in life.

Mr. HURT. Okay. Thank you. And in the SEC budget, have you been following the SEC budget request and the tremendous strain that all these additional regulations are going to put on the SEC? Are you familiar with that?

Mr. SILVERS. I have been following the systematic effort to strip the SEC of the resources necessary to protect American investors by you and your colleagues. Yes, I have.

Mr. HURT. Okay. And so, you understand that by imposing these new costs on these businesses, it necessarily means there is less capital to put into companies that create jobs in Martinsville, Virginia, where I represent the people who have 25 percent unemployment? You understand that?

Mr. SILVERS. Are you asking me to agree with the way you see the world? Or are you asking me a question? I am not sure which.

Mr. HURT. I am asking you a question. And that is—

Mr. SILVERS. Can you restate it?

Mr. HURT. —do you agree that by increasing the costs to these businesses, that it necessarily means they have less capital to put on the street to employ people in this country and specifically, in Martinsville, Virginia—

Mr. SILVERS. Absolutely not.

Mr. HURT. —which is part of my district.

Mr. SILVERS. Absolutely not. And let me explain to you why.

Mr. HURT. How, then, do you—what would you say to the 61 people who now have jobs in Martinsville, Virginia, as a consequence of the investments made by, in this case, Riverside? What would you say to those people?

Mr. SILVERS. I am saying you are cynically exploiting them to deregulate Wall Street and further put our entire country in danger of repeating 2008. That is what I would say.

Mr. HURT. You call it exploitation. I call it a paycheck.

I yield back my time.

Chairman GARRETT. Thank you.

The gentleman from Massachusetts for 5 minutes?

Mr. LYNCH. Yes. Let us continue along that line of questioning, Mr. Silvers.

First of all, I want to thank the chairman. And I want to thank all the witnesses for their willingness to help the committee with its work.

I want to associate myself—and I do this rarely—but I want to associate myself with the remarks of Mr. Silvers. As a general matter, I think this group of bills, these five bills—some are worse than others. But I generally think that the effort to redefine a major swap participant and to induce leverage—hello—I am astounded.

I am astounded that we have not even recovered from this disaster, this financial crisis, and we are planting the seeds for the next one by inducing leverage, by removing liabilities from rating agencies who grade asset-backed securities as AAA and they turn out several weeks later to be junk bonds, to stop the disclosure of CEOs' pay in relation to their employees in denigration of the efforts of Dodd-Frank to align the interests of the CEO and the investors and shareholders, to block the registration of financial advisers for private equity firms. This is back to the future.

I am as astounded by the substance of this proposal as I am by the speed at which we have forgotten what got us into this mess to begin with. It is really breathtaking that we are back into a—regulation.

And in response to the gentleman who asked the question about costs, Mr. Silvers, can you estimate what it cost American homeowners and—well, go globally. These asset-backed securities were sold—they went viral, including through AIG and others. What is the total cost of the failure, the abject failure of us to induce responsibility and accountability and to preserve the integrity of our financial system? What was the cost of that?

Mr. SILVERS. Congressman Lynch, a lot of people have been trying to figure that out. The number is very large. I will give you some numbers to give you a frame of reference.

Mr. LYNCH. Please.

Mr. SILVERS. As I think everyone knows, this Congress gave authority for TARP that was $700 billion.

Mr. LYNCH. Which I voted against. But go ahead.

Mr. SILVERS. Approximately $500 billion was laid out. Current estimates are that the net cost will be somewhere in the $50 billion range for TARP alone. Trillions of dollars were laid out by the Federal Reserve to address the economic crisis and prevent it from worsening. The costs involved in that are very hard to measure.

In terms of vanished wealth, in terms of the fall of the stock market, the fall of the housing market—and the housing market is still falling—my testimony reflects, I think, the general estimates of around $10 trillion.

In terms of lost GDP, it is hard to figure exactly because you have to make assumptions about what would have happened had we not gone through this horrific policy failure. But again, the estimate—I think one could reasonably estimate something on the order of 5 percent of GDP a year for several years running. That is approximately—let us see, GDP is $15 trillion. That is $1.5 trillion in lost GDP. It is very hard to estimate. What is the financial cost one associates with throwing 13 million families out of their homes? I don't know how to price that.

I don't know how to price what it means that multiple millions of Americans have graduated from high school and college and gone into nothing. I don't know how to price that. And, by the way, we are just talking about the United States now. We are not talking about worldwide—Ireland, Iceland, Spain, one could go on. I don't think there is any doubt, but the right number here is well in excess of $10 trillion.

Mr. LYNCH. Okay. I see my time has expired. I thank the gentleman.

And I yield back. Thank you, Mr. Chairman.

Chairman GARRETT. I thank the gentleman and recognize myself for 5 minutes. First, although the gentleman says he is baffled that we are moving legislation or considering legislation that would induce or increase leveraging, I don't know of any of the legislation that the panel has just discussed here today that says anything with regard to leverage.

Second, the gentleman speaks to the fact that we are trying to undo some of the causes—legislation dealing with the underlying causes of what brought us to the—

Mr. LYNCH. By redefining—will the gentleman yield?

Chairman GARRETT. If you will just let me finish this thought.

Mr. LYNCH. Sure.

Chairman GARRETT. —the causes of it. And I don't know that any panel that we have had over the last year-and-a-half said that part of the cause of the problems was the lack of data compilation with regard to salaries, nor was it anything to do with the interconnectedness of private equity funds. So those were not the causes. Those are just the elements that are now the additional burden that we are placing onto industry and the capital markets that are preventing the very same jobs that I think everyone on this panel would like to see brought to fruition.

Did the gentleman have just a—

Mr. LYNCH. Right, just in looking at the way we are redefining major swap participants, we are—allowing entities that do not have the underlying capital as Dodd-Frank would require.

Chairman GARRETT. Yes.

Mr. LYNCH. And so, those folks would be included and be able—that would be an inducement to that type of activity for firms that don't have the underlying capital.

Chairman GARRETT. Okay.

Mr. LYNCH. You will have more of that. That is why I am saying it increases leverage.

Chairman GARRETT. Reclaiming my time. And I am reminded that that provision has already been addressed by this House and has passed this House by over 300 bipartisan votes previously.

Mr. LYNCH. Why did we redefine here, then?

Chairman GARRETT. Well—

Mr. LYNCH. It is also in law—and the House and Senate—

Chairman GARRETT. The gentleman—

Mr. LYNCH. —passed that. And the President signed it.

Chairman GARRETT. I did not yield the remaining time.

Mr. LYNCH. I am sorry.

Chairman GARRETT. So with my remaining time, Mr. Zubrod, I see in your testimony that you are requesting legislative extension of Dodd-Frank with regard to derivatives. Can you very quickly, with regard to rulemaking, talk to us about how much time is necessary in order to get this thing right?

Mr. ZUBROD. I think the Coalition for Derivatives End Users hasn't formally put forward a proposed time request.

Chairman GARRETT. No?

Mr. ZUBROD. But I think it is eventually critical that as we regulate this very large market for the first time, regulators have sufficient time to write thoughtful rules.

Chairman GARRETT. Thank you. And you also mentioned other changes to legislative fixes that the Coalition has looked through. You talked about real-time reporting, the capital considerations with regard to Basel, not creating margin requirements by the end-users, I guess, would be one specific one you need. Anything other than those?

Mr. ZUBROD. We have written over 100 pages of comment letters to the—

Chairman GARRETT. For legislative fixes?

Mr. ZUBROD. On regulatory matters. For now, the items that we are focused on receiving some legislative clarification include the clarification that margins shall not be applicable to end-user transactions.

Chairman GARRETT. Right. That is the main one.

Mr. ZUBROD. And the implementation date.

Chairman GARRETT. Okay.

Mr. Silvers, you came up with a couple of different names for these bills. The Business Mitigation and Price Stabilization Act should be called the "Help Create Another AIG Act." But if you look at the legislation that is drafted out there, any reading of it—and when you consider under the Murphy amendments that passed the House, as I said before, with wide bipartisan support, how would anyone take that to read that it would not capture an AIG situation again? It didn't capture it the last time with the regulators. But why would it not capture it with that definition as we have presented?

Mr. SILVERS. There are, in Dodd-Frank, in addition to those capital requirements that obviously fall under the—that banks fall under through the normal banking system, there are two categories of swaps—of actors in the derivatives market under Dodd-Frank.

Chairman GARRETT. I understand.

Mr. SILVERS. One category is what you call—is a dealer, swaps dealer. The other category is a major swaps participant. The full definitions of both categories are being worked out through regulation at the moment. But the difference between the two fundamentally is the notion of a dealer is somebody who is basically working to—would appear to be somebody working to maintain a balanced book. A major swaps participant would be someone likely to be taking risks. They would be taking one side of a particular position.

What AIG was doing was taking one side of a particular position. They were not a dealer. They sometimes referred to themselves as a dealer. But that is not what they were. They were taking the risk without the other side—

Chairman GARRETT. So you are saying—I understand what they were doing.

Mr. SILVERS. —in a whole set of derivatives—

Chairman GARRETT. So you would say that they would not be captured by this definition?

Mr. SILVERS. While it is always conceivable that the regulators could write their definition of a dealer in such a way as to capture parties that are taking a major position in one direction, it doesn't seem the obvious way one would envision a dealer.

Chairman GARRETT. Mr. Zubrod, do you have a comment on that? And then I will close on that.

Mr. SILVERS. But that is your risk right there.

Chairman GARRETT. I understand your perspective.

Mr. ZUBROD. AIG had a $2 trillion book of derivatives. I think the bill that this House passed and the bill that the Senate passed—each of them would very clearly encompass AIG in its major swap participant definition.

Chairman GARRETT. There is no way they are going to squeak out of this, however the regulators—

Mr. ZUBROD. A $2 trillion derivatives book is not a needle in a haystack.

Mr. SILVERS. But you are gutting that provision.

Chairman GARRETT. Thank you.

Mr. Himes, from Connecticut, for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

Just a question for Mr. Silvers. I share your concern that there is a fairly cynical effort under way now to—in a not terribly thoughtful fashion—roll back a lot of the progress that was made. As a response to all of the catastrophe that you described—and I appreciate the dramatic flair of your testimony. But I am also very conscious of the fact that the exercise of getting this right is a very nuanced, technical, and esoteric thing. And there is one thing I wanted to ask you about, which pertains to private equity. It is something I have been thinking a lot about.

You object to the Small Business Capital Access and Job Preservation Act, suggesting that perhaps private equity entities generate what you call leverage pools of capital. And, by the way, if we are talking about hedge funds, I am with you on that one. But I am really curious whether it is your belief that private equity operates at the fund level with a lot of leverage.

I don't know a lot of private equity entities that operate with leverage at the fund level. Of course, they do leverage-up their investments. But if not, whether you really do believe that even the largest private equity players do create systemic risk.

Mr. SILVERS. Congressman Himes, you correctly point out that where private equity or leverage buy-out funds put equity—put leverage into our economy is at the firm level, not at the management company level or at the fund level. The limiteds are not borrowing money. Right? The company that they invest in is.

As—there were two issues that have led, I think, investor advocates and people concerned about the regulation of the financial system to be in favor of including private equity funds in the requirement to register—that private pools of capital have to register with the SEC. The first issue is the one that I addressed in my oral testimony, which is the issue of systemic risk.

Systemic risk comes as several things happen: one, as the firms that private equity funds invest in get larger; two, as the banking system lays on more and more leveraged loans; and three, as particular private equity sponsors essentially have more and more—have larger and larger sets of obligations through their portfolio companies into the banking system. If the economy weakens, bank lenders and credit rating agencies become very interested in the capacity of the private equity complex to be able to backstop the credits across the pool.

Mr. HIMES. I agree that—

Mr. SILVERS. [Off microphone.]

Mr. HIMES. I am sorry, let me just interrupt.

Mr. SILVERS. Yes.

Mr. HIMES. I am following you here. But it seems to me that the right answer for us, then, is to follow the extenders of leverage, which are typically lenders into the firm level investments. And I am 100 percent with you there. I just am really wondering—and I have one follow-up question about the industry, too—whether we are, in fact, looking at the private equity entities as themselves generators of systemic risk.

Mr. SILVERS. What I was pointing out is contrary to the testimony of my fellow panelists. There is an interlinked quality to that risk at the private equity fund level that is not going to be very easily captured by bank regulators looking at the exposure of this bank or that bank.

The second point that is not in my prior oral testimony, but which is very important to investor advocates is that there is a set of fundamental investor protections such as a single common standard of fiduciary duty and access to Federal courts in cases of breaches of fiduciary duty or worse conduct that is created when a private equity fund registers with the SEC as an investment adviser. And those investor protections are extremely important to the teachers and firefighters and the like—my fellow witnesses.

Mr. HIMES. Thank you. I don't mean to interrupt. But I do actually have one question. It is actually not relevant to the legislation at hand. It is just something that, oddly, I don't know the answer to. It doesn't often happen in these hearings.

But very quickly, if the chairman would indulge me, I have heard anecdote after anecdote of leveraged buy-outs that destroyed jobs and leveraged buy-outs that created jobs. My question to both Ms. Hendrickson and Mr. Silvers—is there any study, any third-party validation as to whether this industry, net-net—and, by the way, it is not perhaps legislatively relevant. I am just curious what the facts are. Is there any third-party validation around whether this industry as a whole creates or subtracts jobs from the economy?

Maybe Ms. Hendrickson, and then Mr. Silvers.

Ms. HENDRICKSON. As with most things, there are many studies. And it depends on which one you choose to look at. The most recent studies that I have seen and corroborated by our own data, actually, are that through the recessionary period, we grew jobs 6 percent. Now, we invest in middle-market-type companies. But the industry average appears to be about 6 percent job growth through the recession.

Mr. HIMES. Thank you.

Ms. HENDRICKSON. There are obviously anecdotal examples where that did not happen.

Mr. SILVERS. There is a gentleman named Joshua Lerner at Harvard who has done very good work in this area. The evidence that he has found is somewhat inconclusive. There are two methodological problems. Many studies, particularly those sponsored by the industry, conflate essentially the LBO business model and the venture business model. No question the venture business model creates jobs.

European studies that have disaggregated those two models tend to find that the—and there is another issue, which has to do with sort of apples to apples issues around companies. The issues that disaggregate the business models typically find that the LBO model destroys jobs, and the leverage model creates them. The V.C. model creates them. The labor movement's view of this is heavily influenced by some very large anecdotes at companies like SafeWay and RJR Nabisco, which involve tens of thousands of lost jobs, worker suicides and the like.

Mr. HIMES. Thank you.

Thank you very much, Mr. Chairman.

Chairman GARRETT. And if there are other things that you just don't know. Okay.

To the—

Mr. HIMES. Don't get used to it.

Chairman GARRETT. Okay. Wow. Okay.

To the gentleman from Arizona for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. I thought that was an interesting question.

Mr. Silvers, forgive me for not jotting these down. Who are the folks that you speak for?

Mr. SILVERS. The AFL-CIO, the Consumer Federation of America, and the Americans for Financial Reform, which is a large Coalition of more than 250 organizations. The members of the Americans for Financial Reform are in my written testimony.

Mr. SCHWEIKERT. Okay. Mr. Silvers, is it typical for those groups to take a position opposing a bill without reading it?

Mr. SILVERS. Excuse me?

Mr. SCHWEIKERT. Is it typical for those organizations to take a position on the bill without reading it?

Mr. SILVERS. I can tell we are going to have a dispute as to what the bill says. Why don't we come to it?

Mr. SCHWEIKERT. Mr. Silvers, can you grab for me the nice, little bill in regards to the $50 million capital formation?

Mr. SILVERS. Just a moment. What did I do with the bills? Sorry. I brought the bill text with me, if—

Mr. SCHWEIKERT. The Small Company Capital Formation Act.

Mr. SILVERS. Okay.

Mr. SCHWEIKERT. H.R. 1070.

Mr. SILVERS. Okay.

Mr. SCHWEIKERT. Do you have it?

Mr. SILVERS. Not yet, but that is okay. Why don't you read the provision that you think I misunderstood?

Mr. SCHWEIKERT. No, no, I was going to ask you—to take you to page three, line six. You made a rather bold statement that—how simple and evil this was because of the lack of audited financials. And I know literacy may be a problem around here, requiring the issuer to file audited financial statements with the Commission and distribute such statements to prospective investors. What are we missing here, Mr. Silvers?

Mr. SILVERS. When we reviewed the bill, the bill gave that as an option to the SEC. If you since changed it to make it mandatory, then I would suggest that is an improvement, and I congratulate you for it. But when we look at it, it was voluntary. It wasn't voluntary. It was an option the SEC could choose to impose.

Mr. SCHWEIKERT. Okay. Mr. Chairman, Mr. Silvers, it was always this way in our work-up. But I appreciate you being willing to play.

Mr., is it "Weild?"

Mr. WEILD. "Weild."

Mr. SCHWEIKERT. "Weild." Could you actually share with me—because you and I have already had some conversation—both the good and the bad you think would come from changing the Rule A amounts, or the Reg A amounts?

Mr. WEILD. First of all, the bill the way it is currently crafted has some—I would call it an enhanced Regulation A, not only in terms of size, but in terms of investor protections. So I applaud the committee on that.

It allows us to access capital—corporations, small corporations—more cost-effectively and avoid the train wrecks that they typically have in the market by not being able to test the waters. And so, that is a great positive—much more cost-effectively because you don't have to add a lot of the exhibits that are typically associated with the prospectus of formal S-1 that add up to quite a bit of cost and that very few people ever actually read in the marketplace.

Mr. SCHWEIKERT. Mr. Weild, share with me what you think the biggest threat to the markets is if we do this.

Mr. WEILD. If we do this? I truly believe there are not big threats to the market. To put it into context, when WorldCom went—filed for bankruptcy, it had $100 billion in assets. And that represents 2,000 $50 million transactions, which in today's terms would be increasing the size of the listed market by 40 percent. So essentially, by strangling small companies and entrepreneurship by not allowing them cost-effective access to capital, we really dampen the economy job formation. And exactly, I would say the constituency that Mr. Silvers represents.

Mr. SCHWEIKERT. All right. Mr. Weild, as you may know, I have a compulsion about making graphs and charts. It is a problem in my statistical background.

Up on the screen—actually, go back one, please, you will notice the lines. And one thing I found fascinating is it looks like over the last decade or so, we have actually had a shrinkage of U.S. listings. While you see our competitors, somewhat of an explosion by some of them. What is your understanding of what has happened to the number of traded equities?

Mr. WEILD. We have lost from the peak in 1997, which interestingly was before the crescendo in the bubble—we have lost 42 percent of listed companies from the United States listed equities markets, which, by definition, is pulling jobs out of the U.S. economy. And by contrast, other countries, including China—the one at the top of the chart there is China. But almost every other industrialized country in the world is net adding listed companies to their markets.

Mr. SCHWEIKERT. Mr. Weild and Mr. Chairman, thank you.

Chairman GARRETT. And I thank the gentleman.

The gentleman from Ohio for 5 minutes?

Mr. STIVERS. Thank you, Mr. Chairman. Thank you for holding this hearing.

I appreciate all the witnesses.

I would like to ask Mr. Deutsch a question about Ford. If you remember, last year Ford had to cancel an offering. You talked about the whole bond market closing down. But clearly, there was a front page article in the B section of the Wall Street Journal about Ford having to cancel, I think it was a $100 million asset-backed bond, because of the very provision we are talking about, Section 929(g) in the Dodd-Frank Act. Can you just explain to the committee quickly what happened there?

Mr. DEUTSCH. Yes, I think Ford and—again, I don't know all the extreme particulars of the Ford transaction. There were actually a number of transactions in the market, coming to the market at that point. I believe Ford had a transaction. I think it was closer to a billion dollars that they were looking to sell off into the secondary market of loans backed by prime quality auto collateral.

Mr. STIVERS. And what is the effect of them not being able to finance that $100 million?

Mr. DEUTSCH. Ultimately, they can't sell cars.

Mr. STIVERS. Or employ people, right?

Mr. DEUTSCH. Which, obviously, you stop employing people to make those cars.

Mr. STIVERS. Right. So, the change in the law was effective immediately. The SEC did step in and have a no-action letter that kept the law from being enforced. And that is where we are today. And that is why some things are allowed to sort of go forward at this point.

But I guess the SEC is maybe talking—according to Mr. Silvers and some other reports I have seen—about removing rating agency references altogether. That is another direction to go. Frankly, that would solve this problem, too. But the result is two things. It has more cost in the marketplace because if the liability is passed on through the increased cost at the rating agencies, it will cost issuers more and, therefore, affect jobs. But the second piece is less information will be available in the marketplace—readily available in the marketplace. Are those good or bad things?

Mr. DEUTSCH. Generally, it is a very bad thing. Although the SEC could change their rules to no longer require that a rating has to be included in a statutory prospectus, you would still have ratings being conveyed to investors.

Mr. STIVERS. Right.

Mr. DEUTSCH. But they are conveyed in these ancillary documents. Why wouldn't you want to convey the information in your primary offering document?

Mr. STIVERS. They would be less readily available is a way to say that.

Mr. DEUTSCH. Of course.

Mr. STIVERS. The information may still be available, but it results in less information in the marketplace.

Mr. DEUTSCH. Correct.

Mr. STIVERS. And so, that is why I prefer this approach as opposed to that approach. You could just remove the rating requirement from the prospectus, which is the other way to go. But it makes information less readily available.

I do have a question for Mr. Silvers really quickly because I want to talk about more information and less information in the marketplace. Can you quickly tell me how people know what an investment grade bond is?

Mr. SILVERS. If you are asking whether I think that having ratings in the bond market is a good idea or not, I think that is a complicated question. I think it is—

Mr. STIVERS. I am not asking you that. I am asking you how people would describe an investment grade bond. If you were going to just tell somebody what an investment grade bond is, what would you refer to? You know what the answer is.

Mr. SILVERS. An investment grade bond is a term of art, and it derives from the credit rating.

Mr. STIVERS. Thank you. And that is the point. Credit ratings are an important part of the information in the marketplace.

Mr. SILVERS. I think you misconstrue my testimony.

Mr. STIVERS. Yes.

Mr. SILVERS. I don't disagree with you.

Mr. STIVERS. Okay. Essentially, what I am telling you is if you remove the ratings from the prospectus, which is the direction you want to go, you are going to have information less readily available in the marketplace.

Mr. SILVERS. Actually—

Mr. STIVERS. It is just a fact.

Mr. SILVERS. No, but you misunderstand the direction I want to go.

Mr. STIVERS. Okay. Okay. I will let you go a little bit here. I don't have much time, though.

Mr. SILVERS. I think you have touched on a very important issue in terms of financial reform.

Mr. STIVERS. And, by the way, it is not that I want to do nothing about the rating agencies.

Mr. SILVERS. No, I know. And I—

Mr. STIVERS. There is work to be done.

Mr. SILVERS. I think it may very well be that you and I completely agree about this.

Mr. STIVERS. Okay.

Mr. SILVERS. Now, it is not a matter of—

Mr. STIVERS. —I am reading or listening to your testimony, by the way.

Mr. SILVERS. Right. It is not a matter on which I can say that it is—you put me in an awkward position, in a sense, because there are differences of opinion in the people that I represent on this question.

Mr. STIVERS. I notice the United Auto Workers not on your list, by the way.

Mr. SILVERS. That is not—

Mr. STIVERS. You are going to have a hard time getting them on this one.

Mr. SILVERS. That was not what I was referring to.

Mr. STIVERS. Okay. Yes.

Mr. SILVERS. All right. What I was referring to is—and I will give you an example.

Mr. STIVERS. Yes.

Mr. SILVERS. Credit ratings have been used to screen out investment grade commercial paper for money markets.

Mr. STIVERS. Yes.

Mr. SILVERS. Many people feel that is a critical function to avoid a huge moral hazard problem in the money market area.

Mr. STIVERS. Can I come back to this? Because I have one more question for Mr. Deutsch because it is an important—something happened in the marketplace last week, and I want to ask him about it.

Redwood Capital made a disclosure, not a required disclosure, about ratings shopping. Would disclosures on ratings shopping help fix a lot of the problems that occurred in the marketplace? I know I am out of time. I think they will let you answer.

Can he answer, Mr. Chairman?

Mr. DEUTSCH. I think certainly additional disclosures around ratings shoppings—I think that many investors would like to see additional disclosure around that. Many investors would find that helpful to understand the different ratings—the agencies that issuers have approached. And so, I think there would be some—that would be well-received by the investor community.

Chairman GARRETT. Thank you.

The gentlelady from New York for 5 minutes?

Dr. HAYWORTH. Thank you, Mr. Chairman.

And I am fascinated by our witnesses' testimony from Mr. Bertsch and Mr. Deutsch, Ms. Hendrickson—forgive me—Mr. Weild and Mr. Zubrod, in particular, because you are describing a litany of loss in a sense, due, no doubt, to unintended consequences. And those losses are very real to the nearly 14 million unemployed Americans who are counting on us to help them. And that is what we are trying to do today.

We have lost resources that should be devoted to job creation. You have described that eloquently in your testimony. That is what we are endeavoring to reverse in the pieces of legislation we have introduced. We have seen that there is a loss of trust in the common sense of our fellow citizens, in this case, investors and entrepreneurs, who are the engines of job creation in so many instances. And this represents a loss for all Americans as working capital is kept out of the marketplace due to regulation-induced stasis, or worse, working capital is migrating out of the United States market entirely. And I think it is important for everybody listening to remember those things.

So in an effort to clarify the highly useful nature of what we are endeavoring to do by repealing Section 953(b) of Dodd-Frank, Mr. Bertsch, could you talk more about the disclosure of information that is currently necessary and how that is useful to investors?

Mr. BERTSCH. Disclosure of information before Dodd-Frank?

Dr. HAYWORTH. Before Dodd-Frank, before 953(b).

Mr. BERTSCH. Sure. There is extensive disclosure on senior executive pay that has been in place for quite a while. It had been modified a few years ago. And I think that the interest in that information on the part of investors relates in part to the fear of conflict of interests to the extent that the CEO, in particular, has influence over that, over his own or her own compensation. So I think that that is appropriate disclosure and has been useful in understanding that whole dynamic.

I do think, frankly, that—and this is my view. With these organizational representations, I haven't done enough of this to know to what extent I should try to clear this. But from my perspective—and I worked most of my career on the investor side, some of the disclosure enhancements made a few years ago by the SEC in a particular compensation disclosure analysis requirement actually complicated things so much that proxy statements are actually less useful than I think they used to be.

It used to be faster and easier to get a pretty good fix on CEO pay than it is now. So I think disclosure requirements can backfire at some point. I think they are legitimate, but I think you want to make them as smart as possible.

Dr. HAYWORTH. The phrase that always comes to my mind when I think about so many of the regulations we talked about that have been promulgated in Dodd-Frank, among other things, is more heat than light is generated by these things.

Speaking of light, compensation disclosure requirements that you have just described, Mr. Bertsch, that perhaps, in fact, we have asked for too much information, so to speak, even before Dodd-Frank—you alluded to a survey among investors, I believe it was, that described their desire, if you will, for more information about compensation.

Mr. BERTSCH. Yes, in the testimony I just referred to, that we have seen a series of shareholder proposals on—requesting reports on pay disparity. And they don't get very high votes.

Dr. HAYWORTH. Right.

Mr. BERTSCH. So that is an indication that shareholders generally don't express a lot of interest as opposed to, for example, the say-on-pay. There were many shareholder resolutions requesting advisory votes on pay. Those got much higher levels of support other than these have. So 6 percent support is not—on an average, is not very high.

Dr. HAYWORTH. And if there were some sort of movement toward say-on-pay, presumably current—or pre-Dodd-Frank data would satisfy the informational requirements for shareholders to make those sorts of decisions—or to participate in those decisions.

Mr. BERTSCH. I think that issue is not, to my knowledge, at this point being addressed again.

Dr. HAYWORTH. Right.

Mr. BERTSCH. But that is a more substantial issue than this one.

Dr. HAYWORTH. Yes.

Mr. BERTSCH. And my major point is that this is actually a lot of work.

Dr. HAYWORTH. Right.

Mr. BERTSCH. This is not a simple statistic to throw out there. And it is not one that I believe is of particular value to investors.

Dr. HAYWORTH. Right. And, indeed, as I understand it, to compute a median—as I understand it, the problem exists on several levels. To identify the population of workers to whom this regulation would actually apply, if we wanted to start the process of data collection. There are all sorts of complications in identifying then what pieces of data would actually be applicable, how they would fit into a computation and then the fact that they would have to be computed for every single employee so as to identify a median.

Mr. BERTSCH. That is correct.

Dr. HAYWORTH. Am I correct?

Mr. BERTSCH. A median is a lot different than an average to calculate. Our members believe that you need to calculate it for every single person in order to arrive at the correct median.

Dr. HAYWORTH. Right. How else could you arrive at a median, indeed?

Mr. BERTSCH. There you go.

Dr. HAYWORTH. I appreciate your clarifying all of those points for us, Mr. Bertsch. Thank you.

Mr. BERTSCH. Yes. Thank you.

Chairman GARRETT. And I announce to the rest of the committee that we do have a vote that is called, but we are just going to plug along as long as we have our panel here. And members here—just the order that—unless anyone else comes from your side, will be—next will be Mr. Royce. And then—I guess the other people have probably stepped out to vote already. So when they come back, they will be in line.

So the gentleman from California for 5 minutes?

Mr. ROYCE. Thank you.

Mr. Weild, I want to thank you for your testimony. And you gave some pretty staggering statistics there that I think should give us all pause. But in terms of capital formation for small-growth companies, you recommend passing this Reg A change. What else should we be focused on here?

Mr. WEILD. I think there are three things that the House Financial Services Committee can think about. One of the Reg A passes, which is a big step forward in terms of knocking down the costs of capital and the certainty of raising money. The second is that the stock market itself, the way it is currently constructed, has deprived issuers of any real choice in market structure. And it is really optimized where the 10 percent of the largest market value stock that represent 90 percent of the volume. It is a one-size-fits-all stock market.

And I think that to create a market structure that—just like bridges, roads, and tunnels are infrastructure to the U.S. economy, so is the stock market. And if we don't have a way of paying for the research, sale support, and the liquidity provision that is so desperately needed by small-cap. companies, then the low end of the market, the smaller companies, die on the vine. They wither in the vine, just like our communities would if we didn't have bridges, roads and tunnels.

The third thing is you might consider in the private market, there are some archaic restrictions, in the private market. The prohibition against general solicitation and an inability for accredited investors effectively to be able to buy and sell stocks in the private market. Those are things that could help capital formation.

Mr. ROYCE. So those things come to mind. I am wondering if there are additional provisions in Dodd-Frank that sort of compound this problem with capital formation. And one of the frequent things we see in the financial press is the conversation about capital flight, about the decision to move business to Europe rather than to try to soldier through here. Because in Europe, they don't have any intention of following our lead on some of these particular provisions that have been raised as a concern, right?

They have a different regulatory framework there. There is certainty to it. And I think that a lot of businesses look at that and say, "All right, we will opt for that as the alternative."

It is a mouse click away, basically, these days to get to do business under a regulation that seems far more certain. We are in the throes of waiting for 300 rules to be written. We haven't been able to reach agreement, for example, between the SEC and the CFTC and get them on the same page—50 differences we know of so far, 60 more rules to come down the pike by September. And after that, 40 more that we are waiting for.

And in this environment, the derivatives business and a lot of other businesses seem to be flirting with relocating. Some of it is already happening. Do you see that as a challenge here?

Mr. WEILD. I see getting the regulation right-sized for the company size to be absolutely critical. I think that is one of the themes that I have heard a little bit here from this panel, that what worked for a $200 billion market value company isn't necessarily appropriate for a $100 million equity market value company.

Mr. ROYCE. We have made no adjustment yet, really, on Sarbanes-Oxley to address this problem, have we, really?

Mr. WEILD. There are some exclusions from 404 for sub-$75 million equity float value company. So there have been some adjustments.

Mr. ROYCE. Do you think that is helping?

Mr. WEILD. I think that the bigger issue—if you look at the charts that we submitted, Congressman, what was interesting was our discovery that the sub-$50 million equity market value companies started to disappear from the IPO market before Sarbanes-Oxley ever came into effect in 2002, that the implosion started in 1997.

Mr. ROYCE. I agree. And I gave these—in my opening statement, I gave these figures. I agree that erosion began for that portion of the market. But what has happened since is that the acceleration has included the entire market. So it is not now just the smaller firms. It is across-the-board. IOPs are now 13 percent of the market. We were 50 percent of the market. This is quite an adjustment.

So I think we can attach some of this to the way in which we have—Sarbanes-Oxley, for example, has really been—we have had a failure to address it in ways that solve at least that problem. I grant you, Mr. Weild, some of your other points in terms of what we have to do for the niche of the market that you are most interested in. But on top of it, I am just saying it is the market in its entirety that we risk losing to Europe and elsewhere.

Mr. WEILD. I would tell you that if you don't get the growth side of the economy back in high gear, then it actually drags down the performance of the entirety of the economy, including the large cap. stock.

Mr. ROYCE. Yes.

Mr. WEILD. To your point about moving capital offshore, I gave a presentation at the New York Stock Exchange to a bunch of pension fund trustees not that long ago. And I sat through a number of the presentations prior to my own. It was very interesting how many consultants to the pension fund industry were advocating to American pension funds to move their money offshore to higher-growth economies, the brick countries, which are Brazil, Russia, India, and China. That is very disturbing.

Mr. ROYCE. Thanks for that information.

I yield back.

Chairman GARRETT. The gentleman yields back?

Mr. ROYCE. Yes. I yield back.

Chairman GARRETT. I thought you had another question.

Mr. ROYCE. I have used all my time.

Chairman GARRETT. With unanimous consent, you can ask your other question.

Mr. ROYCE. Yes, I will then ask another question, if you don't mind.

The NRSRO issue—that has been around for some time. And I was going to ask Mr. Deutsch.

We had a few entities issuing what ended up being flawed rulings. But they were treated as the gold standard with few alternatives. It was very, very frustrating. And in 2006, we tried to correct that in the Credit Rating Agency Reform Act, which I think made some strides to promote competition. That was the goal there, to establish a more transparent rating process.

But unfortunately, the financial markets have turned upside down since the passage of that Act. And clearly, part of it was the credit rating agencies. But Dodd-Frank, I think, took a different approach here and essentially opened the NRSROs up to a very active trial bar. And when I laid out in my initial statement here, I pointed out we had 97 percent of the lawsuits worldwide are here in the United States. The day after the law was enacted, the NRSROs refused to allow their ratings to be used, bringing a temporary freeze to the credit markets before the SEC promised not to enforce the provision.

Where is the happy medium with the NRSROs? We need to encourage due diligence among counterparties in the market, but essentially removing the rating agencies from the picture altogether seems to be overkill. So I was going to ask you, Mr. Deutsch, about that.

Mr. DEUTSCH. I have, I guess, multiple responses. I think first, credit ratings serve an important part of the financial markets. I am not sure either side of the aisle will disagree with that.

The second point is that creating policy reform around the rating agencies has been extraordinarily perplexing.

Mr. ROYCE. Right.

Mr. DEUTSCH. It is very challenging to try to figure out, in a market with some natural economies of scale, how to improve that market and make appreciable change. But I think—

Mr. ROYCE. On that thought, let me give you some time to contemplate the answer, give it back to us in writing. We have 20 seconds left of the vote. And I think Mr. Garrett is a little faster than me. If we head out right now, we can make that vote.

Mr. Chairman, I yield back. Are you ready?

I will get that answer in writing, all right?

Mr. DEUTSCH. Right.

Mr. ROYCE. Thank you very much.

Chairman GARRETT. The gentleman yields back.

I appreciate the testimony of the panel. If there are other questions—and it looks like there may be another question—there may be someone doing what Ed is doing, rushing to the vote, and the others may be rushing back. So with that, unless there is an objection, I will ask one last question and hopefully, find out our one last member, who is probably in a hallway someplace here.

So I yield myself such time as I consume, I guess, to—

[laughter]

Just a question for Mr. Silvers.

With regard to H.R. 1062, which is—you euphemistically called it the "Promote CEO Pay Secrecy Act." Okay. Which is obviously—what the sponsor is trying to do is try to make not such a burdensome requirements in a legislative format. But what I will throw to you is we sort of went through to look to see what is already out there if you do repeal this. Right? What the SEC is doing.

Now, correct me if I am wrong on any of these because this is just our quickly running through it. But even if we pass this, you would still have what the SEC has done. One is companies would be required to disclose a total pay number for the CEO and other senior executives. Is that correct?

Mr. SILVERS. That is a longstanding SEC rule, yes, sir.

Chairman GARRETT. So that information has always been out there, and that would continue to be out there, right?

Mr. SILVERS. Yes.

Chairman GARRETT. Then secondly, companies whose—also the flow is—more specific information around retirement benefits as well.

Mr. SILVERS. The Commission's disclosures around retirement benefits have increased over time. It is certainly true that there is today required disclosure around retirement benefits. There is some dispute about the details of it, I would say, but it is certainly there.

Chairman GARRETT. Okay. So that is there. So you have the pay and the retirement. And thirdly, companies also have to disclose additional information about termination payments, which, I guess, is, what, like golden parachutes and that sort of thing, right?

Mr. SILVERS. Yes. Yes. Mr. Chairman, if you—

Chairman GARRETT. Yes.

Mr. SILVERS. If you would allow me—

Chairman GARRETT. Sure.

Mr. SILVERS. Two points—one is there is no—the Commission has made great progress over the last decade in getting more comprehensive data about CEO pay available to investors and the public. I don't think that is a matter of dispute. I think that the—what is so important about the provision of the Dodd-Frank Act that we are discussing here is that it creates a critical context for evaluating what CEO pay means in the context of a public company.

Right? And the question of whether CEO pay—and this has two consequences. One is whether CEO pay is essentially eroding the corporate culture by effectively placing the CEO and perhaps other senior executives in a completely different place than the other members of their team. And the second issue is, like many issues with CEO pay, whether or not it gives investors and the public a context for determining whether or not the level of CEO pay that you are receiving is essentially commensurate with, in general, the type of value that is being created by this firm.

Chairman GARRETT. But doesn't that go to another requirement they have that the board or the compensation committee, I guess, would actually also have to lay out why is it they are giving the CEO all these benefits, most notably, the executive pay? And so, if it is extremely high, they would have to say this is why we think he is worth "X."

Mr. SILVERS. Right.

Chairman GARRETT. Which, in my opinion, in many cases, also I agree, are astronomical sums that you and I probably can't comprehend. Maybe you can because you—who knows what your salary is. But—

[laughter]

Mr. SILVERS. Let me put it this way. The multiple between my salary and any of the ones that we are talking about is itself a very large and hard to encompass number. I think your—

Chairman GARRETT. There may be multiples between your salary and my salary.

Mr. SILVERS. I think we have that in common, Mr. Chairman.

Chairman GARRETT. Yes, okay.

Mr. SILVERS. The narrative you are discussing is, I think—my colleague on the panel talked about the frustrating issues involved in credit rating agencies and trying to find the right balance, a comment I very much agree with. The SEC has tried to get public corporations to tell investors and the public, give them some meaningful detailed explanation as to why they are paying 300, 400, or 500 times the amount the typical employees are paid, to their CEOs. If you have read those narratives, I think they are uniformly meaningless.

Mr. Chairman, if you could indulge me for 10 seconds? Your colleague, Mr. Schweikert suggests that I hadn't read his bill.

Chairman GARRETT. Yes.

Mr. SILVERS. His bill clearly, as it is now—because it was in a different paragraph—makes auditing of companies under Reg A optional. It is very clear. It was just hidden. And I want to make clear that I stand by my original testimony in that matter. It is in the heading paragraph of that section. And he read a misleading excerpt when he read that section of that bill.

Chairman GARRETT. He was just—I can't say whether he—

Mr. SILVERS. No, I am not—it is not your fault, Mr. Chairman.

Chairman GARRETT. I am certainly not saying that he was misleading. I saw he had a section of the bill actually circled, so he was reading a piece from his own legislation on page three of the legislation.

Mr. SILVERS. It says, "The Commission may determine necessary in the public interest to require an audit." The word "may," as we all know around here, means voluntary.

Chairman GARRETT. With that, I see that—well, no. Is it voluntary for the Commission, but not—

Mr. SILVERS. It is precisely—

Chairman GARRETT. —but not for the company?

Mr. SILVERS. It is precisely as I said it was in response to his question. The way the bill reads, "If the Commission chooses to do," which the Commission may or may not do, right, the Commission can choose to require an audit. But the bill does not require it. It would be perfectly legal, under this bill, for the Commission to sit tight and for companies to go to market and raise up to $50 million in investment from the general public and not provide an audited financial statement.

Chairman GARRETT. The entire premise behind Dodd-Frank is that the regulators, whom we are entrusting with all these grand, new authorities and some regulators, additional funding sources as well, that they are not going to be doing the wrong thing.

Mr. SILVERS. Why don't we just require it? I think that was the testimony of my fellow witness. My testimony is about the bill as written.

Chairman GARRETT. All right.

The gentleman from Ohio?

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you giving me a little more time.

I wanted to ask Mr. Silvers about some of the other sections relating to the credit rating agencies in the Dodd-Frank bill, because, frankly—I don't know if you have it in front of you, and I can bring you my copy, if you need it, but my bill does impact Section 939(g). But I would like to talk to you about Sections 932 and 933, especially. Section 932 subjects rating agencies to additional restrictions on—or disclosures, keeps people from doing revolving door from an issuer to the agencies and then more importantly, Section 933.

Section 933 of Dodd-Frank does subject the rating agencies to legal liability for misleading statements and just untrue statements, which your testimony about Section 939(g) implied that it overturned Section 933 of Dodd-Frank as well. I just would like Mr. Silvers to clarify for the audience and the world that might be watching on C–SPAN3. It won't be a very big world.

[laughter]

Whether he thinks my bill turns over any of the other sections with regard to the rating agencies, including and especially Section 933 of Dodd-Frank.

Mr. SILVERS. As I think the prior exchange showed, it can be dangerous to express an opinion on these matters without having lots of time to look at the text. My testimony did not say that your bill is a grant of total immunity to the credit rating agencies. I think it is nonetheless a grant of immunity.

If you might indulge me a moment or so longer—

Mr. STIVERS. We have a little time now.

Mr. SILVERS. Yes. I think that several people in this hearing have expressed the view that this matter with the rating agencies is complicated. And I very much agree with that. I think our exchange a few moments ago suggests that we probably have some common ground on some of these questions.

Mr. STIVERS. Yes.

Mr. SILVERS. I think the view of the Coalitions and the organizations that I represent here today very much goes back to what Mr. Miller said very—at the—Mr. Miller?

Mr. STIVERS. It was Mr. Sherman, I believe.

Mr. SILVERS. Mr. Sherman, I am sorry, Mr. Sherman's comment at the beginning of the hearing. We need to have a robust regulatory framework for the rating agencies because of the embedded and unresolvable conflicts.

Mr. STIVERS. Conflicts of interest, yes.

Mr. SILVERS. And if we did that, then I think we could talk, I think, with a greater degree of flexibility about a variety of issues of the type that you are concerned with. I think it is absolutely correct that we should not be in a mode of no rating agencies at all because there is a substantial sort of information economics being associated with having rating agencies, if they are properly regulated.

We very much got into a—much as we did with independent auditors prior to Enron and WorldCom, we got into a world where we didn't have the necessary framework to capture those economics. We had sort of false economics around the rating agencies. It seems to me, that might be a sort of space where there might be some bipartisan opportunities.

Mr. STIVERS. I think there are. And I appreciate it. I guess, my point is to say I am not saying that Dodd-Frank did completely bad things about rating agencies. I support Section 932. I support Section 933. I support Section 938.

Section 932 creates disclosures so that rating agencies, for the first time, have to list the assumptions underlying their ratings so investors can understand what those ratings mean. Section 938 creates universality of ratings so that they all have a very similar meaning. And Section 933 gives them real liability if they make meaningful misstatements or purposeful misstatements or mislead people on purpose.

And, I guess, the point that I am trying to bring out is Section 939(g) is only one teeny piece of the—what Dodd-Frank did on the credit rating agencies. And unfortunately, it didn't work. It is not working today. That piece of law is not being enforced. And there is a better way to go by getting rid of it and then moving to what I talked about at the very end of my questions, on an additional disclosure on rating shopping.

And, I guess, Mr. Silvers, I am curious what your thought is about what Redwood did on ratings shopping and whether you think that kind of—and my understanding, from reading the Financial Times, not—the SEC didn't tell me this. But the Financial Times says the SEC may be working on something with regard to that. What I would consider doing in this bill is including a requirement in the bill that ratings shopping has to be disclosed, which is currently not part of Dodd-Frank. And I think it would make this bill a little stronger.

I have talked to Mr. Peters from Michigan about it, frankly. And so, I guess, Mr. Silvers, in the minute we have left, what do you think of that?

Mr. SILVERS. Right. Ratings shopping—I am very pleased to hear that you are working as you say you are on the ratings shopping issue. It is a serious part of the problem.

I think our view would be that there is much unfinished work to be done with the rating agencies. And it seems as though you and your colleagues on both sides of the aisle have some—have a fruitful path here.

Mr. STIVERS. Yes. Thank you.

Mr. SILVERS. Thank you.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate it.

Chairman GARRETT. Thank you.

The gentleman from California is recognized for 5 minutes.

Mr. SHERMAN. I believe it is Mr. Weild who is here to focus on credit rating agencies. No? Which of your—

Mr. DEUTSCH. I would raise my hand, but I am not sure what question you are going to ask.

[laughter]

Mr. SHERMAN. Okay. Right now, other than patriotism, which is often in short supply, why wouldn't a credit rating agency selected by the issuer—and this bill proposes that they wouldn't be liable if they even knowingly gave too high a rating. What constraint would there be on the credit rating agencies?

Mr. DEUTSCH. I think what this bill does is creates a whole panoply of potential liability for a rating agency.

Mr. SHERMAN. When you say this bill, you mean the Stivers bill?

Mr. DEUTSCH. Section 939(g) by repealing—

Mr. SHERMAN. Okay.

Mr. DEUTSCH. —Section 436(g) now.

Mr. SHERMAN. Right.

Mr. DEUTSCH. You would subject the rating agencies to a whole panoply of possible liabilities under Section 11, which is strict liability under the securities law, which is the highest form of liability under those securities laws. So it is not just that you can point out one thing here or one thing there. It creates this whole broad set of liabilities that the rating agencies, whether we like it or not, would say, we are not willing to accept that level of liability. Hence, we won't rate these asset-backed bonds. Hence, those bonds, at least under current SEC law, can't move forward.

Mr. SHERMAN. So are you suggesting we go back to the old approach, no liability and every economic incentive to give AAA and Alt-A?

Mr. DEUTSCH. I think Congressman Stivers' questioning of the witness, Mr. Silvers indicates that there is significant liability for rating agencies. But it is not Section 11's strict liability under the securities law, which currently only applies—

Mr. SHERMAN. Wait a minute. Those rating agencies have testified in this very room that they are so proud that they got a court to rule that, under the First Amendment, you can't sue them and that, therefore, they feel invulnerable and wish to—and it is that invulnerability that emboldened them to get the additional market share that they could get by giving AAA to Alt-A. So why do you think that their legal analysis of the law prior to Dodd-Frank is wrong?

Mr. DEUTSCH. Again, what I think Congressman Stivers is indicating is this is not prior to Dodd-Frank. Dodd-Frank has created private rights of action here.

Mr. SHERMAN. Right. And the position of the credit rating agencies before Dodd-Frank was that they were immune from such private rating. Do you agree with that position?

Mr. DEUTSCH. Correct. I am not here to testify as to Sections 933 or 944, the advisability of that. That is now law. That is moving forward. There are these private rights of action. What I am here to testify is that the repeal of Section 436(g) shut down the securitization markets completely, absolutely without deniability.

Mr. SHERMAN. So you think—

Mr. DEUTSCH. That is a fact in record that if we would have moved forward with—by creating this liability to the rating agencies, they would, in fact, not rate these transactions, and credit would not flow in America.

Mr. SHERMAN. Okay, what about—

Mr. STIVERS. Would the gentleman from California yield for 1 second?

Mr. SHERMAN. Yes, I will.

Mr. STIVERS. Have you looked at Section 933 of Dodd-Frank? It does provide an amount of liability outside of Section 939(g). So I don't want anybody to think that Section 939(g) is the only liability the credit rating agencies had to deal with in Dodd-Frank. There is also Section 933. And I have a summary for you, if you need it.

Mr. SHERMAN. I am just beginning to look at your bill and by implication, which provisions of Dodd-Frank it repeals and what is left afterwards.

But, Mr. Deutsch, are you arguing that the credit rating agencies should be subjected to an ordinary liability negligence standard?

Mr. DEUTSCH. I am arguing that credit rating agencies should not be subjected to the Section 11 strict liability standards that issuers are subjected to because the statements that they are making are looking at the future.

Mr. SHERMAN. But my question was about ordinary negligence liability.

Mr. DEUTSCH. I am answering your question as to what I am testifying is that we are not taking a position on what they should be subjected to.

Mr. SHERMAN. Okay.

Mr. DEUTSCH. It is that they should not be subjected.

Mr. SHERMAN. So let me ask Mr. Silvers. Do you think we should go to a world where there is no strict liability, it is not clear there is negligence liability, the credit rating agency is selected by the issuer, who is anxious to get the highest rating and willing to write a $1 million check? Does that sound like a good system to you?

Mr. SILVERS. No, I do not think that is a good system. My testimony is clear. We are not in favor of extending further legal protections to the credit rating agencies. And furthermore, as, I think, my exchange with Mr. Stivers, hopefully, drew out, there is a deep need to make structural changes in the business model of the rating agencies. And I believe, Congressman, that is your intention. And hopefully, that is something that maybe some bipartisanship should be built around.

Mr. SHERMAN. Yes, I could see quicker implementation of what I believe is Section 939(f), that is to say, a system where the issuer is not selecting their umpire along with Mr. Stivers' bill. And I look forward to working with him to try to, on the one hand, make sure that they don't face excessive liability, and on the other hand, make sure that they are not selected, just as umpires at a baseball game. The pitcher doesn't pick the umpire. And he can't sue the umpire.

Mr. SILVERS. Congressman, if I might just add. I think the distinction between forward-looking and backward-looking statements that the rating agencies would like to hold up here in relation to Section 11 is spurious.

Mr. SHERMAN. I look forward to looking at that distinction.

And I yield back the balance of my nonexistent time.

Chairman GARRETT. There you go.

The gentleman from New York for 5 minutes?

Mr. GRIMM. Thank you, Mr. Chairman.

I think that we all agree the purpose for all of us—and there certainly are good intentions all around. It is the unintended consequences that we have to worry about because we all want the economy to grow. We want to create jobs.

There was a meltdown. There are a lot of reasons for that meltdown. A lot of the rules and regulations simply weren't enforced. There was a lack of proper oversight and enforcement of rules that existed. And I think the pendulum has swung so far the other direction that we are—we can be overregulating and hurting industry.

Very quick question, Ms. Hendrickson. Do you have an approximate cost to your firm, specifically your firm that you will have to—you would expect to pay for compliance to be fully compliant with the Dodd-Frank Act?

Ms. HENDRICKSON. At the moment, I expect the cost to be between $350,000 and $500,000 for the first year. That is buying new software to do trading, to monitor trading activity. And, of course, we don't do anything in the public market. It is to hold legended worthless securities by a third-party custody agent. And then, of course, to hire a third compliance officer to certify valuations of our companies, which were already looked at by two nationally-known accounting firms.

Mr. GRIMM. Thank you.

Mr. Zubrod, my Business Risk Mitigation and Price Stabilization Act, the newly-termed "AIG Act", which is pretty good. I have to admit. I did get a chuckle out of that. That is good. That is very good. End users—will end-users, in your opinion, just in your opinion, migrate the markets that operate under a less punitive regulatory environment if they are not exempt from clearing requirements?

Mr. ZUBROD. I think end-users would certainly evaluate opportunities to ensure that they can operate efficiently and manage their risks sufficiently. But I think the message that we would like to give is that we are simply looking for clarification on something that Congress and this committee intended all along, which is that there would not be a margin requirement on end-users. That is something that was part of the—in addition to containing systemic risk and increasing transparency in this market, Congress came together and said that we also need to ensure that end-users are not subject to the salient economic requirements of this Act.

Mr. GRIMM. If I could, just to put this in perspective, because I think when you talk about the numbers, it scares some people—$600 trillion is the overall market, derivatives market, notional number? Is that somewhere in the realm of reason?

Mr. ZUBROD. That is right. The $600 trillion notional amount is not a measure of risk in the market. It is simply a quantification of the—what we call the notional amount. A more appropriate measure of risk is the market value of the transactions. And once you net offsetting positions, once you contemplate transactions that have been cleared through central clearing—currently about a third of the entire derivatives market is already subject to central clearing. And that will increase substantially as a result of this Act. If you contemplate other such mitigation factors, that $600 trillion amount compresses to something less than $2 trillion in market value, which is a much more appropriate measure of risk.

Mr. GRIMM. Will the growth of clearing reduce systemic risk or increase systemic risk, in your opinion?

Mr. ZUBROD. The Coalition supported both the Act's objective of increasing transparency by subjecting every single derivatives trade to a trade reporting requirement so that regulators could have information on where market risks lie. We also did support increased collateralization, whether through clearing or otherwise, amongst systemically significant users of derivatives. And so, I think that, indeed, the Act will contribute toward mitigation of systemic risk and reduce materially, if not eliminate, the derivatives market's contribution to the "too-big-to-fail" problem.

Mr. GRIMM. Thank you.

Thirty seconds, Mr. Chairman? One last question?

Mr. Silvers, I see that you are a big proponent of Dodd-Frank. And it appears from your testimony that Dodd-Frank really zeroes in on the heart of the problems that caused the meltdown. Simply yes or no, is that accurate?

Mr. SILVERS. Mostly.

Mr. GRIMM. Okay. Is there anywhere in here that it mentions Fannie Mae or Freddie Mac?

Mr. SILVERS. That is why I answered mostly.

Mr. GRIMM. Okay. Thank you. I thought that point needed to be made.

Chairman GARRETT. Thank you. I appreciate that.

And I appreciate the panel. And at this point, I would seek unanimous consent to enter into the record—bear with me here—the following documents: from NASDAQ, a letter with regard to their support for the Small Company Capital Formation Act of 2011; from the New York Stock Exchange strongly supporting the Small Company Capital Formation Act of 2011, among others; from the Center on Executive Compensation, the support of H.R. 1062 seeking to repeal Section 953(b) of the Dodd-Frank Act; and finally, I believe it is a statement from the Credit Union National Association as well. Without objection, it is so ordered.

And finally, this concludes today's hearing. The record will remain open, however, as is always the case, for an additional 30 days for all those folks who still think of additional great questions to provide to the panel, the things that maybe they don't—just don't know about, as some of the other members have suggested earlier in the day.

And so, with that, again, I thank the panel. And this hearing is concluded.

[Whereupon, at 4:04 p.m., the hearing was adjourned.]

A P P E N D I X

March 16, 2011

Remarks of the Honorable Robert Hurt before the Capital Markets Subcommittee

Hearing on Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty

March 16, 2011

Mr. Chairman, thank you for holding today's hearing on these important legislative proposals that will facilitate job creation by increasing the flow of private capital to small businesses.

As noted by Republican and Democrat members in last week's hearing with SEC officials, there is serious concern about the effects of the new government mandate for advisers to private equity included in Dodd-Frank.

These unnecessary registration requirements, which do not make the financial system more stable or less risky, will impose an undue burden on small and mid-sized private equity firms and will decrease capital available to spur job growth.

Even though the new regulations do not go into effect until July, private equity firms are already spending capital on complying instead of providing financing to companies that need private capital to survive, expand, and create jobs.

This is why I have introduced H.R. 1082, the Small Business Capital Access and Job Preservation Act, with bipartisan support. If enacted, private equity advisers will be given the same exemption under Title IV of Dodd-Frank that venture capital advisers received. This will allow small businesses to access capital, expand, and get people back to work.

Today, the committee will hear from Ms. Pamela Hendrickson of the Riverside Company, and she will tell the story of a great example of the relationship between private equity and small business in Martinsville, Virginia, the heart of Virginia's 5th District. Unemployment in Martinsville last year exceeded 20 percent, and, like all areas of my district, is in dire need of jobs.

Commonwealth Laminating and Coating, which manufactures solar control window films, worked with the Riverside to invest in upgrading the company's production capacity. This endeavor created 61 much-needed jobs for residents of the area at a critical time.

This is just one example of private equity-backed companies that employ over 1,500 people in the 5th District of Virginia and 58,000 statewide.

With unemployment still unacceptably high in the 5th District and across the country, now is not the time to impose onerous and unnecessary regulatory requirements that force firms to divert essential capital from preserving and creating jobs.

I look forward to the testimony of our distinguished witnesses and thank them for their appearance before the subcommittee today.

Thank you, Mr. Chairman. I yield back the balance of my time.

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Written Testimony

Kenneth A. Bertsch

President and CEO
Society of Corporate Secretaries and Governance Professionals

March 16, 2011

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Concerning Proposals to Alter or Repeal Section 953(b) of the Dodd-Frank Act, on Disclosure of the Ratio of CEO Compensation to the Median Worker Compensation

My name is Kenneth A. Bertsch. Since December 2010 I have served as President and CEO of the Society of Corporate Secretaries and Governance Professionals (the "Society").

The Society is a professional association, founded in 1946, with more than 3,100 members who serve more than 2,000 companies. Our members are responsible for supporting the work of corporate boards of directors and their committees and the executive management of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. The majority of Society members are attorneys, although our members also include other non-attorney governance professionals. More than half of our members are from small and mid-cap companies.

The Society supports development of corporate governance policies and practices that best serve the functioning of boards and the long-term interests of shareholders.

Until December 2010, I served as Executive Director for Corporate Governance at Morgan Stanley Investment Management. My previous employment entailed work in corporate governance research for investors at Moody's Investors Service, TIAA-CREF and the Investor Responsibility Research Center.

I am honored to give testimony before this Subcommittee on behalf of the Society.

Background

The Committee has asked for our views on the "Pay Ratio" provision of Section 953(b) of the Dodd-Frank Act. This section requires companies to disclose the median of annual total compensation paid to all employees of the company (other than the CEO) as well as the annual total compensation paid to the CEO, and then provide a ratio comparing those two numbers ("Pay Ratio").

Calculation of "annual total compensation" of an employee for purposes of this provision must be determined in accordance with the rules for named executive officers in Item 402 of Regulation S-K.

Summary Comments

We believe that it will be virtually impossible for large global companies to comply with Section 953(b) as now written, and that implementation will impose a substantial burden even on smaller non-global issuers. More importantly, while we acknowledge a public policy concern on pay gaps in the United States, we strongly believe the required ratio will not be material or meaningful to investors in company securities. Accordingly, we believe the provision should not be implemented at this time; rather this section should be repealed and, if it is determined to be appropriate, new more workable legislation should be enacted.

We note also that the SEC faces challenges in implementing the many Dodd-Frank reforms, and is otherwise resource-constrained, as indicated by the recently completed Boston Consulting Group study mandated by Section 967 of the Dodd-Frank Act. The SEC must prioritize and focus on the most important issues facing investors and the securities markets.

The Pay Ratio Would Not Provide Meaningful Information to Investors

We do not believe the Pay Ratio provides useful data for investors, who under existing SEC requirements have access to extensive disclosure on senior executive compensation. It is important to keep in mind that SEC disclosure documents are meant to contain information that a "reasonable investor" needs to make an investment decision. The "reasonable investor" standard for materiality is well-established under law. SEC disclosure documents are not meant to contain every item of information that any investor could possibly want to know. Proliferation of disclosure requirements not centered on a disciplined standard will make SEC disclosure documents unusable for the average investor, while adding costs that ultimately are borne by investors.

The Pay Ratio under Section 953(b) will not provide useful information to investors because it is not comparable in any way – across industries, companies, geographies, or employees. For example, companies located in certain areas of the country pay employees and executives more than others, given the cost of living in those areas. Some businesses have a large number of low-paid workers and some have a higher percentage of part-time employees or seasonal employees. These companies will likely have "worse" Pay Ratios. Some companies have outsourced jobs to locations with lower pay levels in an effort to save costs, and these companies may have "better" Pay Ratios than those that have chosen to maintain their operations (call centers for example) in the United States. In addition, companies with franchisees rather than company-staffed stores will also likely have a "better" Pay Ratio. The Pay Ratio will not be a meaningful measure to compare to the CEO's compensation, or to compare the pay practices compared within a single industry. For this reason we do not believe that shareholders will find this disclosure relevant in deciding whether to invest in the company, or on how to vote in election of directors, or how to vote on a "say on pay" resolution.[1]

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[1] **Illustration of lack of comparability:** A major factor in lack of usefulness of the Pay Ratio is the widely varying practices even within industries on outsourcing of production. Employees of vendors would not be included in the pay ratio. A company that keeps relatively greater production in-house would tend to have a significantly lower median "annual total compensation" than one that outsources extensively.

Consider the following hypothetical, using median "company" salary as currently calculated by Payscale.com in the United States (about $60,000), Poland (about $20,500) and India (about $10,500); other forms of compensation for non-CEO employees are excluded for purposes of this example.

> Company A has 1,000 employees, including 100 U.S.-based executives and other employees, all but the CEO paid at the market median. The other 900 employees are all

We submit that the key data points for considering pay equity that investors could use would be (1) CEO pay, which already is subject to extensive disclosure rules, and (2) market-wide pay information, which is publicly available from various government and private sources. So even aside from the question on whether investors generally would find pay equity ratios useful, the particular ratio mandated under 953(b) would be of limited or no use.

More generally, we believe investors have indicated limited interest in obtaining such pay ratio information from companies. We are aware of votes in 2010 on 10 shareholder proposals requesting reports on pay disparity. On average, the proposals were supported by only 6.1% of the shares voted (and opposed by 93.9%), which is a markedly low level of support.

Finally, if investors are concerned that they need additional disclosure on pay equity from a particular company, they currently may submit shareholder proposals requesting such information, and/or use say-on-pay votes under Dodd-Frank to express their views.

Requirement is Burdensome Well Beyond its Benefit

The Pay Ratio disclosure requirement appears to some observers to be a trivial addition to existing disclosure requirements. However, developing the data to calculate the Pay Ratio would be highly burdensome. SEC Corporation Finance Director Meredith Cross recently testified that she has concerns on whether the SEC staff can make the Pay Ratio provision workable. Other SEC officials have noted that the calculations required by the provision would be extremely difficult, especially for large, multinational corporations that pay workers throughout the world in a variety of methods.

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in Poland and assemble the company's products; assume all Poland employees are paid the same amount, at the market median.

Company B also has 100 U.S. based executive and other employees, with all but the CEO also paid at the market median. However, Company B outsources assembly of its products to another firm, which assembles the products in India. Company B has no other employees.

Assume each company's CEO is paid $1 million. The Pay Ratio for Company A will be "49:1" ($1 million/$20,500 of the median employee at the company), while that for Company B will be "17:1" ($1 million/$60,000). Company A appears to have relatively poor pay equity, even though its assembly work is done in Poland, which has substantially higher median pay than India, and even though the two companies otherwise are similar.

While this hypothetical is but one simplified example of the problem, it shows the danger in disclosing a ratio that is not based on similarly situated employees.

Given the definition of "annual total compensation" as set forth in Section 953(b)(2), many companies, including most large worldwide U.S. companies, would not be able to calculate the "median of the annual total compensation of all employees of the issuer" with the degree of precision and certainty required for information filed under the U.S. securities laws. Payroll systems are not set up to gather the kind of information required under this provision. This is especially the case for companies organized into multiple operating business units. Those business units keep records and have internal controls over what each employee is paid, but they report aggregated figures to the parent company for inclusion in consolidated financial reports for public filings. Thus, the parent company that files SEC reports does not have direct access to the employee-by-employee data necessary to identify the median employee. This is complicated even further when operating business units are based outside the United States or employ people in multiple countries.

Moreover, Section 953(b) requires the issuer to disclose the median of all employees, using the same calculations as are used to determine total pay for named executive officers under the proxy rules. In other words, a company would have to convert the pay of each employee globally into the pay formula applicable to the named executive officers in the Summary Compensation Table. To our knowledge, no public company now calculates each employee's total compensation in the way it is required to calculate total pay on the Summary Compensation Table for named executive officers (usually five individuals). Disclosure of executive pay has a different purpose than internal accounting.

For a company with tens or hundreds of thousands of employees, this would be a large and costly task. Note that many global corporations house compensation data in dozens of computer systems. It is not clear that companies could perform consistent calculation for each employee in all countries and ensure that the results are accurate, even with large expenditure on the data.

As we indicated in Society testimony in 2010, there are a number of questions that must be answered by corporate staff trying to compile data necessary to identify the median employee, including the following:

- How do you handle currency conversions for non-U.S. employees? What rate do you use and as of what date?

- In many parts of the world, compensation includes non-monetary components, such as transportation, housing, direct medical care, security, and sometimes even food. How do you treat these kinds of compensation?

- What if you have employees in countries where local privacy laws do not allow personal compensation information to be sent across borders without express employee consent?

- How do you treat company-matched contributions to 401(k) plans? And, what about company matched contributions to a 401(k) plan that is invested in company stock or discounted employee stock purchase plans? Should we treat those as equity compensation?

- How do you treat employees brought in as part of a mid-year acquisition or new employees that started mid-year? Conversely, how do you treat employees that left as part of a mid-year disposition or were terminated mid-year?

- How do you treat severance paid to terminated employees?

- How do you treat special early retirement programs?

- How do you treat overtime and shift differential payments for hourly workers and non-exempt employees? Is that included in "All Other Compensation"?

- For those employees who have an eligibility waiting period how do you treat the waiting period?

- What about store discounts? Are they excludable?

In summary, we believe that the provision is simply unworkable and would produce information that is not meaningful to investors.

I want to thank the Subcommittee again for the opportunity to provide testimony, and indicate the willingness of the Society to answer questions on this now or in the future, and to comment on the workability of any substitute provisions that Congress may wish to pursue.

American SECURITIZATION FORUM®

Statement of:

Tom Deutsch
Executive Director
American Securitization Forum

Testimony before the:

U.S House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Public Hearing on:

Legislative Proposals to Promote Job Creation,
Capital Formation, and Market Certainty

March 16, 2011

One World Financial Center, 30th Floor ▪ New York, NY 10281 ▪ 212.412.7100 ▪ www.americansecuritization.com

Chairman Garrett, Ranking Member Waters, my name is Tom Deutsch and as the Executive Director of the American Securitization Forum ("ASF")[1], I appreciate the opportunity to testify here today on behalf of the 330 ASF member institutions who originate the collateral, structure the transactions, serve as trustees, trade the bonds, service the loans and invest the capital in the preponderance of residential mortgage- and asset-backed securities ("RMBS" and "ABS," respectively) in the United States that provides the capital markets funding for a significant portion of the Main Street credit made available in America by banks, auto finance companies, student loan originators, credit card companies and small and medium size business lenders.

ASF submits this testimony to express our views relating to Section 939G (Effect of Rule 436(g)) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Dodd-Frank"). Section 939G of Dodd-Frank required the immediate repeal of Rule 436(g), which became effective on July 22, 2010. Rule 436(g) under the Securities Act of 1933, as amended (the "Securities Act"), exempted nationally recognized statistical rating organizations ("NRSROs") from expert liability under Section 11 of the Securities Act when their ratings appeared in a statutory prospectus.

ASF supports appropriate reforms within the ABS market and we have held extensive dialogues with policymakers during the drafting, and now with the implementation, of Dodd-Frank to help assist with effective and appropriate rulemaking to ensure the continued recovery

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

of a vibrant securitization market, which ultimately benefits consumers, businesses and the real economy.

This testimony seeks to address key concerns in the below outline:

- I. Role and Importance of Securitization in the Financial System and U.S. Economy
- II. The Repeal of Rule 436(g)
    - a. Regulatory and Legislative History of Rule 436(g)
    - b. Implications of the Repeal of Rule 436(g) on the Securitization Market
    - c. ASF Proposed Solutions to These Implications
        - i. Amend Regulation AB to Eliminate Required Ratings Inclusion
        - ii. Legislation to Repeal the Repeal of Rule 436(g)
- III. The FDIC's Orderly Liquidation Authority
    - a. Intent to Harmonize Dodd-Frank with the Bankruptcy Code
    - b. Preferential Transfer Issue
        - i. Consequences of the Inconsistency for Consumer and Commercial Credit Industries
        - ii. FDIC's General Counsel Letter I
    - c. Repudiation Power Issue
        - i. FDIC's General Counsel Letter II
- IV. Conclusion

At the outset, let me emphasize that ASF agrees with the goal of reducing overreliance on credit ratings and addressing flaws in the ratings process. We support sensible efforts to ensure that credit ratings are developed and used appropriately. However, as this testimony will outline, we share many of the concerns expressed by market participants, both before and after the enactment of the Dodd-Frank Act, as to the wisdom and efficacy of the repeal of Rule 436(g) by the Dodd-Frank Act as required by Section 939G.

In an October, 2009 release by the Securities and Exchange Commission ("SEC") seeking input on the advisability of repealing Rule 436(g), the SEC's first question for commenters to respond to was, "If we were to subject all credit rating agencies to Sections 7 and 11 of the Securities Act by rescinding Rule 436(g), would registrants be able to obtain the consent required to use ratings in connection with registered offerings of rated securities?"[2] A number of commenters to this proposal indicated that consent would be extremely difficult to obtain. On July 22, 2010, the day after Dodd-Frank was passed and the day the repeal of Rule 436(g) went into effect, this question received an answer grounded in reality—NRSROs did not consent to including their ratings in prospectuses. Since SEC rules require inclusion of ratings in ABS prospectuses and issuers were unable to include ratings in their prospectuses, the entire securitization market shut down. Immediately, issuers of all forms of asset-backed securitizations began scrambling to determine how they would be able to continue capital markets financing of their lending to consumers and businesses.

Fortunately, the staff of the SEC patched up this shutdown late in the day on July 22, 2010 by granting a six month no-action relief for registered offerings of ABS, which was set to expire on January 23, 2011 ("July Letter"). Given the looming shutdown of the ABS markets when the July Letter was expected to expire, ASF sought and the SEC issued on November 23, 2010 (the "436(g) no-action letter")[3] an extension of the no-action letter until further notice.

The ASF applauds the staff of the SEC for their decision to issue the no-action letter to help keep open the critically important securitization markets, but we believe a permanent solution is needed to ensure the long-term viability of the U.S. public securitization markets. In particular, we cautiously note that the language of the current 436(g) no-action letter provides no ongoing certainty as to a permanent SEC policy, as the letter is effective only "until further notice."

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[2] 17 CFR Part 220, page 22.
[3] The SEC's no-action letter dated November 23, 2010 is available at http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.

Ultimately, ASF believes that the appropriate action is a legislative fix to permanently remedy the issue so as to avoid the potential long-term shutdown of the public securitization market in light of the market uncertainty this issue continues to cause for the industry. This issue is of great concern, not only to the securitization market, but to the credit markets generally, and to consumers in particular. If such a permanent remedy does not ultimately occur, consumers and businesses may ultimately face a more constricted credit market, resulting in fewer financing options and higher costs.

I. <u>Role and Importance of Securitization in the Financial System and U.S. Economy</u>

Securitization—generally speaking, the process of pooling and financing consumer and business assets in the capital markets by issuing securities, the payment on which depends primarily on the performance of those underlying assets—plays an essential role in the financial system and the broader U.S. economy. Over the past 40 years, securitization has grown from a relatively small and unknown segment of the financial markets to a mainstream source of credit and financing for individuals and businesses alike.

In the past, securitization has been a significant source of consumer and residential mortgage lending in the United States and, while down from its peak levels, as of June 2009, out of $18 trillion worth of real estate loans and consumer credit, nearly 19% was funded through private-label securitization.[4] As evidenced by such programs as The Federal Reserve Bank of New York's Term Asset-Backed Securities Loan Facility, there is clear recognition of the importance of the securitization process and the access to financing that it provides lenders, and

[4] Navigating the Financial Challenges Ahead, Global Financial Stability Report, World Economic and Financial Surveys, International Monetary Fund (Oct. 2009), 78.

of its importance to the availability of credit that ultimately flows to consumers, businesses and the real economy.

In recent years, the role that securitization has assumed in providing both consumers and businesses with credit has been striking: currently, there are over $11 trillion of outstanding securitized assets, including RMBS, ABS and asset-backed commercial paper ("ABCP"). This represents a market substantially larger than the normal size of all outstanding marketable U.S. Treasury securities—bonds, bills, notes, and TIPS combined.[5] Between 1990 and 2006, issuance of MBS grew at an annually compounded rate of 13%, from $259 billion to $2 trillion a year.[6] In the same time period, issuance of ABS secured by auto loans, credit cards, home equity loans, equipment loans, student loans and other assets, grew from $43 billion to $753 billion. In 2006, just before the downturn, nearly $2.9 trillion in RMBS and ABS were issued. As these data demonstrate, securitization is clearly a critical sector of today's financial markets.

The importance of securitization becomes more evident by observing the significant proportion of consumer credit it has financed in the U.S. It is estimated that securitization has funded between 30% and 75% of lending in various markets, including an estimated 64% of outstanding home mortgages.[7] Securitization plays a critical role in non-mortgage consumer credit as well. Historically, banks have securitized 50-60% of their credit card assets.[8] Meanwhile, in the auto industry, approximately 91% of auto industry sales are financed through

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[5] U.S. Department of the Treasury, "Monthly Statement of the Public Debt of the United States: January 31, 2011," (January 2011). <http://www.treasurydirect.gov/govt/reports/pd/mspd/2011/opds012011.pdf>.
[6] National Economic Research Associates, Inc. ("NERA"), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," pg. 16 (June 2009). <http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf> (the "NERA Study")
[7] Fitch Ratings, "U.S. Housing Reform Proposal FAQs: Filling the Void" pg. 1-2 (Feb. 2011). <http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=606315> (free registration required).
[8] Citigroup, "Does the World Need Securitization?" pg. 10 (Dec. 2008). <http://www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf>.

auto ABS.[9] Overall, recent data collected by the Federal Reserve Board show that securitization has provided over 25% of all outstanding U.S. consumer credit.[10] Securitization also provides an important source of commercial mortgage loan financing throughout the U.S., through the issuance of commercial mortgage-backed securities ("CMBS").

Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future. ASF is supportive of efforts to increase measured and appropriate reforms to the ratings process, but we believe policymakers must carefully balance any measures that aim to revise regulations around the use of credit ratings in ABS with the potential for unintended consequences, should these measures impede market recovery and further constrain the availability of credit.

Over the years, securitization has grown in large measure because of the benefits and value it delivers to transaction participants and to the financial system. Among these benefits and value are the following:

A. *Efficiency and Cost of Financing.* By linking financing terms to the performance of a discrete asset or pool of assets, rather than to the future profitability or claims-paying potential of an operating company, securitization often provides a cheaper and more efficient form of financing than other types of equity or debt financing.

[9] Ibid., pg. 10.
[10] Federal Reserve Board of Governors, "G19: Consumer Credit," (Sept. 2009). <http://www.federalreserve.gov/releases/g19/current/g19.htm>.

B. *Incremental Credit Creation.* By enabling capital to be raised via securitization, lenders can obtain additional funding from the capital markets that can be used to support incremental credit creation. In contrast, loans that are made and held in a financial institution's portfolio occupy that capital until the loans are repaid.

C. *Credit Cost Reduction.* The economic efficiencies and increased liquidity available from securitization can serve to lower the cost of credit to consumers and businesses. Several academic studies have demonstrated this result. A recent study by National Economic Research Associates, Inc., concluded that securitization lowers the cost of consumer credit, reducing yield spreads across a range of products including residential mortgages, credit card receivables and automobile loans.[11]

D. *Liquidity Creation.* Securitization often offers issuers an alternative and cheaper form of financing than is available from traditional bank lending, or debt or equity financing. As a result, securitization serves as an alternative and complementary form of liquidity creation within the capital markets and primary lending markets.

E. *Risk Transfer.* Securitization allows entities that originate credit risk to transfer that risk throughout the financial markets to parties willing to assume it, such as institutional investors and hedge funds.[12]

F. *Customized Financing and Investment Products.* Securitization allows for precise and customized creation of financing and investment products tailored to the specific needs of both issuers and investors. For example, issuers can tailor securitization structures to meet their capital needs and preferences and diversify their sources of financing and

[11] NERA Study, pg. 16. <http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf>.
[12] The vast majority of investors in the securitization market are institutional investors, including banks, insurance companies, mutual funds, money market funds, pension funds, hedge funds and other large pools of capital.

liquidity. Investors can tailor securitized products to meet their specific credit, duration, diversification and other investment objectives.

Recognizing these and other benefits, policymakers globally have taken steps to help encourage and facilitate the recovery of securitization activity. The G-7 finance ministers, representing the world's largest economies, declared that "the current situation calls for urgent and exceptional action…to restart the secondary markets for mortgages and other securitized assets."[13] The Department of the Treasury stated in March, 2009, that "while the intricacies of secondary markets and securitization…may be complex, these loans account for almost half of the credit going to Main Street,"[14] underscoring the critical nature of securitization in today's economy. The current Chairman of the Federal Reserve Board noted that securitization "provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits" and also that "it substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks."[15] Echoing that statement, the International Monetary Fund (IMF) noted in its *Global Financial Stability Report* that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions,"[16] while the Financial Stability Oversight Council in its recent study on *Macroeconomic Effects of Risk Retention Requirements* stated that, "[b]y providing access to the

[13] G-7 Finance Ministers and Central Bank Governors Plan of Action (Oct. 10, 2008). <http://www.treas.gov/press/releases/hp1195.htm>.

[14] U.S. Department of the Treasury, "Road to Stability: Consumer & Business Lending Initiative," (March 2009). <http://www.financialstability.gov/roadtostability/lendinginitiative.html>.

[15] Bernanke, Ben S., "Speech at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California." *Board of Governors of the Federal Reserve System* (Oct. 2008). <http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm>.

[16] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg.33. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

capital markets, securitization has improved the availability and affordability of credit to a diverse group of businesses, consumers, and homeowners in the United States." There is clear recognition in the official sector of the importance of the securitization process and the access to financing that it provides lenders as well as its importance in providing credit that ultimately flows to consumers, businesses and the real economy.

Restoration of function and confidence to the securitization markets is a particularly urgent need, in light of capital and liquidity constraints currently confronting financial institutions and markets globally. As mentioned above, nearly $11 trillion in U.S. assets are funded at present via securitization. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, such as those expected in Basel III, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environment. In fact, the IMF estimated that a financing "gap" of $440 billion existed between total U.S. credit capacity available for the nonfinancial sector and U.S. total credit demand from that sector for the year 2009.[17] Moreover, non-bank finance companies, which have played an important role in providing financing to consumers and small businesses, are particularly reliant on securitization to fund their lending activities, because they do not have access to deposit-based funding. Small businesses, which employ approximately 50% of the nation's workforce, depend on securitization to supply credit that is used to pay employees, finance inventory and investment, and fulfill other business purposes. Furthermore, many jobs are made possible by securitization. For example, a lack of financing for mortgages hampers the housing

[17] International Monetary Fund, "The Road to Recovery." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg. 29. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

industry; likewise, constriction of trade receivable financing can adversely affect employment opportunities in the manufacturing sector. To jump start the engine of growth and jobs, a robust securitization sector is needed to help restore credit availability.

II. The Repeal of Rule 436(g)

a. Regulatory and Legislative History of Rule 436(g)

Rule 436(g) of the Securities Act is often referred to as the NRSRO expert exemption because its effect is to exempt NRSROs from liability as experts for their ratings under Section 11 of the Securities Act. Section 939G of the Dodd-Frank Act provides that "Rule 436(g) promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect" (the "Repeal of Rule 436(g)").

If the ratings of registered ABS are a condition to the issuance or sale of such ABS, Item 1103(a)(9) and Item 1120 of Regulation AB ("Reg AB")[18] require disclosure in the statutory prospectuses of the minimum rating required and the identity of each rating agency issuing the ratings (regardless of whether the entity is an NRSRO).[19] Currently, investors expect that the ABS they purchase from underwriters will have specific ratings. For most senior investors, their investment guidelines require certain investment grade ratings to be available before that investor may purchase a particular security. For this reason, ABS underwriting agreements (pursuant to which the underwriters commit to purchase the ABS from the issuer (or the depositor)) have, as a closing condition, the receipt of evidence that the rating agencies have assigned specific ratings. As a result, under Regulation AB, ABS issuers must disclose in the statutory prospectus the ratings that are a condition to the issuance or sale of the ABS and the identity of the rating

[18] 17 C.F.R. §§229.1100 - 229.1123.
[19] See Item 1103(a)(9) and Item 1120 of Regulation AB.

agency issuing the rating. In addition, in response to comments received from SEC staff during the review process, certain issuers using shelf registration statements include a statement to the effect that the ABS must be rated investment grade at the time of issuance.

Rule 436(g) specifically provided that credit ratings issued by NRSROs (but not other credit rating agencies) on debt securities, convertible debt securities and preferred stock were *not* considered part of the registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. Section 7 of the Securities Act requires any accountant or person whose profession gives authority to a statement made by him (often referred to as an "expert") who is named as having prepared or certified any part of the registration statement, or who is named as having prepared or certified a report for use in connection with the registration, to file a written consent with the registration statement. Because Rule 436(g) specifically provided that ratings issued by NRSROs were not considered part of the registration statement prepared or certified by a person within the meaning of Section 7, prior to the repeal of Rule 436(g), NRSROs were specifically exempt from the Section 7 requirement to file a written consent.

Because NRSROs did not file consents as experts, they were not subject to the strict liability under Section 11 of the Securities Act for the ratings included in a registration statement. Section 11 imposes liability *over and above* that which would apply under common law or under Rule 10b-5 of the Securities Exchange Act of 1934, as amended, on those who are involved in the preparation of the registration statement. Section 11 of the Securities Act applies to any person that signs the registration statement, directors of the issuer, underwriters and "experts" who have been named in the registration statement as having prepared or certified any part of the registration statement or any report or valuation used in connection with the registration statement that provided their consent for filing with a registration statement. Therefore, although Item 1103(a)(9) and Item 1120 of Regulation AB require disclosure of the ratings that are a condition to the sale or issuance of the ABS and the identity of the rating agency (and, in some cases, the issuer agreed to disclose that the ABS must be rated investment grade at the time of issuance), Rule 436(g) specifically exempted NRSROs from the consent requirement under Section 7 of the Securities Act. This, in turn, meant NRSROs were not subject to Section 11 of the Securities Act, which imposes civil liability on experts providing a consent for filing with a registration statement.

b. Implications of the Repeal of Rule 436(g) on the Securitization Market

We note that while many believe that registrants would be able to comply with the disclosure requirements of Items 1103(a)(9) and 1120 without triggering the Section 7 consent requirement, from the time of enactment of Dodd-Frank last year, no ABS public market participant was comfortable from a legal standpoint moving forward on this basis until provided with guidance from the SEC in the form of a no-action letter.[20] Given the uncertainty with

[20] Many members of the ASF believe that the disclosure required under Item 1103(a)(9) and Item 1120 of Regulation AB does not trigger a requirement to file a consent, consistent with the SEC's statements in its October 2009 concept release on the proposed rescission of Rule 436(g) (available at http://www.sec.gov/rules/concept/2009/33-9071fr.pdf and http://www.sec.gov/rules/concept/2009/33-9071afr.pdf). In that release and the companion release on disclosure of credit ratings (available at http://www.sec.gov/rules/proposed/2009/33-9070fr.pdf and http://www.sec.gov/rules/proposed/2009/33-9070afr.pdf) the SEC said that the proposed disclosure requirement and regarding credit ratings "would not be triggered if the only disclosure ... is related to ... the terms of agreements that refer to credit ratings..." and that the SEC "preliminarily believe[d] that a consent would not be required for such disclosure." This statement would appear to cover reference to an underwriting agreement that has a closing condition that the securities receive a minimum rating from an identified rating agency required under Item 1103(a)(9) and Item 1120 of Regulation AB.

Additionally, we note that because the required disclosure only includes the minimum required rating (and in some cases, a statement that the securities must be rated investment grade) and *not* the rating itself, Section 7 of the Securities Act is not implicated under the SEC's own position that "[t]he consent requirement in Securities Act Section 7(a) applies only when a report, valuation or opinion of an expert is *included or summarized* in the registration statement and attributed to the third party and thus becomes 'expertised' disclosure for purposes of Securities Act Section 11(a), with resultant Section 11 liability for the expert...." (emphasis added). See SEC respect to the applicability of the Section 7 consent requirement, with the repeal of Rule 436(g) under the Securities Act, if and when the SEC staff issues guidance contrary to the current 436(g) no-action letter, public issuance of ABS would again shut down unless issuers obtain the consent of the NRSROs rating the securities. Several of the NRSROs continue to study this matter but have expressed concern with the scope and magnitude of Section 11 strict liability attached to their being considered an "expert." Section 11 liability is considered "strict," which would create potential enterprise liability for any NRSRO, given that the damages could be so significant. Moreover, a rating is a forward looking assessment of expected performance that could be construed or litigated as an expert 'prediction' or 'estimation' of performance. In ABS transactions, the Section 11 liability that attaches to issuers and underwriters is grounded in historical information and facts that are verifiable (and hence not 'predictions' of what may occur in the future). This concern is consistent with comments previously made by the NRSROs to the SEC in connection with proposals that would have subjected NRSROs to the consent requirement, and therefore, increased liability.

For the most part, credit ratings perform an invaluable role in our financial system. They allow investors to sort the universe of potential debt investments into categories of relative riskiness and allow a starting point from which investors can more efficiently perform their own level of due diligence. Without ratings, the markets would lose an effective sorting devise, investors would not have a point of origin for their own due diligence, and disorder would likely result. Redundant replication would replace specialization, and impede the efficiency of capital

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Compliance and Disclosure Interpretations, Question 141.02. The condition to issuance or the ratings requirement is just that, a condition or a requirement, not the inclusion or summary of a report of an expert, not even the attribution of a statement to an "expert."

markets operations, which in turn would slow the formation and reduce the flow of credit into our economy. Again, credit ratings should not be the only source of information, but instead should be one of a number of inputs into an overall assessment of value.

In fact, other provisions in Dodd-Frank require investors to be less reliant on the ratings agencies and to engage in greater independent analysis. But this is like requiring a person to wear belts <u>and</u> suspenders, while knowing the very act of requiring both results in there being no pants to wear, as we saw in the disappearance of the offering of ABS in July, 2010.

Given these concerns, it appears most, if not all, of the NRSROs would not be in a position to provide the written consent arguably required by Section 7 in the case where the SEC staff were to no longer provide the current 436(g) no-action relief. Additionally, if the SEC staff were to issue guidance to effectively eliminate the current relief, any transition period afforded the NRSROs may not provide the NRSROs sufficient time to adjust to the new environment by creating and implementing policies and procedures relating to their issuance of consents, including the planning and execution of the "reasonable investigation" contemplated by Section 11(b)(3)(B) of the Securities Act or the installation of related internal supervisory controls. Moreover, it is unclear at this time if, regardless of the length of any implementation period, any NRSRO would agree to provide a written consent for filing with a registration statement given the associated liability of their statements. Instead, one or more NRSROs may elect to cease rating publicly issued ABS. Given the investor demands in the ABS market for ratings on ABS (and the current requirement that the ABS be rated investment grade to be offered on a shelf registration basis), we believe this would likely bring the public ABS markets to a standstill at any moment if the SEC staff were to eliminate the relief provided by the current 436(g) no-action letter. The ASF actively supports the effort to create a sustainable securitization market and believes the intersection of the Repeal of Rule 436(g) and a renewed enforcement of Item 1103(a)(9) and Item 1120 of Regulation AB would result in a market paralysis, similar to the one that occurred in the initial days after passage of the Dodd-Frank Act, that is damaging to market participants, investors and consumers alike.

c. ASF Proposed Solutions to These Implications

i. Amend Regulation AB to Eliminate Required Ratings Inclusion

One potential permanent solution to this situation is that Item 1103(a)(9) and Item 1120 of Reg AB could be amended to be accompanied by an instruction that the specific ratings and rating agencies are not required to be disclosed in statutory prospectuses and that no consent of the rating agency is required in these circumstances. In fact, in testimony question and answer last week before a House Government Oversight and Reform Subcommittee hearing, the Chairman of the SEC, Mary Shapiro, indicated that the SEC "staff is working through a reconsideration of our disclosure requirements [for ABS], and I believe that they will recommend that we eliminate our pre-existing requirement for including the ratings, and therefore the liability provisions can go forward."

ii. Legislation to Repeal the Repeal of Rule 436(g)

Although we endorse this potential solution to amend Reg AB, we emphasize our membership's continued preference for a legislative fix to repeal the repeal of Rule 436(g) as the best policy for eliminating the unwanted effects of Dodd-Frank Section 939G. If ratings are to be conveyed to investors, issuers should have the ability to convey these ratings to investors as part of the primary, comprehensive offering documents (statutory prospectuses), rather than through assorted ancillary communications such as free writing prospectuses. Moreover, a regulatory fix, such as the foregoing proposal, would impose an additional burden on the SEC to pursue its regulatory authority in order to negate the harmful effects of this Section of the legislation, at a time when the SEC is already inundated with the task of undertaking the large-scale rulemakings required by Dodd-Frank. In contrast, at a critical time for consumers, businesses and the U.S. economy, we believe that an act by Congress to repeal this Section would provide the most straightforward and effective way to remove a key barrier that remains to resuming the normal flow of credit in America.

III. The FDIC's Orderly Liquidation Authority

In December of 2010, two other issues emerged under Dodd-Frank that also threatened the viability of the non-bank sectors of the securitization market. Title II of Dodd-Frank sets forth the Orderly Liquidation Authority ("OLA") of the Federal Deposit Insurance Corporation ("FDIC") through which the FDIC can exercise certain powers in the event that a "covered financial company" (a "Covered Financial Company")[21] enters receivership. A Covered Financial Company is a nonbank that is primarily engaged in financial activity and upon its failure would have serious adverse effects on the financial stability of the United States.

The Dodd-Frank Act requires the FDIC to implement OLA and, to the extent possible, to harmonize its rules with the insolvency laws that would otherwise apply. To date, two separate issues have been identified and pursued by market participants and each required immediate attention by the FDIC to prevent further damage to the already fragile securitization markets. The first issue involves securitizations of Covered Financial Companies where the perfection of the security interest on the underlying paper was accomplished by a Uniform Commercial Code (the "UCC") filing, which generally occurs for auto and student loan securitizations, rather than by possession. In such a case, the FDIC under OLA could arguably trump the securitization's lien on the underlying auto or student loans and leave the investors in the securitization unsecured. The second issue involves the scope of the repudiation power that could be exercised

[21] The Orderly Liquidation Authority ("OLA") provisions of Dodd-Frank allow for the FDIC to be appointed as the liquidating receiver of a "covered financial company." A "covered financial company" subject to these provisions:

- is not an insured depository institution,
- is primarily engaged in activities that are financial in nature and the consolidated revenues of such company from such activities are 85% or more of its consolidated revenues; and
- is in default or in danger of being in default, and, among other things, "the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States" (a "Systemic Risk Determination").

by the FDIC as receiver for a Covered Financial Company under OLA. Our membership very much appreciated the FDIC's General Counsel taking immediate steps to also 'patch' these issues in part, although considerable uncertainty remains without a legislative solution.

Congress has required through Dodd-Frank that the FDIC harmonize applicable rules and regulations promulgated under OLA with the insolvency and bankruptcy laws that would otherwise apply. Despite clarity in the legislative intent, ambiguity in the statutory language of Title II has caused substantial consternation and uncertainty in the securitization markets and has required prompt interpretive actions from the FDIC, at a time when the FDIC is already inundated with the task of undertaking the numerous large-scale rulemakings required by Dodd-Frank. For these reasons, market participants may be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, whether OLA rules or bankruptcy rules would ultimately apply. To provide much needed certainty, and to ensure that the intent of the OLA provisions under Dodd-Frank are carried out, we believe that a legislative solution is necessary and we stand ready to endorse a bill that requires the OLA provisions to be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation.

a. **Intent to Harmonize Dodd-Frank with the Bankruptcy Code**

In enacting OLA, Congress intended to create a new statutory regime for the orderly liquidation of Covered Financial Companies. However, several sources, including the Dodd-Frank Act itself, suggest that Congress also intended for the resulting statutory regime to operate in such a way as to minimize the likelihood of different results to creditors of such potential Covered Financial Companies from those results arising under Title 11 of the United States Code (the "Bankruptcy Code").

Sections 210(a)(7)(B) and (d)(2)(B) of the Dodd-Frank Act, provide that, in the context of OLA liquidation, "a creditor shall, in no event, receive less than the amount that creditor is entitled to receive" if the FDIC "had not been appointed receiver with respect to [a] covered financial company; and the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code." Furthermore, Section 209 of the Dodd-Frank Act mandates that the FDIC "seek to harmonize applicable rules and regulations promulgated under [OLA] with the insolvency laws that would otherwise apply to a covered financial company." In the Notice of Proposed Rulemaking issued by the FDIC with respect to OLA[22], the FDIC states that "[t]he liquidation rules of [OLA] are designed to create parity in the treatment of creditors with the Bankruptcy Code" and that "the provisions that empower the FDIC to avoid and recover fraudulent transfers, preferential transfers and unauthorized transfers of property by the covered financial company are drawn from Bankruptcy Code provisions."

The underlying policy rationale behind this desire for harmonization is likely that Congress wanted to avoid requiring parties extending credit to potential Covered Financial Companies to be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, which regime would ultimately apply as what constitutes a Covered Financial Company is, at least at this point, a moving target that is determined at the time of receivership. And even if "covered financial company" is strictly

[22] See http://www.fdic.gov/regulations/laws/federal/2010/10propose1019.pdf.

defined, companies may still never be able to feel comfortable making a predetermination as to their status with respect to a potential future receivership.

If a creditor faces the possibility of two different insolvency regimes, it will have to structure transactions to comply with both. Doing so will raise transaction costs and ultimately raise the costs and lower the availability of credit. Raising the costs and reducing the availability of credit are especially problematic if the rules under OLA producing a different outcome than under bankruptcy law cannot be justified on the grounds that they provide important benefits in controlling systemic risk. In other words, a company may have to plan on being considered a Covered Financial Company even though they may ultimately not be determined to be systemically important. Moreover, a small company that has no reasonable basis for concluding it is a Covered Financial Company may ultimately be acquired by a Covered Financial Company and hence now subject to OLA.

b. **Preferential Transfer Issue**

This past December, ASF became aware of an interpretive issue under Section 210(a)(11) of the Dodd-Frank Act relating to the power of the FDIC to avoid preferential transfers. The issue primarily affects the U.S. consumer finance and commercial credit industries and relates to the interpretation of several inconsistent provisions of the Dodd-Frank Act, although the legislative intent of these provisions appears to be clear. Generally, OLA could be interpreted to give the FDIC, as receiver for a Covered Financial Company, broader powers to avoid certain previously perfected security interests than a trustee (a "Bankruptcy Trustee") under the Bankruptcy Code would have upon a Chapter 7 liquidation of the same Covered Financial

Company. As an example, if a Covered Financial Company securitized chattel paper, such as auto loans, and did not deliver the paper to a custodian for the securitization but instead relied on UCC filings for perfection, the FDIC could potentially trump the securitization's lien on the underlying paper and leave the investors in the securitization unsecured. This result would not occur under the Bankruptcy Code. To eliminate the ambiguity in a manner consistent with the legislative intent, ASF suggested in a December 13th letter to the FDIC that these "preference provisions" would benefit from additional rulemaking by the FDIC, or by the issuance of further guidance in the form of a "policy statement" or other release on which the affected industries could rely.[23]

In the letter, we identified an inconsistency in the drafting of the preference provisions of Section 210(a)(11) of the Dodd-Frank Act, which, if read in a certain way, would create a disparity between the treatment of creditors of potential Covered Financial Companies under the Bankruptcy Code and under OLA. Specifically, defining when a "transfer" is "made" by reference to when the rights of a "bona fide purchaser" are superior to the rights of a holder of a previously perfected security interest is a concept which, under the Bankruptcy Code is applied only in the context of fraudulent transfers and of preferential transfers of real property other than fixtures. Under OLA this concept is applied in the context of not only fraudulent transfers (Section 210(a)(11)(A) of the Dodd-Frank Act) and preferential transfers of real property other than fixtures but also to preferential transfers of personal property and fixtures (Section 210(a)(11)(B) of the Dodd-Frank Act). The result is that the FDIC as receiver for a Covered Financial Company under OLA may have broader powers than does a Bankruptcy Trustee under

[23] See http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_orderly_liquidation_letter_to_the_fdic_12_13_10.pdf.

the Bankruptcy Code to avoid, as preferential transfers, certain previously perfected security interests in personal property and fixtures, even though the transfers are inherently non-preferential.

We requested in the letter that the FDIC issue guidance resolving the ambiguity, and providing that, (1) consistent with the Bankruptcy Code, the "bona fide purchaser" standard for defining when a transfer is "made" will be applied under OLA only with respect to fraudulent transfers and to preferential transfers of real property other than fixtures; (2) the standard found in Section 547(e)(1)(B) of the Bankruptcy Code be applied to determine the timing of transfers of personal property and fixtures and (3) the 30-day grace period to perfect a transfer, found in Section 547(e)(2) of the Bankruptcy Code be applied to preferences under Section 210(11)(B) of the Dodd-Frank Act. Although the statute's drafting inconsistency is a narrow and technical one, we believed, and continue to believe, that the resulting ambiguity is of considerable practical importance to the consumer and commercial credit industries, as many standard practices in these industries have been established and have evolved, in response to, and in reliance on, the well established Bankruptcy Code provisions.

i. **Consequences of the Inconsistency for Consumer and Commercial Credit Industries**

The ambiguity described above could potentially impact all lending secured by personal property, securitizations of personal property and even sales involving non-possessory interests in personal property where perfection of transfers of such property by possession or other means could trump perfection by filing a financing statement under the UCC[24] or other similar filings or actions under other applicable law. The issue arises most prominently with respect to consumer and commercial credit transactions in which the subject property is characterized under the UCC either as "chattel paper" or as an "instrument." In the securitization industry, this could affect many different asset classes, but would predominantly affect auto and student loans. Specifically, the ambiguity could affect sales[25] of chattel paper or instruments, as well as transactions in which chattel paper or instruments serve as collateral securing a party's obligations if, in either case, the transfer has been properly perfected by filing a financing statement, as permitted under the UCC, and not through possession (which is not required for such proper perfection if perfection has been obtained by filing).

Section 9-102(a)(11) of the UCC defines "chattel paper" to include "a record or records that evidence both a monetary obligation, and a security interest in specific goods ... or a lease of specific goods." Section 9-102(a)(47) of the UCC defines an "instrument" as "a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary endorsement or assignment." Under the UCC, a security interest in chattel paper or instruments may be properly perfected by filing a financing statement, among other means.

Under the UCC, while the filing of a financing statement would properly perfect a security interest in chattel paper or instruments, such that a "hypothetical lien creditor" could not

[24] See *e.g.,* UCC Section 9-330.
[25] Under Section 1-201(37) of the UCC, the term "security interest" includes "any interest of.....a buyer...of chattel paper."

acquire a security interest in the chattel paper or instrument that is superior to that of the secured party, the filing of a financing statement alone would not prevent a "bona fide purchaser" from acquiring a security interest in the chattel paper or instrument that is superior to that of the secured party.[26] Therefore, while the Bankruptcy Trustee under the Bankruptcy Code *would not* be able to avoid as a preferential transfer a security interest in chattel paper or instruments granted and perfected by means of filing a financing statement at closing or within 30 days of closing, the FDIC under OLA *would* potentially be able to avoid as a preferential transfer that very same security interest.

Upon the avoidance of such transfer, the claim otherwise secured by a properly perfected security interest would become an unsecured claim in the FDIC receivership. As a result, the creditor would receive less than it would have received in a Chapter 7 Bankruptcy Code liquidation of the same company.

The consequences to the consumer and commercial credit industries – and their creditor counterparties – are further, and indeed greatly, exacerbated by the absence of a "transition rule" for OLA. Many credit facilities, securitizations and sales date prior to the enactment of the Dodd-Frank Act, and were structured in reliance on the certainty of the provisions of the Bankruptcy Code. The documentation, policies and procedures of both the financial companies and their creditors, and the overall architecture of these transactions and programs, depended on

[26] This is a consequence, for chattel paper, of the rule found in Section 9-330(b) of the UCC: "A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105 in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party." A good faith purchaser of an instrument who takes possession of it is likewise given priority under Section 9-330(d) of the UCC and, in the case of a negotiable instrument, a holder in due course of the negotiable instrument obtains priority under Section 9-331 of the UCC. None of these purchasers, who rely upon possession of the chattel paper or instrument, have an obligation to conduct UCC searches to discover any filed financing statements in order to obtain priority.

the proper and effective perfection achieved by the filing of a UCC financing statement. Although in some instances these existing transactions and programs could now be re-engineered to comply with the "bona fide purchaser" construct applicable to fraudulent transfers and preferential transfers of real property other than fixtures, that is only a partial solution, and one which will be time consuming, difficult and expensive to implement. The delays needed for such implementation would also be expected to adversely affect the liquidity of the affected financed company during the delay, as it will be difficult, if not impossible during the period of delay to enter into new financing facilities, or portfolio sales, which rely on the existing practices.

With respect to programs currently in place, the re-engineering is in any event only a "partial solution." This is due to the look-back provisions of the preference rules. These rules, which provide that a solution, once implemented, is itself a transfer of property of the debtor to or for the account of a creditor on account of an antecedent debt. As a result, the implementation of the solution would not eliminate the creditor's preference risk until the preference period, commencing on the implementation of the solution has past. The general preference look-back period is 90 days, but for transfers among affiliated companies, the look-back period is a year. Since many consumer and commercial finance companies structure their financing, securitization and secondary-market activities through transfers to subsidiaries, the look-back period arguably could be a year. Accordingly, creditor counterparties will severely discount the efficacy of any proposed solution.

Further, while some types of consumer and commercial credit transactions are documented by "chattel paper" and "instruments", others are not (such others being characterized under the UCC as, for example, "accounts" or "general intangibles"). Sometimes these are different products of the same finance company (for example, certain types of inventory financings), while in other instances they may be the identical product, simply documented in a different way (this is the case in the student loan industry). Under OLA, in some cases a properly perfected security interest could be attacked as a preferential transfer which another very similar transaction could not be. Thus, the effects and the uncertainty to financial companies' creditor counterparties are further magnified.

ii. FDIC's General Counsel's Letter I

On December 29, 2010, the FDIC issued a General Counsel's Letter to the ASF in which it provided an interpretation of the OLA provisions of the Dodd-Frank Act that effectively alleviated the concerns outlined in our December 13th letter.[27] The letter acknowledged the inconsistencies between the OLA provisions and the Bankruptcy Code that were highlighted in ASF's letter and concluded that the treatment of preferential and fraudulent transfers under the OLA provisions was intended to be consistent with the related provisions under the Bankruptcy Code. In addition to providing an interpretation, the letter indicated that FDIC staff would recommend to the FDIC Board of Directors that the Board adopt a regulation to the same effect, in consultation with the Financial Stability Oversight Council. Just yesterday, at the March 15, 2011 Board Meeting, the FDIC issued a "Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act"[28] that, among other things, purports to "ensure that the preferential and fraudulent transfer provisions of the Dodd-Frank Act are implemented consistently with the

[27] See http://www.americansecuritization.com/uploadedFiles/FDICGeneralCounselLetterreOLA-12-29-10.pdf.
[28] See NPR at http://www.fdic.gov/news/board/10MarNo6.pdf.

corresponding provisions of the Bankruptcy Code" and [conform OLA] "to the interpretation provided by the FDIC General Counsel in December 2010."[29] ASF applauds the FDIC for taking action on this critically important issue and attempting to resolve the ambiguity in Title II. We believe that the proposed rules are a step in the right direction and plan to provide detailed comment with respect to any outstanding concerns. Yesterdays' FDIC NPR did not, however, address a second and even more troubling aspect to the securitization market as a result of the new OLA provisions.

c. **Repudiation Power Issue**

This past December, ASF became aware of another issue relating to the authority of the FDIC to repudiate contracts under Section 210(c)(1) of the Dodd-Frank Act and the scope of the temporary automatic stay under Section 210(c)(13) of the Dodd-Frank Act. These provisions raise concerns regarding two issues that are crucial not only to the securitization market but to all parties that have financial dealings with a Covered Financial Company or a covered subsidiary thereof: (1) whether a transfer of property by the Covered Financial Company or a covered subsidiary thereof would constitute an absolute sale or a secured borrowing and (2) whether the separate existence of another person or entity would be respected and its assets and liabilities not substantively consolidated with the assets and liabilities of the Covered Financial Company or of any covered financial subsidiary thereof.

The insolvency laws that would apply to Covered Financial Companies in the absence of OLA are rather clear on these legal-isolation issues, and supply well-established principles for resolving them. Most notable are the decades of precedent that exist under the Bankruptcy Code

[29] See FDIC Press Release issued March 15, 2011 at http://www.fdic.gov/news/news/press/2011/pr11056.html.

and in judicial decisions under the Bankruptcy Code. Financial-market participants have relied on these principles and this precedent when transacting business with financial companies that, under the Dodd-Frank Act, may be designated as Covered Financial Companies and subjected to liquidation under OLA. The concern that has emerged is whether the Dodd-Frank Act required that the FDIC, as receiver for a Covered Financial Company or a covered subsidiary thereof, respect and follow these legal authorities as well.

The resolution of this concern, in our view, is clear. As noted previously, under Section 209 of the Dodd-Frank Act, Congress has directed the FDIC to harmonize its rules implementing OLA "with the insolvency laws that would otherwise apply to a covered financial company." The underlying policy rationale behind this desire for harmonization is that Congress wanted to avoid requiring parties engaging in transactions with financial companies and their subsidiaries to be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of executing the transaction, which regime would ultimately apply. This holds even more true for transactions that were executed before the Dodd-Frank Act was signed into law and that, due to the absence of any transition provision in OLA, could be affected by such a liquidation. We note further in this context that the Senate Report on the Dodd-Frank Act, in its Section on OLA, observes that "the use of this [OLA] authority [is expected to be] very rare. There is a strong presumption that the Bankruptcy Code will continue to apply to most failing financial companies...including large financial companies." Senate Report at 58. Our concern with respect to the Section 210(c) repudiation authority goes to precisely this point: there are long-standing Bankruptcy Code doctrines which financial companies have been careful to follow in their sale, securitization and other commercial transactions and programs. For those companies to now try to structure transactions to an unknown target, just in case this "very rare" authority may be invoked in the future, appears to us to be costly and unnecessary.

Because of the mandate in Section 209, we believe that the FDIC would be required to respect and follow "the insolvency laws that would otherwise apply to a covered financial company" when addressing any legal-isolation issue under OLA, including in the context of its repudiation power under Section 210(c)(1) of the Dodd-Frank Act and the temporary automatic stay under Section 210(c)(13) of the Dodd-Frank Act.

i. FDIC's General Counsel Letter II

On January 14th, ASF submitted a letter to the FDIC requesting that the FDIC issue, as promptly as practicable, a letter from the Acting General Counsel to the effect that:

(a) The FDIC as receiver for a covered financial company shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or re-characterize as property of the covered financial company or the receivership financial assets transferred by the covered financial company, provided that such transfer satisfies the conditions for a legal true sale as applied in the law defining property of the estate under the Bankruptcy Code.

(b) The Act does not itself contain any provision which would mandate a different approach or analysis regarding the factors or circumstances under which

> the separate existence of one or more legal entities would properly be disregarded than the existing approach or analysis under the Bankruptcy Code.[30]

In response to ASF's Request, the FDIC issued a General Counsel's Letter on January 14th addressing the concerns raised in ASF's request.[31] In the letter, the FDIC clarified that its repudiation power under the OLA provisions of the Dodd-Frank Act would be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation, on an interim basis until 90 days after the FDIC Board of Directors adopts a regulation to formally address the matter, or until at least June 30, 2011. Again, we applaud the FDIC for its quick action to patch this issue that the market so desperately needed. However, we believe that a legislative solution is necessary to achieve certainty in the market once the interim relief expires and stand ready to endorse a bill that requires the OLA provisions to be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation. Such a bill would be consistent with the legislative intent that (i) "a creditor shall, in no event, receive less than the amount that creditor is entitled to receive" if the FDIC "had not been appointed receiver with respect to [a] covered financial company; and the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code"[32] and (ii) the FDIC "seek to harmonize applicable rules and regulations promulgated under [OLA] with the insolvency laws that would otherwise apply to a covered financial company."[33] Such a bill would also

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[30] See http://www.americansecuritization.com/uploadedFiles/ASF_Orderly_Liquidation_Letter_to_the_FDIC_1_14_11.pdf.

[31] See http://www.americansecuritization.com/uploadedFiles/GC_Letter_to_ASF_1_14_2011.pdf.

[32] See Sections 210(a)(7)(B) and (d)(2)(B) of the Dodd-Frank Act.

[33] See Section 209 of the Dodd-Frank Act.

avoid the situation where parties extending credit to potential Covered Financial Companies would be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, which regime would ultimately apply.

Finally, we are also concerned about the potential for the FDIC to reach beyond the clear intent of Dodd-Frank and use its OLA power to implement conditions for non-banks that are similar to the ones prescribed for the FDIC's bank securitization safe harbor. ASF submitted multiple comment letters with respect to the FDIC's Advanced Notice of Proposed Rulemaking and Notice of Proposed Rulemaking regarding the proposed securitization safe harbor for banks. The ASF and its membership continue to strongly oppose linking a determination of whether financial assets have been legally isolated in the case of receivership to preconditions addressing capital structure, disclosure, documentation, origination and compensation. Under the bank safe harbor, investors will bear the burden of the loss of the safe harbor if any of the securitization preconditions are not satisfied by the issuer or sponsor. Investors in securitization should bear risks associated with the assets underlying a securitization but not risks associated with the originator, who may or may not subsequently be deemed to be a Covered Financial Company.

IV. Conclusion

ASF supports permanent legislative solution to the issues created by Dodd-Frank's repeal of Rule 436(g) and certain aspects of the Orderly Liquidation Authority in order to avoid another shutdown of the securitization market. The ASF has been a strong and vocal advocate for targeted securitization market reforms and we continue to work constructively with policymakers to identify and implement them. We applaud the willingness of the Subcommittee to convene this hearing to revisit an important topic that directly impacts financing for U.S. homeowners, consumers and businesses, and we greatly appreciate the invitation to appear before this Subcommittee to share our views related to this current issue. I look forward to answering any questions the Subcommittee may have.

Thank you.

Testimony on Legislation to Provide a Registration Exemption for Private Equity Fund Advisers

By

Pamela B. Hendrickson, Chief Operating Officer, The Riverside Company

Before the
United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
Wednesday, March 16, 2011

Chairman Garrett, Ranking Member Waters, Members of the Subcommittee: Thank you for the opportunity to testify today on this important legislation.

My name is Pam Hendrickson, and I'm the chief operating officer of The Riverside Company. Riverside is a private equity firm that manages $3.5 billion of investor funds. We use that money to buy and build small companies – companies with annual operating cash flow under $20 million that, with Riverside's capital and guidance, will grow and create hundreds of jobs. Many of those jobs are in small towns across America where the Riverside-owned company is a major employer. Today, Riverside owns 50 companies in the U.S. Together, those companies employ more than 10,000 people. We're not alone. There are more than 2,000 other private equity firms like us that buy and build small and medium-sized companies in the U.S.

I'm here to support legislation introduced by Representative Hurt of Virginia that would eliminate the requirement that private equity firms register with and report financial data to the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940, as required by provisions of the Dodd-Frank Act.

The registration of private equity firms as proposed by Dodd- Frank will not accomplish the Act's stated purpose of helping identify and reduce systemic risk in the U.S. financial system. But it will impose an undue burden on private equity firms – especially small and mid-sized firms – in terms of both money and time. And that will divert scarce resources from buying and building small and mid-sized companies – the engines that drive job growth in the United States.

The most important thing to understand about the private equity business model is that we invest in businesses and people – not publicly-traded securities. Private equity firms only make money for their investors and partners when the companies they acquire grow, increase earnings, create more jobs and become more successful. That's good for investors – and for us – but it's also good for the companies in which we invest, their employees, and the communities in which they operate.

I would like to tell you a story about what we do in hopes that you will see that the private equity business model, especially for firms doing private deals in the middle market, simply does not pose systemic financial risk.

Commonwealth Laminating and Coating (CLC) is a small company based in Martinsville Virginia, a town that for many years depended on furniture and textile manufacturing to support its economy. In recent years, both industries have been hit hard by a changing global economy.

CLC manufactures solar control window films that help shield cars, houses and commercial properties from the sun's heat. Its products are sold all over the world – and they all are manufactured in the company's state-of-the-art Martinsville facility. In Martinsville, CLC is a shining star.

In 2006, Steve Phillips, CEO of CLC, realized that he needed much more capital to continue to grow his company. His existing shareholders simply didn't have the necessary funds. Riverside was approached as a potential capital source and acquired a majority ownership interest in CLC in April of 2006. Beginning in mid-2008 and continuing throughout 2009, at the height of the recession, Riverside and CLC together invested an additional $16 million in capital to significantly boost the company's production capacity. A key component of this capital investment program was a new dyed film line that improved product quality and strengthened the company's competitive position. Together, we grew jobs by 73%, adding 61 jobs in Martinsville. CLC also participated in Riverside's strategic sourcing program which enabled the company to reduce its costs on such things as shipping and telephony by about 16%.

By the time Riverside sold CLC last summer, the company had grown its earnings by 277%. The teachers, firefighters and government employees whose pension funds invested in Riverside also received a significant return.

The bottom line: With the help of Riverside's capital, investment management expertise, strategic sourcing programs and a great CEO, this small company in Martinsville, Virginia nearly quadrupled its earnings during the 4½ years it was owned by Riverside. This is what Riverside and firms like us do every single day with thousands of companies, whether it's

Veritext, a very successful court reporting company in Florham Park, New Jersey or Momentum, a fabric distributor to commercial furniture manufacturers in Irvine, California.

Let's look at the CLC investment through a different lens. Let's suppose the CLC investment hadn't turned out as well as it did. Could a failure there have created the type of cascading losses that caused the recent financial crisis? The answer is a resounding "No." That simply is not possible.

Why? Investors in private equity funds are in it for the long term. They commit capital over a ten-year period and they generally have no right to pull out their money – so called redemptive rights – except in the case of gross negligence. Even then, the fund in which they have invested must be wound down in an orderly fashion.

Even if the CLC investment had not been successful, Riverside would not have been forced to sell other assets into a down market to fund investor redemptions. The impact from a CLC bankruptcy would have been on only one loan. There could not have been a "run on the bank" – the type of scenario that drove Bear Stearns into liquidation. Certainly the bank that lent us the money to buy CLC could have lost money – but Standard & Poors data shows that the average gross leverage ratio for private equity-owned companies is about 4 to 1. Lehman Brothers, in the year before it went bankrupt, was leveraged at nearly 30 to 1, according to Lehman's own internal analysis.

At Riverside, the average leverage ratio for our companies is well under that for the S&P 500 index of large, publicly-traded companies. In 22 years and across 136 acquisitions, senior lenders in Riverside's deals have lost money only four times. Our senior loan loss ratio is less than ½ of 1%. That, by the way, includes the impact of the Great Recession – surely not enough to "break the bank." Viewed from another perspective, banks simply won't lend to PE firms who lose money frequently. It's bad business.

Furthermore, our transactions are not interconnected with other financial market players, or in a manner such that they are related to each other, there is no cross collateralization and no cross default – each transaction stands on its own.

You also might wonder "What about the private equity fund itself? What kind of leverage is involved at the fund level?" Private equity buyout funds generally do not take on leverage at the fund level, other than short term-loans to fund future capital calls of investors to help with timing the closing of a transaction. And the parent companies of private equity partnerships generally have little or no debt either. As a result, private equity buyout funds do not face margin calls from creditors or unsustainable debt burdens regardless of how their underlying investments perform.

And, even if investors lose money on one transaction such as CLC, they are investing in a fund with many investments, which ensure a diversified portfolio.

Let me give you an example. One of our funds, Riverside Capital Appreciation Fund 2000, invested in 21 companies. Two of those 21 companies failed. Despite those two failures, each dollar invested in that fund returned $2.10 to our investors.

This is not the Wild Wild West. Our industry is closely watched and heavily scrutinized by a very sophisticated group of investors. Private equity investors generally are large, very sophisticated pension funds, foundations and endowments. They allocate small percentages of their assets – typically around 5% and almost always less than 10% – to this less liquid but higher-yielding asset class. They use consultants and advisors to set and manage their allocations and to select the best private equity managers. Darwin would be pleased – only the fittest get funded and survive.

Investments in private equity funds are negotiated with the private equity fund manager, not sold to the public. Private fund investors typically are represented by experienced legal counsel. They also are organized into the International Association of Limited Partners (ILPA), which has issued industry standards for economics, governance rights and financial reporting. Virtually all funds have an advisory board of investors who provide additional oversight. State laws provide fiduciary and other protections to investors. To the extent that a private equity investment adviser uses a placement agent to sell funds, SEC and FINRA oversight applies.

What about protection for those who buy companies *from* private equity firms? When a private equity fund decides it is time to sell an investment, the sales process takes one of two routes. One is an Initial Public Offering ("IPO"). There is substantial legislation providing investor protections related to an IPO that already applies to private equity IPOs. The second route is a private sale to a strategic or financial buyer where extensive due diligence is performed by the buyer. Because of this kind of scrutiny on exit, there is no systemic risk created by these privately-negotiated transactions.

Private equity has been around almost 50 years. It has survived at least three major cyclical downturns and has flourished precisely because of its ability to deliver superior risk adjusted returns. In all these years, how much time has the SEC or this committee had to devote to worrying about negative macro-economic impact or investor fraud in PE? I think the answers to both of those questions speak for themselves.

So now, let's look at what would have happened in the CLC example if the proposed registration and reporting requirements had been in place.

When we purchased the securities of CLC they were stock certificates prepared by our attorneys. On the back of these securities, written in large capital letters, was a notice that they cannot be traded and are restricted. If someone found them on the street they would be worth nothing. So we placed these stock certificates in a vault in our attorney's offices, for which there is no charge. Under the proposed registration and reporting rules, we would need to hire, and pay a third-party custodian to hold on to these restricted, untradeable securities. Some firms charge up to $50,000 a year for this service. This seems like a tremendous waste of time and resources.

What about valuation? Most private equity funds are required to report their fund valuations according to generally accepted accounting principles (known as U.S. GAAP), with valuations performed under the guidelines of FASB rule 157. Under these guidelines, our investors require us to value our portfolio companies every quarter with an audit by a nationally recognized accounting firm done annually.

Valuing private companies – where there is no publicly-traded stock – is an art, not a science. It is challenging and it is expensive. There is no exchange or ready market where an accountant can determine how much a buyer would be willing to pay for the company. In fact, there generally is no agreement between two buyers on what the company is worth. Bids from buyers vary greatly.

According to our understanding of Item C in Section 1 of the proposed new reporting form PF, all private equity firms would be required to calculate the value and performance of each of their funds on a monthly basis. Smaller firms would be required to report those monthly numbers once a year, while firms with assets of $1 billion or more would have to do so on a quarterly basis. To accurately calculate the valuation of each fund, the SEC would, in effect, be requiring that we calculate the value of each company in which the fund has invested on a monthly basis.

That means that under the proposed registration and reporting rules, Riverside would need to hire a compliance officer to certify the valuations of our tiny companies to the SEC. That is in addition to the two national accounting firms assisting us with our GAAP valuations. You can do the math – 50 companies times 12 months means we would have to undertake 600 separate valuations each year to comply with the regulation.

Members of the Association for Corporate Growth, who comprise only a portion of the PE world, estimate that they have invested in 20,000 small and middle market companies. Under the new rules, just this small group might need to calculate 240,000 company values each year. It is hard to imagine that the SEC will have either the knowledge or resources to evaluate these calculations in a way that would help protect the financial system from a systemic collapse. And by the way, the estimated annual costs per firm of this exercise ranges from $500,000 to $1 million or more, according to comments filed with the SEC. Some firms simply will not be able to afford the expense.

There are other implications. At our firm, we operate an ongoing education program for the senior officers of our portfolio companies. We call it Riverside University. Operating it costs us several hundred thousand dollars each year.

Two weeks ago, as part of that program, we hosted a procurement webinar for our small companies. About 70 people dialed in to learn about better ways to manage and buy inventory. Next month, instead of developing plans for another useful course for our portfolio company executives, I will need to spend time looking at a150-page compliance manual designed to help control a set of risks which don't really seem to exist. I'll also have to begin building a budget to implement that compliance program and will have to decide where that money will come from.

It would be a much better use of Riverside's time and resources to help our portfolio companies grow and create jobs than to spend time and money building a compliance infrastructure to solve a non-existent problem.

We believe that the Dodd-Frank registration and reporting requirements for private equity would have a devastating impact on the private equity community, especially on the smaller firms. We believe it will not do anything to help prevent the next financial crisis. Even if the costs to the industry are viewed as an insurance premium against risk, we believe the "insurance premiums" would be better spent creating jobs, growing companies such as CLC and generating high returns for the public and private pension funds that invest in these companies.

Private equity exists in large part because the public equity markets do not do a good job of serving the capital needs of small companies – the companies that generate the most job growth. America led the way in the founding of private equity and remains the largest and most advanced private equity market. Instead of imposing additional costs and regulatory burdens, we should be celebrating this American innovation and supporting a system that has steadily provided critical capital to small and growing businesses, thereby strengthening companies and communities and creating more jobs.

Thank you for your time and consideration.

Testimony of Damon A. Silvers

Policy Director and Special Counsel

American Federation of Labor and Congress of Industrial Organizations

House Subcommittee on Capital Markets and Government Sponsored Enterprises

Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty

March 16, 2011

Good afternoon, Chairman Garrett and Ranking Member Waters. Thank you for the opportunity to testify today. My name is Damon Silvers and I am the Policy Director and Special Counsel for the AFL-CIO. I am testifying today on behalf of Americans for Financial Reform and the Consumer Federation of America, as well as for the AFL-CIO.[1] Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups which have come together to reform the financial system. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as Nobel Prize-winning economists. The organizations of the AFR represent well over 50 million Americans.[2]

I am also the Deputy Chair of the Congressional Oversight Panel created under the Emergency Economic Stabilization Act of 2008 to oversee the TARP. My testimony reflects my views and the views of the AFR, the AFL-CIO and the CFA, and is not on behalf of the Panel, its staff or its chair, former Senator Ted Kauffman. The Oversight Panel has done substantial work touching on each of the topics being considered today and I have with me copies of each of the relevant reports.

The title of today's hearing is "Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty." These, of course, are very important goals. In fact, they are the very goals that the Dodd-Frank Wall Street Reform and Consumer Protection Act sought to achieve after the most traumatic financial crisis since the Great Depression caused 8 million lost jobs, left up to 13 million families facing foreclosure, and destroyed $10 trillion in household wealth.

When Congress passed the Dodd-Frank Act it took a critical step toward restoring confidence in the financial markets. Well-regulated financial markets facilitate capital formation and help private companies obtain the financing they need to grow and create jobs. Poorly regulated

[1] The AFL-CIO is the country's largest labor federation and represents 12.2 million union members. Union-sponsored pension and employee benefit places hold more than $480 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate or public-sector employers. The Consumer Federation of America (CFA) is an association of nearly 300 nonprofit consumer groups that was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] A full list of AFR members is attached.

markets lead to bubbles and panics and excess volatility which destroy confidence and jobs. If we want well regulated markets, Congress must first give regulators the opportunity to implement the new law and the financing necessary to do so effectively.

The American people are genuinely worried about unemployment and are frustrated that Congress is focused on side-issues that will not help get people back to work. A Kaiser Health Tracking Poll conducted in February found that 71 percent of adults in this country feel that Congress is paying too little attention to the economy and jobs.[3] Tragically, cynical exercises in financial deregulation such as the bills under consideration today are only going to intensify public frustration with Congress.

If there was a truth in labeling act for Congress:

"The Business Risk Mitigation and Price Stabilization Act", would be called the "Help Create Another AIG Act." The proposal, would amend the definition of a "major swap participant" to prevent regulators from designating for special oversight undercapitalized and highly leveraged financial institutions that maintain major derivatives positions that threaten U.S. financial stability. I have here the Congressional Oversight Panel's unanimous bipartisan report on AIG that will hopefully help refresh the Subcommittee's memory as to where this type of deregulation leads.

"The Burdensome Data Collection Relief Act", which would repeal the Dodd-Frank requirement that issuers disclose pay disparity ratios, would be called "The Promote CEO Pay Secrecy Act." I have here the Oversight Panel's unanimous bipartisan report on executive compensation and the TARP, which among other things contains the testimony of the Special Master for Executive Pay that executives of our country's major financial firms "feathered their own nests" to the tune of billions of dollars while their companies were receiving public money.

"The Small Business Capital Access and Job Preservation Act", which would amend the Investment Advisers Act of 1940 to provide a registration exemption for private equity fund advisers, would be called "The No Accountability for Leveraged Buyout Funds Act." I have here the Regulatory Reform Report of the Congressional Oversight Panel which lays out the systemic risks associated with leveraged private pools of capital.

"Small Company Capital Formation Act of 2011", which would allow offerings of up to $50 million to rely on the Regulation A exemption from SEC registration to offer securities to the investing public of companies that do not have audited financial statements, would be called "The Promote Penny Stock Fraud Act"; and finally

"The Asset-Backed Market Stabilization Act", which would exempt rating agencies from the same standards that apply to other experts giving opinions in connection with offerings of asset-backed securities, would be called "Legal Immunity for the People Who Brought You the Financial Panic Act."

[3] Kaiser Health Tracking Poll -- February 2011, *available at* http://kff.org/kaiserpolls/upload/8156-F.pdf.

The importance of the principles of transparency and the culpability of credit rating agencies in the financial catastrophe is discussed in nearly every report of our Panel. Each one of these reports is available on our Panel's website.[4]

In reality, these legislative proposals are not attempts to help put Americans back to work or restore confidence in our financial markets. The proposals are an attempt to chip away at the first meaningful steps toward re-regulating our financial markets after 30 years of deregulation led to the worst financial crisis, the worst unemployment, and the greatest economic suffering in our country since the Great Depression. For this reason, the Americans for Financial Reform, the AFL-CIO, and the Consumer Federation of America strongly oppose these efforts on behalf of Wall Street interests to weaken the Dodd-Frank Act.

The remainder of my testimony will address each of these proposals in greater detail.

1. "The Business Risk Mitigation and Price Stabilization Act"

Before describing what this legislation would do, it would perhaps be best to start by saying what it does <u>not</u> do. The Dodd-Frank Act already exempts end-users – non-financial entities that are using swaps to hedge or mitigate commercial risk – from any clearing or trading requirement. In addition, in recent testimony before the Senate Agriculture Committee, CFTC chairman Gary Gensler clearly laid out that the CFTC will exclude end-users from any margin requirements that may apply to other entities and the rationale behind such an exemption:

> "Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities...Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users."

Thus, the Act does not act to exempt end-users from clearing and margin requirements – this exemption already exists.

Instead, the Act strikes at the definition of a "major swap participant", or MSP. MSPs are companies that maintain substantial positions in derivatives that go beyond any need to hedge true commercial risks created by actual production of a product or service. Because they maintain large swaps positions for purely speculative purposes, these entities are in effect financial companies, not commercial end-users. One clear example during the financial crisis was the American International Group (AIG), an insurance company which maintained large swaps positions unrelated to its core business. In the future, more firms could likewise build up large positions in the swaps market for speculative purposes that could threaten financial stability.

- The designation of an entity as a "major swap participant" allows regulators to spot these kinds of companies and impose sensible capital and leverage requirements on them to ensure that

[4] http:/www.cop.senate.gov.

– unlike AIG – they have the capital to back up the bets they make. Unfortunately, the Act would practically eliminate the ability of regulators to designate MSPs. Some of the critical changes include: Allowing companies to escape MSP designation through a hedging exemption if their derivatives position simply "reduces" their commercial risk (instead of actually hedging or mitigating it, as currently permitted in the Dodd-Frank Act). A swaps position completely unrelated to a company's core business could theoretically "reduce" their commercial risk under some circumstances, by diversifying the company's exposures. Unfortunately, it could also introduce substantial additional risk.

- Eliminating the ability of regulators to designate for special MSP oversight undercapitalized and highly leveraged financial institutions that maintain major swaps positions that threaten U.S. financial stability. The clearest example of such an institution would be a large hedge fund that took major leveraged derivatives positions to boost returns. We know from the example of Long Term Capital Management that such hedge funds can potentially create systemic risks.

- By adding the word "net" to the definition of major swap exposure, the bill would also exempt from MSP designation entities which have very large derivatives positions with one counterparty, but claim these positions are balanced by hedging positions they have purchased from another counterparty. As we learned during the financial crisis, counterparty failure can quickly lead such hedges to become ineffective, particularly in turbulent market conditions when they are most important.

2. *"The Burdensome Data Collection Relief Act"*

Section 953(b) of the Dodd-Frank Act seeks to provide investors with improved disclosure of public company compensation practices, through a pay disparity ratio comparing the chief executive officer's total compensation to median employee wages. Investors will benefit from the greater transparency provided by Section 953(b) disclosures. For many companies, particularly in the financial, high-tech, and service sectors, employee compensation is frequently the single biggest expense. Investors will benefit from greater transparency about this spending because high CEO-to-worker pay disparities hurt employee morale and productivity.

Issuer concerns regarding Section 953(b) seem extraordinarily passionate in light of the issues they purport to be concerned about. In reality, compared to much of the SEC's existing disclosure regime, the data requirements of 953(b) are relatively modest. Prior to the passage of Dodd-Frank, at least one major public company, Whole Foods, already disclosed its average employee's compensation in its annual proxy statement and the CEO's annual cash compensation is capped at a maximum ratio of the company's average annual employee wage.[5] In the U.S., all employers are required to report each employee's annual compensation to the Internal Revenue Service on Form W-2, as reported under "wages, tips, and other compensation." The national tax authorities of most other countries have similar reporting

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[5] Whole Foods Market, Inc., 2011 Proxy Statement filed Jan. 18, 2011, pages 15-16, available at http://www.sec.gov/Archives/edgar/data/865436/000120677411000059/wholefoods_def14a.htm.

requirements for withholding tax purposes. Moreover, because payroll processing is integral to the accounting process, collecting the required information to comply with Section 953(b) should be attainable for any company that is capable of receiving a clean audit opinion.

Perhaps most importantly, Section 953(b) gives the investing public the information necessary to make the judgment as to whether executive pay packages are appropriate in light of the overall compensation environment in the firm. Greater transparency about median employee compensation levels and workforce wage disparities will help investors better understand how individual companies compare to their industry peers as well as the compensation strategies of entire industries. We note that any concerns about Section 953(b) potentially misleading investors can be remedied by providing investors with still further disclosure. For example, companies are free to provide a narrative discussion and analysis of their Section 953(b) disclosures that would explain why their company's particular approach to the management of their employees leads to their company's particular ratio.

Some issuers have argued that Section 953(b) disclosures will lead to companies restructuring their workforces to manipulate the information. Such a decision would be an improper breach of fiduciary duty under state corporate laws that require boards of directors to put the interests of the corporation and its shareholders before the interests of company CEOs who may be potentially embarrassed by their companies' Section 953(b) disclosures.

Repealing Section 953(b) would be a clear statement that the Congress of the United States believes it is more important to shield excessive and unfair CEO pay from public scrutiny than to protect the investing public from the consequences of excessive pay for companies and their shareholders.

3. "The Small Business Capital Access and Job Preservation Act"

During the legislative process, our organizations were strong proponents of the provisions of Dodd-Frank that will require advisers to hedge funds and leveraged buyout funds/private equity funds to register with the Securities and Exchange Commission. The Small Business Capital Access and Job Preservation Act would exempt LBO fund advisers from registration under the Investment Advisers Act of 1940, denying investors in these funds the protections of investing with a registered investment adviser, and denying the SEC the authority to collect comprehensive data from private equity fund managers necessary to monitor systemic risk.

Those who oppose the Dodd-Frank Act's requirement that managers of private equity funds register with the SEC argue that private equity funds do not pose a systemic threat. Opponents cite as an example the average leverage ratio of a private equity portfolio company compared to the highly-leveraged investment bank Lehman Brothers shortly before its default, which were 4 to 1 and 30 to 1, respectively. Their arguments, however, ignore the impact that outstanding debt issued to finance leveraged buyouts can have on the broader economy.

A more appropriate examination of the potential systemic risks associated with leveraged buyout activities must consider financial intermediaries' exposures to leveraged buyout debt. There was a boom in risky lending to companies purchased in leveraged buyouts conducted by private equity firms that corresponded with the boom in risky lending to home buyers. Around $1 trillion in LBO ("private equity") loans were issued in 2006 and 2007 alone. The risky loan-products offered to home buyers had counterparts in the leveraged buyout arena. Instead of "NINJA loan", referring to the risky loans made to borrowers with "no income, no job and no assets," banks often made "covenant-lite" loans to PE funds that omitted important items from lending agreements that were intended to allow the lender to avoid unnecessary losses. LBOs also used financing similar to the option adjustable rate mortgages (Option ARM) mortgages, the riskiest type of subprime mortgage. The LBO loan product that is substantially similar to an Option ARM allows the borrowing company to make interest payments by issuing additional debt to the lender instead of paying in cash (payment-in-kind or "PIK").[6] As with the Option ARM, this increases the principal owed on the loan. Interest payments are then based on a higher loan value, and when the bill finally comes due the borrower often suffers "payment shock" because of inadequate funds available to pay off the debt.

According to the Financial Times, "covenant-lite loans that strip out safeguards for investors, dividend deals in private equity-controlled companies, and a third class of instruments, payment-in-kind toggle notes, were widely criticized as part of the easy lending that led to the credit crunch."[7] So far this year, more than $30 billion of covenant-lite loans have already been issued. This surpasses 2006, the second-biggest year of covenant-lite loan issues on record, when $24 billion were issued. The largest annual issuance was 2007, when $100 billion in covenant-lite loans were issued.[8] The resurgence of these risky loans led Moody's to issue a warning earlier this month that these loans "may be laying the groundwork for painful fallout from the next credit downturn."[9]

According to Moody's, "The relatively swift recovery of debt markets following the credit crisis masked the true risk of covenant-lite loans... In a more prolonged credit downturn, companies with lenient covenant terms would be more likely to default, and their lenders would likely recover less than would investors in defaulted companies with more restrictive covenants."[10]

In addition to giving regulators the opportunity to collect data important to determining whether private equity fund activities may pose a systemic threat, registration under the Investment Advisers Act would provide important protections to investors in these funds. Registered investment advisers are required to file a "Form ADV" with the SEC and update it on an annual basis. The Form ADV has two parts. Part I includes information about an adviser's business, the persons who own or control the adviser, and whether the adviser or certain of its personnel have

[6] Caroline Salas, *Bondholders Lucky to Get 10 Cents in Looming Defaults*, Bloomberg (April 23, 2008), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ah5Lg9TW9B_M.
[7] Nicole Bullock, *Risky loans stage comeback*, FT (March 13, 2011), *available at* http://www.ft.com/cms/s/0/9f7c528c-4da3-11e0-85e4-00144feab49a.html#ixzz1GchehYL7.
[8] Id.
[9] Nicole Bullock, *Moody's warns on covenant-lite loans*, FT (March 10, 2011), *available at* http://www.ft.com/cms/s/0/2795693a-4a9b-11e0-82ab-00144feab49a.html#ixzz1GcjtWQ2M.
[10] Moody's Investor Services, *Announcement: Moody's: Covenant-Lite May Lead to Larger Investor Losses in Next Credit Downturn*, Moody's Global Credit Research (March 10, 2011), *announcement available at* http://www.moodys.com/viewresearchdoc.aspx?lang=en&cy=global&docid=PR_215517.

been sanctioned for violating the securities laws or other laws. This is available to the public online. Part II is a written disclosure statement that provides information about business practices, fees, and conflicts of interest the adviser may have with its clients. This must be provided to clients and potential clients of the fund and is not available to the public.

Registered investment advisers also have a duty to act as fiduciaries in dealings with their clients. This means advisers must hold the client's interest above their own in all matters. They are required to avoid conflicts of interest and, if conflicts cannot be avoided, they must describe those conflicts to investors and explain how they will maintain their impartiality.

4. *"Small Company Capital Formation Act of 2011"*

The Small Company Capital Formation Act of 2011 would make it easier for companies to raise money from the public without meeting the investor protection standards appropriate to a public offering. The draft bill would do so by allowing offerings of up to $50 million to rely on the Regulation A exemption from SEC registration. Currently, Regulation A provides an exemption from registration with the SEC for public offerings of up to $5 million in any 12-month period. As with registered offerings, the securities can be offered publicly and traded freely in the secondary market. Companies that take advantage of the exemption must file an offering statement with the SEC for review consisting of a notification, offering circular, and exhibits. Companies that rely on the Regulation A exemption do not have to submit audited financial statements, and they are not subject to Exchange Act reporting obligations after the offering unless the company has more than $10 million in total assets and more than 500 shareholders. In addition, issuers in Regulation A offerings are permitted to "test the waters" by soliciting interest in the offering before filing any offering statement with the SEC.

The draft legislation would require the SEC to raise the Regulation A threshold to $50 million. In doing so, it would permit, but not require, the SEC to impose additional conditions on such offerings. These include authorizing the agency to: require the issuer to file audited financial statements, require the issuer to submit the offering statement and related filings electronically, and establish disqualification provisions based on the disciplinary history of the issuer or related parties. The legislation would also permit the SEC to impose additional unspecified periodic reporting requirements on companies which make use of the exemption. While we appreciate the fact that the bill sponsor has attempted to include provisions designed to enhance investor protections associated with these offerings, we are concerned that the bill does not guarantee that these added protections would be imposed even as it requires that the exemption be expanded. Moreover, we do not believe the advocates of this approach have provided sufficient evidence that the change is warranted or given adequate thought to the potential harm to investors that could result.

We appreciate that there is a legitimate concern about the challenges that smaller firms have coming to market and would be happy to have a discussion about appropriate policy responses. Making the market more opaque, however, is likely to exacerbate those problems. In addition, we have a real concern about who is advocating for this measure. To the extent that venture capital firms are advocating for this, Congress should be aware that venture capital firms generally do not want to sell very small companies into the public markets because their profits depend on high initial public offering prices or prices in the secondary market. If the primary advocates for this measure are venture capital firms, it strongly suggests that they are looking to sell into the public markets companies that have failed to meet their own expectations for growth or profitability. Congress should be very wary of weakening auditing and disclosure requirements for such offerings of such portfolio companies.

More generally, the harsh reality is that small companies are more prone to fraud, more likely to have weak corporate governance practices, and less likely to have effective internal controls. Moreover, they are more likely to fail, even where there is no corporate wrong-doing behind the failure. Thus, easing these small companies' access to public markets means increasing the likelihood that investors will lose money. This legislation would increase by a factor of ten the amount of money investors could lose in a single offering. Furthermore, offerings such as these are prime targets for the "pump and dump" schemes that have long haunted the penny stock markets.

The justification for proposals to weaken investor protections associated with small company offerings is generally that taking very small companies' public promotes job growth. This is in itself a questionable premise. The risks of this approach are clear from the tech stock boom and bust, when we adopted a similar policy of encouraging companies to raise money from the public without adequate attention to the risks to investors.

In the short run, investors pumped in capital and jobs were created. But the ensuing tech stock bust wiped out trillions in market value and more than a million jobs. A few years later, roughly half the tech companies that went public during the boom were gone. The hard lesson is that lasting economic growth cannot be built on a foundation of lax regulation and unreliable financial reporting.

5. *"The Asset-Backed Market Stabilization Act"*

The draft legislation proposed by Rep. Stivers to restore Rule 436(g) of the Securities Act would effectively exempt Nationally Recognized Statistical Rating Organizations ("NRSROs") from the same standards that apply to other experts giving opinions in connection with offerings of asset-backed securities. By repealing Rule 436(g), the Dodd-Frank Act subjected NRSROs to potential liability under the Securities Act for making untrue statements of material fact in connection with prospectuses for asset-based securities. Rather than comply with the new standards, the NRSROs threatened to shut down the asset-backed securities markets altogether by refusing to allow their ratings to be disclosed in prospectuses. The SEC responded by adopting a "no action" position, first for six months and then indefinitely, indicating it would not bring enforcement actions against issuers that did not disclose ratings in prospectuses. The stated intent of the SEC action was to buy time for the agency to complete its efforts to remove references to ratings from its laws and regulations without driving affected offerings into the private market in the interim. While our organizations question the wisdom of that approach, it is far preferable to the outright reversal on Rule 436(g) proposed by this legislation.

Conclusion

When Congress passed the Dodd-Frank Act it took a critical step toward restoring confidence in the financial markets. This is a step which will facilitate capital formation and help private companies obtain the financing they need to grow and create jobs. But, Congress must first give regulators the opportunity to implement the new law and the financing necessary to do so effectively.

The proposals under consideration during today's hearing are not about putting Americans back to work. The proposals are an attempt to chip away at the first meaningful steps toward re-regulating our financial markets after 30 years of deregulation led to the worst financial crisis since the Great Depression. Thank you.

Appendix A

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- ACORN
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America"s Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute

- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women"s Policy Research
- Krull & Company
- Laborers" International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People"s Action
- National Council of Women"s Organizations
- Next Step
- OMB Watch
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer"s for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club

- The Institute for College Access & Success
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council

- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG

- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action

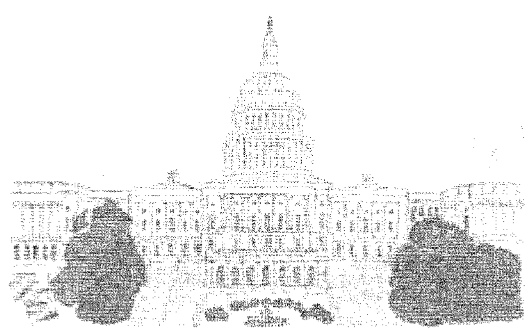
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Leadership Conference on Civil and Human Rights
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- TICAS

- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Grant Thornton

Hearing on legislative proposals to promote job creation, capital formation and market certainty

Statement of David Weild, Senior Advisor — Grant Thornton LLP
before the U.S. House of Representatives Financial Services Committee
Capital Markets and Government Sponsored Enterprises Subcommittee
March 16, 2011



Contents

Introduction

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for inviting me to testify this afternoon on Job Creation, Capital Formation and Market Certainty — issues critical to our nation's economic future.

My name is David Weild, and I am the Senior Advisor overseeing the Capital Markets Group of Grant Thornton LLP, one of the six global audit, tax and advisory organizations.

Grant Thornton Capital Markets Group provides analysis, insight and support to companies accessing today's global capital markets. These companies run the gamut from private companies that are bootstrapped by mom and pop entrepreneurs to venture capital and private equity-backed companies — both small and large.

Summary

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The United States stock market, once the envy of the world, has suffered a devastating decline in numbers of small initial public offerings (IPOs). Our research and analysis of relevant data strongly demonstrates that small businesses and entrepreneurs cannot access the capital they need to grow and create jobs. The United States is losing more public companies from our listed stock exchanges than we are replacing with new IPOs. When measured by number of listed companies, America's stock exchanges are declining, while those of other developed nations are increasing. It is imperative that Congress, regulators and stakeholders in the debate evaluate and take action to increase the number of U.S. publicly listed companies.

As outlined in the Small Company Capital Formation Act of 2011 (the Reg A bill), an increase to the Regulation A (or Reg A) ceiling will provide a less costly and more effective alternative for smaller, entrepreneurial companies that want to access the public capital markets. It may also enable smaller, growth-oriented companies to access the public market at an earlier stage in their growth cycle.

Passage of the proposed Reg A bill is a necessary first step in a campaign to bring back the small IPO, generate jobs and revitalize the U.S. economy.

Small initial public offerings — the catalyst for creating new jobs — have nearly disappeared

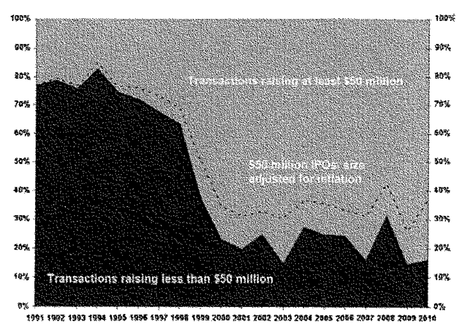
As you can see in Figure 1, from 1991 to 1997, nearly 80% of U.S. IPOs were smaller than $50 million. By 2000, the number of sub-$50 million IPOs had declined to only 20% of the market. When small businesses cannot access capital to fuel their expansion, high-quality job creation is harmed.

Interestingly, the bigger-IPO decades of the 1980s and 1990s produced more than 20 million net new jobs per decade, while the 2000s decade produced none. According to *The Washington Post*, "There ... [was] zero net job creation since December 1999. No previous decade going back to the 1940s had job growth of less than 20 percent."[1]

Perhaps most alarming is that small IPOs — defined as those raising less than $50 million — have practically gone the way of the dodo bird, becoming virtually extinct.

Figure 1

Small IPOs have gone the way of the dodo bird.



Sources: Dealogic, Capital Markets Advisory Partners
Data includes corporate IPOs as of 12/31/10, excluding funds, REITS, SPACS and LPs.

[1] "Aughts were a lost decade for U.S. Economy, Workers" by Neil Irwin, The Washington Post, Jan 2, 2010.

The United States is losing more public companies than we are replacing with new IPOs, causing job depletion rather than job creation

The United States' capacity to generate new listings is well below replacement needs. In an average year, it takes approximately 360 new listings just to replace delistings from U.S. stock markets, and upwards of 520 new listings per year to grow the number of listed companies at 3% GDP rates. We've not seen numbers like this in over a decade.

We are losing far more companies than we are replacing with new IPOs. We have averaged only 129 IPOs per year since 2001, with only 61 IPOs in 2009 and 153 IPOs in 2010 — this compared to the headiness of 1991-2000 with averages of 530 IPOs per year.

Technological, regulatory and legislative change destroyed the U.S. IPO market

Figure 1 shows us that the decline in small IPOs began in the mid-1990s, long before Sarbanes-Oxley took effect in 2002. The root cause — not addressed by the Reg A bill — is the loss of the stock market model that provided the broker-dealer community with the economics necessary to sustain infrastructure investments that are essential to support small companies once they are public. Essentially, regulatory changes pulled the rug out from under small public companies.

Research analysts, salesmen and liquidity providers are the infrastructure — the bridges, roads and tunnels — of a stock market that supports small public companies. Strip away the revenue model that pays for this infrastructure, and the IPO market goes into secular decline — just as commerce suffers without continued investment in bridges, roads and tunnels.

Today's one-size-fits-all stock market model — the unintended consequence of well-intended regulatory change — has deprived issuers in this country of any real alternative as to how their stocks are supported. And while certain stocks will support demand themselves through their larger-than-life brands — Facebook, Twitter and anything that is "Brand China" — the vast majority of IPOs, once they are public, will need significant support manufactured for their stocks. In today's stock market, that support has been lost and is now a major hidden and undocumented cost to public companies. The problem can be traced back to a series of regulatory changes that were uncoordinated, near-sighted and ultimately destructive to the small capitalization IPO market, which has been the growth engine of our stock markets and our economy for a century.[2] This is more significant than people generally understand, because the median exchange-listed company is a "microcap" stock — with only a $450 million equity market value.

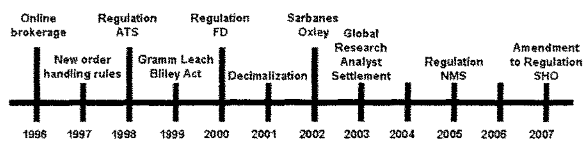
[2] In December 2009, our studies were entered into the public record by Senator Ted Kaufman (D-DE) during a speech: "Kaufman calls decline in IPOs 'choke point' to job creation, economic recovery."

How did we get to this point?

Beginning in 1997, cumulative actions by Congress and the SEC — all nobly aimed at lowering transaction costs for individuals — had the disastrous consequence of destroying the economic infrastructure that made it possible for small cap IPOs to thrive on our markets (Figure 2). We call this "The Stock Market Consumer Paradox": Consumers are harmed by transaction costs that are too low to pay for the equity research, sales and liquidity (capital) necessary to support small cap public companies. Jobs are lost. Investment returns decline. Innovation declines. National security — dependent on innovation — is compromised. Consumers are harmed.

Figure 2

A series of unfortunate events



Source: "The Perfect Storm," pp. 21-23, *Market structure is causing the IPO crisis — and more*, by David Weild and Edward Kim, June 2010, published by Grant Thornton.

Since 2008, Edward Kim and I have co-authored several Grant Thornton studies[3] that are recognized by many in the industry as the authoritative works that first documented and detailed the reasons behind this decline in the U.S. stock markets. The conclusions are alarming. Every year since 1997, we have suffered a decline in the number of listed companies on our stock exchanges. Every. Single. Year.

Trading spreads and commissions collapsed to pennies and sub-pennies; long-term investment was quickly replaced by short-term trading; and investment banks cut capital, sales and research support to small cap stocks in an effort to make diminished revenues cover costs. Many investment banks sold out to larger firms, went out of business or pursued other more lucrative and less socially advantageous lines of business.

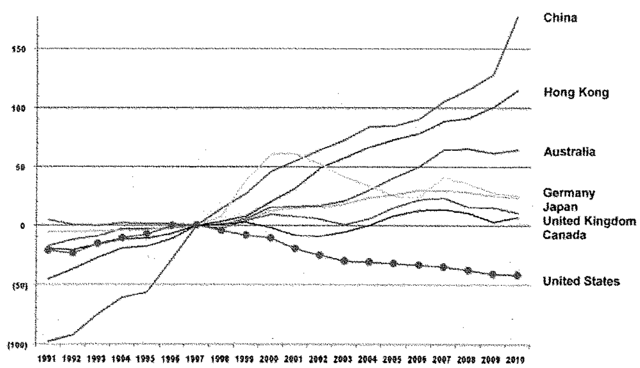
[3] Weild, David and Kim, Edward, "Why are IPOs in the ICU?", November 2008; Weild and Kim, "Market structure is causing the IPO crisis," October 2009; Weild and Kim, "A wake-up call for America," November 2009; Weild and Kim, "Market structure is causing the IPO crisis — and more," June 2010.

The United States' market listings are declining, while those of other nations are increasing

The U.S. has experienced a decline in market listings, while other developed nations have enjoyed significant increases. In 1997, there were a total 8,823 publicly listed companies on the New York Stock Exchange, NASDAQ Stock Market and American Stock Exchange. That number represents the peak of listings in this country. In a span of just 13 years, that number has dropped by over 42% to a mere 5,091 listings as of the end of February 2011.[4] No other developed nation has experienced such a decline. In fact, most have enjoyed increases, with the Asian markets — notably in China and Hong Kong — showing particular strength (Figure 3). If that doesn't scare us, then nothing will. This is our self-induced economic immolation, and we — as Americans — can and must do better than this.

Figure 3

U.S. listings have decreased by over 42% since 1997.
Listings are indexed to 1997.



Sources: World Federation of Exchanges, Capital Markets Advisory Partners, Grant Thornton LLP.

[4] World Federation of Exchanges.

The crux of this U.S. decline is the loss of support for small IPOs, defined as those raising less than \$50 million. Intel, Amgen, Oracle, Cisco, Starbucks, Yahoo! — each of these companies raised less than \$50 million when they went public.

The number of IPOs needed to maintain our markets and to drive GDP growth is *much* larger than anything seen in the IPO market over the last decade, and we applaud the Small Company Capital Formation Act of 2011 (the Reg A bill) as the beginning of a campaign to bring back the small IPO, the U.S. economy and our stock markets.

Regulation A

Background

Regulation A was originally enacted during the Great Depression to help the economy by improving small business access to equity capital. Few start-ups and growth companies have the option to borrow money from a bank, and consequently, access to equity "risk capital" is essential to drive entrepreneurship — not just for venture-backed companies, but for "mom and pop" entrepreneurs as well. So when the IPO market catches a cold, private businesses' access to risk capital may catch pneumonia.

Impact of the Reg A bill on capital formation and job creation

This bill does three things that are enormously beneficial for small companies, capital formation and, in turn, the U.S. economy:

1. It will drive down costs for issuers by permitting the use of a simpler "Offering Circular" for the SEC's review.
2. It opens up the Regulation A exemption to a size that will allow companies to list on the NYSE and NASDAQ and to avail themselves of the so-called "Blue Sky" exemption, thus avoiding very costly state-by-state filings (the current Reg A limit of $5 million is below NYSE and NASDAQ listing minimums).
3. It will allow issuers to gauge the viability of an offering by meeting with investors *before* incurring the significant costs of an offering.

This last, so-called "testing-the-waters" provision may not seem like much, but there has been a steady increase[5] — dating back to the mid-1990s — in IPOs that are postponed, withdrawn, priced below the low end of the IPO filing range or that have broken the IPO price within 30 days of the completion of the offering. These so-called "busted deals" can be ruinous to small companies: As recently as 2009, "busted deals" exceeded 70% of all IPOs.

[5] *Transaction Leverage* by David Weild and Edward Kim, 2011.

Recommend passage of the Reg A bill with stipulations

I fully endorse the passage of this bill to increase the cap on Regulation A from $5 million to $50 million, with the following requirements:

1. That issuers file audited financial statements with the Securities and Exchange Commission and distribute such statements to prospective investors
2. That issuers be required to submit their offering statements to the SEC electronically
3. That periodic disclosures be determined by the SEC (we recommend that they mimic those required of registered companies)
4. That the SEC stipulate so-called "bad boy" provisions to disqualify from participation in this market those individuals or entities with a disciplinary or criminal history.

In addition, I would make one minor suggestion to the Reg A bill: that all financings are done through a FINRA-registered firm. My concern is that a minority of unscrupulous investors will pitch adverse deal structures (e.g., "death spiral converts") and that issuers may not understand these structures' implications to the company or its shareholders. While this may be controlled for at the listed-company level (i.e., NYSE and NASDAQ) through the rulemaking of our stock exchanges, it would not be controlled for in the "over-the-counter market." Requiring the use of a FINRA-registered firm might minimize abuse.

Conclusion

I applaud the Subcommittee for seeking solutions to the capital formation challenges that small growth companies face and for recognizing that action must be taken to drive job creation and economic growth. For the reasons enumerated, I firmly support the passage of the Small Company Capital Formation Act of 2011.

Please note, however, that this Reg A bill alone is not nearly sufficient to get the IPO market back on track and to get America back on the path to prosperity. Therefore I am also calling for the chartering by Congress of a new national stock market — one that focuses on providing the essential economic model that sustains the infrastructure needed to support small public companies and drives long-term growth and prosperity for all Americans. A market such as this would also drive tax revenues without costing taxpayers a dime.

Thank you for this opportunity to present information on such an important topic. I am pleased to answer any questions.

About David Weild

David Weild is a Senior Advisor to Grant Thornton LLP's Capital Markets Group, which provides strategies and insights into today's global capital markets.

Experience

David is the founder of Capital Markets Advisory Partners and the former vice-chairman and executive vice-president of The NASDAQ Stock Market, with oversight of the more than 4,000 listed companies. Prior to NASDAQ, he spent 14 years at Prudential Securities in a number of senior management roles, including president of eCommerce, head of corporate finance, head of technology investment banking and head of equity capital markets in New York, London and Tokyo. He worked on more than 1,000 IPOs, follow-on offerings and convertible transactions and was an innovator of new issue systems and securities underwriting structures, including the use of Form S-3s to mitigate risk for small capitalization companies raising equity and convertible debt capital. He created the Market Intelligence Desk — or "MID" — while at NASDAQ to support issuers in their quest to better understand what was impacting trading in their stocks.

Education

David holds an MBA from the Stern School of Business and a BA from Wesleyan University. He has studied on exchange at The Sorbonne, Ecole des Haute Etudes Commerciales and The Stockholm School of Economics.

Industry participation

David has participated in the NYSE's and National Venture Capital Association's Blue Ribbon Regional Task Force to explore ways to help restore a vibrant IPO market and keep innovation flourishing in the United States, and in the International Stock Exchange Executives Emeriti Small Business Financing Crisis Task Force. He served as Director of the National Investor Relations Institute's New York chapter and currently holds board positions at Helium.com and Hanley & Associates. David testified recently before the CFTC-SEC Joint Panel on Emerging Regulatory Issues in the wake of the May 2010 "flash crash" and is often interviewed by the financial news media.

Publications

David and Edward Kim have co-authored a number of Grant Thornton studies, including *Why are IPOs in the ICU?* in 2008. Released in the fall of 2009, *Market structure is causing the IPO crisis* (updated by *Market structure is causing the IPO crisis — and more* in 2010) and *A wake-up call for America* have been entered into the Congressional Record and the Federal Register.

About Grant Thornton LLP

Grant Thornton LLP helps dynamic organizations navigate the complexities of today's business landscape by cutting through the jargon to provide audit, tax and advisory solutions that offer real value. Our niche is the growth engine of America's economy: private entrepreneurial businesses and mid-sized public companies — the very audience that will generate the new jobs our country so desperately needs.

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Hearing on Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty before the Capital Markets Subcommittee of the House Committee on Financial Services

Statement of Luke Zubrod
Director, Chatham Financial

March 16, 2011

Good afternoon Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I thank you for the opportunity to testify today regarding legislative proposals to promote job creation, capital formation and market certainty. My name is Luke Zubrod and I am a Director at Chatham Financial ("Chatham"). Today, Chatham speaks on behalf of the Coalition for Derivatives End-Users ("Coalition"). The Coalition represents thousands of companies across the U.S. that utilize over-the-counter ("OTC") derivatives to manage day-to-day business risks. The companies represented by the Coalition use derivatives to reduce risks in their businesses - not to take on risk through speculation.

Chatham is an independent advisor and service provider to hundreds of businesses that use derivatives to reduce their interest rate and foreign currency risk. A global firm based in Pennsylvania, Chatham serves as a trusted advisor to over 1,000 end-user clients ranging from Fortune 100 companies to small businesses, including clients in 46 states and every state represented by Members of this subcommittee.

The Coalition supports the efforts of this subcommittee to pass legislation aimed at reducing systemic risk and increasing transparency in the OTC derivatives market. The Coalition also appreciates the bipartisan nature of the present undertaking. The Coalition believes that a bipartisan, bicameral effort will be necessary to ensure that end users of derivatives are not unduly burdened by regulation intended to curb risks associated with firms whose derivatives use makes them systemically risky. The overwhelming, and bipartisan, support for end users was made clear in the amendments adopted to the financial reform legislation that passed the House in December of 2009. Several amendments, including the Murphy-McMahon amendment which passed with 304 votes, were intended to ensure that the salient economic requirements of the Act were appropriately focused on those entities whose use of derivatives could jeopardize financial stability. In essence, they were intended to protect end users from onerous bank-like regulation that would divert precious working capital from job-creating activities, including research & development and business expansion.

Let me turn to where things now stand in terms of implementing the derivatives title of the Dodd-Frank Act and point out where end users have the greatest concerns.

The Coalition appreciates recent comments by Federal Reserve Board Chairman Ben Bernanke, Commodity Futures Trading Commission ("CFTC") Chairman Gary Gensler, and Securities and Exchange Commission ("SEC") Chairman Mary Schapiro indicating that margin requirements should not be imposed retroactively. Appropriately, the chairmen recognize that the retroactive imposition of a margin requirement would upset the reasonable expectations of market participants when they entered into pre-existing contracts and could severely restrict economic growth.

The Coalition is concerned, however, by recent testimony provided by regulators concerning the imposition of margin requirements on end-user transactions used prudently for the purpose of risk management. Congress recognized that the imposition of margin on end user transactions would divert working capital from job-creating activities and hamper economic growth, while offering no appreciable mitigation of systemic risk. Indeed, following the conclusion of the conference committee, the chairmen of the four committees with primary jurisdiction over Title VII took steps to make clear that regulators did not have the authority to impose margin on end-user hedges; however, in spite of congressional intent and the clear language of the statute, some regulators appear to have interpreted Title VII as giving them authority to impose margin on end-user hedges and - even worse - *requiring* swap dealers to impose margin requirements on all end-user hedges. We never thought we would need to come back to Congress seeking legislation to prevent regulators from imposing margin on end-user companies, either directly or indirectly, but that is the position in which we now find ourselves.

We respectfully request that this committee provide end users with certainty by clarifying that their hedges will not be subject to margin requirements. In addition to providing important certainty for Main Street businesses, such a clarification would promote international harmonization and minimize regulatory arbitrage.

The Coalition appreciates the hard work of the CFTC, SEC and prudential regulators in proposing more than half of the 150 or more expected rules to meet the one-year rulemaking timeline mandated by Congress. The regulators have run an open and transparent process and have met with representatives of the Coalition approximately a dozen times. The Coalition has submitted numerous comment letters to assist the regulators in improving proposed rules and in identifying regulations that might unintentionally harm well-functioning segments of the market. However, we are concerned that the statutory deadline for rulemaking does not allow regulators sufficient time to incorporate recommendations, craft thoughtful rules, and conduct adequate cost-benefit analyses. Though regulators have sufficient authority to adopt a phased-in approach to the implementation of rules, we are eager to ensure the final rules strengthen the market and minimize unintended and unnecessary consequences. We therefore respectfully ask this committee to consider extending the date by which final derivatives regulations must be promulgated, which is now set at July 15, 2011.

Additionally, though we strongly support the legislation's transparency objective, we are concerned that proposed real-time reporting rules could inadvertently jeopardize end user's ability to secure efficient market pricing in certain situations. In particular, it is important that large or less liquid transactions be classified as block trades and that the public reporting of such transactions be adequately delayed. If reporting of these types of trades occurs instantaneously, it could provide a roadmap for other market participants to trade on that information and, through such "front-running," make the end-user trades more expensive. In this way, the real time reporting requirement could work at cross-purposes to the objective of increasing transparency, ultimately increasing the cost of managing risk for larger trades.

Finally, the Coalition is concerned that capital adequacy guidelines finalized by the Basel Committee on Banking Supervision late last year could unnecessarily and substantially increase end-user costs incurred as they use derivatives to manage their business risks. Though we support appropriate risk-based increases to banks' capital, we believe proposed requirements fail to reflect this committee's consensus that end-user risk management activities do not contribute to systemic risk. If capital charges are disproportionately increased, end users may opt out of hedging, which in turn would translate to increased volatility in consumer prices for things like airline tickets, apartment rents, farm equipment, various types of financing, life insurance contracts, and even the price of cereal.

As regulators go about the important work of finalizing rules intended to address problems revealed by the financial crisis, it is critical that well-functioning aspects of these markets not be harmed. It is essential to preserve Main Street businesses' efficient access to these important risk management tools. We appreciate your attention to these concerns and look forward to continuing to support the subcommittee's efforts to ensure that derivatives regulations do not unnecessarily burden American businesses, jeopardize economic growth, or harm job creation.

Thank you for the opportunity to testify today and I am happy to address any questions you may have.

Center On Executive Compensation

March 15, 2011

The Honorable Scott Garrett
United States House of Representatives
2244 Rayburn House Office Building
Washington, DC 20515

RE: Support of H.R. 1062 Seeking Repeal of Section 953(b) of the Dodd-Frank Act

Dear Congressman Garrett:

On behalf of the Center On Executive Compensation, I am writing to express our strong support for the Burdensome Data Collection Relief Act (H.R. 1062) to repeal the pay ratio disclosure mandate in Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The disclosure creates an administratively unfeasible reporting requirement in which the costs far outweigh the benefits and would not provide shareholders with useful information or facilitate a better understanding of pay practices. In addition, repealing the pay ratio disclosure requirement would be a helpful step in executing President Obama's initiative to eliminate unnecessary, burdensome and costly regulations.

As you may know, the Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 300 large companies, and the Center's Subscribers represent a broad cross-section of industries.

Section 953(b) of the Dodd-Frank Act requires the SEC to draft regulations mandating companies disclose the ratio of the median pay of all employees to the total pay of the chief executive officer. The SEC has indicated that the prescriptive provision would require companies to calculate the pay of every employee globally, whether full- or part-time, in the same manner as compensation is calculated for named executive officers. Many global companies have tens of thousands of employees located in dozens of countries, each with their own separate payroll systems and pay reporting requirements. In order to calculate the median pay of all employees, a company will have to gather and calculate this information for each employee, determine the pay of each employee from highest to lowest and then identify the employee whose pay is exactly halfway between the highest-paid and lowest-paid employee. Since most companies are not equipped to handle this exercise, they will be required to invest considerable resources to determining the pay ratio, which is ultimately meaningless.

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The Honorable Scott Garrett
March 15, 2011
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The pay ratio requirement would not advance the stated objectives of the financial reform legislation nor does it provide useful information to investors. The pay of employees at all levels of an organization is subject to various forces in the market, such as competition, geography and job type. Moreover, the pay ratio does not take into account a company's structure, such as the degree to which it relies on third parties for certain services like manufacturing or information processing. For these reasons, the ratio would not provide meaningful information to investors to enable them to make better investment decisions. The ratios would not be comparable between companies.

The Center commends your efforts to execute the President's mandate to review and eliminate counterproductive and costly regulations that hamper the competitiveness of American jobs. The Center stands ready to work with you and members of your staff to ensure that the Dodd-Frank Act will lead to the positive reform that was intended when it was enacted.

If you have any questions, please contact me at tbartl@execcomp.org.

Sincerely,

Timothy J. Bartl

Timothy J. Bartl
Senior Vice President and General Counsel

cc: Members of the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Financial Services Committee

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cuna.org
BILL CHENEY
President & CEO

March 16, 2011

The Honorable Scott Garrett	The Honorable Maxine Waters
Chairman	Ranking Member
Subcommittee on Capital Markets and	Subcommittee on Capital Markets and
Government Sponsored Enterprises	Government Sponsored Enterprises
Committee on Financial Services	Committee on Financial Services
United States House of Representatives	United States House of Representatives
Washington, DC 20515	Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

On behalf of the Credit Union National Association (CUNA), I respectfully ask that this letter be made a part of the record of today's hearing entitled, "Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty." CUNA represents nearly 90% of America's 7,600 state and federally chartered credit unions and their 93 million members.
Since their founding in the United States over 100 years ago, credit unions have been serving the credit needs of their small business-owning members. While not the largest portion of credit union lending, small business lending is the fastest growing segment of credit union lending by a significant margin. Unfortunately, since 1998, credit unions have been subject to an arbitrary statutory cap on business lending of 12.25% of a credit union's total assets; as a result, today, many credit unions are rapidly approaching the cap while others choose not to engage in business lending because of the cap. In an effort to promote economic recovery and job creation, we strongly urge Congress to increase the credit union member business lending cap.

Last year, the administration gave its support to legislation to increase the credit union business lending cap to 27.5% of total assets, and worked with the National Credit Union Administration to shape this legislation. We conservatively estimate that if this bill became law, credit unions could lend an additional $13 billion to small businesses in the first year after implementation, helping them to create nearly 140,000 new jobs. This is a commonsense economic recovery and job creation measure that requires no taxpayer money and does not expand the size of government.

Unlike the recently enacted Small Business Lending Fund Act, which gave community banks $30 billion of taxpayer money as an incentive to lend to small businesses, increasing the credit union business lending cap could be done without spending a dime of taxpayer money and without increasing the size of government. To be clear: credit unions do not need taxpayer money to lend more to small businesses: they need the authority from Congress to do so.

AMERICA'S CREDIT UNIONS
PO Box 431 | Madison, WI 53701-0431 | 5710 Mineral Point Road | Madison, WI 53705-4454 | PHONE: 608-231-4000

As you are undoubtedly aware, the major banking trade associations oppose credit unions' efforts to help small businesses. Their opposition demonstrates that once again the bankers have their facts wrong and their priorities confused.

The bankers say increasing the credit union member business lending cap is not necessary because there are not very many credit unions approaching the cap; but the truth is that there are nearly 350 credit unions at or quickly approaching the cap, accounting for approximately 60% of credit union business lending – the credit unions that have experience serving small businesses are the ones approaching the cap. If the cap is not increased, the ability of these credit unions to continue to be there for their small business-owning members will be jeopardized. This legislation is targeted toward those credit unions with business lending experience, and only permits credit unions which are well capitalized, close to the current cap and with a history of safe and sound business lending to apply for authorization to lend above the current cap level.

The bankers also claim that an increase in the credit union business lending cap somehow means that credit unions are not fulfilling their mission to provide credit to their members. While it is true that part of the credit union mission is to serve those of modest means, it is also true that many modest means individuals run small businesses and need credit. This is especially the case in economic downturns because unemployed and discouraged job seekers are more likely to form businesses during these events.

The bankers complain about the credit union tax status that the Joint Committee on Taxation says will cost $600 million this year but which the data suggest will provide over $10 billion in benefit to credit union members as well as those who do not belong to credit unions. Yet, these same bankers take $30 billion of taxpayer money and show no increased willingness to lend to small businesses.

Let's face it: the banker's objection is rooted in their fear of competition, which given the circumstances is relatively hollow. Credit unions currently hold 5% of the small business loans issued by depository institutions. We believe that many of the additional business loans granted by credit unions once the cap is increased would not be loans otherwise made by banks. They would be loans too small for a bank to consider, or to borrowers unwilling to deal with a bank. However, even if all of the new credit union loans would have been made by banks, and if credit union business lending doubled (both quite unlikely), that would still leave banks with 90% of the business lending market.

The Honorable Scott Garrett
The Honorable Maxine Waters
March 16, 2011
Page Three

What is more troubling than their rhetorical arguments is the fact that they miss the point of this legislation entirely. This legislation is not about credit unions; it is about helping small businesses access credit. Yet, the bankers seem more concerned about keeping credit unions from helping small businesses than helping small businesses themselves. Credit unions understand that in order for the economy to fully recover, small businesses need access to credit which will help their businesses grow. Credit unions have capital to lend, a history of prudent and safe small business lending, and a mission to help provide access to credit to their members—including their small business-owning members. We just need Congress to act.

America's credit unions and their 93 million members stand ready to be part of the solution to the economic problems our nation faces. To that end, we encourage Congress to consider legislation increasing the credit union member business lending cap. **This is a commonsense economic recovery and job creation measure that requires no taxpayer money and does not expand the size of government.**

Best Regards,

Bill Cheney
President & CEO

NASDAQ OMX

March 16, 2011

The Honorable Spencer T. Bachus
Chairman
House Committee on Financial Services
Washington, D.C. 20515

The Honorable Scott Garrett
Chairman, Subcommittee on Capital Markets
House Committee on Financial Services
Washington, D.C. 20515

Dear Chairman Bachus and Chairman Garrett,

NASDAQ OMX wishes to commend the Committee on Financial Services for its plans to consider legislation authored by Rep. David Schweikert, the Small Company Capital Formation Act of 2011. This legislation will make relevant an important financial tool for small companies to access equity capital as they transition from startup status, without the full burden of SEC registration.

There is no one single policy or legislative action, in and of itself, that will repair the damage done to our capital markets over the last several years through the unintended consequences of well-intentioned laws and regulatory changes. In the aggregate, these changes serve as an enormous disincentive for smaller companies to go public and have foreclosed other avenues for companies to raise capital. While we agree that this legislation is appropriate to ease that capital formation process for those smaller companies, more certainly needs to be done. This is an important long-term jobs issue.

At NASDAQ OMX, we worry about the ability of the venture community and investors to help our entrepreneurs and dreamers create strong world-changing companies. IPOs are not just investment vehicles for the media to report their "pop" on Day 1 of trading…something larger happens. Important companies like Microsoft, CISCO, Apple, Yahoo, Biogen, Google, Intel, Gilead Sciences and thousands of others have created exponential opportunities for new products, medicines, and improvements to how we live our lives and employed hundreds of thousands of people in doing so. Growth companies listed on NASDAQ OMX have created new American jobs at a rate more than 50% above the U.S. economy as a whole since 1992. We believe the modern venture-backed IPO is worth saving.

NASDAQ OMX is working on other ways to help smaller companies. Last year we proposed an exchange platform, to be called the BX Venture Market, that would allow companies with a minimum of $2 million in market capitalization trade in a well-regulated exchange environment. We are currently awaiting SEC approval of this platform, but believe it also will be an important tool for smaller companies to raise money.

NASDAQ OMX believes that other actions are necessary to help small companies. For much of the 1980s and 1990s as many as three-quarters of companies raising capital at IPO in the U.S. raised less than $50 million, that fraction has hovered around one-quarter for the past decade. We believe that a holistic evaluation of the entire regulatory environment around innovation and entrepreneurship is strongly warranted. We hope to work with you and the committee on this important subject in the coming weeks and months.

Please let us know how we can be helpful. Thank you again for moving this legislation forward and for your leadership on behalf of our capital markets.

Sincerely,

Frank Hatheway

Frank Hatheway
Chief Economist

NYSE Euronext

March 16, 2011

The Honorable Spencer Bachus
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Barney Frank
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman and Ranking Member Frank,

NYSE Euronext strongly supports the "Small Company Capital Formation Act of 2011." This legislation will help more American entrepreneurs access the capital they need to expand their businesses and create new jobs. I commend the Chairman and Representative David Schweikert for their leadership on this important issue and encourage the House Financial Services Committee to pass this bill.

Regulation A was adopted by the Securities and Exchange Commission (SEC) to enable small businesses to offer their securities publicly in accordance with streamlined offering and disclosure requirements. However, the Regulation A exemption is rarely used because the $5 million threshold, which has not changed since 1992, is too low to warrant companies incurring the time and expense necessary to satisfy the offering and disclosure requirements with going public.

Increasing the SEC's Regulation A exemption from $5 million to $50 million would open America's capital markets to more entrepreneurs. By reducing the regulatory burden and expense of raising capital from the investing public, Congress can boost the flow of capital to small businesses and fuel America's most vigorous job-creation machine. Regulation A can also help entrepreneurs access private capital by providing liquidity opportunities at a lower level than might be feasible for an IPO using full registration.

Despite improving economic conditions, entrepreneurs and small businesses are still unable access the capital they need to grow and create jobs. A record 41 percent of small business owners say they cannot get adequate financing, according to the National Small Business Association – up from 22 percent in 2008. A critical source of funding – the public capital markets – has been largely closed off to America's proven job creators. An increased Regulation A ceiling will provide a valuable alternative for smaller, entrepreneurial companies by giving them access to the public market at an earlier stage in their growth cycle. NYSE Euronext looks forward to continuing to work with this Congress to strengthen the growth and competitiveness of U.S. public companies as well as support job-creation.

Sincerely,

Duncan Niederauer

Riverside

April 15, 2011

The Hon. Robert Hurt
1516 Longworth House Office Building
Washington, DC 20515

Dear Rep. Hurt:

Thank you for the opportunity to respond to additional questions related to my testimony at the March 16 hearing before the Capital Markets Subcommittee on H.R. 1082, the Small Business Capital Access and Job Preservation Act. I'll do my best to address the issues you raise in as complete and specific a manner as possible. However, if any of my comments require further clarification, please do not hesitate to let me know and I'll be happy to respond.

Question 1

Some have alleged that private equity funds are nothing more than "leveraged buyout funds," which pose a systemic risk to the U.S. financial system. Is this true? Why or why not?

Private equity funds themselves do not pose any risk to the financial system of the United States because of the nature and structure of the private equity business model. Quite the contrary, private equity has become an important source of capital and a tool for driving growth and improving performance at thousands of companies across the country and around the world. In addition, private equity firms have delivered superior investment returns to their investors which include scores of public and private pension funds, university endowments, charitable foundations and other investors.

Under the private equity ownership structure, a private equity partnership and its investors acquire companies — either by taking a public company private or through a heavily negotiated private transaction with the owners of a private business. Often, companies in the public market are undervalued and need new capital to grow. In a private transaction, companies are often in need of new sources of capital and more professional management. Private equity brings these resources to these companies by investing time, energy, talent and capital to improve the company's performance and prospects and most importantly to grow these companies and create jobs. After several years, usually between four and five, the private equity partnership sells the company, hopefully at a premium to the purchase price. Generally, 80 percent of the profits go to the limited partner investors.

partnership . growth . integrity

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Unlike the mortgage-backed securities and other instruments that led to the near collapse of the U.S. financial system in 2008, private equity investments are just that – private. Private equity funds invest in companies – not publicly traded securities. These investments cannot be quickly sold or traded. They are illiquid.

Private equity funds rely on long-term capital commitments from limited partners. Generally, limited partner investments are "locked up" for periods of up to ten years. Therefore, these funds are not susceptible to a "run on the bank." Because private equity funds do not provide redemption opportunities to investors before the fund matures, they never are forced to sell companies into a down market to raise cash.

In addition, private equity-sponsored companies are not deeply interconnected with other financial market participants and are not in a position to trigger cascading losses that trigger systemic risk. The failure of one company would have no effect on the other companies held by the private equity partnership.

Question 2

Are private equity funds leveraged? If so, how do they use leverage to conduct their business?

Private equity funds generally do not take on leverage at the fund level other than very short term borrowing to bridge capital contributions from their investors and the parent companies of private equity partnerships generally have little or no debt. As a result, private equity funds do not face margin calls from creditors or unsustainable debt burdens.

It is true that many – but not all – private equity-backed companies take on debt at the time of their acquisition. That leverage generally is assumed to increase the efficiency of the equity capital that is put to work in buying companies – and to ensure higher returns for limited partner investors, such as pension funds, endowments and foundations. Sustaining a moderate level of leverage at the company level also means that more equity capital is available for the private equity partnership to invest in additional companies therefore creating a more diversified portfolio for its investors.

And while the funds are not levered, the levels of portfolio company debt are generally in the range of 3 to 2 or even 1 to 1, far less than the 30 to 1 ratio that prevailed at Lehman Brothers at the time of its collapse. Any debt associated with the acquisition of a private equity-backed company already is subject to regulatory scrutiny through the institution that is extending the credit. Aggregated data on leverage at the portfolio company level is transmitted to a variety of federal regulators by the lending institutions. If the government wishes to limit leverage, doing so through the regulated lending institutions seems like the appropriate place to intervene.

The loans that banks extend to portfolio companies on behalf of private equity sponsors are not interconnected. The failure of one private-equity backed company will not trigger the failure of another. In addition, studies consistently show that private equity-backed companies generally enjoy a lower default rate than other, similarly financed companies.

For example, a Private Equity Growth Capital Council analysis of 3,200 private equity-backed companies acquired between 2000 and 2009 and held through 2008-2009 found that, during the "Great Recession" of 2008-2009, these businesses defaulted at less than one-half the rate of comparable companies: 2.84 percent versus 6.17 percent. It is also worth noting that a 2008 study by the Boston Consulting Group predicting massive defaults among private equity-backed companies proved to be false. It simply did not happen.

Question 3

The January 2009 Congressional Oversight Panel ("COP") "Special Report on Regulatory Reform" has been cited by some as evidence that private equity funds are a source of systemic risk because they are highly leveraged. A closer review of the partisan report shows that the panel members were sharply divided, and I identify myself with the Republican members who determined that no private pools of capital received any taxpayer assistance during the financial crisis and concluded that private pools of capital did not pose a risk to the U.S. Financial System. That being said, are small and mid-sized private equity funds leveraged in a manner similar to financial institutions? Did your firm or any private equity firms to your knowledge take TARP of any other type of taxpayer funding during or after the financial crisis?

It may come as a surprise to those who cite this report as evidence that private equity poses systemic financial risk, but the words "private equity" appear exactly four times in the body of the 50-page main document – and they always appear in tandem with the words "hedge funds." In fact, the report lumps private equity in with other components of the "shadow financial system" without undertaking any analysis of what private equity is or how it works. It is noteworthy, however, that the report, with apparently unintended irony, specifically calls on Congress to "grant the SEC clear authority to require *hedge fund advisors* (italics are mine) to register as investment advisors under the Investment Advisors (sic) Act." There is no mention of requiring similar registration for private equity fund advisers.

Neither Riverside nor any private equity firm of which I am aware either requested or was given TARP funds or any other type of taxpayer assistance during or after the advent of the financial crisis.

Question 4

What will be the impact of the Dodd-Frank Act on private equity firms? Specifically, how will the new Securities and Exchange Commission ("SEC") registration requirement affect your firm's ability to invest in small businesses and other companies that need restructuring?

The rules on registration and financial reporting for private equity fund managers proposed by the Securities and Exchange Commission would impose significant burdens on private equity firms – especially smaller firms – and divert money and time away from their primary mission – making investments and growing companies. These burdens include partners' time spent away from deal sourcing, managing investments and deal making as well as the actual dollar cost of compliance. (Please see the answer to Question 5).

Question 5

Do you have an approximately cost that your firm will expect to pay in complying with the SEC registration requirements in the Dodd-Frank Act? Would these compliance costs directly limit the amount of capital your companies would otherwise invest in small businesses?

We estimate that the total cost to Riverside for complying with the SEC registration and reporting requirements of the Dodd-Frank Act will be in the neighborhood of $775,000 for the first year and $525,000 per year thereafter. By way of context, $775,000 would better be spent by the private equity firm hiring talent to help invest in and grow its portfolio companies.

Those costs are broken down as follows:

- Fees associated with creation and implementation of Compliance Policies - $250,000 (one time)
- Hiring of a compliance officer and team - $425,000 (annual)
- Purchase of software to monitor trading activity (even though we don't work in the public markets) - $30,000 annual cost
- Ongoing custody fees for safekeeping worthless securities currently held at no charge by our law firm - $25,000
- Annual legal costs to update form ADV, etc. - $30,000 annually
- Costs of attending "compliance seminars" - $15,000

Question 6

It is my understanding that private equity firms have been critical sources of investment in the private sector during times of economic recovery. Can you explain exactly how Riverside and other private equity firms have helped get America back on track to save and create jobs in the wake of the financial crisis?

According to the U.S. Bureau of Labor Statistics, the United States lost a total of 7.8 million jobs from 2007 through 2010, a decline of 5.6 percent. For the companies that Riverside owned during that time (this includes 29 North American portfolio companies that we owned on December 31, 2007 and still own today) our portfolio headcount increased by 9 percent. This is organic growth (pro forma for add-on acquisitions) and represents true job creation.

Riverside

How did we do it? First, we supported our portfolio companies with additional equity investments when companies were in need of capital. Riverside invested $56 million in support equity into these businesses during this time (12 of 29 companies received support). This represents 18 percent of our total investment in these companies – real money. When the economy turned south, we didn't just hand over the keys to lenders, but we stepped up with support capital needed to survive. This meant not only providing capital to hire new people, but meant that people employed by these companies kept their jobs during the downturn.

In addition to equity, Riverside made available to its portfolio companies sophisticated operational resources and strategic guidance. These resources include:

- Executive leadership – In the 18 of the 29 companies discussed above, Riverside Operating Partners were very involved in helping to guide the company, either as the CEO or the Chairman of the Board. These are expensive and skilled resources, offered to our portfolio companies for greatly reduced rates
- Planning – We work with each of our new investments to develop a 100-day plan and a longer-term strategic plan. The company works closely with our team of investment and operating professionals to develop these plans to professionalize the business and drive toward goals.
- Toolkit resources – A list of pre-vetted consultants are provided to help our companies meet growth goals or improve operations. Examples include: pricing strategies, lean manufacturing, sales growth, brand marketing and many more.
- Pooled purchasing – Riverside manages pooled purchasing programs to help our companies reduce costs by buying services (office supplies, shipping services) with the same leverage as a large buyer, but with individual service requirements fulfilled. In 2010, this resulted in $13 million of savings for our portfolio of small companies.
- Riverside University – Riverside offers education and training events for our companies throughout the year, culminating in an annual forum where all CFOs, CEO, and outside board of directors meet at our Riverside Leadership Summit.

Each of these resources help our companies grow and we believe they explain the job growth in our portfolio and show that our objectives are far more than cutting costs. From 2007 to 2010 the same group of companies grew organic sales by 7 percent. Real GDP during that time period grew just 0.1 percent. When we buy a company we help the management team write its first strategic plan, commission its first audit and hire its first Board of Directors. With our capital and help, entrepreneurs can professionalize their businesses to make them more competitive and able to grow.

Not only did we support the companies we owned during this time period, we continued to invest in new companies. From 2008 through 2010 Riverside invested $471 million in 42 new US investments, during a time when lenders and strategic buyers were holding onto their money. These investments have a total enterprise value of $1.1 billion, which means that Riverside funded these with 42 percent equity (and 58 percent debt). This conservative leverage ratio is in line with other LBO transactions of this size according to S&P's Leveraged Lending Review, and a far cry from the leverage that many assume are in place for private equity investments.

To give you a clearer picture of Riverside's dedication and support to small businesses in America, here's just one example of the way that Riverside supports its investments.

Riverside invested in Paris, Kentucky based Monessen, a manufacturer of fireplaces, in March 2006. Within the next 12 months the housing market began to crash, and Monessen became a troubled investment. Riverside supported the company with two additional equity investments in the first half of 2008.

Riverside also helped Monessen expand significantly through the acquisition of CFM, a competitor, which we purchased out of bankruptcy in July 2008. That acquisition required an additional $50 million of investor capital. The add-on acquisition provided Monessen with a large number of new customers, brand names, and 3 additional manufacturing facilities.

Since mid-2008 Riverside has supported a number of initiatives at Monessen including brand and product line rationalization; transportation systems management; labor productivity improvement; supply chain management and long-range strategic planning. These improvements are reflected in the company's financial performance: during 2010 revenues increased by 12 percent and earnings grew from -$5 million in 2009 to +$3.6 million in 2010. The company is projecting sales to increase even more in 2011 to $113 million, and earnings to $8 million.

Let me also call to your attention a 2009 study by Dr. Robert J. Shapiro, former Undersecretary of Commerce for Economic Affairs under President Bill Clinton, which concluded that private equity investments play a key role in driving economic recoveries. The study was funded in part by the Private Equity Council.

In the study's conclusion, Dr. Shapiro writes: "The evidence and data suggest that the private equity sector can play a constructive and positive role during the current recession and its initial recovery. The numbers of private investments typically rise during recessions and continue to rise during the initial years of recovery. Moreover, total private equity investment grows much faster during the initial year of recovery than overall business investment. There is also some evidence which may suggest that private equity-held [companies] create jobs during the initial stages of recoveries while employment across the economy continues to contract."

(I have attached a copy of the study to this email.)

In addition, a series of studies conducted by Prof. Josh Lerner of Harvard University for the World Economic Forum generally concluded that global private equity investment has made significant contributions to the global and U.S. economies. The studies concluded that private equity investment:

- Creates new jobs at a faster pace than the industry average.
- Over time, ends job losses at companies that already were eliminating jobs at a faster rate than their peers.
- Drives economically important innovation.
- Represents long-term investment.
- Builds stronger, better-managed and more productive companies.

- Benefits workers through higher wages.
- Grows industries faster (as measured by employment, value added and total production) than other forms of ownership.

(I have attached a detailed, four-page summary of the three WEF studies that includes links to the original documents.)

Question 7

How many advisers to private equity firms will be unable to take advantage of the current registration exemption contained in the Dodd-Frank Act, which exempts advisers managing less than $150 million in assets? How large are the largest private equity funds that currently operate in the U.S.? Were any of these funds registered with the SEC prior to enactment of the Dodd-Frank Act?

According to PitchBook Data, Inc., a private equity research organization based in Seattle, Washington, there are approximately 2,080 private equity firms based in the United States. Of those, 570 – or about 27 percent – have more than $150 million in assets under management.

Preqin, a financial research organization based in the United Kingdom, in a 2010 report, listed the largest private equity firms based in the United States as: Goldman Sachs Private Equity Group, which has raised $91.9 billion in funds over the past ten years; The Carlyle Group, with $51 billion in funds raised; TGP (formerly Texas Pacific Group) with $49.9 billion; Kohlberg Kravis Roberts & Col (KKR) with $46.7 billion; The Blackstone Group with $46 billion; Oaktree Capital Management with $44.1 billion; Bain Capital with $38.2 billion; Apollo Management with $34.2 billion; Warburg Pincus with $30.8 billion and HarbourVest Partners with $26.3 billion. At least eight of these firms were registered as investment advisers with the Securities and Exchange Commission prior to passage of the Dodd-Frank Act in July 2010.

Question 8

During consideration of Dodd-Frank, some members of Congress suggested that the SEC's oversight of your business would be minimal. Do you have any reason to believe that statement is true?

Based on the SEC proposals to expand private fund adviser registration Form ADV and initiate private fund adviser reporting Form PF, we believe that SEC oversight will be substantial. For example:

Monthly fund valuations – The proposed SEC Form PF requires all registered private equity firms to calculate the value of their funds – and therefore portfolio companies – on a monthly basis, and report those numbers annually or quarterly, depending on firm size.

It makes no sense to require monthly valuations of private equity funds – and therefore of all the companies in which the funds invest – as these are illiquid assets that are not traded. Valuations of private companies are complex calculations and require detailed analysis – you don't just look up the ticker symbol at the end of the month to see how much the investment is worth and report it to your investors. The incremental costs to value these private businesses monthly would be unduly burdensome. These expenses would reduce the amount of money private equity firms have to make investments.

Third-party custody of securities – Part 2 of Form ADV requires firms to provide third-party custody of their securities. However, securities in companies in which private equity firms invest are private, have legends on them stating that they are not registered and cannot be traded and require an executed power of attorney for them to be sold to a third party. Since they are unlisted, they cannot be traded in public markets. And, if they are lost, the owners can complete a lost security affidavit and the securities can be replaced at no risk to the owner. Audits of the financial statements of these funds are generally prepared under US GAAP which requires the auditors to verify the existence of these securities. In addition, many banks require that the equity securities pledged to them be held by the banks themselves. Therefore, it makes no sense to require that they be held in custody by third parties at considerable expense when there is no benefit to the investors in the fund...

Compliance and disclosure to investors – Part 2 of Form ADV contains extensive compliance and disclosure requirements, including creation and adoption of a code of ethics, that will be costly to carry out and which do not enhance or improve upon any of the disclosures required in Limited Partner Agreements.

Trading practices – Requirements regarding trading practices, including procedures by which the adviser satisfies its best execution obligation and allocates aggregated trades among clients, make no sense for private equity firms that do not trade any public securities for their clients' accounts.

Restrictions on proprietary trading – Requirements regarding proprietary trading by the adviser and the personal trading activities of the people the adviser supervises have no bearing on private equity firms, which do not engage in trading public securities for clients.

Portfolio management processes – Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolio investments with clients' investment objectives, make little sense for private equity firms, as these issues are all covered by Limited Partner Agreements and are heavily negotiated with investors.

While these proposed rules will do nothing to mitigate systemic financial risk, they will consume hundreds of thousands of dollars and thousands of hours of time that would be better spent making investments in companies and creating jobs.

Question 9

In the March 16, 2011 Capital Markets Subcommittee hearing, a witness from the AFL-CIO stated that registered investment advisers "also have a duty to act as fiduciaries in dealing with their clients." While this is certainly true, is it not also true that investment advisers owe a fiduciary duty under federal law regardless if they are registered? Do these firms not already owe fiduciary duty under state law as well if the fund is a limited partnership, as is typical of most private equity firms? Finally, do anti-fraud provisions of the Investment Advisers Act of 1940 apply to both registered and unregistered investment advisers?

Investment Advisers in fact do owe fiduciary duties to their clients under both federal and state law. With respect to federal law, as embodied in the Investment Advisers Act of 1940, these duties arise whether or not the investment adviser is registered or unregistered with the SEC. While the Investment Advisers Act does not mention the term "fiduciary" specifically, the anti-fraud provisions of Section 206 apply equally to both registered and unregistered investment advisers. With respect to state law, most if not all states impose fiduciary duties on investment advisers, either through statutory provisions of their respective investment adviser laws, statutory provisions of their limited partnership and limited liability company laws, or under state common law. However, these state laws can, to some extent, be modified or limited through contractual provisions contained in partnership agreements and limited liability company agreements.

If you have any additional questions, I'd be happy to answer them.

Sincerely,

Pamela Hendrickson
Chief Operation Officer
The Riverside Company
Rockefeller Center
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Riverside