LEGISLATIVE PROPOSALS TO RELIEVE THE RED TAPE BURDEN ON INVESTORS AND JOB CREATORS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

MAY 23, 2013

Printed for the use of the Committee on Financial Services

Serial No. 113–26

U.S. GOVERNMENT PRINTING OFFICE

81–761 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

JEB HENSARLING, Texas, *Chairman*

GARY G. MILLER, California, *Vice Chairman*
SPENCER BACHUS, Alabama, *Chairman Emeritus*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
ROBERT HURT, Virginia
MICHAEL G. GRIMM, New York
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee
MARLIN A. STUTZMAN, Indiana
MICK MULVANEY, South Carolina
RANDY HULTGREN, Illinois
DENNIS A. ROSS, Florida
ROBERT PITTENGER, North Carolina
ANN WAGNER, Missouri
ANDY BARR, Kentucky
TOM COTTON, Arkansas
KEITH J. ROTHFUS, Pennsylvania

MAXINE WATERS, California, *Ranking Member*
CAROLYN B. MALONEY, New York
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
STEPHEN F. LYNCH, Massachusetts
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware
TERRI A. SEWELL, Alabama
BILL FOSTER, Illinois
DANIEL T. KILDEE, Michigan
PATRICK MURPHY, Florida
JOHN K. DELANEY, Maryland
KYRSTEN SINEMA, Arizona
JOYCE BEATTY, Ohio
DENNY HECK, Washington

SHANNON MCGAHN, *Staff Director*
JAMES H. CLINGER, *Chief Counsel*

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

SCOTT GARRETT, New Jersey, *Chairman*

ROBERT HURT, Virginia, *Vice Chairman*
SPENCER BACHUS, Alabama
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RANDY NEUGEBAUER, Texas
MICHELE BACHMANN, Minnesota
KEVIN McCARTHY, California
LYNN A. WESTMORELAND, Georgia
BILL HUIZENGA, Michigan
MICHAEL G. GRIMM, New York
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee
MICK MULVANEY, South Carolina
RANDY HULTGREN, Illinois
DENNIS A. ROSS, Florida
ANN WAGNER, Missouri

CAROLYN B. MALONEY, New York, *Ranking Member*
BRAD SHERMAN, California
RUBÉN HINOJOSA, Texas
STEPHEN F. LYNCH, Massachusetts
GWEN MOORE, Wisconsin
ED PERLMUTTER, Colorado
DAVID SCOTT, Georgia
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
KEITH ELLISON, Minnesota
MELVIN L. WATT, North Carolina
BILL FOSTER, Illinois
JOHN C. CARNEY, JR., Delaware
TERRI A. SEWELL, Alabama
DANIEL T. KILDEE, Michigan

CONTENTS

LEGISLATIVE PROPOSALS TO RELIEVE THE RED TAPE BURDEN ON INVESTORS AND JOB CREATORS

Thursday, May 23, 2013

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 9:31 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, King, Royce, Huizenga, Stivers, Fincher, Mulvaney, Hultgren, Ross, Wagner; Maloney, Sherman, Scott, Himes, Peters, Watt, Foster, and Carney.

Also present: Representative Green.

Chairman GARRETT. Greetings. Good morning, everyone. Good morning to the panel.

The Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. Today's hearing is entitled, "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators."

I welcome the panel to today's hearing. We will begin with opening statements, and after that, we will turn to the panel. And with that, I recognize myself for 3 minutes for an opening statement.

Today's hearing is entitled, as I said, "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators," and it will focus on four specific pieces of legislation that would remove various regulatory impediments and target red tape that hinders small businesses' ability to create new jobs and help the economy grow.

The Dodd-Frank Act significantly expanded the SEC's authority. However, Congress did not first determine that this unprecedented expansion was necessary to further their mission or that the SEC was capable of executing its new authorities and mission.

Despite what my Democratic colleagues are likely to allege, we are not attempting to deregulate the financial services industry. Very simply, the bills before us are a series of targeted and pragmatic fixes to some of the most burdensome and unnecessary provisions of Dodd-Frank.

In fact, three of the four bills before us today already enjoyed bipartisan support last Congress. The SEC has a threefold mission: to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation. So by removing unnecessary and time-consuming requirements, these bills discussed in today's hearing will ensure that the SEC has the time and resources to focus on its core mission and reach other congressional mandates, such as those outlined in the JOBS Act, which the SEC has failed to fully implement. Last week, there was a lot of discussion about the SEC's resources. Now, these four bills fix many of the unnecessary provisions of Dodd-Frank, freeing up SEC resources to be devoted to mission-critical rules.

I want to specifically recognize and thank Congressman Hurt, Congressman Huizenga, and Congresswoman Wagner for their terrific work on these bills. I commend each of you, and I look forward to passing these bills through the committee, hopefully in a bipartisan manner, as we have done in the past.

In conclusion, the Dodd-Frank Act, was not written in stone or handed down from on high, and Congress has an obligation to amend or repeal those provisions that did not cause or contribute to the financial crisis and whose cost outweigh their purported benefits. That is what we begin with today.

And with that, I now turn to the gentlelady from New York, Mrs. Maloney, for 4 minutes.

Mrs. MALONEY. I thank the gentleman for his leadership, and I welcome all the witnesses. This hearing will focus on four bills that are designed, as the title of the hearing suggests, to relieve what is seen as red tape.

So we have four bills under consideration today. The first would repeal a section of Dodd-Frank that requires companies to disclose the ratio of the total compensation of their CEO to that of the median compensated employees on a quarterly basis.

The intent was to bring transparency to the compensation process and to encourage fair practices. The SEC has not written rules yet in this area, and when the committee reviewed this bill in the last Congress, an amendment was passed that gave the SEC additional authority to narrow the requirements while maintaining the intent behind the provision.

The second bill would exempt certain private equity fund managers from the SEC registration requirement. Private equity registration was something we incorporated into the Dodd-Frank Act because many believed there were areas in the industry that were completely dark, even while recognizing that this was not the cause of the financial crisis.

The bill this committee reviewed last year included an amendment from my colleague and friend, Mr. Himes, which said that only private equity firms that were leveraged more than two to one would be required to register. Since that time—and his bill did pass the committee—the SEC has required private equity firms to register.

The third bill we are looking at would prohibit the PCAOB from mandating audit firm rotation. I would like to understand why audit firm rotation is necessary, and I question why we are interfering with the PCAOB's independent authority.

Finally, a fourth bill would put additional hurdles on the SEC to interfere with its ability to write rules that would change the legal standard for broker-dealers. Dodd-Frank required the SEC to study the fiduciary duty broker-dealers owe to their clients and that investment advisers have. The SEC completed the study, and recommended a uniform standard for broker-dealers and investment advisers. However, they have not yet proposed a rule that is under comment, and some feel that this is not a necessary—that there are different duties.

I look forward to hearing from the panelists today and gaining a greater understanding of this issue. I want to thank everybody for coming, and I want to thank everyone who authored these important bills, and I especially thank our chairman for calling this important hearing. Thank you.

Chairman GARRETT. I thank the gentlelady. The gentleman from Virginia is now recognized for 4 minutes.

Mr. HURT. Thank you, Mr. Chairman. Mr. Chairman, thank you for holding today's hearing on these important proposals. Today, we will discuss several bills that will reduce the regulatory burdens that restrict the flow of private capital to small businesses.

In Virginia's 5th District, thousands of jobs would not exist but for the investment of private equity. These critical investments allow our small businesses to innovate, expand their operations, and create jobs. One P.E.-backed company in my district, Virginia Candle, told me that, "Without private investment, we would not have been able to take our business out of a garage in Lynchburg, and into millions of homes all across the world."

The same can be said for many small businesses in the districts of Representatives here in this room, and all throughout Congress. Unfortunately, Dodd-Frank placed a costly and unnecessary regulatory burden on private equity by exempting advisers to similar investment funds. These unnecessary registration requirements, which do not increase the stability of our financial system, impose an undue burden on small and mid-sized private equity firms, and therefore decrease capital available to spur job growth.

That is why I have introduced H.R. 1105, the Small Business Capital Access and Job Preservation Act. This bill is co-sponsored, as the ranking member said, by Representatives Himes and Cooper. If enacted, these undue burdens on private equity advisers will be eliminated, and they will be given the same exemption that SEC's registration requirements under Title 4 of Dodd-Frank, that venture capital advisers receive. Additionally, the bill will specifically limit the exemption to advisers to private equity funds that have leverage of less than 2:1.

It is important to note that private equity funds did not cause the financial crisis. They do not appear to be a source of systemic risk, as some have suggested. These funds are not highly interconnected with other financial market participants, therefore, the failure of a private equity fund would be highly unlikely to trigger cascading losses that would lead to a similar financial crisis. By eliminating unnecessary regulations, this bill seeks to expand capital formation so that companies can innovate, expand, and create jobs.

In that same vein, I have introduced H.R. 1564, the Audit Integrity and Job Protection Act, with Representative Meeks. This bill will eliminate the threat of mandatory audit firm rotation by prohibiting the Public Company Accounting Oversight Board, the PCAOB, from moving ahead with its potential rulemaking.

In 2011, the PCAOB released a concept draft to impose mandatory audit firm rotation, a directive requiring public companies to change their independent auditor every few years. As a result, this proposal would significantly impair the quality of public audits; reduce the supervision and oversight of audit committees; and impose significant, unnecessary costs that impede investment and harm investors and consumers.

A GAO study conducted pursuant to Sarbanes-Oxley found that initial year audit costs under mandatory audit firm rotation would increase by more than 20 percent over subsequent year costs in order for the auditor to acquire the necessary knowledge of the public company. Beyond harming the competitive position of American public companies, I have heard from innovative private companies in Virginia's 5th District, including many of our research and development bio-tech firms, that mandatory audit firm rotation would create a further disincentive to go public in light of the increased costs, and already complex regulatory scheme.

Both the SEC and Congress have previously rejected mandatory audit firm rotation, and most recently, the JOBS Act explicitly banned audit firm rotation for emerging growth companies. Let me close by saying that unemployment in my district, Virginia's 5th District, continues to be unacceptably high. We cannot continue to impose onerous and unnecessary regulatory requirements that force firms to divert essential capital from preserving and creating jobs, to needless rules and regulations.

I look forward to the testimony of each of our distinguished witnesses today, and I thank them for their appearance before the subcommittee. Mr. Chairman, thank you, and I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back. And before I go to Mr. Scott, I yield to the gentlelady from New York for a unanimous consent request.

Mrs. MALONEY. It is done.

Chairman GARRETT. I thought you wanted to—

Mrs. MALONEY. Oh. I have a legislative proposal here and statement from Ian Simpson, the director of global governance for CalPERS, the California Public Employees Retirement System, and I request unanimous consent to place it into the record.

Chairman GARRETT. Without objection, it is so ordered.

Mrs. MALONEY. Thank you.

Chairman GARRETT. Thank you. Mr. Scott is now recognized.

Mr. SCOTT. Thank you, Chairman Garrett, and thank you, Ranking Member Maloney.

This is an important subject, and I kind of view these four bills with a bit of trepidation. I think it is important for us to be very careful. The Dodd-Frank Act is an extraordinarily important act to make sure that we never get into a financial crisis such as we had before.

And I do believe in making the right kind of adjustments. Oftentimes when we make adjustments, we sometimes can create unintended consequences, create sometimes more of a problem than we had before, so we have four bills.

The Audit Integrity and Job Protection Act addresses questions as to whether or not mandatory audit firm rotation by the Public Company Auditing Oversight Board is the most efficient way to enhance auditor independence and audit quality. I think it is important that we hear from our accounting firms on that. They are the ones that have to make all of this work. And we have to make sure that we get the right answers.

H.R. 1135, the Burdensome Data Collection Relief Act, looks to repeal disclosure requirements for a public company's ratio of CEO pay to median employee, as is required under Dodd-Frank. There are reasons why such language was put into Dodd-Frank. So, I think we have to be very careful.

H.R. 1105, the Small Business Capital Access and Job Preservation Act, exempts investment advisers to certain private equity firms from SEC registration and reporting. Again, this is required under Dodd-Frank. What does the SEC say about this? I am saying all of these things were put in for a purpose.

So, as we move forward to address the many regulatory issues raised by these pieces of legislation, what I am saying is, we have to get the right balance, and balance the concerns on behalf of, yes investors, but also consumers. Also, the users, and our constituents with the concerns that are raised by American public companies, many of which are also run by our constituents and have stakes in our communities.

I believe in transparency, and I am also a pragmatist who recognizes that while notably improving admittedly less than satisfactory economic and market conditions that our American businesses are operating under, we must do everything we can to improve conditions, and facilitate growth without imposing any undue, unexpected regulatory burdens. And I am sure my colleagues share in this evenhandedness. If they are onerous, we need to say why. Onerous to one person, might not be onerous to another. So, all I am asking for is that we move with a very clear, jaundiced eye, and not with an overwhelming zeal to move in and try to undermine or repeal Dodd-Frank.

With that, I yield back.

Chairman GARRETT. The gentleman yields back. Before we go to Mrs. Wagner, the gentlelady from New York is recognized for 30 seconds.

Mrs. MALONEY. I would just like to take this opportunity to thank Kristin Richardson for her extraordinary work on this committee, and prior to that, for her work in my district office in New York. She has done an extraordinary job and will be leaving to join the private sector. But I am deeply grateful for her sacrifice, and her devotion, and her hard work. Thank you, Kristin.

[applause]

Chairman GARRETT. So we will be seeing you in New York when we go up to New York? Great. Okay.

Mrs. Wagner is now recognized for 3 minutes.

Mrs. WAGNER. Thank you very much, Mr. Chairman.

The first thing I would like to note is that the discussion draft amending Section 913 of the Dodd-Frank Act that I have circulated is just that, a draft. And I appreciate the opportunity to have it included in this hearing to receive all of the proper input. The draft is intended to address what has become one of the biggest issues facing retail investors today. I guess this has simply become known as the fiduciary issue. And what we have is two different Federal agencies, the SEC and the Department of Labor, heading towards a separate and massive rulemaking that could fundamentally change the way in which families and investors choose financial products and services, and not necessarily for the better.

Today, we will focus on the SEC. In January 2011, the SEC proposed adopting a "uniform fiduciary standard for brokers and advisers for their dealings with retail customers." While the SEC claimed this proposal would better protect investors, the agency failed to provide any evidence to support such a claim. And in fact, failed to provide any data, or evidence showing that retail customers were being harmed or disadvantaged under current standards of conduct.

SEC Commissioner Paredes, and then-Commissioner Casey said in a joint statement that the study "failed to justify its recommendation that the Commission embark on fundamentally changing the regulatory regime for the broker-dealers and investment advisers." And even though investor confusion surrounding standards of care was the main rationale behind the study's recommendation, Paredes and Casey went on to say that the uniform standard "may in fact create new sources of confusion for investors."

So it seems to me that we have a solution in desperate search of a problem. And the solution could end up harming investors more than helping them. The draft that I have circulated is meant to address the shortcomings of the SEC's proposal, and to ensure that regulators do not lose focus on the fact that, at the end of the day, it is everyday Americans who are harmed most when Federal agencies regulate without justification.

I hate to break it to you, but it is not the ultra-wealthy, or the 1 percent who are most affected by this: it is the new dad looking to buy life insurance so he can sleep better at night; or the mom looking to set up an education account for her child who gets turned away because she is told that she is not sufficiently wealthy; or the grandfather who has fewer choices when deciding how to pass on wealth to his grandchildren.

You don't protect investors by simply restricting their choices and adopting a one-size-fits-all regulatory regime. In fact, I would submit that this does more harm than good.

The draft legislation would improve the regulatory process by requiring the SEC to identify whether investors are being harmed or disadvantaged under current standards of care, and also require the SEC to conduct a rigorous cost-benefit of any potential rule.

In addition, the SEC would be required to verify that any final rule would actually reduce, I underscore, reduce investor confusion. I think we can all agree that the SEC shouldn't make the problem worse.

I thank the chairman for the time, and I look forward to hearing from our witnesses today on this very important matter. And I yield back my time.

Chairman GARRETT. Thank you. And before we get to the witnesses, one last comment. The gentleman from—

Mr. HURT. Mr. Chairman, I just have two letters: one from the Association for Corporate Growth; and one from the Investment Company Institute and the Independent Directors Council. And I was wondering if I could have unanimous consent to make them a part of the record?

Chairman GARRETT. Without objection, it is so ordered.

Mr. HURT. Thank you.

Chairman GARRETT. Now, we can go to the panel. And thank you to the entire panel for being here today. For those who have not been here before, just recognize that your entire written testimony will be made a part of the record. We will now yield to you 5 minutes each.

We also ask that you—we always say this a number of times—make sure that your button is pushed and that the microphone, as you have done, is pulled fairly close to you, otherwise it is sometimes hard to hear you.

So to begin things, from the University of Mississippi, Mr. Bullard, you are recognized for 5 minutes.

STATEMENT OF MERCER E. BULLARD, PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC., AND JESSIE D. PUCKETT, JR., LECTURER AND ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

Mr. BULLARD. Thank you, Chairman Garrett, Congresswoman Wagner, and members of the subcommittee for the opportunity to appear before you today. It is certainly an honor and a privilege to be back before the committee.

I would like to direct my comments today to the draft cost-benefit bill, and although I am going to talk about the bill as if it is final text, I just want you to note that I do appreciate it is a draft, and certainly I wouldn't be surprised if there were changes made to the text going forward.

I also want to note that the bill's cost-benefit requirements, in theory, are certainly unobjectionable. And for the most part, they describe how the SEC should think about cost-benefit analysis in doing its rulemaking. However, in practice, the requirements will have little relationship to how cost-benefit analysis is actually conducted.

My concern is that they will not improve cost-benefit analysis. Rather, they will impede or simply prevent needed rulemaking, add unproductive employees to government payrolls, and trigger more litigation and more expense for all parties involved.

Excessive cost-benefit requirements ultimately will turn government agencies into the Orwellian two factions that opponents of red tape claim to oppose. Legal challenges to rules have proven time and time again that there is only one standard for cost-benefit analysis that is really needed, the arbitrary and capricious standard under the Administrative Procedures Act.

Industry participants have been successfully challenging inadequate cost-benefit analysis under that standard for decades. One consequence of the regulatory paralysis that excessive cost-benefit standards create that does not receive much attention is the problem of unintended consequences.

As every experienced lawyer knows, one response to regulatory paralysis is always the same—rulemaking through enforcement. The fiduciary duty is no exception. States bring State law fiduciary claims against brokers. FINRA brings FINRA rule-based fiduciary claims against brokers. Fiduciary claims are the most common claims in FINRA arbitration proceedings where no one even knows what the standards are that are being applied because arbitration panels are not required to tell us what they are.

When you take away the SEC's ability to define the fiduciary duty, you guarantee that there will be dozens of versions of fiduciary duties promulgated by dozens of sources of authority. Excessive cost-benefit standards ultimately promote the development of non-uniform, enforcement-based law.

Others will also step in and do their own rulemaking. Let me read you the headline from an article on Rick Ketchum's speech, delivered only yesterday—"FINRA's Ketchum to SEC: Act Now on Fiduciary, or We Will Make Our Own Disclosure Rules." FINRA rules already have a substantive fiduciary component. Industry lawyers have characterized its most recent amendments to a suitability rule as establishing a de facto fiduciary standard.

The fiduciary duty has already blossomed, gassing 1,000 lights that are anything but illuminating. As an alternative to rulemaking, the SEC itself has brought a number of claims, for example, for failures to disclose revenue-sharing payments that allege what are essentially fiduciary duty violations clothed in the garb of anti-fraud claims.

In fact, one might even predict that when cost-benefit requirements threaten to paralyze rulemaking by the SEC or the CFPB, for example, the Executive Branch might choose to sidestep rulemaking by appointing prosecutors to run those agencies.

The cost-benefit bill also requires SEC coordination with other agencies that may reflect an intent to constrain the DOL's own fiduciary rulemaking. If so, in light of recent events, I would say this approach is at least premature. The DOL's original proposal, which has been roundly criticized by me in this room itself and others, has been withdrawn.

The DOL is conducting an intensive cost-benefit analysis. DOL's officials have expressly stated they are crafting exemptions for re-proposal that are designed to accommodate existing industry practices. And the re-proposal is only a couple of months off. I would say that Congress should at least wait to know what the DOL proposal is going to be before seeking to prevent the rulemaking from going forward.

The bill also includes a provision that requires the SEC to make a finding, as a condition of adopting a fiduciary rule, that the rule would reduce investor confusion about the legal standards that apply to financial professionals. This customer confusion test does nothing more than hold investors hostage, denying them the right to an efficient fiduciary standard until they can prove that they have achieved a higher level of legal sophistication.

The solution to investor confusion is not to require investors to become smarter about regulations. It is to make smarter regulations.

In conclusion, the bill requires that the SEC, again, as a condition of imposing a fiduciary duty on brokers, to impose unrelated rules on investment advisers. There is no question the SEC should consider whether broker rules that apply to activities that advisers also engage in should be extended to advisers as well.

But making the adoption of a fiduciary rule automatically triggers such unrelated rulemaking, creates a strong inference that this provision is nothing more than rent seeking by an industry that wishes to regulate its competitors into submission. Investor adviser rules, like the fiduciary rule, should stand or fall on their own merits.

Thank you, and I would be happy to answer any questions.

[The prepared statement of Mr. Bullard can be found on page 39 of the appendix.]

Chairman GARRETT. I thank the gentleman. Next, from the Association for Advanced Life Underwriting, Mr. Ehinger, you are recognized for 5 minutes, and welcome to the panel.

STATEMENT OF KEN EHINGER, CHIEF EXECUTIVE OFFICER, M HOLDINGS SECURITIES, INC., ON BEHALF OF THE ASSOCIATION FOR ADVANCED LIFE UNDERWRITING (AALU)

Mr. EHINGER. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I am Ken Ehinger, president and chief executive officer of M Holdings Securities, Inc. I am testifying today on behalf of the Association for Advanced Life Underwriting.

We appreciate the opportunity you have given us to testify on draft legislation by Representative Wagner. Her draft legislation would, in essence, require the SEC to identify a real need and determine that there will be real benefits outweighing the costs before upending the current standards that apply to broker-dealers.

While we understand the Wagner proposal is a discussion draft at this point, we support her effort as a sensible proposal that we believe will lead to better rulemaking by the SEC.

I have spent more than 3 decades in the securities and insurance business. I was honored to share that experience with this subcommittee when I testified more than a year-and-a-half ago.

As I said then, a standard of care for financial professionals that sounds good in theory may fail in practice if it is vague and amorphous and provides no guideposts for compliance. And, a fiduciary duty offers little protection if regulators do not have the tools and resources to effectively oversee the financial professionals who are subject to it.

I reiterate those statements today.

During consideration of Dodd-Frank, the then-Chairman of the SEC advocated that the bill include a legislative mandate to the SEC to impose a new standard on broker-dealers. Congress rejected that approach and directed the SEC to study whether there were gaps in existing investor protection before acting on any new rule.

The 2011 SEC study was criticized on all sides because of the lack of economic analysis and findings of specific harm and market failure supporting its conclusions. The SEC says that it needs to address investor confusion. A 2008 Rand Corporation report found that investors were confused about the legal differences between brokers, dealers, and investment advisers, although they were very satisfied with their own financial professionals.

But instead of addressing the confusion issue by developing better, clearer, and more concise disclosure about the role in which a financial professional serves, the SEC took a different path. Over the past 5 years, it has used precious time and staff resources to continue to press for a change in the broker-dealer standard of care to conform to the standard that applies to investment advisers.

The SEC most recently set out various options for reform in this area in a 72-page release requesting a mountain of data, little of which relates to whether investors are being harmed.

I have great respect for the SEC and for its dedicated staff. But, the Commission has detailed dozens of staff to work on this discretionary rulemaking project over the last few years.

I believe the SEC could make much better use of those staff, if it would do two things. First, direct two or three to develop a targeted disclosure rule that addresses any issue of investor confusion. And second, reassign the others to fill what continues to be a monumental gap in investment adviser inspections and oversight.

Representative Wagner's bill would address these issues very directly. If the criteria in her discussion draft had been in place from the outset, precious time and resources would have been saved by the SEC. The focus on the SEC's regulatory effort would have been to identify real and specific harm, and then to craft a rule or other remedy to address that harm cost-effectively. Investors would have been far better off.

AALU's members are licensed life insurance professionals. Many are licensed in multiple States. Most AALU members are registered representatives at SEC and FINRA-registered broker-dealers, and/or are investment adviser representatives of SEC-registered advisers. Our members are subject to multiple layers of Federal and State regulation and oversight.

The variable insurance products our members sell, which trigger broker-dealer registration, give customers investment choices and an insurance guarantee, which has been recognized as even more important in recent years of market volatility.

The range and features of products such as variable life and variable annuities make it difficult to determine which product is "best," and a "best interest" standard almost certainly would lead to increased litigation. Determining what is "best" would be highly subjective, opening a producer to second-guessing and liability, often years after the sale of the product.

Life insurance enables individuals and families from all economic brackets to maintain independence in the face of potential financial catastrophe. The life insurance industry, through permanent life insurance and annuities, provides 20 percent of Americans' long-term savings.

Two out of three American families—that's 75 million families—count on the important financial security that life insurance products provide. Therefore, any proposed change in regulation that could limit consumer choices and access to these critical protection and savings vehicles should meet a high burden with respect to the need for the changes.

I want to thank you again for the opportunity to testify. AALU looks forward to continuing to work with you on these critical issues.

[The prepared statement of Mr. Ehinger can be found on page 57 of the appendix.]

Chairman GARRETT. And I thank the gentleman. It is good to see you back here again.

Mr. Quaadman from the U.S. Chamber of Commerce, welcome to the panel.

STATEMENT OF THOMAS QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

If you take a look at the four issues that are before us today, there is a common thread that runs throughout them. There is a lack of benefit for investors and businesses. There are large costs that are imposed on businesses. And there is a mode of government micromanagement that inhibits investors and the ability for businesses to grow and create jobs.

That is why the Chamber, in releasing our Fix, Add, Replace (FAR) agenda earlier this year, included these four issues as those that should be addressed. The FAR agenda was specifically designed to fix the flaws in Dodd-Frank, add the issues that were left unaddressed in Dodd-Frank, and replace those provisions that are unfixable.

In looking at the specifics of the four issues before us, the Chamber supports H.R. 1135, the Burdensome Data Collection Relief Act, which would repeal Section 953(b) of the Dodd-Frank Act. The pay ratio disclosure in Section 953(b) in Dodd-Frank creates a corporate disclosure that forces businesses to disclose irrelevant information for investors. It doesn't convey information to investors as to company performance, their long-term prospects or its management.

Instead, it imposes costly compliance burdens that, if you take a look at a public company that may be operating in dozens, if not in over 100 countries, they have to reconcile differing definitions of compensation, employees, and benefits, quantify those, and then take into account currency fluctuations over all those different borders.

So if you take a look at the information provided by the Center On Executive Compensation, one company has estimated it will cost almost $8 million to comply with this provision; another company has estimated it will cost $2 million just to determine the pension benefits that could be subject to this provision.

When you start to extrapolate those numbers across the more than 10,000 public companies in the United States, you are looking at costs well into the hundreds of millions of dollars.

The Chamber also supports H.R. 1105, the Small Business Capital Access and Job Preservation Act. This solves the problem, the classic problem, of trying to pound a square peg into a round hole. The SEC has created a mismatch of trying to impose public investor disclosures upon private investors.

Therefore, private equity funds, which are important sources of capital for the business community, have to safeguard untradeable securities and also have to start to engage in expensive periodic valuations of businesses that are in their portfolio.

It has been estimated by the Association for Corporate Growth that for each of these businesses in a portfolio, it will cost the fund between $500,000 and $1 million. When you take a look at a private equity fund that could be invested in 20, 30, or 50 businesses, that starts to actually sideline a sizable amount of capital that could be used for productive purposes.

The Chamber also supports H.R. 1564, the Audit Integrity and Job Protection Act. The Chamber agrees that Congress should not legislate independent standard setting standards and that there should be independent standard setting. But this is an example where the PCAOB has left its field of audit region and got into corporate governance. With possibly only two to three audit firms engaged in audit activities in an industry, it could actually turn into a government mandate as to what vendor a company should use and when they should use them.

Furthermore, this will diminish audit committee oversight. The GAO, as has been noted, has estimated this would raise audit costs by at least 20 percent and it would harm audit quality. Over 90 percent of the commenters to the PCAOB over the last 2 years have opposed this provision and then, in fact, the majority of investors have also done so.

The Chamber is also very appreciative of Congresswoman Wagner's discussion draft on Section 913 of Dodd-Frank. The Chamber echoes the concerns of over 150 Members of Congress on a bipartisan basis who have raised concerns about fiduciary duty roles.

We agree that there needs to be a coordinated effort amongst the SEC and other Federal agencies to look at the issue and then determine what the problems are, what the solutions are, and what the cost-benefit should be.

Unfortunately, what we have seen with the history of joint rulemakings under Dodd-Frank, is they have happened in a disjointed manner. They have happened out of sequence and they have created market confusion in and of themselves.

That, we think, is something that would harm investors and the businesses that they help capitalize.

Finally, I would just like to say if you take a look at each of these issues and bills in the abstract, they are trying to address costs and burdens, as I mentioned, but we also need to look at them on a much broader and global basis.

We would also support consideration of Congressman Fincher's bill, H.R. 1221, the Basel III Capital Impact Study, which would look at a cumulative impact study of various Dodd-Frank rulemakings.

Finally, I would just like to say we commend Congress for the bipartisan action it took last year in passing the JOBS Act. And we think that the passage of these four bills is a page from the same playbook and would support that. Thank you.

[The prepared statement of Mr. Quaadman can be found on page 67 of the appendix.]

Chairman GARRETT. And I thank the gentleman.

Now, on behalf of the Small Business Investor Alliance, Mr. Reich. Welcome, and you are recognized for 5 minutes.

STATEMENT OF MARC A. REICH, PRESIDENT, IRONWOOD CAPITAL, ON BEHALF OF THE SMALL BUSINESS INVESTOR ALLIANCE (SBIA)

Mr. REICH. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for the opportunity to testify today.

My name is Marc Reich, and I am president of Ironwood Capital, a private equity firm in Avon, Connecticut. I represent the Small Business Investor Alliance, the trade association of lower middle market private equity firms, and the many institutional investors that provide the capital that we, in turn, invest in small and medium-sized businesses nationwide.

My firm manages six private equity funds, four of which are organized as small business investment companies, investment funds that are licensed and regulated by the U.S. Small Business Administration. We invest subordinated debt and equity in amounts ranging from $5 million to $12 million to support small business owners in growth financings, recapitalizations, and buyouts. I strongly support H.R. 1105, the Small Business Capital Access and Job Preservation Act, introduced by Representatives Hurt, Himes, Garrett and Cooper. Thank you to the committee for examining this bill today, and especially to the sponsors of the legislation for working so diligently to bring it to this point.

H.R. 1105 strengthens the ecosystem of the private equity marketplace by reducing overregulation that threatens capital access for small businesses. The Investment Advisers Act of 1940 as modified by Dodd-Frank requires private fund advisers to register with the SEC if they manage more than $150 million of capital.

Since the Act became effective, over 1,500 private equity funds have registered with the SEC.

My testimony today will be brief and pointed, focusing on a few of the most common and vexing problems experienced by managers of middle market private equity funds as a result of SEC registration and regulation, in my view, the potential negative impact on small businesses if H.R. 1105 does not become law.

First, however, I would like to speak to the issue of middle market private equity and systemic risk to the financial system. The global economic downturn was a tremendous stress test for the financial system. The middle market private equity industry weathered the downturn in good shape.

In fact, private equity saved many small businesses during the financial crisis when their access to capital was severely curtailed.

Middle market private equity doesn't create systemic risk by trading in synthetic financial instruments. We don't speculate on currency or commodities. We don't put the retirement funds of individuals at risk. We invest directly in small businesses, the backbone of our economy and the growth engine for job creation.

I support having a strong body of regulation within which to operate. Good government regulation is, in fact, the strength of our system. But that regulation must be appropriate to the context to which it is applied, should not be redundant with or in conflict with other regulations, and should not adversely impact the flow of capital—in our case, again, the flow of capital to U.S. small businesses.

SEC compliance and regulatory costs are especially high for small investment funds. At Ironwood Capital, we already spend approximately $250,000 annually on SBA compliance costs. Initial SEC registration costs us $100,000, plus an additional $250,000 annually thereafter.

In addition to the actual dollar cost of additional compliance, having a second Federal regulator removes fund managers from their primary role of investing in and coaching small businesses. While this is true for both large and small funds, there is a disproportionate impact on smaller funds since they have smaller chains, teams, and operate in very lean environments, but face the same array of regulations.

Many of the regulatory requirements we now face under SEC rules are inappropriate to the nature of our business. We invest almost exclusively in privately held companies and hold securities which are not readily marketable or otherwise transferable. Nonetheless, we are now subject to the SEC custodial rules, which require us to hire a third-party custodian to hold onto untradeable securities.

If our securities ended up in the hands of unscrupulous people seeking to profit from them, nothing would happen.

Likewise, we are now required to retain and archive all e-mail messages, then review them to detect illegal activity, such as insider trading. Again, we don't hold anything that is tradable. But we are subject to this rule. This is a purely regulatory exercise with no benefit to investors, nor does it contribute to the safety and integrity of the overall financial system.

Having two regulators overseeing substantially the same segment of the market has resulted in several unnecessary and costly situations.

In one case, the manager of multiple SBICs now regulated by the SEC has been preparing its financial statements for years in accordance with SBA regulatory accounting standards, but was required by the SEC to restate all of their financial statements on a GAAP basis, which cost them about $500,000.

The effect of relatively high compliance expenses and conflicting regulation motivates managers of small funds to either exit the business or raise far more capital for their next fund to offset the cost of double regulation, which, in turn, has the effect of causing those funds to now invest in bigger companies, leaving the smaller companies significantly out in the cold. Neither option is good for the sustained flow of capital to small businesses.

Thank you to the committee for holding this hearing on H.R. 1105, a bill that removes overregulation and helps small business. The SBIA looks forward to working with you to craft better legislation and the appropriate modifications. I am happy to answer any questions you may have.

Thank you.

[The prepared statement of Mr. Reich can be found on page 106 of the appendix.]

Chairman GARRETT. I thank the gentleman.

From the AFL-CIO, welcome back, Mr. Silvers.

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

Mr. SILVERS. Good morning, Chairman Garrett. It is a pleasure to be with you again. And good morning to you, Ranking Member Maloney.

I am Damon Silvers, the policy director and special counsel to the AFL-CIO. I want to thank you and the committee for the opportunity to appear today.

Since 1980, the United States has gone through several cycles of financial deregulation, each of which was followed by speculative bubbles and mass unemployment. The Bank of England has estimated that the worldwide costs of the collapse of the most recent U.S.-centered financial bubble driven by deregulation is in excess of $60 trillion and rising.

Today, this committee is considering a package of bills, each of which is wrong-headed in its own peculiar way, but when taken as a package, together with other measures being taken up by the House such as derivatives deregulation, constitute the House seeking to initiate yet another round of financial deregulation. If successful, there is no reason to believe that the outcome of this effort will be any different than the outcomes of the last 3 times that Congress went in this direction.

Now, I am going to take up briefly each of the four bills. In my written testimony, there is a detailed analysis.

H.R. 1135, the Burdensome Data Collection Relief Act, seeks in truth to keep secret the relationship between CEO pay and the median pay of other employees at public companies by repealing Section 953-b of the Dodd-Frank Act, which requires such disclosure. The AFL-CIO strongly opposes H.R. 1135. It is a bill designed to hide material information from investors, to encourage runaway CEO pay, and to increase economic inequality. Each of these outcomes of this bill will feed systemic risk.

H.R. 1105, the Small Business Capital Access and Job Preservation Act, as drafted now—it could be drafted to narrowly address the concerns the previous witness, Mr. Reich, has raised, which I think are legitimate—has nothing to do with small business. It exempts leveraged buyout firms. That is what private equity is code for. It exempts leveraged buyout firms from the registration and reporting requirements in the Dodd-Frank Act.

This bill would increase systemic risk, weaken investor protections, and offer further regulatory subsidies to leveraged buyout firms, a portion of Wall Street that is already the beneficiary of inexcusable tax subsidies. And it is drafted in a manner aimed at misleading Members of this House into thinking the bill has meaningful protection against leverage when it does not, because the firms do not incur leverage at the firm level. They do so at the investment level. For all of these reasons, the AFL-CIO strongly opposes H.R. 1105.

The draft legislation to amend Section 913 of the Dodd-Frank Act places a number of unusual procedural obstacles in the way of the SEC strengthening the standard of conduct that is applied to broker-dealers' treatment of their clients. Currently—and this has not come out yet, despite the amount of time spent in this hearing on this bill—brokers have no legal duty to give investors advice that is actually in the client's interest.

This fact was at the heart of Goldman-Sachs' defense when the SEC charged Goldman with selling credit default swaps in the Abacus transaction to clients without telling them the swaps had been designed by the party on the other side of the transaction. In a sense, this draft bill is designed to facilitate Goldman-Sachs and their future imitators continuing treatment of their less favored clients as feedstock for their most favored clients. The AFL-CIO strongly opposes this bill.

H.R. 1564, the Audit Integrity and Job Protection Act, seeks to prevent the Public Company Accounting Oversight Board (PCAOB) from placing limits on the length of time a public company can use the same audit firm, audit firm rotation. H.R. 1564 both substantively weakens the ability of the PCAOB to play its role in protecting our economy against systemic risk, and it weakens the independence of the body. Both results are contrary to the public interest, and will significantly increase the risk of financial crisis, and the AFL-CIO opposes this bill.

I should note that the subcommittee does not possess the information the PCAOB has as a result of its inspection process. I would suggest the subcommittee consider seeking to grant itself that authority so it can have the information the regulator has, as the regulator considers whether or not to do this, from the inspections.

Now, in conclusion, there is an urgent financial regulatory agenda, and it is not this one. That agenda is completing the Dodd-Frank rulemaking process, really taking on too-big-too-fail institutions, as Senators Brown and Vitter are attempting to do, and fairly taxing the financial sector, starting with ending the carried interest loophole and enacting a financial transaction tax.

This subcommittee should turn away from yet another costly indulgence in the delusions of deregulation, and instead focus on how to strengthen our statutory and regulatory protections against systemic risk and the exploitation of investors.

Once again, on behalf of the AFL-CIO, I want to thank the subcommittee for the opportunity to appear. I look forward to your questions.

[The prepared statement of Mr. Silvers can be found on page 116 of the appendix.]

Chairman GARRETT. Thank you.

On behalf of the Society of Corporate Secretaries and Governance Professionals, Mr. Smith, you are recognized for 5 minutes.

Thank you.

STATEMENT OF ROBERT SMITH, CORPORATE SECRETARY, VICE PRESIDENT AND DEPUTY GENERAL COUNSEL, NISOURCE, INC., ON BEHALF OF THE SOCIETY OF CORPORATE SECRETARIES AND GOVERNANCE PROFESSIONALS

Mr. SMITH. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I am here today in my capacity as director of the Society of Corporate Secretaries and Governance Professionals, and I appreciate the opportunity to participate in this hearing. And I will jump right in to the heart of the issues.

My comments this morning will be limited to the CEO pay ratio disclosures and potential audit firm rotation issues. We believe these issues, if implemented, would be detrimental both to companies and their investors. With respect to H.R. 1564, we believe that the exclusive authority to hire and retain an audit firm should remain with the company's independent audit committee.

The audit committee remains tasked by Congress and the SEC with the responsibility of selecting a company's audit firm, and we believe the audit committee is best able to judge if the audit firm is bringing the right level of technical competence, objective, and professional skepticism to its work. Mandatory rotation would unnecessarily impinge on the audit committee's independent judgment and fiduciary duties, and it would replace this with an arbitrary one-size-fits-all requirement.

Second, we believe that the costs of mandatory rotation outweigh any benefits from a blanket rule. The costs associated with mandatory audit firm rotation are considerable, entailing as much as 2,600 to 3,700 hours of audit committee, senior management, and staff time.

Additionally, approximately half of our surveyed members indicated they believe fees for audit committee and audit-related services would increase 20 percent or more in the initial years following the auditor change. In addition, the GAO also estimated that additional costs would average approximately 80 percent higher than the audit costs had there been no change.

Furthermore, we believe that the benefits of forced rotation would be minimal and that rotation would likely have a negative effect on audit quality. More than 85 percent of our members surveyed were very concerned about the loss of the audit firm's institutional knowledge of the company and industry if required to switch auditors. And 70 percent of the responding members that had experienced an auditor change in the last 10 years indicated that they had noticed a change in the audit quality as a result of the new engagement.

Finally, we believe that mandatory auditor rotation would leave many public companies with few experienced and eligible audit firms. Many public companies in certain industries have very limited choices with respect to audit firms with appropriate expertise.

Many, again as a practical matter, only use one or two of the big four firms to provide their audit services. Nearly 90 percent of our members surveyed indicated that their company's audit committee evaluates audit firms based on industry knowledge or international scope, and considered these items very important in the selection of the audit firm.

Requiring a company to choose a less qualified, less experienced firm seems significantly less than ideal from a governance perspective. For these reasons, we oppose mandatory audit firm rotation.

With respect to CEO pay ratio, we believe the requirement that the ratio be based on the median employee is simply unworkable. In order to know who the median employee is, each company in the United States would have to calculate the cash and non-cash compensation for every employee: full time; part time; domestic; international; hourly; and salaried.

Pension accruals would have to be calculated by actuaries and H.R. professionals for no productive purpose other than to determine the median employee. International companies face an even more daunting task. They have foreign subsidiaries that have completely different computer systems, pay scales, compensation structures, and laws, including privacy laws in some jurisdictions that could prohibit the transfer of personal compensation information across borders without express consent of that employee. The potential issues with pay ratio are significant and numerous.

Additionally, this type of disclosure does not appear to be desired by shareholders or investors. The 12 shareholder proposals of which we are aware that have been voted on since 2010 on average received less than 7 percent support. The bottom line is that there are already a lot of disclosures on compensation and shareholders have a regular venue and voice in the compensation process through say on pay.

The disclosure is not meaningful. The skewed results that would result where two similar companies produced the same equipment, but one outsources the production of its products and the other one does not, clearly demonstrates the non-materiality and even potentially misleading nature of the disclosures.

Similarly, the inclusion of part-time employees and international employees yields absurd results, where a full-time executive would be compared with a part-time employee who may only work 20 hours per week, or with international employees who may live in a third world country.

Lastly, we agree with the Chamber's earlier comments that these additional disclosures could be incredibly costly without an offsetting benefit that would justify the cost. Hiring staff to perform the detailed calculation and then audit it and confirm it so that it is reliable and accurate would be daunting and overly burdensome. For these reasons, we believe that the requirement should be repealed.

Thank you very much.

[The prepared statement of Mr. Smith can be found on page 126 of the appendix.]

Chairman GARRETT. Thank you.

And representing the Center On Executive Compensation, Mr. Tharp.

Welcome.

STATEMENT OF CHARLES G. THARP, CHIEF EXECUTIVE OFFICER, CENTER ON EXECUTIVE COMPENSATION

Mr. THARP. Thank you. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. My name is Charlie Tharp, and on behalf of the Center On Executive Compensation, I am pleased to provide our views on Section 953(b) of the Dodd-Frank Act, commonly known as the pay ratio mandate, and to express our strong support for Congressman Huizenga's bill, H.R. 1135, which would repeal the pay ratio.

As was commented earlier, we believe that it would impose significant costs on organizations, especially global employers, and would divert resources from more productive uses such as job creation and investment without providing meaningful information to investors.

The Center On Executive Compensation is an advocacy and research organization. And we are a division of the H.R. Policy Association, which represents human resource executives of over 340 large companies, 100 of whom are members of the Center.

I would like to make four key points in support of our review for the repeal of Section 953(b). The first is that the pay ratio calculation is overly complex. As was mentioned, the law would require that a company find the median compensation—not the average—of employees using the definition of pay that is used for the summary compensation table in the proxy disclosure.

Companies don't keep that information except for the calculation of the high five executives, and this is something that would have to be gathered manually and calculated. And as was pointed out, there is really no other legitimate business reason to collect the information in this way, so it would be a redundant effort.

Second, there is a requirement that it be conducted on all employees. And that would include part-time and full-time employees. And as it is literally read, that could be employees around the world in various locations, no matter how many hours they work for the company. Again, this data is not housed in any accessible way by companies.

And third, there would be a burden to conduct this collection of data. In our survey, half of our companies said it would take 3 months to collect this data. Another 20 percent said it would take 5 months. And this is information that would have to be disclosed in each SEC filing from a company, which are numerous.

I would offer one example from one of our subscribers that said they have no existing way to calculate the annual total compensation of every employee around the world. They have 101 payroll systems. They have 3,600 employees who are paid in 2 different countries because of the nature of their assignment. Six countries that use noncalendar tax years. And it was mentioned earlier that many countries have privacy rules that inhibit the ability to share this information.

There is also a tremendous expense, as Mr. Quaadman pointed out, since the cost of implementation would be millions of dollars. The two examples used, one company would be $7.6 million as their estimate just to collect this data. And the pension calculations, again, would be over $2 million.

The final point is that it is information which isn't useful to investors and which investors haven't asked for. If you look at the differences between company structures, the labor markets in which they operate, the product markets, it would be very difficult to compare information across companies.

And in those cases where shareholders have had an opportunity to vote on the pay ratio, the 9 that were in 2010, none received support of over 10 percent by investors, and the average support was just a little over 6 percent. And it is clear that when given the opportunity to request this information—over 90 percent of investors have voted against it.

In conclusion, we believe that the pay ratio wouldn't be helpful to investors, would be potentially confusing, and would be overly costly and burdensome to implement. And that is why we support repeal. Again, thank you very much for the opportunity to offer our views.

[The prepared statement of Mr. Tharp can be found on page 142 of the appendix.]

Chairman GARRETT. Thank you. Just so the panel knows, votes have been called, but I think we will get in at least one series of questions, and then close after that. I am not going to go next, as I normally would as Chair. I am going to defer to the vice chairman. The gentleman from Virginia is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. Again, I thank each of the panelists for being here. I guess I wanted to first talk about the private equity registration bill, and wanted to first turn my attention to Mr. Quaadman. Obviously, the purpose of Dodd-Frank is to get at the idea of systemic risk. How do we prevent systemic risk and prevent another financial crisis?

Obviously it strikes me, as the chairman said, that the implementation of Dodd-Frank and the enactment of Dodd-Frank is not something that should prevent us in and of itself from looking at ways to make Dodd-Frank more useful or to make it less harmful, especially to those who are trying to create jobs.

And jobs is obviously—if you look at my rural Virginia fifth district, there are places in my district where we have had unemployment as high as 15 percent. So this is a very real issue, and capital formation is very important.

I was wondering if you could maybe talk a little bit about the importance of private equity in capital formation, and then also address the issue of systemic risk and whether or not the investment that takes place as a consequence of that really presents any systemic risk as contemplated by Dodd-Frank.

Mr. QUAADMAN. Thank you, Mr. Hurt. First off, in the United States we have an extremely diverse set of capital financing for businesses. So, private equity is a very important part of that.

Private equity obviously can be where a fund comes in and takes a troubled company and turns it around. On the other side, they can take a smaller company that is looking to grow and provide them with the basis to do so. So private equity in that regard is a very critical part of the funding structure that businesses have.

In terms of systemic risk, private equity was not a cause of the financial crisis. In fact, when you take a look at Title I of Dodd-Frank through the prior Vitter Amendment, which was the last amendment agreed to in the Senate, the Senate on a bipartisan basis put a very strong line around what systemic risk can actually be in order to keep as many non-financial companies out of it.

So when you take the fact that private equity was not a part of the financial crisis, where you actually have Congress and Dodd-Frank trying to restrict systemic risk regulation, clearly this is—private equity should not fall within the focus of this.

Mr. HURT. Thank you. Mr. Reich, I wanted to see if you could also address the issue of systemic risk, and then also talk about whether or not this added regulation has the potential of perhaps creating more systemic risk, more too-big-to-fail. I think you addressed that a little bit in your comments, but maybe you could address that issue?

Mr. REICH. I would be happy to. Thank you for the question. As I said in my comments, it has been demonstrated that private equity hasn't contributed in any meaningful way, and maybe perhaps not at all, to the systemic risk.

Part of that is because of structure. And the private equity industry, whether by design or through evolution, is a very, very stable system. Our investors are not individuals. They are large financial institutions. We have California State Teachers. We have New Hampshire Prudential, MetLife, all major investors. It is not Ma and Pa Kettle showing up with their savings in a coffee can asking to invest in private equity. But the structure is such that when our investors are in, they are in. They can't exit. They commit to a 10-year period, which creates real stability in the system. We all saw what happened with the hedge funds. They have quarterly redemption rights, and people were running for the door and created tremendous problems. Private equity, again, is very, very stable—structurally very stable.

As to the systemic risk, it is interesting when you take a look at Dodd-Frank and H.R. 1105 and what has gone on—and by the way, I don't view this as a step towards deregulation.

Mr. HURT. Yes. But my time is running out, and I really want you to address what the implication for capital formation for small businesses could be?

Mr. REICH. Certainly. What happened is because of the cost of regulation, the players that continue in the industry have had to raise more capital to cover the increased costs. That creates some systemic risk in itself because it is forcing more capital into the hands of fewer. So we have less diversification. And by moving up in size, they can't invest in the smaller businesses. So the smaller businesses really get hurt in the process.

Mr. HURT. Excellent. Thank you. I yield back the time I don't have.

Chairman GARRETT. The gentleman yields back.

Votes were called about 7 minutes ago, so let's go into recess. We only have two votes, so it should not take long. As a matter of fact, after they vote the first time, we move right into the second vote, and then we will whip back here. So we will be in recess until that second vote is over. Thank you.

[recess]

Chairman GARRETT. The hearing is called back to order. And at this time, I yield to the gentlelady from New York.

Mrs. MALONEY. I would like to follow up on the question by my good friend, Mr. Hurt, who is very sensitive, and I respect his sensitivity to being sensitive to the really burdensome requirements on smaller firms. But also to involve in the conversation Mr. Quaadman and Mr. Silvers, who had really competing statements on the bill. Already, people have started registering in these private equity firms with the SEC.

And now, firms under $150 million are exempted from registration. Yet Mr. Silvers, in your testimony, you said the way that this is written is that it applies to the leverage at the fund level, and only to private equity funds, and that it would exempt many private equity funds. Could you explain that further? You made it sound like the leverage argument doesn't really apply to the private equity funds. Maybe a better way to help the small firms would be to raise the ceiling as opposed to going into the leverage idea? I would like the comments of the panel on that. Mr. Silvers, and then Mr. Quaadman, and Mr. Reich, or anybody who would like to respond.

Mr. SILVERS. Congresswoman, what my testimony addresses is that leverage, which is the systemic risk issue associated with leverage buyout firms or private equity firms. Leverage in these firms is incurred not at the firm, but at the level of the partnership. So if you put in the bill language as is currently in the bill that says, we are not exempting firms with leverage, that language is completely misleading because it measures the leverage at the investment fund level, and not at the level of the companies the investment fund controls.

Leveraged buy-outs are done at the company level, right? So that in a given leverage buy-out, a private equity firm might own the equity, the controlling share in 10 operating companies. Each of those operating companies will have done the borrowing. The way the language is written right now, you can have vast amounts of leverage in the total portfolio controlled by that leverage buy-out fund, and it would register the way leverage is measured in this bill as none whatsoever. Now your question about size? My reaction to Mr. Reich's testimony was that he was describing the concerns of funds that were somewhat larger than the $150 million level, but were not in the big-time of private—in the world of leverage buy-outs and private equity.

And also, funds that were perhaps less leveraged than the typical large player in the business. Now, I would agree with you that I think that his testimony raises a question of whether the $150 million limit is the right number. I am not going to express a view on that today. I am somewhat skeptical, but I think it would be worth looking into. But the way this bill is written, it is very easily a blanket exemption for funds that definitely represent systemic risk.

Mrs. MALONEY. Okay. Mr. Quaadman?

Mr. QUAADMAN. Mrs. Maloney, thank you for the thoughtful question. I think first off, some of the work that Mr. Himes has done, which was incorporated with this bill has been very helpful. I do think Mr. Hurt's approach is actually a very thoughtful way forward. What we are seeing with the SEC is that you have an agency that is really geared toward public company disclosures and regulations. And that while Congress made a decision that there should be more oversight over private equity firms, the way that it is being done, it is being done through a check-the-box mentality that neither benefits the regulators nor does it help the P.E. firms themselves.

So I think there is an appropriate balance here where you can have P.E. firms that can go out there and help businesses with capital, and with management, and not necessarily put onerous regulatory burdens on them. And it is just a matter of that balance.

Mrs. MALONEY. Mr. Reich, and anyone else who would like to comment? Mr. Bullard? Mr. Reich, please, if you could comment on this discussion?

Mr. REICH. On that specific point, you are certainly correct. There is leverage both at the firm level, the fund level, and at the company level. But again, I think it is best covered just by disclosure. And I think there is adequate disclosure that is required right now by the SEC and the government in general to assess the systemic risk. I don't see it as a big problem, however.

Mrs. MALONEY. Okay. Mr. Bullard?

Mr. HURT [presiding]. Just briefly.

Mr. BULLARD. I would just like to point out that the SEC dealt with this issue in its venture capital rulemaking, which is the other major category that is exempted. It dealt specifically with the leverage requirements that are imposed on venture capital. It seems to me that looking at this bill, the 2:1 ratio doesn't really do the kind of leverage restriction that you are looking for, simply—but directing the SEC to do the leverage restrictions itself would solve the problem. And the venture capital rulemaking seemed to be the one the industry was happy with the resolution. It is one that people were happy with the way the SEC dealt with leverage—

Mr. HURT. Thank you.

Mr. BULLARD. —I think that might be a better fix to that approach.

Mr. HURT. The gentlelady's time has expired. The Chair now recognizes Mrs. Wagner for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman. And thank you all for being here today. Mr. Ehinger, I want to begin with just a general question, sir. What effect do you believe a broad, loosely defined fiduciary standard will have on retail, investors, and families who purchase insurance or other financial products?

Mr. EHINGER. Thank you, Congresswoman Wagner. I appreciate the question. I also wanted to repeat one of your statements, that this is a solution in search of a problem, for sure. But I think in answer to your question, almost certainly it could create some increased liability. My concerns would be that particularly with respect to the life insurance business, there would be a shift to other kinds of products, non-bearable products, which in essence means less choice. I also think many insurance agents may choose not to stay registered, again not offering the opportunity to their clients perhaps to have the choices that are available at this point today.

So I think that, coupled with higher costs, that again will be passed on in some regard could have a detrimental effect on, really the accessibility for products and services to all—

Mrs. WAGNER. I couldn't agree more. Again, Mr. Ehinger, in the Section 913 study, the SEC failed to identify any kind of systemic harm or disadvantage being done to investors under current standards of conduct. How do you feel that omission undermined, or misinformed the study's recommendations to adopt a uniform fiduciary standard?

Mr. EHINGER. I think the only thing that has been found—and I will reference back to the 2008 Rand study—with respect to the concerns about not understanding the legal responsibilities is confusion. And it is our view, our position that confusion is not resolved by changing legal structures, and creating more confusion, by having multiple definitions of what, even the term fiduciary means.

Confusion is resolved by proper, simplified disclosures, we think with access to better information in a more in-depth way. And in addition, education, and the SEC has a division really set up to address that, as well.

Mrs. WAGNER. I think those are the two big takeaways. I know you have mentioned the 2008 Rand study, as have I, about the confusion issue. But to me, the most interesting thing about that study is that they said that generally, most investors and families were very happy with the services that financial professionals were in fact providing them. So I think those are the two big interesting takeaways there. So then it would seem, as the SEC pointed out in their study, that investor confusion is the real issue to be addressed.

And for the record here, I do want to state that I do believe it is a completely legitimate concern. But, do you feel that there are better ways for the SEC to address investor confusion, as opposed to making wholesale changes in the way that financial professionals are regulated?

Mr. EHINGER. I do, absolutely. And so I am reiterating what I mentioned before and that is to more properly and in a simple way, disclose really the roles and responsibilities of the investment folks who are working with individuals. And also to really support the educational efforts, as well. I think the other side of that is really if there is some concern about that confusion, one of the things that ought to be understood is really what the gaps truly are between the different ways that regulators, whether it is the B.D. regulators, or whether it is the SEC regulators act in practice.

Mr. EHINGER. Because the term, fiduciary, while it may appear, and it may sound as a higher standard, in practice that standard really depends on how it is really enforced, how it is really complied with.

Mrs. WAGNER. I appreciate that. I have limited time. Mr. Quaadman, you used a phrase in your testimony that caught my eye. You stated that the SEC has shown benign neglect to retail advisers through past rulemakings. Who will ultimately pay the price if fiduciary standards are broadly applied with little regard to the cost or restrictions on choice that would come with it?

Mr. QUAADMAN. Thank you for asking that question. First off, in terms of investor confusion that you were talking about and the increased cost, it is going to be the retail investor that is going to face that confusion, face that cost. And, in fact, they actually may have less products to choose from if we don't have coordinated rulemaking.

What has also been clear with the SEC, in terms of their policies over the last several years, which is why we use that term, in terms of enfranchising retail investors or retail investor protections, whatever, they have always gone down to the bottom of the list in favor of institutional investors and others, so that, unfortunately, it is the mom-and-pop shareholder who has really been neglected and is unfortunately going to pay a price at the end of the day.

Mr. HURT. Thank you, Mr. Quaadman.

Mrs. WAGNER. Thank you.

Mr. HURT. I thank the gentlelady, and the Chair now recognizes Mr. Scott for 5 minutes.

Mr. SCOTT. Thank you very much. As I said in my opening statement, we have to get sort of a delicate balance on many of these issues. Let me talk about the first one. We have a serious problem in this country and that problem is this wide gap between what those at the top are making and those in the middle are making in terms of income. And so, Dodd-Frank attempts to address that.

I heard some of the same arguments against that, that we had on say on pay. I have nothing against people making as much money as they want to make, and can make. And I don't think there is anything in this section that does that. But we have a serious problem. And the country cannot go on with this huge wage and income gap between the top half of 1 percent, our CEOs making gobs of money, which they have a right to do, I don't question that. But when you get to the middle class, this country's heart and soul is based on the middle class, and it is shrinking.

And so, Mr. Silvers, I would like for you to address for a moment why this is so important and how we can remove some of the arguments—and Mr. Smith, you make good arguments, and I want to come to another point, because I think I agree with you on this necessary audit rotation, which I want to get to, as well.

But Mr. Silvers, please address why this is really, really important and give some factual information as to where we are going if we don't address—we will not have a middle class.

The other point I want to make is that these people, these are public companies. And these individuals of the middle class make investments in these companies. They have a right to know, and I think what we are trying to do with this ratio is to try to come up with some mechanism that would encourage a fairer deal in compensation for the middle class.

Mr. Silvers?

Mr. SILVERS. Thank you, Congressman Scott. Let me begin with your point about income inequality.

CEO pay, at the height of the post-war economic boom, when corporate profits were highest and when middle-class income growth was strongest, was 24 times that of the pay of the average worker. Now today, there are different studies with different numbers, and my testimony cites a study by Bloomberg, the news organization, which finds that average CEO to worker pay ratio in the S&P 500 is 204 to 1.

Other studies have found in varying years in the last decade, the ratio is as high as 500 to 1. There are two things about these studies, though, that make them limited in understanding just how bad the problem is that would be corrected if the SEC were to issue the implementing rules on the Dodd-Frank measure that we are discussing this morning.

The first problem is that these numbers are actually not firm-specific, meaning it is impossible for anyone—you, in your role as a legislator, an investor, an employee, anyone—to know what those numbers are company by company and to make judgments based on what those numbers are.

And this is important because academic study after academic study cited in my written testimony, and the wisdom of management experts like Peter Drucker, is that this ratio is a key window into whether or not companies are actually being run as teams and whether or not they are going to be capable of generating long-term value over time.

The other issue, and it has been cited by several of my fellow witnesses in a kind of upside-down way, but the other issue is we live in a global economy. If you want to understand how a global public firm is being run, and whether it is being run in a manner that is sustainable and is likely to produce maximum effort on everyone's part, you need to know what the executive pay—how the executive pay looks for the firm globally.

I'm sorry, sir.

Mr. SCOTT. I only have 20 seconds, and I think those are excellent points. We have addressed that a little.

But Mr. Smith, I think your point is well-taken. I have concerns about this mandatory rotation of audit firms. Auditing and accounting firms get right to the skeletal operations, the intricacy, the complexities of companies in dealing with taxes, audits, all of that. You can't get more deep penetration.

And I think there is something lost if we try to mandate that industry, put a time scope on how long or what accounting companies can do and then they must rotate when the whole purpose in the accounting firms is familiarity. So I am with Mr. Silvers and with Mr. Smith, I think those are the two major bills that we have to examine closer. Thank you, Mr. Chairman.

Mr. HURT. I thank the gentleman. The gentleman's time has expired. The Chair now recognizes Mr. King from New York for 5 minutes.

Mr. KING. Thank you, Mr. Hurt. And I intend to yield time back to you. But first, I would like to ask Mr. Quaadman whether he believes there is a need to study the cumulative impact of the Dodd-Frank rulemakings? And are you aware of any estimates regarding their impact to date?

Mr. QUAADMAN. Thank you, Mr. King. If you just take a look at some of the bills here, as I mentioned before, pay ratio could cost $7 million for a large company. If you take a look at audit firm rotation, you could have a firm that spends $100 million on audit costs, and that could go up by at least $20 million. Just those two bills alone could cost a company $27 million.

We also have to take a look at the Volcker Rule and others, to take a look at the money market fund regulations that are coming down that could boost the cost of capital for some firms by 400 basis points. So we think that a study like that is needed.

Mr. KING. Thank you. I yield the balance of my time to Mr. Hurt.

Mr. HURT. Thank you, Mr. King. I would like to just focus a couple of questions on the audit firm rotation bill. Obviously, investor protection is an extremely important jurisdiction of this committee and the SEC and the PCAOB.

But I was wondering if I could get Mr. Quaadman just to talk briefly about the protections that are already organically found within the corporate audit committee process. And what are the incentives? If you could just talk about that broadly in terms of investor protection?

Mr. QUAADMAN. Thank you, Mr. Hurt. First off, Sarbanes-Oxley greatly strengthened audit committees and the role that they have and the independence that they have. So Congress, through its directive, has actually authorized the audit committee to really be the overseer of financial reporting for a company.

What is happening here is that what the PCAOB has been looking at for 2 years, despite overwhelming opposition, is to actually neuter the audit committee, go against what Congress wanted to do and really start to create rotation.

What is also going on, and I just want to throw this out there, is this isn't happening in a vacuum because in the European Union, they are not only looking at mandatory audit form rotation, but they are also looking at something known as mandatory re-tendering, which means that every couple of years, a company has to go out regardless and just solicit new bids.

This is just going to create a vicious cycle where there is going to be constant marketing going on and actually everybody's—their eyes are going to be taken off the ball of, in terms of good financial audited financial statements.

Mr. HURT. Thank you. Mr. Smith, over the years this issue has been looked at before, the audit firm rotation. Could you talk a little bit about what findings and conclusions have been made in previous bodies that have examined this issue?

Mr. SMITH. Yes, thank you. When I looked at it—I am trying to remember the exact years, but it is in my written testimony—there were findings that showed several failures that were the result of the weakened state of the audit committee, as the reports were—I am sorry, not of the audit committee, of the audit firms, in doing their audit in those reports as they were considering this rulemaking 3 separate times over the last decade or so.

So the record is clear in those committee reports with respect to the weakening of the audit committees.

Mr. HURT. And can you talk a little bit about the actual costs that this suddenly accrues to the company, and are there any benefits? If we are going to talk about the cost-benefit side of this, in your opinion, do the benefits, if there are any benefits, outweigh the costs?

Mr. SMITH. Sure. As we surveyed our members, the members responded that they would expect to see at least a 20 percent increase in the audit costs over—

Mr. HURT. Which is consistent with the GAO study.

Mr. SMITH. And the GAO even went further and they had a range that averaged approximately 80 percent of an increase just in the first year alone. And so what happens is you combine that increase in costs and the perceived benefit of independence and audit skepticism. But what really happens as we sieve through those concept releases is that not only do you have the increased costs but you also have a deterioration and a learning curve that is going on at the audit firms, which is substantial, and creates risks that an audit committee should be—I believe, have a choice and exercise their fiduciary duties in order to make that decision as opposed to having it mandated.

Mr. HURT. You think that the imposition of such a rule would affect your company's competitiveness and the competitiveness of American companies generally?

Mr. SMITH. I think it would be hard to say that increasing our costs by a substantial amount in the millions of dollars, which would be money that otherwise would be used for capital improvements and capital investments on infrastructure or creation of jobs through other investments, would not harm the economic state of our company or any other—

Mr. HURT. Thank you, Mr. Smith. And I think the gentleman's time has expired.

I recognize Mr. Himes for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman. I was moved by Congressman Scott's comments and want to associate myself with those comments. I honestly don't know whether disclosure is going to fundamentally alter compensation in this country. But I know that in addition to the economic challenges that the disparity creates, there is a perception of fairness issue that is terribly important.

And in the presence of members of the industry, I have been in those meetings where compensation is determined always with an eye to comparability, comparable pay. I would suggest that we have to start going to fairness or we will be in a lot of trouble.

Mr. Silvers, on H.R. 1105, you talked about the leverage limitation, the 2X leverage limitation. You said this limitation was clearly drafted in bad faith. Mr. Silvers, I drafted that limitation, and I object on two counts. One, I see what happens to this institution when we challenge each other's good faith or thereof, and I also see what happens when we get to each other's motivations.

But more importantly, I drafted this leverage limitation because of a criticism that you raised 2 years when you came before this committee and said these are large leveraged pools of capital. Now in discussion, we ultimately determined that they are not large leveraged pools of capital, that in fact they create leverage at the industrial company level that they purpose.

But I thought, gosh, a lot of people out there think that they are a large leveraged pool of capital, and perhaps we ought to address that by saying that if they were to become such, we should put a limitation on them. Mr. Silvers, since you got this personal, I would point out that I have about a 95 percent AFL-CIO voting record. So I suspect that we can philosophically find agreement on many issues. But I do want to pursue this issue now that we have moved the discussion to the sponsored companies, the Burger Kings, and the car wash companies that LBO firms, love them or hate them, invest in.

I am wondering whether anybody on the panel can point to a Burger King—and by the way, there have been monumental failures, for example, Federated Department Stores. Can anybody on the panel point to an LBO'd or an MBO'd company that went down because their banks made unwise decisions or because bondholders made unwise decisions that created systemic risk? An LBO private equity purchased company that got leveraged the way companies do every single day in our economy, that went down and created a systemic problem for the United States of America. Okay. That is a lengthy period of silence.

So what I—Mr. Silvers, you move on to the bond market. And I have two questions. You move on to the bond market in your testimony here. And I agree with you, by the way. I suspect that there may be a bubble developing in the high-yield market.

But I am puzzled by using that as an argument against a bill which simply attempts to take the smaller private equity companies, unleveraged by definition because of that limitation that I put in, and not have them sending reams of data to the SEC that is a burden to them and which we have acknowledged doesn't create systemic risk.

How does the existence of H.R. 1105 or the nonexistence of H.R. 1105 in any way impact the bond market, and in particular the high-yield market? If H.R. 1105 passes, is the high-yield market going to be any different?

Mr. SILVERS. Congressman?

Mr. HIMES. Yes.

Mr. SILVERS. Your statement ratifies my criticism of your bill because you make clear that you understand that the issue of leverage in the leveraged buyout or private equity business is an issue of portfolio leverage and not of firm leverage, and that you understood that when you wrote the bill. I think that is all there is to be said about this.

Mr. HIMES. You and I both know that these entities don't take on leverage. By the way, 2 years ago you testified that they were highly leveraged pools of capital.

Mr. SILVERS. No. I disagree with that, Congressman.

Mr. HIMES. Well, the record will show it. But I—out of an abundance of caution—put in that limitation. I was on the high-yield market. I have one other question, though. H.R. 1105—this is your testimony—would deny investors and private equity funds, including worker's pension funds, protections of investing with a registered investment adviser. And I take that very seriously.

My understanding is that investors like the AFL-CIO pension funds and others which invest in these funds are accredited institutional investors, that is to say, sophisticated investors. And my understanding further is that they negotiate partnership agreements with these funds in which they say, we want this kind of disclosure.

We want this—that there is a negotiation in which those accredited and institutional investors receive protections that a retail investor couldn't possibly hope to negotiate with respect to a company they may invest in. So where is the investor protection angle here?

Mr. SILVERS. Congressman, you rightly point out that there are some pension funds that are large enough dealing with large leveraged buyout firms or hedge funds or venture capital firms in certain market conditions to effectively negotiate bespoke or customized terms. That is true.

Our concern is that those funds are not the only funds that are out there. There are many smaller funds, and there have been market conditions over the last 15 years in which even large funds had effectively no ability to negotiate fundamental investor protections such as the ones that you cited from my testimony.

Registration with the SEC as an investment adviser protects all of those funds, right? And as we both know, the limitations on who can invest in a private equity fund, a leveraged buyout fund, a hedge fund, a venture capital fund, those limitations ensure that we are not talking about mom-and-pop investors anyway.

Mr. HURT. The gentleman's time has expired.

Mr. HIMES. Thank you, Mr. Chairman.

Mr. HURT. The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. I intend to yield my entire 5 minutes to the gentlelady from Missouri, Mrs. Wagner.

Mr. HURT. Mrs. Wagner is recognized.

Mrs. WAGNER. Thank you very much, Mr. Mulvaney, and Mr. Chairman. Mr. Ehinger, just in follow up here, in the Section 913 study, the SEC staff claimed that it is not likely that many broker-dealers would "implement major changes to their businesses in response to the imposition of a uniform fiduciary standard." And it also went on to say that the uniform standard would "not require that broker-dealers limit the range of products and services they currently offered to retail investors."

I guess I would be interested in both Mr. Ehinger and Mr. Quaadman, do you agree with either of these assessments?

Mr. EHINGER. I do not agree. I think having the experience of 3 decades, as I said, of being involved in the broker-dealer securities and insurance business, I can say that the changes would be many.

First of all, compliance oversight, and perhaps even expectation of plans for any and all transactions, whether they were solicited or unsolicited types of transactions, would probably come into place: disclosure document requirements; more complex audits; and supervisory reviews.

The supervision that we do in our firm, we will look at the transactions and the insurance products that are sold in particular on a one-on-one basis specific to that situation. And if we are looking at that relative to plans as such, it could be very difficult to discern what is best.

We have already spoken to some of our liability insurance organizations, errors and omissions insurance in particular, who estimate that costs would increase as much as 20 to 30 percent to anticipate this. Not to mention what I mentioned earlier, and that is the unknown. That is the legal liability cost that there is, as well. I think there would be many changes.

Mrs. WAGNER. Mr. Quaadman?

Mr. QUAADMAN. I echo the same concerns. We have talked to our members about this, and we are getting a lot of the same feedback also.

Mrs. WAGNER. Great. Wonderful. Thank you. I yield back my time to the Chair. Mr. Hurt, if you have any—

Mr. HURT. I thank the gentlelady. The gentlelady yields back. The Chair now recognizes Mr. Carney for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman. Thank you to the panelists for coming in. I would like to go back to the discussion about costs of audit rotation. Mr. Smith, there was some discussion a couple of questioners ago about those costs.

Could you summarize them again and talk specifically about what the costs—what drives those higher costs from the GAO study and the survey, I think that you said you did, of corporate secretaries? What are the elements of those higher costs? Eighty percent in the one case, and I think you said 20 percent in terms of your corporate secretaries. If that wasn't the number, whatever that number is.

Mr. SMITH. It was 20 percent and 80 percent, respectively. One example of one of our members that we have documented in the written testimony is a large global company that voluntarily rotated its audit firm within the past 10 years.

And I have ballparked its numbers, but in the written testimony, I break it down showing that they estimated that there were approximately 100 hours of audit committee time that were utilized, 500 to 600 hours of senior management, and 2,000 to 3,000 hours of finance, legal, tax, accounting, and internal audit employee's times. And so, if you think about—

Mr. CARNEY. So as you transition from one firm to another, it involves a lot of extra time of staff to bring that firm up-to-speed on the particularities of that company's operation.

Mr. SMITH. Absolutely. So if you picture an audit committee who is independently charged with making sure that the audited financials are correct and accurate, and they are thinking about making a change, they have to go through for the shareholder's benefit, and we are all happy that they have to, to examine any potential firms that are coming in to make sure that they can get the same high level of comfort that they have with their current firm in order to make a decision to transfer it.

They would also then have to go through a process of documenting and making sure that reports were put into place and transition plans were put into place that begin the transition. And then afterwards, there are heightened levels of double-checking to make sure that everyone followed the processes needed to do that. So, it is just a tremendous amount of work.

Mr. CARNEY. Presumably, there are some benefits involved in the rotation. Mr. Silvers expressed his objection to the bill. And I guess I would ask you, Mr. Silvers, what the benefits are opposite those costs and why you think they are justified?

Mr. SILVERS. In my written testimony, I—

Mr. CARNEY. And I think there was other testimony, and somebody can correct me if I am wrong, that there are really effectively only two or three firms that actually do this.

Mr. SILVERS. Congressman, in my testimony, I go into, at some length, the challenges of this issue. Because there are currently really only four global audit firms, and some of them have specialties, and companies can find themselves in really challenging spots. The issue on the other side, though, is the question of auditor independence. And the issue of whether or not the same company has had the same auditor for decades, for example, which is true in the case of some long-lived companies, whether there really can be the requisite level of independence at that point?

Mr. CARNEY. Yes, I understand that. Is there anything in Sarbanes-Oxley, for instance, that puts something in the audit committee to balance that out? You, or Mr. Smith, either one?

Mr. SILVERS. Congressman, there is no question, as one of the prior witnesses said, Mr. Quaadman I believe, that Sarbanes-Oxley strengthened auditor committee independence, and made the relationship between auditors and issuers more independent. We have been though for the last 10 years since Sarbanes-Oxley passed, more than 10 years we have been in this environment with only 4 major audit firms. And we have been through a major financial crisis that raised serious issues about whether the current—about whether the audit firms really performed their roles properly.

In my written testimony, and earlier in this hearing, I mentioned that the PCAOB has done extensive examinations of what occurred during that crisis. And they are in relation to auditor independence. The PCAOB's interest, as I understand it, and I serve on the standing advisory group for the PCAOB's interest in auditor rotation is, I believe, based significantly on the results of those inspection reports. And I would urge—before this subcommittee moves on this bill—

Mr. CARNEY. I am running out of time, and I would have liked some time to talk a little bit about the systemic risk that—and some of the other bills, but did you have something else, Mr. Smith, you wanted to add?

Mr. SMITH. If I could. Your question was on what Sarbanes-Oxley did to strengthen—

Mr. CARNEY. Right. Does it counterbalance this issue of independence?

Mr. SMITH. —and so the audit committees were strengthened. There is a requirement that they be completely independent, and that is modified in the major exchange rules as well. There is also partner rotation that must occur on a regular basis. And so, if you think about what partner rotation does, it brings a fresh set of eyes. Someone who presumably is not cozy with management, if that were the case anyway, to make sure, and to have that fresh look. So—

Mr. CARNEY. And presume, actually, some additional cost. Thank you.

Mr. SMITH. Correct.

Mr. CARNEY. I see my time has expired.

Mr. HURT. The gentleman's time has expired. The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, who is also the patron of H.R. 1135, for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman, I appreciate that. And I would be more than willing to grant my friend 30 seconds if he wanted to pursue that line of questioning on the systemic risk? It may be a continuation of a conversation we already started.

Mr. HURT. The gentleman is recognized for—

Mr. CARNEY. Yes, I just wanted—

Mr. HURT. —30 seconds?

Mr. CARNEY. —to go back to the back-and-forth with my colleague Mr. Himes, Mr. Silvers. And I am at a loss to understand how the two pieces of legislation that are being discussed implicate systemic risk? And maybe you could summarize that briefly?

Mr. SILVERS. Congressman, you mean the registration—

Mr. CARNEY. Both the registration one and the pay ratio one.

Mr. CARNEY. I understand the overall purpose in pay ratio in particular. But I don't understand how it implicates systemic risk.

Mr. SILVERS. I will start with CEO pay, okay?

Mr. CARNEY. All right.

Mr. SILVERS. As I stated in my written testimony, the CEO pay rule does 3 things. It proves the ability to look at firms and whether they are essentially unbalanced in the way they are managed, right? Such that CEO—

Mr. HUIZENGA. Before I reclaim my time, I am going to have you hurry that up very quickly, because it is eating into my time, and I have some questions, as well. Because I am at a loss, as well.

I appreciate that. I am at a loss as to how this possibly puts companies, or a system at risk. Systemic risk was something that you were talking about, and it seems to me—and we had some conversations here about Dodd-Frank not only being a regulatory bill, but it is a social engineering document, I understand that might have been the motivation for some in the drafting of it. I am just afraid that this is more of a knee-jerk reaction to any kind of discussion about changing, improving, or looking at, or opening up Dodd-Frank. And we saw that 2 weeks ago when the Administration, through Secretary Lew, opposed all of the bipartisan derivatives bills.

We are seeing that now, I think. And it seems to me that this is part of the problem with Washington, D.C. We can't have a rational conversation without somebody having a knee-jerk reaction. But Mr. Quaadman, Mr. Smith, Mr. Tharp, obviously you heard Mr. Silvers report that my legislation specifically would significantly increase this risk, and I am very curious to see whether you agree with that. And whether that creates pitfalls in our economy? And how disclosing CEO to worker pay ratio determines the performance of these companies with a particular sector in the market?

So if you don't mind, in my remaining 2 minutes?

Mr. QUAADMAN. Okay Mr. Huizenga, if I could answer that in two ways, and also to take up something that has been discussed by both Mr. Silvers and Mr. Scott, Dodd-Frank actually mandates that there is a joint rulemaking, which is not yet complete, on intent of compensation rules, which is supposed to look at excesses in compensation, and to deal with potential issues of compensation in the financial crisis. So regulators are already looking at that. Pay ratio in and of itself isn't designed to deal with those systemic risk issues.

Second, in answer to your question, let me just give two examples. If you were to take a company, let's say a retail chain or a fast-food chain or whatever, that has a lot of hourly workers, they are going to have a high differential. If you take a Wall Street firm where you could have a lot of employees making comparable pay to a CEO, they are going to have a very low ratio. So what does that ratio tell you about the company? About the industry? It doesn't convey anything that is material to investors. And materiality should be the test.

Mr. HUIZENGA. And Mr. Tharp?

Mr. THARP. Congressman, I think it is a great question that there should be an assessment to the extent to which the purported relationship between pay ratio and risk would be a factor. And in fact, in the written testimony from Mr. Silvers, he cites James Collins' work on "Good to Great." And we did a little research. Those companies in fact have a higher pay ratio than the average company, and of the 11 cited—in fact one went bankrupt and the other was Fannie Mae, but their ratio is 412, versus the—and this is AFL-CIO data, versus the data of the average CEO, which is 354, according to their data.

Mr. HUIZENGA. Yes.

Mr. THARP. So, I think there should be challenges to the basic assumption that it does lead to better performance, or—

Mr. HUIZENGA. I agree, and I am very familiar with "Good to Great." I came out of an organization which used that book as a basis of how it operated. And, I am tempted to take a friendly amendment from somebody that would require union executive pay to be compared to union membership pay. And then maybe we should expand that to who they are affiliated with in France, the Philippines, Greece, and others, to get a better picture, rather than hiding "material information."

And I think that everybody would realize that with 57 unions, and 12 million members, even the AFL-CIO would have some difficulties in doing that. Mr. Chairman, my time is up, and I appreciate that.

Mr. HURT. Thank you. The gentleman's time has expired. The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you. Mr. Quaadman, we have been working on a separate issue, which is the proposal of the FASB to require the capitalization of leases. They are supposed to define Generally Accepted Accounting Principles (GAAP). It has been generally accepted for 200 years that you don't do that, where our profession is only 200 years old. Why don't I ask you to just spend a minute explaining what the harm would be if that proposal goes forward?

Mr. QUAADMAN. Thank you, Mr. Chairman. Thank you for your leadership on this issue, along with Mr. Campbell. What this would do is it would—number one, it would actually boost up the liabilities that are on balance sheets of companies by trillions of dollars. That would actually impact their ability to raise debt. It would also increase reporting requirements as well as onerous requirements. It would also shut down the ability of companies to get equipment. And also for commercial real estate tax refunction.

What is more important, however, is that the investor community 3 years into this project has said that this exposure draft will not provide any more additional information than they already have today. So while you have all of the costs that are going to be borne by businesses, investors aren't going to be benefited. So it is really a question of why are we even doing it?

Mr. SHERMAN. And wouldn't we be penalizing those companies that enter into 5- and 10- and 20-year leases, and give a push towards less certainty in stability in leases, communities, shopping centers, et cetera?

Mr. QUAADMAN. That is correct. It actually will focus business activities on a much shorter-term basis and less on a long-term basis.

And it will also artificially force an earlier recognition of expenses than actually happen.

Mr. SHERMAN. I want to turn to, I guess, Mr. Smith, on the audit rotation. One concern I have is, we only have, as you point out, four firms. Could there be a circumstance where there are only two firms with the capacity, both in terms of having offices in the right place, if you are headquartered in Wichita, only one of those firms may have an office in Wichita. You may be in an industry that only a couple of firms have specialty in.

So if we currently return Firm A, and the only other firm in the world that can do it is Firm B, and we have to abandon firm—right now we can always tell Firm A to keep their fees down, otherwise we will go to B. If you require me to go with B, how high will the audit fee be then?

Mr. SMITH. Yes, and even more troubling is that it takes away the competitive nature of the transfer for sure, right? Because they know that you are going to be coming to them, so there would be no competitive negotiation of the transfer fee, presumably. But even additionally, the feedback from our members is—and specifically in certain industries where you only have two audit firms that would be qualified, or expertise to the level that would make an audit committee comfortable, both of those firms may be engaged by that company in the first instance, right?

Because there are non-audit fees that are being used, and so you could already have them engaged on matters that—you are already working with them, so is there really that transfer you are looking at? So I think there is a hyped—

Mr. SHERMAN. Now—

Mr. SMITH. —perception that there would be an independent shift in that case. Having said that—

Mr. SHERMAN. —you pointed—

Mr. SMITH. —the firms—the large firms work closely with those companies anyway.

Mr. SHERMAN. —you pointed out that currently there is at least rotation of the engagement or audit partner?

Mr. SMITH. Correct.

Mr. SHERMAN. One thing I bored my colleagues with is—and I don't know whether this has become just practice or whether it is mandated, that the technical review department of the audit firm actually sign off. Arthur Andersen had a policy of don't ask, don't tell, that is to say, the technical review department, if they weren't asked, they didn't tell.

With the four firms that still exist, is there at least a practice and is there a mandate that the technical review department actually review the audit before the sign-off?

Mr. SMITH. My understanding is that the concurring partner relationship has been significantly strengthened as a result of the audit changes that took place through 2003 in Sarbanes-Oxley.

Mr. SHERMAN. And then, finally, you quantified the additional work that the company has to do when they change auditors. What is the increased fee likely to be? It is not only the time of their own employees, but they are going to have to write a bigger check. Any idea what the start-up fee, changeover fee, additional fee is as a percentage?

Mr. SMITH. Other than those percentages, I really don't have hard numbers at my fingertips right now. But they would be expected to be very significant and—

Mr. SHERMAN. Half a year about?

Mr. SMITH. At 80 percent, according to the GAO study. You are really looking at almost double the audit fees, which—

Mr. SHERMAN. So you pay 108—

Mr. SMITH. —if you have a $8 to $10 million audit fee, then you are looking at almost $6 to $8 million in increased costs.

Mr. SHERMAN. Thank you.

Mr. HURT. The gentleman's time has expired.

Let me again thank the witnesses for their testimony today. I also thank you, in addition to your insights, for your patience as we had to work through our voting schedule.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, the hearing is adjourned. Thank you.

[Whereupon, at 1:52 p.m., the hearing was adjourned.]

A P P E N D I X

May 23, 2013

OPENING STATEMENT OF REP. BILL HUIZENGA

House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators

May 22, 2013

Chairman Garrett and Ranking Member Maloney, thank you for holding this important hearing to discuss legislative proposals to help reduce the regulator red tape burden on investors and job creators.

I, along with Subcommittee Chairman Garrett, introduced H.R. 1135, the Burdensome Data Collection Relief Act, a bill to repeal the pay ratio disclosure mandate in Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This disclosure requirement creates an administratively burdensome reporting requirement in which the costs far outweigh the benefits and fail to provide shareholders with useful information or facilitate a better understanding of pay practices.

Under Dodd-Frank, Section 953(b) requires all publicly traded companies to calculate and disclose for each filing with the Securities and Exchange Commission the median annual total compensation of all employees of the company excluding the Chief Executive Officer (CEO), disclose the annual total compensation of the CEO, and calculate and disclose a ratio comparing those two numbers.

This onerous 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 executive officers. Many global companies have tens of thousands of employees located in dozens of countries. Additionally, the pay ratio of a particular company depends on a variety of factors, such as the industry in which the company operates, the geographical locations of the company, the types of employees that make up the company, and the competitive market.

Needless to say, this pay ratio requirement places a significant burden on publicly-traded companies that would provide very little, if any, benefit to investors. By removing this regulatory burden, companies will be able to more effectively and efficiently use their resources to create more jobs in the workforce. I urge swift passage of H.R. 1135 and I look forward to hearing from the distinguished panel.

Testimony of Mercer E. Bullard

President and Founder
Fund Democracy, Inc.

and

Jessie D. Puckett, Jr., Lecturer and
Associate Professor of Law
University of Mississippi School of Law

before the

Subcommittee on Capital Markets and
Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

on

Legislative Proposals to Relieve the Red Tape Burden
on Investors and Job Creators

May 23, 2013

Chairman Garrett, Ranking Member Waters, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss legislative proposals being considered by the Subcommittee. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a Jessie D. Puckett, Jr., Lecturer and Associate Professor of Law at the University of Mississippi School of Law. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the Public Company Accounting Oversight Board's Investor Advisory Group; and an Accredited Investment Fiduciary. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee; an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

This testimony is based on my general experience over a number of years as an investor advocate, journalist, academic, regulator, financial planner, private practitioner and expert witness and consultant. I have been engaged in financial services regulatory issues from a variety of perspectives and attempt to provide testimony that reflects the interests of investors, diverse views of various constituents, and the practical exigencies of real-world legal practice and compliance.

In this written submission, I have focused on the Wagner Fiduciary Discussion Draft, which I refer to as the "Act." Part I of my testimony addresses the cost-benefit provisions contained in Sections 15(k)(1) – (3) of the Act (for clarity, I refer to the "Sections" as they would appear in the Exchange Act, as amended). Part II addresses the coordination provision in Section 15(k)(5). Section 15(k)(4)'s customer confusion provision is discussed in Part III, and Section 15(k)(6)'s investment adviser rulemaking provision is discussed in Part IV.

In summary, the Act's cost-benefit provisions would improperly constrain the SEC's ability to do what Congress asked it to do by authorizing rulemaking under Section 913 of the Dodd-Frank Act. Section 913 commanded the SEC to consider whether broker-dealers, like investment advisers, should be subject to a "best interest of the customer" standard when providing personalized, retail investment advice. The Act would substantially impede the SEC's ability to analyze this option, much less to propose a rule.

The interagency coordination of rulemaking provision, to the extent that the "conflicts" it addresses are limited to actual conflicts, is appropriate. However, the provision appears to reflect an ultimate goal of preventing the Department of Labor from moving forward with a fiduciary proposal that may impose more stringent requirements than SEC rules impose. First, it is the employee benefits law created by Congress that mandates more stringent requirements for retirement plan investments. Second, the Act's coordination provision may reflect concerns regarding the DOL's initial fiduciary proposal, but the DOL has withdrawn that proposal and indicated that it plans to issue a substantially revised re-proposal in a matter of months. Before acting on the DOL's new proposal, Congress should at least determine what the DOL is proposing.

Finally, the customer confusion and investment adviser regulation are fundamentally flawed. The customer confusion provision effectively provides that investors are to be denied the benefit of a fiduciary rule for broker-dealers unless they can demonstrate an improved understanding of the legal duties that apply to broker-dealers. This provision suggests that confused investors are the problem. In fact, the problem is caused by rules that apply different standards to different financial professionals providing the same services.

The investment adviser rulemaking provision essentially requires that the Commission impose unrelated regulations on investment advisers, regardless of whether such rules are warranted, as a condition of adopting a best interest standard for broker-dealers. The provision appears to be nothing more than a rent-seeking effort by one industry to gain an advantage over another simply by subjecting to them to more rules.

I. Cost-Benefit Provisions

The cost-benefit provisions in Sections 15(k)(1) – (3) of the Act reflect generally appropriate aspirational standards for rulemaking, but as statutory mandates they will adversely affect the SEC's ability to decide how best to exercise its authority under Section 913 of the Dodd-Frank Act. These provisions will distort the integration of cost-benefit analysis into the SEC's rulemaking; further substitute expert agency discretion with inexpert judicial rulemaking; create legal uncertainty; chill necessary rulemaking; generate unnecessary and unproductive litigation; increase the SEC's operating expense and size while impeding its efficient operation; and promote the development of non-uniform, enforcement-based law.

A. The Burdens of Cost-Benefit Requirements

The Act's cost-benefit provisions will create redundancies and confusion that will only impede the SEC's ability to conduct a balanced cost-benefit analysis of the efficacy of fiduciary rules for broker-dealers.[1] SEC rulemaking is subject to a panoply of cost-benefit analysis requirements that already substantially and unnecessarily interfere with the process of efficient rulemaking. Section 2(b) of the Securities Act, Section 3(f) of the Exchange Act, Section 202(c) of the Investment

[1] *See* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (May 22, 2013) ("The overall effect of the proposed legislation would be to place unreasonable conditions on the Securities and Exchange Commission as it considers whether to raise the standard of conduct that applies to brokers when they give personalized investment advice to retail investors.") *available at* http://www.consumerfed.org/pdfs/CFA-AFR-Wagner-Bill-Opposition-Letter.pdf.

Advisers Act and Section 3(c) of the Investment Company require that the Commission, when adopting rules under those statutes, "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[2] Section 23(a)(2) of the Exchange Act requires that the Commission "consider . . . the impact . . . on competition" and prohibits the adopting of any rule that "would impose a burden on competition not necessary or appropriate in the furtherance of the purposes of [the Exchange Act]." That provision also requires a written statement of the "reasons" for a determination that any [such] burden on competition" is necessary and appropriate in the furtherance of the purposes of [the Exchange Act]." These provisions are themselves substantially redundant statements of the "arbitrary and capricious standard" of review under Section 706 of the Administrative Procedures Act, which provides that a court shall vacate agency rules that it finds, among other grounds, to be "arbitrary, capricious, [or] an abuse of discretion." The operation of this particular standard as a constraint on rulemaking has been repeatedly demonstrated by courts that have vacated SEC rules deemed to be arbitrary and capricious.[3] The arbitrary and capricious standard has repeatedly proved to provide all of the leverage needed to overturn agency rules that do not reflect good cost-benefit analysis.

The Act does nothing to clarify or otherwise improve cost-benefit requirements that already apply to SEC rulemaking. Rather, the Act adds complexity and cost to what is already an overly cumbersome web of rules about rulemaking. It

[2] The full text of Section 2(b) is as follows:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[3] *See, e.g., Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (vacating proxy access rule on arbitrary and capricious grounds and because of failure to conduct adequate cost-benefit analysis); *American Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010) (vacating equity-indexed annuities rule on arbitrary and capricious grounds); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (vacating mutual fund rule because of failure to consider costs and alternatives).

repeats requirements that the SEC assess the costs and benefits of any fiduciary rulemaking and creates new, specific lines of analysis – such as section 15(k)(3)'s "harm to investors" inquiry – that add nothing substantive to the SEC's existing procedures. The Act will simply require that yet another piece of analysis be added to any fiduciary rule proposing and/or adopting release that translates the actual cost-benefit analysis conducted by the Commission into yet another redundant legislative framework. The effect on staffing will be to add more hours to the workload of the bevy of lawyers whose primary responsibility is not to develop rules that efficiently regulate the conduct of financial services providers, but to administer rules about rules that regulate rulemaking agencies. These lawyers play an essential role in agency rulemaking, but when their process-based role overwhelms the substantive issues at hand, as legislation such as the Act makes inevitable, government bureaucracy becomes precisely the Orwellian tumefaction that opponents of "red tape" claim to oppose. A former SEC official's assessment of another cost-benefit bill, H.R. 2308, applies equally to the Act:

> the Act would consume vast amounts of SEC staff time with periodic reviews of the existing substantial body of federal securities regulations to find anything deemed "outmoded, ineffective, insufficient or excessively burdensome."[4]

The solution to regulatory red tape is not to expand *infinitum* internal government processes and, consequently, government payrolls so that agencies consume a perpetually increasing share of national resources while creating less and less social value for society. Rather, the solution is to streamline agency processes in order to minimize the role of procedural analysis and maximize the role of substantive analysis. The comments of the official cited above are again apropros:

[4] Hearing before the Committee on Financial Services, House of Representatives at 4 (Sep. 15, 2011) (testimony of Stephen J. Crimmins) *available at* http://financialservices.house.gov/UploadedFiles/091511crimmins.pdf.

> Just as America's businesses need new SEC rules to streamline capital formation and traders need new SEC rules to streamline markets, so also we must give the SEC itself a streamlined process for issuing those rules. The SEC already has to include dozens of pages of detailed cost-benefit and other economic analysis every time it writes a rule, and we don't need to pile on more requirements.[5]

The Act "piles on more requirements" that will expand government while making it less efficient. If Congress wishes to facilitate cost-benefit analysis, then it should begin not by adding to the already byzantine network of administrative shackles, but by streamlining and consolidating cost-benefit and information collection standards so that agencies can focus on the analysis, rather than the analysis of the analysis.

The Act also reflects a popular but erroneous belief that an agency can exhaust every avenue of inquiry that might reasonably lead to a better understanding of a rule's costs and benefits. In fact, regulatory action is invariably based on imperfect information, just as regulation invariably requires the exercise of reasoned judgment in the known absence of information that theoretically could improve the regulatory decisionmaking process.[6] Efficient rulemaking necessarily

---

[5] *Id.*

[6] Former SEC Secretary Jack Katz aptly described this misperception in testimony before the full Committee:

> While I have long supported the use of cost benefit analysis as one component of the rulemaking process, I have also believed that the process has limitations that are often overlooked. Cost-benefit analyses are and will always be fundamentally limited. They require estimates of the impact of events that have not yet happened. Simply put, it is difficult if not impossible for any regulator to know what will happen when a regulation is adopted. Capital markets are the reflection of large numbers of individuals making individual decisions. A regulator rarely has the capacity to predict with certainty how individuals or firms will respond to a new rule. If a regulator can't predict the response, it is difficult to accurately quantify the cost of compliance or quantify the value of benefits before one knows how the industry will achieve compliance. The current means of developing cost benefit analysis may be manipulated or fail to take into account facts that may not be readily apparent yet important to the ultimate purpose of a proposed rule.

Id. at 14, *available at* http://financialservices.house.gov/UploadedFiles/091511katz.pdf.

reflects accepting the reality that decisive action is not possible if perfect information is a necessary predicate. The Act will increase the likelihood that the SEC will avoid taking needed regulatory action simply out of fear that its rules will be vacated for having left some cost-benefit stone unturned.[7]

B. Raising the Bar to Guarantee Failure?

As with other cost-benefit bills, it is unclear what problem the Act is intended to solve. Critics claim that SEC rulemaking has not satisfied existing cost-benefit requirements, and there is support for this critique.[8] However, the SEC's past failure to satisfy current standards would logically support legislation designed to bring about such compliance, not to make compliance more difficult. For example, Congress could provide the Commission with the financial resources that it would need to conduct the cost-benefit analysis that the Act requires.[9]

Instead, the Act raises the bar for the SEC's cost-benefit analysis. This approach is the equivalent of addressing a national deficiency in college students'

[7] *Cf. id.* at 15 (testimony of SEC Chairman Mary Schapiro) (H.R. 2308 "would create a new potential challenge to future rules") *available at http://financialservices.house.gov/UploadedFiles/091511schapiro.pdf. See also* Jesse Hamilton, *Dodd-Frank Rules Slow at SEC after Cost Challenge*, Bloomberg (Mar. 5, 2012) *available at* http://www.bloomberg.com/news/2012-03-06/dodd-frank-rules-slow-at-sec-after-court-cost-benefit-challenge.html; Phil Mattingly & Jesse Hamilton, *Broker Fiduciary Rule Delayed by Cost-Benefit Analysis, SEC Says*, Bloomberg BusinessWeek (Jan. 20, 2012) *available at* http://www.businessweek.com/news/2012-01-20/broker-fiduciary-rule-delayed-by-cost-benefit-analysis-sec-says.html; Peter Madigan, *CFTC and SEC Facing Legal Anxiety Over Cost-Benefit Analyses*, Risk Magazine (Oct. 3, 2011) (published under the original headline: *Cost-Benefit Paralysis*) *available at* http://www.risk.net/risk-magazine/feature/2111501/cftc-sec-facing-legal-anxiety-cost-benefit-analyses.

[8] *See* Hearing before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, United States House of Representatives (Apr. 17, 2012) (testimony of Mercer Bullard) *available at* http://oversight.house.gov/wp-content/uploads/2012/04/4-17-12-Bullard-Testimony.pdf.

[9] Hearing before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives (May 7, 2013) (testimony of SEC Chairman Mary Jo White) ("The S.E.C.'s current level of resources still presents significant challenges as we seek to keep pace with the growing size and complexity of the securities markets and fulfill our broad mandates and responsibilities.") *available at* http://www.sec.gov/news/testimony/2013/ts050713mjw.htm.

test scores by simply raising the score needed to past the test. The only rational explanation for this approach is that the Act is not intended to improve the SEC's cost-benefit analysis, but rather to ensure that, when the SEC *has* improved its cost-benefit analysis, the cost-benefit bar will have been raised to a point that guarantees failure. It appears that the purpose of pending cost-benefit bills is move standards beyond the SEC's reach so as to make legally sufficient rulemaking almost impossible.

Increasing the complexity and burdens of cost-benefit requirements, rather than addressing a perceived failure to comply with existing requirements, is much likelier to degrade the SEC's capacity to make efficient, effective rules than to improve it. The heightened standards of the Act will make it even more difficult for the Commission to conduct fiduciary rulemaking, just as recently passed H.R. 1062 will make all rulemaking more difficult.[10] The purpose of these bills appears to be to prevent rulemaking altogether.

C. Unintended Consequences

Even if the purpose of the Act is simply to insulate broker-dealers from being subject to a fiduciary duty, the Act will not achieve its goal. Regulatory paralysis invariably has unintended consequences that often impose far greater costs on industry than the costs that industry believes it has avoided by preventing rulemaking. The SEC's inaction, for example, in the face of problems arising during the last decade from analysts' conflicts of interest, mutual funds' use of stale prices and inadequate disclosure of revenue sharing effectively ceded these areas to *de*

[10] *See* Melanie Waddell, *House Passes SEC Cost-Benefit Bill*, AdvisorOne.com (May 17, 2013) (quoting SEC Chairman Mary Jo White, H.R. 1062 will put SEC rules "under constant challenge") *available at* http://www.advisorone.com/2013/05/17/house-passes-sec-cost-benefit-bill; Andrew Ackerman, *House Lawmakers Pass SEC Cost-benefit Bill*, Wall St. J. (May 17, 2013) (OMB statement that H.R. 1062 would "add onerous procedures that would threaten the implementation of key reforms related to financial stability and investor protection.").

facto rulemaking by state attorneys general and other enforcement officials. In each case, the SEC's failure to conduct rulemaking resulted in Balkanized, *ad hoc* lawmaking that left all interested parties (other than litigators) worse off. When critics complain that the SEC rulemaking relies on inadequate cost-benefit analysis, they are often choosing, in effect, that law be made through less efficient, less effective means that are more costly to industry.

It is foolhardy to think that agencies will simply surrender to the rulemaking paralysis that the Act and bills like it would impose. Agency leadership knows that they will be held accountable for fraud that occurs on their watch, regardless of whether Congress is the party responsible for the agency's not adopting rules that would have most efficiently minimized the fraud. Agency leadership accordingly will find other, less efficient ways to fill gaps and resolve inconsistencies in the law. This is precisely what has happened in the fiduciary sphere.

The Commission has brought a series of enforcement actions that, in effect, impose a quasi-fiduciary duty with respect to revenue sharing arrangements.[11] Revenue sharing disclosure is precisely the kind of conflict disclosure that a fiduciary duty would clearly require.[12] Courts have found that the nondisclosure of revenue sharing is not necessarily fraudulent. A fiduciary duty (or targeted conduct rule) therefore is necessary to cause disclosure of the conflict of interest that revenue sharing payments. Instead of rulemaking,[13] the SEC has regulated revenue

---

[11] *See* Mercer Bullard, *The Fiduciary Study: A Triumph of Substance Over Form?* (citing cases at footnote 41) (forthcoming in Boston University Review Banking and Financial Law) *available at* http://ssrn.com/abstract=1669636). "Revenue sharing" refers to payments by mutual fund investment advisers to brokers as compensation for selling fund shares. *See* Mercer Bullard, *Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?* 76 U. Cin. L. Rev. 559, 570 (2008).

[12] *See* Michael Koffler, *The Brave New World of Fiduciary Duty for Broker-Dealers and Investment Advisers*, Sutherland Asbill & Brennan LLP, at 13, 24 (Apr. 2010) (subjecting broker-dealers to a fiduciary duty would require that they disclose the revenue sharing payments) at http://www.investmentadvisor.com/Issues/2010/April-2010/PublishingImages/Envestnet_Fiduciary%20Duty.pdf).

[13] In 2004, the Commission proposed a rule that would have addressed revenue sharing disclosure. It re-proposed the rule in 2005, but has continued to be unable to reach a final resolution on this issue.

sharing through enforcement, essentially bringing a series of enforcement actions against broker-dealers under antifraud rules for conduct that is not necessarily fraud.[14] States, FINRA and private litigants in FINRA arbitration, have also brought revenue sharing claims,[15] thereby creating a multijurisdictional set of rules that should be consolidated in a single, uniform, SEC-promulgated standard. Rulemaking through multijurisdictional enforcement and private litigation creates uncertainty, encourages deception over compliance, and favors product and service providers that are inclined to flout the law. Overly burdensome cost-benefit requirements such as those imposed by the Act will simply drive more regulation into enforcement.

Moreover, cost-benefit gridlock in one agency creates vacuums that other actors will fill. The absence of a fiduciary rule has led FINRA to expand the scope of suitability obligations to include what practitioners have recognized is a quasi-fiduciary standard clothed as a suitability duty.[16] The absence of a fiduciary duty has

---

See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Exchange Act Rel. No. 51274 (Feb. 28, 2005) (re-proposal); Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Exchange Act Rel. Nos. 49148, at note 55 (Jan. 29, 2004) (original proposal). This rulemaking illustrates the kind of regulatory paralysis that the Act will only exacerbate.

[14] *See supra* note 11.

[15] *See, e.g., Aucoin v. Gauthier*, 35 So.3d 326 (La.App. 1 Cir., 2010) (arbitration panel's dismissal of claims based on, *inter alia*, failure to disclose revenue sharing payments was subject to doctrine of res judicata); *California v. Edward D. Jones & Co.*, 65 Cal.Rptr.3d 130 (Cal.App.4th 2007) (state claim regarding revenue sharing disclosure); *Capital Research and Mmgt. Co. v. Brown*, 53 Cal.Rptr.3d 770 (Cal. App.4th 2007) (same); *see generally* Kelly Wiese, *Settlement approved in A.G. Edwards Case*, Missouri Lawyers Media, 2010 WLNR 12936709 (June 20, 2010) (describing settlement of state law claims based on failure to disclose revenue sharing); Will Deener, *Suit Says Edward Jones Withheld Information: Law Firm Predicts Number of Complaints Against Broker Will Grow*, Dallas Morning News at 4D, 2005 WLNR 24667030 (July 8, 2005) (describing dozens of revenue sharing disclosure cases filed in arbitration by a single firm); *The Fiduciary Study: A Triumph of Substance Over Form? supra* at 21 - 22.

[16] *See Order Approving Proposed Rule Change*, File No. SR-FINRA-2010-039, Exchange Act Rel. No. 63325, 75 F.R. 71479 (Nov. 23, 2010) (SEC release approving FINRA Rule 2111, effective July 9, 2012); Seth Lipner, *The New FINRA Suitability Rules*, 1969 PLI/CORP 173, 192 (Aug. 2, 2012)(FINRA's

allowed undisclosed conflicts in Individual Retirement Accounts, thereby providing greater pressure for the DOL, which is responsible for protecting IRA investors, to step into the void. The absence of a rule-based fiduciary duty has created greater uncertainty by effectively assigning more responsibility for defining fiduciary standards to the dark reaches of FINRA arbitration, where fiduciary breaches are the most common claim brought by investors,[17] but where no guidance about its contours is provided because arbitrators do not issue written explanations of their decisions. Rulemaking paralysis will cause the stresses created by gaps and inconsistencies, like water running downhill, to find another means of release.

The Act does not even foreclose SEC rulemaking under the very Section 913 authority that it seeks to extinguish. The Act's cost-benefit provisions apply to rules promulgated pursuant to Section 15(k)(1), which authorizes imposing conduct standards on broker-dealers pursuant to Advisers Act Section 211. The Act has no effect on the SEC's authority under Section 15(k)(2) to require disclosure specific to the sale of proprietary products, or under Section 15(l)(1) to impose disclosure requirements regarding broker-dealer relationships with customers, or, most pointedly, under Section 15(l)(2) to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes" for broker-dealers. These three provisions cover a wide swath of territory that would otherwise be covered by a fiduciary duty, but the rulemaking they permit is far

new suitability rule does not impose a fiduciary duty but "brings FINRA closer to imposing such a standard on brokers"); Duane Thompson, *FINRA's Quasi-Fiduciary Rule*, fi360 BLOG, July 11, 2012 *available at* http://blog.fi360.com/fi360_blog/2012/07/finras-quasi-fiduciary-rule.html; Christina N. Davilas, David C. Boch, W. Hardy Callcott and John R. Snyder, *FINRA Issues Additional Guidance on its Soon to be Implemented New Suitability Rule* (May 31, 2012) (FINRA "Guidance Announces a new, "Best interests of the Client Standard" that "may be viewed as akin to a fiduciary duty.").

[17] Breach of fiduciary duty was the most frequently asserted arbitration claim from 2008 through mid-2012. For example, of the 4,729 arbitration claims filed in 2011, 2,589 (55%) included breach of fiduciary duty claims. *See* FINRA Dispute Resolution Statistics (July 2012) *available at* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/. *See, e.g., In the Matter of Billings v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, FINRA Arbitration No. 11-01948 (Oct. 12, 2012) (finding respondent violated fiduciary duty to claimants and awarding monetary relief) *available at* http://finraawardsonline.finra.org/viewDocument.aspx?DocNb=59344.

more invasive and constraining than a best interest standard. Ironically, the cost-benefit burdens that the Act would place on a generalized fiduciary duty may push regulators to prohibit outright practices that would have been palatable under a fiduciary rule. In addition, imposing cost-benefit requirements on a one, discrete grant of rulemaking authority under Section 913 implies a Congressional intent to impose *lower* cost-benefit standards on other grants of authority in the same Section.

The point here is not to show how better drafting could help the Act accomplish its purpose, but rather to illustrate how targeted cost-benefit requirements are particularly ill-suited as indirect mechanisms for repealing or restricting agency rulemaking authority. Even if the Act were revised to cover the three grants of Section 913 authority described above, FINRA would still retain expansive authority to adopt the functional equivalent of a fiduciary duty for its members that would not be subject to the Act's prescriptions (it has, in effect, already begun this process). The Act could be amended to address this end-run, but that would have no effect on SEC enforcement actions. Congress could restrict the SEC's ability to bring fiduciary cases clothed as fraud claims, although it is not entirely clear how, but this would have no affect on public and private enforcement actions under state securities laws. The Act is not just bad policy; it reflects a fatally flawed strategy that is likely to have adverse consequences for all affected parties.

II. Coordination with Federal Agencies

The Act's coordination requirement in Section 15(k)(5) is yet another example of overly intrusive Congressional oversight and appears to reflect a general misunderstanding regarding rulemaking under the securities laws and the Employee Retirement Income Security Act of 1974 ("ERISA"). The Act requires that the Commission take steps to "coordinate retail customer standards of conduct" to minimize conflicts among rules promulgated by other federal agencies. This requirement is presumably intended primarily to ensure that the SEC rulemaking does not conflict with the DOL's ongoing fiduciary rulemaking.

To the extent that "conflicts" refers to situations in which that complying with one set of rules will render a firm out of compliance with another set of rules, there is no reason to believe that the DOL and SEC rules will be in conflict. There was nothing in the DOL's original fiduciary proposal, since withdrawn, or in any statements by the SEC or its staff regarding the SEC's fiduciary rulemaking that would create such a true conflict. In the past, the agencies have routinely ensured that such conflicts are not created, and I am aware of no current conflict between their rules. The most recent *potential* conflict between a DOL rule and the rule of another agency (the CFTC) was resolved before the DOL rule became final. While the DOL's initial fiduciary proposal had its shortcomings, no one has identified anything in the proposal that would have created such a true "conflict."

The concern animating the coordination provision appears not to be a "conflict" in the true sense of the term, but rather the possibility that the DOL may impose more stringent standards, for example, on broker-dealers who advise IRAs than are imposed under SEC rules. This is not a conflict, but an appropriate and necessary policy. In ERISA, Congress *required* that IRAs and other retirement vehicles be subject to more stringent standards than other investments. And it is widely accepted that retirement investments *should* be subject to more stringent standards.

Securities law and ERISA are different regulatory schemes because they should be different. The public interest in employee benefit plans is far greater than for securities investments in general. Investment regulation takes on greater importance in the context of retirement benefits, where losses resulting from misconduct have greater adverse individual and societal consequences than losses associated with securities investments generally. The DOL's application of ERISA's fiduciary duty therefore should not be expected to descend to the level of securities regulation, just as the SEC's application of the fiduciary duty under the securities laws should not be expected to rise to the level of ERISA's requirements.

A possible interpretation of the coordination provision is that it reflects a desire to require the DOL to defer to the SEC's fiduciary rulemaking.[18] For a number of reasons, this effort is ill-advised. Granted, the DOL's initial proposal had fatal flaws, about which I have previously written and testified.[19] The primary flaw was that the proposal failed to extend to new ERISA fiduciaries the same kinds of prohibited transaction exemptions that are relied upon by current ERISA fiduciaries. But the DOL has done all that one could reasonably ask in the wake of its initial foray. It has withdrawn the proposal. It is conducting an exhaustive cost-benefit analysis. And Phylis Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration, has repeatedly stated that the re-proposal will include prohibited transaction exemptions that are designed to accommodate existing industry practices.[20] The DOL is likely to issue a proposal in a matter of months. Congress should at least determine what the DOL actually proposes before attempting to use mandatory "conflicts" coordination to address problems that it speculates the proposal may create.

[18] Some industry lobbyists appear to have incorrectly interpreted the Act this way, possibly as a reflection of its supporters' expectations. *See, e.g.*, Mark Schoeff, *House Bill Seen Slowing DOL's Fiduciary Push*, Investment News (May 15, 2013) *available at* http://www.investmentnews.com/article/20130515/FREE/130519952#.

[19] *See, e.g.*, Mercer Bullard, DOL's Fiduciary Proposal Misses the Mark, Morningstar.com (June 13, 2011) *available at* http://news.morningstar.com/articlenet/article.aspx?id=384065.

[20] *See* Dianna Britton, *Borzi Hints at Exemptions to DOL Fiduciary Rule*, WealthManagement.com (Apr. 29, 2013) (reporting Borzi comments at conference: "We have to be able to make a finding that allowing certain kinds of transactions and forms of compensation that would otherwise be prohibited because they have the potential for being conflicted for being self-dealing, we have to be able to make a finding that they're in the best interest of participants and beneficiaries.
We think that there are types of compensation that would otherwise be prohibited under a flat prohibition that we will be able to make that finding for.") *available at* http://wealthmanagement.com/imca-2013-annual-conference/borzi-hints-exemptions-dol-fiduciary-rule.

III. Making Investors Pay for Regulatory Confusion

Section 15(k)(4) of the Act requires that the Commission make "formal findings" that a fiduciary rule would "reduce the confusion of a retail customer" about "standards of conduct" that apply to financial professionals. In other words, if the Commission decides that a fiduciary duty would be in the best interests of investors, it must determine that investors have improved their understanding of the legal duties of financial professionals before it can adopt the rule. Thus, the provision effectively requires that Americans become smarter about the legal duties of financial professionals before they can receive the benefit of a fiduciary duty.

The problem of customer confusion is not a problem with the customer; it is a problem with regulation. Customers reasonably expect one standard, but they get something else. They expect professionals who provide them with specialized, personalized advice to be required to act in their best interest, but they receive only the protection of a suitability standard instead. Their best interest expectation is deeply embedded in hundreds of years of common law precedent that holds professionals to higher standards of care and loyalty. Yet this standard is contradicted by the reality that broker-dealers provide professional, personalized investment advice without being held to the almost universal standard that applies to similar professionals, including investment advisers, in commercial contexts.

Regardless of whether one agrees that broker-dealers should be subject to a fiduciary duty, the view that the *investors* are the problem that needs to be solved is extraordinary. It adopts a "blame the victim" approach where fraud is the fault of the investor who loses his life savings investing in products recommended by a conflicted broker because the *investor* should have understood that the broker was not required to act in his best interests. The Act's customer confusion provision does nothing more than hold Americans hostage, denying them the right to efficient legal standards until they prove to regulators that they acquire the legal sophistication to understand them. The solution to investor confusion is not to require investors to become smarter about regulations, but to make smarter regulations.

IV. Rent-Seeking "Harmonization"

Section 15(k)(6) of the Act imposes a *de facto* requirement that, if the SEC imposes a fiduciary duty on broker-dealers, it must impose a host of additional, unrelated regulations on investment advisers. The provision expressly states that "[t]he Commission shall not propose rules under paragraph (1) for brokers or dealers unless the Commission also proposes rules under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) in the same rulemaking." There is no necessary connection between fiduciary rulemaking and rulemaking for advisers. The provision appears to be nothing more than rent seeking by an industry that wishes to regulate their clients' competitors into submission.

A comparison of this provision and the rest of the Act gives credence to this view. On the one hand, the Act seeks to *restrain* the SEC from adopting rules applied to broker-dealers. On the other hand, it expressly *requires* rulemaking for investment advisers. On the one hand, the Act imposes a host of cost-benefit burdens on rulemaking applicable to broker-dealers. On the other hand, it imposes no cost-benefit burdens on rulemaking applicable to investment advisers. The adoption of a fiduciary duty for broker-dealers automatically triggers rulemaking for investment advisers. Rulemaking for investment advisers does not trigger the adoption of fiduciary duty for broker-dealers. It does not seem to matter what rules are adopted or why, as long as they purport to address "any harm" to investors resulting from differences between investment adviser and broker-dealers regulation. Section 15(k)(6) creates the impression that the Act's purpose is simply to promote the interests of one industry over another without any regard for efficient regulation.

This is not to say that rulemaking to address other inconsistencies between broker-dealer and investment adviser regulation is unwarranted. The SEC should identify and resolve such inconsistencies in the same way that the inconsistent application of the fiduciary duty should be resolved – based on the principle of *functional* regulation. When broker-dealers and advisers provide the same services, they should be subject to the same rules. A fiduciary duty should be applied to financial professionals when they provide personalized retail investment advice, regardless of whether they are broker-dealers or investment advisers. When they are not subject to the same rules, the SEC should consider whether the rules that apply to one should be: (1) extended to the other or (2) eliminated altogether. In contrast, Section 15(k)(6) suggests that the only option is to subject investment advisers to broker-dealer rules even if the rules should apply to no one. This illustrates precisely the kind of blind commitment to an ever-expanding regulatory web that is the antithesis of smart regulation.

The SEC should consider whether broker-dealer rules that are inappropriate for investment advisers may be inappropriate for broker-dealers as well. Similarly, it should consider, when a particular standard for investment advisory services is not appropriate for broker-dealers, whether it may also be inappropriate for investment advisers. The Commission has previously determined that principal trades between broker-dealers and their advisory clients that do not comply with Section 206(3) of the Investment Advisers Act may, in some circumstances, be appropriate. Such transactions may also be appropriate between investment advisers and their clients on similar terms. If the SEC's blanket ban on advisers' testimonials is considered excessive for advisory services provided by broker-dealers, then the SEC should reconsider the ban for investment advisers. The same holds for other rules adopted under Section 206(4). However, the Act's bias for automatically extending broker-dealer rules to investment advisers applies precisely the reflexive rulemaking approach that leads to excessive regulation in the first place.

Statement of Ken Ehinger
Chief Executive Officer, M Holdings Securities, Inc.
On behalf of the Association for Advanced Life Underwriting (AALU)

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
House Financial Services Committee

May 23, 2013

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee, I am Ken Ehinger, President and Chief Executive Officer of M Holdings Securities, Inc.[1] I am testifying today on behalf of the Association for Advanced Life Underwriting. AALU appreciates the opportunity you have given us to testify on draft legislation by Representative Wagner. Her draft legislation would, in essence, require the SEC to identify a real need and determine that there will be real benefits outweighing the costs before upending the current standards that apply to broker-dealers. While we understand that the text of the Wagner proposal is a discussion draft at this point, we support her effort as a sensible proposal that we believe will lead to better rulemaking on the part of the SEC.

I have spent more than three decades in the securities and insurance business. I was honored to share my experience with this Subcommittee when I testified more than a year and a half ago. As I said then, a standard of care for financial professionals that sounds good in theory may fail in practice if it is vague and amorphous and provides no guideposts for compliance. And, a fiduciary duty offers little protection if regulators do not have the tools and resources to effectively oversee the financial professionals who are subject to it. I reiterate those statements today.

During consideration of Dodd-Frank, the then-Chair of the SEC advocated that the bill include a legislative mandate to the SEC to impose a new standard on broker-dealers. Congress rejected that approach and, instead, directed the SEC to study whether there were gaps in existing investor protection before acting on any new rule.[2]

The study produced in 2011 by the SEC staff was criticized on all sides because of the lack of economic analysis and findings of specific harm and market failure supporting its conclusions. The study's lack of empirical support was even acknowledged by a consumer advocate who testified here on the panel with me 18 months ago.

---

[1] As President and CEO of M Securities, Mr. Ehinger oversees all aspects of M Financial Group's Broker/Dealer and Registered Investment Adviser. Mr. Ehinger has a diverse background in the securities and insurance industries that spans more than three decades. Additional biographical information about Mr. Ehinger is attached to this statement.

[2] *See* Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011) [hereinafter *SEC Staff Study*], *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

The SEC has stated that it needs to address investor confusion. This issue was highlighted in a 2008 Rand Corporation report, which found that investors were confused about the legal differences between brokers, dealers and investment advisers, although investors were very satisfied with their own financial professionals. [3] But, instead of addressing the confusion issue by working to develop better, clearer and more concise disclosure about the role in which a financial professional serves, the SEC took a different path. Over the past five years, the SEC has used precious time, staff resources, and, yes, private sector resources by continuing to press for a change in the broker-dealer standard of care to conform to the standard that applies to investment advisers. The SEC most recently set out various options for reform in this area in a 72-page release requesting a mountain of data, little of which relates to whether investors are being harmed.[4]

I have great respect for the SEC and for its dedicated staff. I appreciate what Chairman White said last week about her personal commitment to rigorous economic analysis to bolster its rulemakings going forward. But, I would like this Subcommittee to consider for a moment that the Commission has detailed dozens of staff to work on this discretionary rulemaking project over the last few years. I believe the SEC could make much better use of those talented and experienced staff, if it would do two things. First, direct two or three of those staff to develop a targeted disclosure rule that addresses any issue of investor confusion. Second, reassign the others to fill what continues to be, by the SEC's own acknowledgement, a monumental gap in investment adviser inspections and oversight.

Representative Wagner's bill would address these issues very directly. If the criteria in her discussion draft before you today had been in place from the outset, precious time and resources would have been saved by the SEC. The focus on the SEC's regulatory effort would have been to identify real and specific harm and then to craft a rule or other remedy to address that harm cost-effectively.[5] Investors would have been far better off.

It is well recognized that the regulatory and oversight regime for broker-dealers is more rigorous than the regulation of investment advisers. [6] If any changes are to be made to enhance investor protection, priority should be given to bringing adviser regulation up to the level for

[3] *See* Angela A. Hung *et al.*, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[4] Duties of Brokers, Dealers, and Investment Advisers, 78 Fed. Reg. 45, (March 7, 2013).

[5] Note that the need for rigorous economic analysis is critical, in view of the SEC's experiences in rule challenges, where the D.C. Circuit Court of Appeals has overturned Commission rulemaking for failing to conduct appropriate economic analysis. *See* Business Roundtable and Chamber of Commerce v. SEC, No. 10-1305 slip op. (D.C. Cir. Jul. 22, 2011), *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf.

[6] *See, e.g.,* Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011), *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

broker-dealers. This is critical, since, annually only 8% of the 11,000 registered investment advisors are examined by the SEC, compared to a 50% examination rate for broker-dealers by FINRA and the SEC. And, although all broker-dealers are subject to the dual oversight and regulation of the SEC and FINRA, most investment advisers with less than $100 million in assets under management are not subject to SEC inspection at all. Those advisers are left solely to the states – and the inspection rate varies from state to state. Moreover, broker-dealers also are subject to much more rigorous scrutiny before they are allowed to register; they also are subject to much more rigorous ongoing supervisory requirements.

Potential Impact of a New Standard for Broker-Dealers

As a practical matter, let me discuss how the SEC's effort to change broker-dealer standards would directly affect AALU's membership. AALU is a nation-wide organization of nearly 2,300 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement, and deferred compensation and employment benefit services. Many of our members have served the same individual clients and their families for decades. Our customers are of primary importance to us and, for that reason, we work closely with them to understand their needs and objectives in connection with the insurance and investment products we are authorized to sell, within the framework of our contracts with carriers and other obligations under all of the laws and regulations to which we are subject.

All of our members are licensed insurance professionals; many are licensed in multiple states. Many of our members own their own insurance agencies, in some cases with multiple offices, and some of these agencies own or are affiliated with registered broker-dealers or investment advisers. Many AALU members are registered representatives of SEC/FINRA-registered broker-dealers and/or are investment adviser representatives of SEC-registered investment advisers. Our members therefore are subject to multiple layers of federal and state regulation and oversight. We believe we have a unique perspective on the effectiveness of regulation and oversight by various regulators, particularly with regard to sales of insurance-related products.

Many life insurance producers offer variable life insurance and variable annuities, in addition to what may be viewed as more traditional life insurance products. These bundled products offer consumers investment choices for their accumulating cash values – the variable element of the product – with separate guarantees from the issuer such as a guaranteed death benefit and lifetime income guarantees, which are important options for customers seeking to address their life insurance protection and retirement needs and which have been recognized as even more important in recent years of market volatility. It is the sale of these products that triggers broker-dealer registration and SEC, FINRA, and state securities regulation and oversight for those producers. Any major changes in SEC regulation of broker-dealers, such as changing current standards for broker-dealers to an investment adviser-type standard, would have a significant impact on these producers and could potentially affect their relationships with, and their ability to serve, their customers, particularly with regard to the range of products offered as well as the costs of those products. For this reason, AALU on August 30, 2010 filed extensive comments with the SEC in connection with its Section 913 Study, in order to educate the

Commission on the extent of current regulation of insurance producers who sell variable products.[7]

AALU's submission to the SEC explained, for example, that the design of variable life insurance products requires medical and financial underwriting in determining insurable interest that goes beyond the requirements for traditional securities products. The rigor and breadth of applications relating to these products requires an assessment primarily of financial and protection needs. This necessitates an analysis related to death benefit, cash values, tax implications and costs. In each situation, the issuing insurance company is involved in determining the appropriateness of the product for the customer as it relates to risk selection and general suitability. In addition to the SEC's and FINRA's roles in the registration and sales of these products, state insurance commissions also regulate these products. Insurance producers/registered representatives who sell these products are subject to supervision by an SEC/FINRA-regulated broker-dealer and also subject to the terms of their contract with the issuing insurance company, which is subject to regulation by multiple state insurance regulators. Indeed, the scope and level of regulation is significantly higher for variable life insurance products than for other securities products under current law. However, the SEC Staff seemingly gave little weight to the extensive information provided by AALU and other insurance organizations[8] on the comprehensive and overlapping requirements of state insurance regulation and federal, state and FINRA securities regulation relating to variable products, under which insurance producers operate.

We believe consideration of the multiple layers of regulation and oversight of these variable insurance products, together with their product-specific disclosure and due diligence requirements, should have led the SEC Staff to conclude that no change in standards or further regulation is necessary, or at least to specify why, notwithstanding the current multiple and overlapping regulation of these products, a different, more subjective standard – the "best interest" standard – should be applied. We expressed strong concerns that applying such a standard, in addition to all of the existing regulatory requirements, could result in many insurance producers moving away from variable to fixed insurance products, limiting customer choice and increasing costs. The cost of meeting all regulatory and compliance obligations is already significant for all brokers, but especially insurance producers, due to levels of oversight and requirements that already exist. Our submission expressed our serious misgivings that an unwarranted change in the legal standard that requires increased time and compliance costs could render the delivery of this service too costly for insurance producers and the average customer, resulting in limited access to valuable insurance protection. However, the SEC Staff Study report did not acknowledge the comprehensive and overlapping regulation of insurance professionals.

---

[7] *See* Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2631.pdf.

[8] *See* Comment Letter from American Council of Life Insurers, Association for Advanced Life Underwriting, Financial Services Institute, Insured Retirement Institute, National Association of Insurance and Financial Advisors, and Securities Industry and Financial Markets Association, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2532.pdf.

In addition, without any empirical evidence or data, the SEC Staff Study report dismissed concerns that the proposed regulatory changes would limit choice and access to financial products and services.[9]

The regulatory regime applicable to broker-dealers is more rigorous than that applicable to investment advisers, including: the level of regulatory oversight and examinations; the legal requirements for internal supervision programs; the specific liability of supervisors, which is designed to assure that they vigorously supervise the activities of those subject to their supervision; the qualification requirements for salespersons/advisers and supervisors; requirements for training and continuing education; and the nature and totality of the regulatory requirements in furthering effective programs of supervision and oversight to protect retail customers.

If the goal of imposing upon financial intermediaries any legal duty – fiduciary or otherwise – is anything other than to create liability for the intermediary, it should be to protect investors through assuring appropriate broker and adviser conduct. Regulation should provide appropriate and effective guideposts. In other words, regulation should provide clear rules of conduct, from which a financial services organization can develop training for its employees, supervision of their conduct, procedures to achieve compliance, and measures by which they can audit their conduct. Regulators then can examine and measure financial services professionals against these rules and assess for compliance. Thus, the regulations should be (1) clear and understandable to the financial professionals to whom they apply; (2) capable of being measured and monitored by supervisory personnel who are held accountable for compliance (and which are, in fact, monitored by supervisory personnel); and (3) capable of being audited and enforced by regulators. This is the model FINRA follows. It is not the Advisers Act model, where the broad, amorphous fiduciary standard of conduct has evolved essentially from case law and SEC enforcement actions.[10]

Investor Confusion Can, and Should Be, Addressed More Effectively

AALU members believe our customers fully understand the role in which our members operate. Indeed, if there is any concern about the current level of disclosures, we believe many customers feel buried under the weight of required disclosure and account-related documents.

[9] *See SEC Staff Study*, *supra* n. 2 at 161-162, simply citing SEC staff views rather than specific supporting data: "The Staff believes that its recommended uniform fiduciary standard recognizes the value of preserving investor choice with respect to the variety of products and services involving the provision of investment advice and how investors may pay for them. . . . The Staff believes that the recommended uniform fiduciary standard would not require that broker-dealers limit, nor would it necessarily result in broker-dealers limiting, the range of products and services they currently offered to retail investors. . . . The Staff believes that . . . the recommended uniform fiduciary standard would in and of itself, not adversely impact [the retail investor] populations' access to financial products and services."

[10] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963); *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

Nonetheless, we support efforts, such as FINRA's Notice 10-54, to develop better and clearer disclosure for customers of broker-dealers.[11] Indeed, we believe the FINRA process offers the potential to give thoughtful consideration to the types of disclosures that investors would find most useful in making investment decisions and to simplify the information most relevant to consumers. In AALU's comment letter to FINRA, we advocated for a simple document provided at the beginning of a customer relationship, with information about the roles, conflicts and services provided by a broker-dealer.

On this issue, the 2008 RAND Report also offers some critical insight. Many participants in RAND's survey apparently complained, "[t]he way [disclosures] are written is not easily understandable to the average investor, and the information in disclosures is not sufficient."[12] Of course, we know that both the SEC and FINRA have heard this complaint year after year, over many decades, and yet regulators to date have not written the kind of rules that would facilitate the type of simple, brief, "plain English" disclosures investors want and need. We believe this underscores the need for FINRA, together with the SEC, to develop and implement investor testing and investor education as part of the process of developing any new disclosure rules in this area.

Studies that (1) reflect investor confusion over legal duties that apply to financial professionals but also (2) show investor satisfaction about their own financial services provider point clearly to the need for more effective disclosures and investor education, not the need for wholesale changes in the legal standards.

Need to Address the Investment Adviser Inspection Gap

As we have testified previously, we believe the SEC, in its advocacy of a fiduciary duty almost to the exclusion of other, more pertinent reforms, has misplaced priorities. The first step in protecting investors has to be to assure they are well informed. They need to be informed about the role in which a financial services professional operates. They should be informed about who regulates them and when they were last inspected by a regulator. They need to understand what their rights are if there is a dispute with the financial services professional. They need to understand conflicts of interest. As a first step, the SEC should review current disclosures and consider changes where they believe disclosures are lacking.

Moreover, if investor confusion is to be the basis for new regulation, we submit that few investors understand that if their financial services professional is a registered broker-dealer, it is supervised by the SEC, FINRA, and state securities regulators, and likely is inspected approximately once every two years, but if the investor's financial service professional is a

---

[11] *See* FINRA Notice 10-54, *Disclosure of Services, Conflicts and Duties* (Oct. 2010) *available at* http://www.finra.org/Industry/Regulation/Notices/2010/P122361; Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2631.pdf.

[12] *See* Angela A. Hung *et al.*, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, at 19, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

registered investment adviser it may be inspected approximately once every 10 years, according to the SEC's own budget projections.[13] Broker-dealers also employ significantly more internal resources, programs and procedures to comply with their responsibilities under Commission and FINRA rules, compared to investment advisers – a difference in regulatory requirements we also believe is unknown to most investors, who arguably would express concern if surveyed on this point. The level of internal broker-dealer resources committed to compliance, together with the industry's financial support of FINRA for its oversight of broker-dealers, is a significant multiple of government and private sector resources devoted to compliance on the investment adviser side.

No standard of care is effective without a mechanism to monitor and enforce its application. The Commission and other regulators and self-regulatory organizations already devote the clear majority of their oversight and inspection resources to broker-dealers. An investment adviser who is compensated based on assets under management or fees for services and time can be just as likely to make an inappropriate recommendation to garner more assets as any commission-based broker. Devoting limited Commission resources to imposing a uniform standard of conduct for brokers, dealers and investment advisers should be considered only if and when the oversight, inspection, and supervision gap between broker-dealers and investment advisers is sufficiently addressed.

Imposing a broad, vague fiduciary duty on broker-dealers would provide no increase in investor protection

While under certain circumstances (such as when a broker has discretionary authority over a customer's account) a broker may be held to the legal standard of a "fiduciary," we believe Advisers Act regulation or a broad fiduciary duty standard has not provided superior investor protection for customers of investment advisers and would not provide a measurable increase in investor protection for retail customers of broker-dealers. In contrast, a regime for advisers that more closely resembles that for brokers and dealers would likely benefit retail customers, in view of the specificity of the rules and the strong examination program resulting from FINRA oversight.

For variable life insurance products sold by licensed insurance agents in particular, which are among the most highly-regulated products sold by the most highly-regulated financial services professionals, nothing under the Advisers Act regulatory scheme compares to the comprehensive and robust customer protections already in place: comprehensive due diligence with respect to the customer's needs and financial capacity; suitability assessment relating to both annuity and investment products; disclosures to customers about the investment product; transaction-by-transaction review and approval by the carrier/issuer; immediate and transaction-by-transaction review of each transaction by a broker-dealers' securities principal; and meaningful and effective oversight by as many as four different levels of regulators (and often involving multiple regulators at the state level). While we do not believe AALU members'

[13] *See* U.S. Securities and Exchange Commission FY 2014 Congressional Budget Justification, *available at* http://www.sec.gov/about/reports/secfy14congbudgjust.pdf.

clients are confused about the insurance producer's role and any potential conflicts, the SEC does not need to look to the Advisers Act or to a newly-created "best interest" standard under Dodd-Frank to address any confusion, should it be identified. The Commission and FINRA have ample other authority (authority existing both prior to and after enactment of Dodd-Frank) to require additional disclosures by brokers to their customers.

Even beyond highly regulated variable products, as discussed above, the Commission/FINRA regulatory and oversight regime for brokers and dealers – which is highly specific, proactive, capable of being monitored by supervisors (and is, in fact, monitored) and capable of being audited by regulators (and is, in fact, regularly audited by regulators) is rigorous. In fact, we believe investors, if fairly surveyed, would choose a regime which provides specific rules of conduct to guide financial professionals, imposes liability upon supervisors for failing to meet robust supervisory requirements, and provides for periodic and robust regulatory oversight, over a regime in which a financial professional may have a legal "fiduciary" obligation but operates under the assumption that a regulator may audit its activities only once every 10 years. The comparative benefits of the broker-dealer regulatory and oversight regime over the current regime for investment advisers have been amply demonstrated.

Imposing an Advisers Act fiduciary duty standard or "best interest" standard could harm investors by reducing customer choice and access to financial services

The concept of "fiduciary duty" addresses the age-old agent monitoring problem (the lack of a principal's control over, and inability to continuously monitor, its agent) by imposing various duties and obligations enforced through the courts. The elements of the duty are principles-based, not rules based, and the duty is, by its very nature, after-the-fact liability creating.[14]

Many of our members operate under the Adviser's Act implied fiduciary duty and under certain specific rules adopted by the Commission under the Advisers Act. But a general fiduciary standard is inappropriate as applied broadly to sales of securities products where the broker does not hold himself/herself out as an investment adviser and does not exercise

[14] At a May 4, 2010 Senate Judiciary Subcommittee hearing, Professor Larry E. Ribstein, Associate Dean of the University of Illinois College of Law and an expert on fiduciary law, testified that "fiduciary duty is one of the most amorphous concepts in the law" – a concept developed through case law, predominantly at the state level. He stated that imposing such a duty "would result in massive uncertainty" and pointed to the lack of clarity after more than 40 years of litigation over the fiduciary standard in section 36 of the Investment Company Act, as well as the "ill-defined duty for investment advisers." At that same hearing, J.W. Verret, Assistant Professor of Law, George Mason University, testified about the difficulty of applying a fiduciary duty standard: "[U]nder a fiduciary standard and after the fact, [] it is too tempting to decide whether a decision was fair at the time it was made in light of how the investment ultimately performs." He noted, "[I]n administering fiduciary duty laws, it is nearly impossible to avoid being influenced by the perfect vision of hindsight." *See* transcript of Senate Hearing 111-835, Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?, *available at* http://judiciary.senate.gov/resources/transcripts/111transcripts.cfm.

discretionary authority. It is particularly inappropriate for bundled, self-contained products like variable life and variable annuities, which come pre-assembled with several investment choices and separate contractual guarantees from the issuer such as guaranteed death benefits and lifetime income guarantees. The range and features of these products makes it difficult to determine which product is "best" and, under a "best interest" standard, almost certainly would lead to increased litigation. Our members have a long history of being able to determine suitability – and we operate under FINRA and state insurance regulators' enhanced suitability standards for these products. However, determining what is "best" would be a highly subjective determination, opening a producer to second-guessing and liability, often years after the sale of a product.

- Is the best product in a rising market the one that is most aggressively allocated to equities? Some would argue that is the case.
- But, could the best product for the client that dies three years into the contract be the one with the highest death benefit?
- In a prolonged depressed equity market, is the product with the best income guarantee the most favorable to the client?
- Which is the best product for clients when there are tradeoffs, such as one product with fewer investment choices and lower costs and another with higher charges but a wider range of investment choices?

The 2011 SEC Staff Study and the SEC's most recent release on this subject say nothing about how its proposed best interest test would apply to these products.

Thus, we believe the imposition of a broad new "best interest" or fiduciary duty standard inevitably will lead to uncertainty and litigation. In our view, this will influence many life insurance producers to withdraw from the sale of these products and reduce investor access to them.

Conclusion

AALU believes the current legal and regulatory standards of care for brokers and advisers are fundamentally sound and recognize the importance of delivering a range of choices to customers based on needs and costs. Well-publicized abuses and failures that led to the recent financial reform effort have not been related to the standards of care for brokers, dealers and advisers. Indeed, where there have been abuses and scandals, they in large part have been due to the failure of vigorous regulatory oversight and enforcement of existing standards, and not any identifiable weaknesses in the standards themselves. This problem will remain regardless of any changes to the standard. As a result, the focus should be on the process of ensuring that the standard appropriate to a defined customer relationship is met.

We also believe the issue of investor confusion is somewhat misdirected. There exist many choices and options in accessing financial services that may be "confusing" to customers without their becoming educated beyond their desire. Yet, these differences in product choices, costs and services are fundamental to a delivery system that allows people across all wealth and income levels to access the benefits of financial services in some form. The solution is not to eliminate potential confusion through homogenization, but to ensure understanding of the standard selected to meet their needs and the role in which a financial professional is serving them.

Let me close by saying that life insurance enables individuals and families from all economic brackets to maintain independence in the face of potential financial catastrophe. The life insurance industry, through permanent life insurance and annuities, provides 20% of Americans' long-term savings. Two out of three American families – that's 75 million families – count on the important financial security that life insurance products provide. Therefore, any proposed change in regulation that could limit consumer choices and access to these critical protection and savings vehicles should meet a high burden with respect to the need for the changes.

I have spent most of my professional career working in businesses that are regulated by the SEC. It is in the interest of all of us who are regulated by the Commission to have a strong and respected regulator to police our markets and instill and enhance investor confidence, which is the foundation for capital formation and savings in the U.S.

Thank you for the opportunity to testify in this important hearing. AALU looks forward to continuing to work with you on these critical issues.

Statement of the U.S. Chamber of Commerce

ON: Legislative Proposals to Relieve the Red Tape Burden on ' investors and Job Creators

TO: The Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Tom Quaadman

DATE: May 23, 2013

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney and members of the Capital Markets and Government Sponsored Enterprises subcommittee. My name is Tom Quaadman, vice president of the Center for Capital Markets Competitiveness (CCMC) at the U.S. Chamber of Commerce (Chamber). The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region. I appreciate the opportunity to testify before the subcommittee today on behalf of the businesses that the Chamber represents.

The Chamber supports the bills that are the subject of today's hearing— H.R. 1105, the Small Business Capital Access and Jobs Preservation Act; H.R. 1135, the Burdensome Data Collection Relief Act; H.R. 1564, the Audit Integrity and Jobs Protection Act; and a discussion draft, presented by Representative Wagner, to amend Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, regarding the provision of protections for retail customers and their relationship with broker-dealers. These bills address several of the issues the Chamber highlighted earlier this year for further action by Congress and the Administration to provide the financial regulatory structure and oversight that is needed for the American economy to grow and create jobs.

In 2007, the Chamber created the Center for Capital Markets Competitiveness to promote financial regulatory reform needed for efficient capital markets in a 21st century global economy. The Chamber did so because even before the financial crisis, it was becoming more difficult for American businesses to raise capital, there was and continues to be a steady decline in the number of public companies in the United States, and new businesses are eschewing traditional forms of public company financing in favor of more private forms of financing. While we need diverse public and private company capital markets, this overall trend is not a positive one for investors or the American economy.

We can no longer wait to address these issues if we want the American capital markets to be the most efficient and attractive in the world.

In March the Chamber released the **Fix, Add, Replace** Agenda (FAR Agenda) to address financial regulatory reform in the wake of the passage of the Dodd-Frank Act.[1] The FAR Agenda proposes to:

Fix those areas of the Dodd-Frank Act that aren't working properly;

[1] Copy of the FAR Agenda is attached as Exhibit 1.

Add those issues that weren't addressed in the Dodd-Frank Act; and

Replace those provisions of the Dodd-Frank Act that are unfixable.

The FAR Agenda is not an exhaustive list of issues and solutions, but it is a starting place for a dialogue on how to provide the American economy with the tools of capital formation needed to foster growth and job creation for the next generation.

We are pleased that the legislative proposals, which are the subject of today's hearing, are ones that are part of the FAR Agenda and ones that the Chamber supports. Let me take this opportunity to discuss those legislative proposals in greater detail.

1. H.R. 1135, the Burdensome Data Collection Relief Act

H.R. 1135, the "Burdensome Data Collection Relief Act,"[2] would repeal section 953(b) of the Dodd-Frank Act which requires public companies to disclose a ratio of the median compensation of all employees to the compensation of the Chief Executive Officer.

The Chamber opposed the inclusion of the pay ratio because it does not provide investors with information relevant to the long-term performance of a company, and it would force companies to spend finite resources to compute the irrelevant ratios.

Such a ratio will contribute to the clutter that has made public company disclosures increasingly irrelevant as a means of providing useful information to investors to make decisions on how to deploy capital with a reasonable expectation of return. For instance, a business that has a large hourly work force, such as a retail or fast food chain, will have a high differential in their ratio, while a Wall Street firm, where it is not uncommon for employees to make an amount comparable to the CEO; will have a much lower differential.

This ratio does not convey information on the performance of a company, the health of a company, or what the long-term prospects of a company are. Indeed, proxy advisory firms have failed miserably in determining peer groups for investors to evaluate comparable CEO compensation. If private firms have failed in this effort, it is hard to see how a government mandated ratio with no relation to investment decisions is any better.

[2] *See* Chamber letter in support of H.R. 1135 attached as Exhibit 2.

Section 953(b) also imposes costly burdensome data collection requirements upon businesses. For businesses that operate in many nations, this would require companies to reconcile differing definitions and practices of compensation and benefits, adjust this compensation to currency fluctuations, and settle potential differences in definitions and practices as to whom employees may actually be. According to the Center On Executive Compensation, one company has estimated that it would cost $7.6 million and take 26 weeks to compile this information, and another has estimated that it would cost $2 million dollars alone to determine the actuarial benefit of pension benefits for employees. To extrapolate those costs among the 10,000 plus public companies in the United States, we could face compliance costs in excess of $1 billion dollars.

That is why the Chamber and the Center On Executive Compensation sent a letter to the Securities Exchange Commission (SEC), signed by 23 trade associations expressing concerns regarding the pay ratio provisions of the Dodd-Frank Act.[3]

Disclosure requirements that fail to convey relevant information to investors and impose costly burdens on companies are by definition immaterial and antithetical to productive capital formation, and therefore, the Chamber believes they should be repealed.

2. H.R. 1105, the Small Business Capital Access and Job Preservation Act

H.R. 1105, the "Small Business Capital Access and Job Preservation Act,"[4] would amend the Investment Advisers Act of 1940 to exempt private equity fund investment advisers from its registration and reporting requirements, provided that each private equity fund has not borrowed and does not have outstanding a principal amount exceeding twice its invested capital commitments. This bill seeks to enhance the capital formation needed to build new businesses, expand existing businesses, and create jobs.

Companies small and large, particularly new businesses, need a mix of capital sources to meet short-term and long-term growth needs. This diversity of capital has provided the liquidity needed for different sized firms to be able to have the opportunity to achieve success. Congress recognized these facts and the need to increase diverse portals of capital access in passing the bi-partisan Jumpstart Our Businesses Startups Act ("JOBS Act") last year.

[3] Letter to SEC Chairman Mary Schapiro, dated January 19, 2012, is attached as exhibit 3.
[4] *See* Chamber letter in support of H.R. 1105 attached as exhibit 4.

The Small Business Capital Access and Job Preservation Act builds upon the JOBS Act and is itself an important innovation that will help to insure that small businesses continue to have access to diverse forms of capital formation.

Private equity financing is an important form of financing for smaller businesses that are trying to grow. In fact, between 1995 and 2010, over 23,000 companies, employing 3 million people, were backed by private capital. These firms grew jobs at a rate of 64% compared to other companies which only grew jobs at a rate of 18%.[5] It should also be noted that private equity financing was not a cause of the financial crisis and that business models utilizing private equity financing do not pose interconnected risk to the economy. Yet, the Dodd-Frank Act requires that private equity firms must register with the SEC. This places upon the private equity firms onerous reporting requirements through form PF, including the valuation of privately held portfolio companies, as well as expensive custodial requirements for untradeable legend equities.

Requirements such as these are not only costly; they are designed for public company investors, not investors in privately held companies. Thus, the requirements are also a mismatch for the investment model. The costs of these requirements may be prohibitive for smaller firms that specialize in investing in the middle markets. Therefore, the failure to pass this legislation can cut off funding sources for small businesses. This will create a cascading investment inertia that will harm smaller businesses that need assistance to grow. Such investment inertia will create adverse macro growth scenarios for the economy.

The Chamber believes that the bi-partisan Small Business Capital Access and Job Preservation Act is a measured response to preserve the role of Private Equity funding as a conduit of capital for small growing businesses.

3. H.R. 1564, the Audit Integrity and Job Protection Act

H.R. 1564, the "Audit Integrity and Job Protection Act,"[6] would prohibit the Public Company Accounting Oversight Board (PCAOB) from implementing rules requiring public companies rotate audit firms on a mandatory basis. Implementation of mandatory audit firm rotation will harm investors, endanger the competitive position of American public companies, and degrade audit quality.

---

[5] Growtheeconomy.org.

[6] *See* Chamber letter in support of H.R. 1564 attached as Exhibit 5.

The PCAOB appears to have embarked on an agenda that is leading far afield from its specific, but important, mandate to regulate auditors. Mandatory audit firm rotation would reduce the supervision and oversight of the audit committee and management, rolling back strong corporate governance policies. Indeed, we must question why the government, or a quasi-government entity, should mandate which vendor a business should use.

Let's take a look at the history of the mandatory audit firm rotation debate:

- Congress, in debating Sarbanes-Oxley, explicitly declined to enact provisions requiring mandatory firm rotation;
- Congress, in passing the JOBS Act, specifically exempted emerging growth companies from being subjected to any potential rules requiring mandatory audit firm rotation;
- The General Accounting Office (GAO) has twice reviewed and rejected the need for mandatory firm rotation. The GAO noted that mandatory audit firm rotation would increase audit costs by at least 20%;
- Academic studies have demonstrated that mandatory firm rotation may harm companies through higher costs and increased incidence of undetected fraud;
- The PCAOB has failed to provide information through the inspections process demonstrating a need for mandatory firm rotation[7];
- Over 90% of commenters on the concept release have opposed the concept of mandatory firm rotation; and
- The majority of investors commenting on the concept release also opposed mandatory firm rotation.

Despite this history and almost universal opposition to mandatory firm rotation, the PCAOB continues to consider a concept release on the subject, one that has been open since August 2011. The PCAOB's failure to demonstrate how the benefits of rotation outweigh the costs or address the cogent and consistent concerns

[7] *See* Chamber letter to PCAOB Chairman James Doty of October 5, 2012 attached as Exhibit 6 raising concerns about the PCAOB inspections process and the failure of the PCAOB to define audit failure.

raised by investors and businesses lead us to question why valuable resources, time, and monies are being spent on this project.

The Chamber believes that the PCAOB can better spend its time, effort, and resources on other projects such as updating auditing standards or developing a basic definition of audit failure. With the continued consideration of the concept release on mandatory audit firm rotation, the Chamber is concerned that the PCAOB is leaving the realm of audit regulation and crossing the threshold of regulating corporate governance, a subject area that has been left to state corporate law and the Securities Exchange Commission.

The Chamber supports independent standard setting; however, we believe that the recent proposal on mandatory firm rotation weakens audit committees, is outside the bounds of audit regulation, and enters an area outside the PCAOB's authority – corporate governance. H.R. 1564 reaffirms the line of demarcation, as established in Sarbanes-Oxley, that the PCAOB's jurisdiction is limited to that of an audit regulator, while corporate governance and executive compensation reside with the SEC, state corporate law, and boards of directors.

4. A discussion draft to amend Section 913 of the Dodd-Frank Act

Section 913 of the Dodd-Frank Act requires the SEC to study and, if necessary, develop a rulemaking to address issues surrounding the standard of care for broker-dealers and investment advisors in the dispensing of investment advice and services for retail customers. It should be noted that the Department of Labor (DOL) is engaged in a similar rulemaking under its jurisdiction.

The discussion draft presented by Representative Wagner requires the SEC to satisfy certain requirements before moving forward with any rulemakings under Section 913. Specifically, the discussion draft requires that the SEC identify the harm to retail customers due to brokers or dealers operating under different standards of conduct than those that apply to investment advisers. Furthermore, the SEC must conduct a rigorous cost-benefit analysis and determine that this analysis 1) demonstrates that the benefits of the rule justify the costs; 2) identifies and assesses alternatives to the rule and determines that the rule is the most effective path; and 3) ensures that the rule improves current regulations.

These are reasonable requirements; however, past regulatory failures justify this legislative mandate.

The D.C. Circuit Court of Appeals has repeatedly invalidated SEC rulemakings, most recently in *Business Roundtable & U.S. Chamber of Commerce v. Securities and Exchange Commission*, because of a faulty cost-benefit analysis. Systemic issues have prevented the SEC from determining the costs of a proposed regulation, what the benefits of a proposed regulation are, and if the costs outweigh the benefits. Similarly, President Obama's executive order on regulatory reform[8] requires non-independent agencies to clearly identify a problem and then to regulate, with the least burdensome impact on society, if no alternatives to regulation exist. Finally, with many joint rulemakings required under the Dodd-Frank Act, the SEC has historically been a laggard, making the joint regulatory process disjointed and uncoordinated.

In addition, the discussion draft calls for the SEC to coordinate its rulemaking on retail customer standards of conduct with other federal agencies, including the DOL, to minimize any conflicts among related regulations. We couldn't agree more. As there has been increasing overlap between the DOL and SEC in the area of retirement plans, we strongly urge these two agencies to work together to create a coordinated fiduciary standard.

Although the DOL withdrew its proposed rule in late 2011 and intends to re-propose a similar rule, the original proposed rule covered persons who are investment advisers as defined in the Investment Advisers Act of 1940. The DOL noted that this reference to the Investment Advisers Act definition also includes the various exclusions from that definition. However, an entity that is exempt under the Investment Advisers Act may still be a fiduciary under one of the other alternative definitions in the DOL regulation.

Different sets of rules and requirements applicable to the same assets will lead to additional costs and complexities for the underlying participants and account holders. This issue is further complicated to the extent that an individual may have several accounts at the same financial institution, some of which may be only subject to the SEC rules, and others of which may be subject to the new ERISA requirements as well as the SEC rules. Inconsistent rules will be confusing to investors and problematic for service providers to implement. Without coordination between the agencies, plan sponsors and plan professionals will spend significant resources unnecessarily trying to comply with two different sets of rules that are trying to reach the same goal. This situation could result in retail customers, plan participants, and beneficiaries not receiving the necessary tools and assistance necessary to achieve a

---

[8] Executive Order 13563

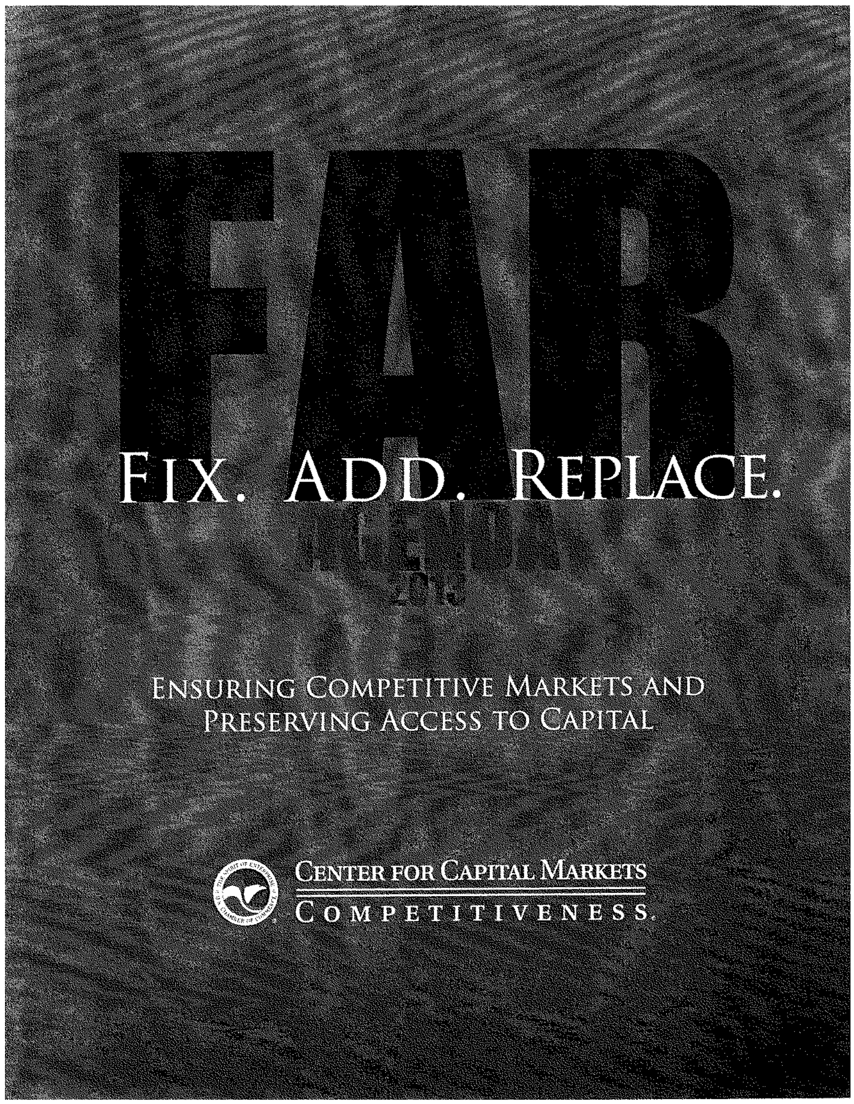
financially sound retirement at a time when this is critically important, or only receiving such investment support at an additional cost.

In short, the Wagner discussion draft imposes common sense requirements, as the SEC Regulatory Accountability Act does, on a potential area of rulemaking of importance to retail investors and the businesses they provide capital to. Indeed, the Chamber has been disappointed with the benign neglect that the SEC has shown to retail investors who have been disenfranchised by past rulemakings. The Chamber believes that the Wagner discussion draft should be introduced and passed and requests that the Subcommittee look into other issues regarding retail shareholders, particularly the sharp decline in participation by retail shareholders in voting in director elections and shareholder proposals.

***

The Chamber believes that these bills are important steps in promoting strong policies conducive to long-term economic growth and job creation. We need to have a diverse capital market system to sustain a varied set of business structures. Similarly, we must also preserve the public company structure, which is a unique and successful form of wealth creation for employees, as well as retail investors. This package of legislative proposals strikes the appropriate balance in achieving those goals.

I will be happy to take any questions that you may have.


FAR
FIX. ADD. REPLACE.
ENSURING COMPETITIVE MARKETS AND
PRESERVING ACCESS TO CAPITAL
CENTER FOR CAPITAL MARKETS
COMPETITIVENESS.

FAR

FIX. ADD. REPLACE.

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

FAR Agenda: Ensuring Competitive Markets and Preserving Access to Capital

In 2007, the U.S. Chamber of Commerce established the Center for Capital Markets Competitiveness (CCMC) to advance America's global leadership in capital formation by supporting capital markets that are the most fair, transparent, efficient, and innovative in the world.

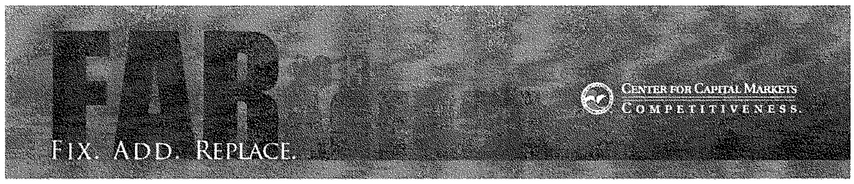
Economic growth and job creation are fueled by access to diverse sources of capital—from many forms of investors and credit providers. From a budding entrepreneur maxing out his credit card to start a new business to the growing company accessing the public markets to expand, every business relies on a well-functioning financial system to provide credit, liquidity, investment, and financial risk management.

Financial regulatory reform was long overdue. The U.S. financial regulatory system dates back to the reforms made after the Great Depression. Prior to the 2008 financial crisis, the CCMC called for reform with its bipartisan blueprint to modernize this outdated regulatory architecture and eliminate gaps, duplication, and regulatory dead-zones.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) sought to address some of these challenges by bringing more transparency to derivatives and improving consumer protection. And, yet, it largely left the existing byzantine regulatory structure intact—adding new layers and agencies, including the Financial Stability Oversight Council, the Consumer Financial Protection Bureau, and the Office of Financial Research. All told, 20 separate federal agencies are left with the task of implementing more than 400 Dodd-Frank rules as well as dozens of studies and reports.

Over two and a half years into Dodd-Frank implementation, the complexity and on-going duplication is challenging both regulators and the regulated. Rules requiring multiple agencies to act in coordination are either delayed, considered out of sequence, or producing outright conflicts. For example, the Commodity Futures Trading Commission (CFTC) and the prudential banking regulators have proposed fundamentally different approaches to "margining" over-the-counter swaps that non-financial companies use to hedge their risk. Because the discrepancy is based on different interpretations of Congressional intent rather than regulators moving ahead in unison, it appears that Congress will have to intervene to settle this dispute—another unnecessary delay.

An additional example: The Volker Rule has been appropriately delayed because nobody can agree on a simple definition of the problem they are trying to solve!



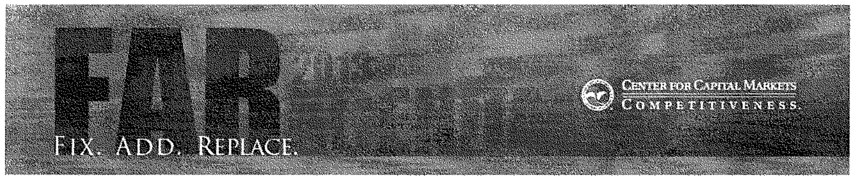
Faced with uncertain and conflicting rules of the road as well as skyrocketing compliance costs, financial firms are gradually making decisions that impact their ability to serve customers either by eliminating products or by getting out of certain markets altogether. And, rather than being able to invest in new ways to respond to customer needs, many financial firms are either focused almost exclusively on implementing the regulatory changes or simply waiting on the sidelines for more clarity.

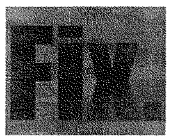
It is time to take a hard look at where we stand and answer some basic questions:

- Are there areas where Dodd-Frank simply isn't working as intended or where regulators need further clarity from Congress? How do we **fix** this?
- What **add**itional steps should we take in areas that were left unaddressed in Dodd-Frank? For example, should we consolidate regulators or at a minimum ensure more effective coordination among the dozens of financial regulators?
- Are there provisions of Dodd-Frank that simply don't work and need to be **replace**d?

While there will be honest disagreements about particular provisions, almost everyone can agree that today's financial regulatory structure and oversight is still **F.A.R.** from what is needed.

In an effort to address these challenges constructively, the CCMC has prepared the following list of concerns we believe need to be addressed. The "Fix, Add, Replace (FAR)" agenda we are proposing is not an exhaustive list of all the challenges or changes needed, but it does reflect the areas that have the broadest impact on the American economy and the millions of businesses that rely on an effective capital formation system.





Legislative and Regulatory Fixes to Dodd-Frank and Beyond

As with any broad legislation, Dodd-Frank has left gaps and created unintended consequences. In addition, as regulators have scrambled to meet statutory deadlines, they have felt constrained by the rigidity of the statute in some areas or misinterpreted Congressional intent in others. And, in some cases regulators have simply created unworkable regulatory regimes. CCMC is advocating for the following statutory and regulatory **FIXES** to ensure well-functioning, robust capital markets.

CFPB: Establish Fundamental Checks and Balances

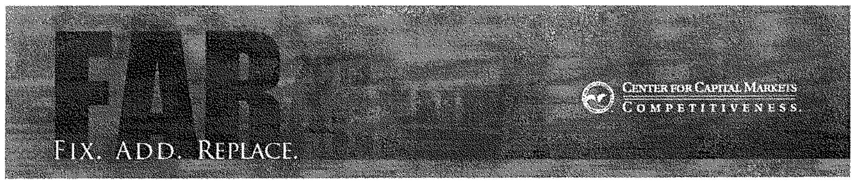
- Replace the single director leadership structure at the Consumer Financial Protection Bureau (CFPB) with a bipartisan commission to ensure continuity and a balanced approach to policymaking.
- Restore appropriate Congressional oversight by bringing the CFPB's budget within the formal appropriations process, similar to most independent agencies.
- Ensure more effective coordination with safety and soundness regulators to guarantee that CFPB regulations do not conflict with other regulations or otherwise undermine the diversity and soundness of the banking system.

Derivatives: Ensure End-Users are Able to Manage Financial Risks

- Enact legislation that would exempt non-financial end-users from onerous, costly, and unnecessary margin requirements, consistent with the Congressional intent when Dodd-Frank was passed.
- Ensure that purely internal, inter-affiliate derivatives transactions are exempt from clearing, margin, and other requirements more appropriately applied to market-facing swaps, consistent with the Congressional intent when Dodd-Frank was passed.
- Clarify that non-financial companies that use centralized treasury units to hedge risk will be eligible for the end-user clearing exception.
- Limit the extraterritorial reach of domestic derivatives regulation to ensure U.S. dealers are not disadvantaged overseas and to ensure that Main Street non-financial companies' cross-border counterparty relationships are not undermined by overlapping regulation.

FSOC: Enhance Transparency and Better Coordination among Financial Regulators

- Support efforts to increase the transparency of Financial Stability Oversight Council (FSOC) when it acts in a regulatory capacity.



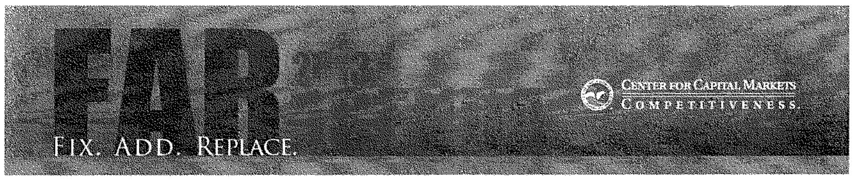
- Restore appropriate Congressional oversight by bringing the Office of Financial Research's (OFR) budget within the formal appropriations process.
- Create a "regulatory conflict" window at the FSOC with the goal of streamlining and ending duplicative regulatory initiatives and structures and harmonizing conflicting regulations among agencies.
- Ensure that the OFR coordinates and streamlines data collection among agencies to prevent the duplicative collection of information.
- Safeguard the confidentiality of proprietary and consumer information gathered from data requests and examinations across all regulators.
- Prohibit final systemically important financial institution (SIFI) designations for non-bank financial companies until all systemic risk rules are finalized.
- Ensure that systemic risk regulation and orderly liquidation authority for non-bank financial companies are not bank-centric, but are tailored to the business model of a specific company to prevent policies that may cause unnecessary market disruptions.
- Reform FSOC so that the views of the agencies, and not the Chairman of agencies sitting as individuals, are represented on the Council.

Money Market Mutual Fund Reform: Preserve and Further Strengthen an Essential Liquidity Management Product for Companies, States, and Non-Profits

- Advocate that any regulatory changes to Money Market Mutual Funds (MMMFs) seek to strengthen these funds while preserving their utility to customers.
- Ensure all additional reforms effectively address clearly defined problems and conduct a thorough analysis of potential reforms to MMMFs to understand the broader economic impacts and the company specific operational impacts, notably the tax and accounting issues that would ensue from floating the Net Asset Value.
- Continue to press for the Securities and Exchange Commission (SEC) to be the primary regulator for this securities product responsible and for implementing any additional reforms.

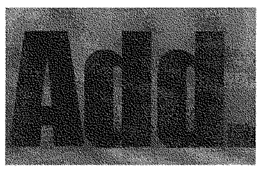
Fiduciary Standard: Preserve Choice and Affordability for Retail Investment and Retirement Savings

- Preserve various levels of "fiduciary" standard—suitability standard, fiduciary standard of care, and ERISA fiduciary duty—so that investors have the option to determine level of service and cost of investments.
- Coordinate related fiduciary rulemakings at the SEC and Department of Labor (DOL) to avoid regulatory conflict and stakeholder confusion.
- Ensure that only plan sponsors and service providers to ERISA-based plans are subject to ERISA's fiduciary duty.



Whistleblower Regulation: Ensure Enhanced Whistleblower Programs Do Not Undermine Strong Company Compliance Programs

- Amend the SEC and CFTC's whistleblower programs to make any wrongdoer convicted of a crime ineligible for an award.
- Amend the SEC and CFTC's whistleblower program to provide consistency with Sarbanes-Oxley required compliance programs by requiring internal reporting of the alleged misconduct, either before or simultaneously reporting the information to the various Commissions.



The Unresolved

CCMC believes that to ensure our markets are the most competitive in the world and our system is better positioned to foresee the next crisis, the following must be **ADDED** to the financial regulatory agendas of the administration and Congress.

Modernize the SEC: Create a World-Class 21st Century Securities Regulator

- Develop a bold and clear plan on how to make rulemaking, supervision, inspections, and enforcement operations within SEC more effective.
- Appoint a deputy chairman to develop and implement a transformational reform plan to break down silos, develop priorities for agency action, and instill managerial accountability and discipline.
- Link increased funding and resources to timely and clear progress towards achieving the plan.
- Put in place procedures to ensure that necessary technology improvements can be effectively incorporated in furthering the SEC's mission.
- Reform hiring practices to acquire the talent needed to regulate complex markets and products.

Regulatory Streamlining and Structural Reform: Improve Regulatory Process to Consolidate or Better Coordinate Regulators

- Extend the requirements for cost-benefit analysis under Executive Orders 13563 and 13579 to all independent agencies.
- Make financial services regulatory agencies and bodies subject to the Unfunded Mandates Reform Act.
- Create systems in all financial regulatory agencies to regularly review and update existing regulations and, if necessary, sunset obsolete regulations.

- Create a post-implementation requirement for a new regulation to undergo a cost-benefit analysis 2 years after promulgation to assess the real-world costs and allow for a correction of unintended consequences.
- Streamline, rationalize, and consolidate regulatory structure by consolidating the SEC and CFTC and explore potential additional changes.

CFPB: Define New "Abusive" Standard to Enable Effective Compliance

- Require the Consumer Financial Protection Bureau (CFPB) to conduct a transparent process to define the "abusive" standard through a policy statement—similar to the statement issued by the FTC defining the Commission's "unfairness" authority.

Restore Securitization Markets

- Address issues that continue to impede the development of liquid, efficient, and well-regulated securitization markets that are critical to efficient debt financing for businesses.

Global Regulatory Coordination: Ensure International Regulatory Efforts Do Not Produce Conflicting Regulations That Are Unworkable

- Ensure greater regulatory coordination on key areas of financial regulation, such as derivatives and systemic risk to ensure a level playing field and globally compatible approaches to regulation when appropriate.
- End efforts to apply domestic regulations extraterritorially and create mechanisms to ensure effective coordination among international regulators to resolve cross-border issues.

Corporate Governance: Ensure Transparent, Evidence-Based Standard Setting

- Hold proxy advisory firms, principally Institutional Shareholder Services and Glass Lewis, to standards that move the industry towards a more accountable, transparent, and evidence-based policymaking process while eliminating core conflicts of interest.

Enfranchising Retail Investors: Make it Easier Rather than Harder for Average Investors to Vote Their Shares

- Promote retail investor participation in proxy voting through examining possible interpretive guidance to give retail shareholders access to Client Directed Voting and greater use of enhanced broker internet platforms, and encouraging greater use of web-based communications and technology.
- Educate retail investors on the distinction between the roles and the fiduciary responsibilities of investment advisors and broker-dealers.

FAR 2013
FIX. ADD. REPLACE.

CENTER FOR CAPITAL MARKETS COMPETITIVENESS.

Financial Reporting: Further Improve Systems to Better Serve All Users of Financial Statements

- Create a consistent global standard for accounting and auditing so investors around the globe are using the same financial reporting "language" and to ensure better investment decisions can be made.
- Require the Public Company Accounting Oversight Board (PCAOB) and Financial Accounting Standards Board (FASB) to follow transparency requirements of the Administrative Procedures Act (APA) and Federal Advisory Committee Act (FACA) in developing standards and conduct cost-benefit analysis of proposed standards.
- Create a financial reporting forum made up of regulators, standard-setters, investors, and businesses to proactively identify problems within the financial reporting system and suggest solutions.

Private Sector Housing Financing: Allow the Private Sector to Return to the Housing Market

- Enact reform that will enable a robust and responsible return of the private sector to the broader housing finance market.

Replace

The Unfixable

The Center for Capital Markets Competitiveness is committed to keeping the United States as the global leader in capital formation. To accomplish this goal, some recent regulatory proposals, including a handful of provisions in Dodd-Frank that undermine rather than strengthen capital formation and well-functioning markets, need to be **REPLACED** or abandoned. CCMC believes the following issues must be resolved to ensure our competitiveness.

The Volcker Rule: The Wrong Approach

- Repeal the Volcker Rule and replace it with higher capital requirements for financial services firms that engage in proprietary trading.

Corporate Governance: Ensure Compliance Requirements Add Shareholder Value and Don't Discourage Companies from Accessing Public Markets

- Repeal Conflict Minerals and Resource Extraction rules that place costly burdens on American businesses while failing to achieve foreign policy objectives. Empower appropriate foreign policy apparatus to resolve international conflicts.

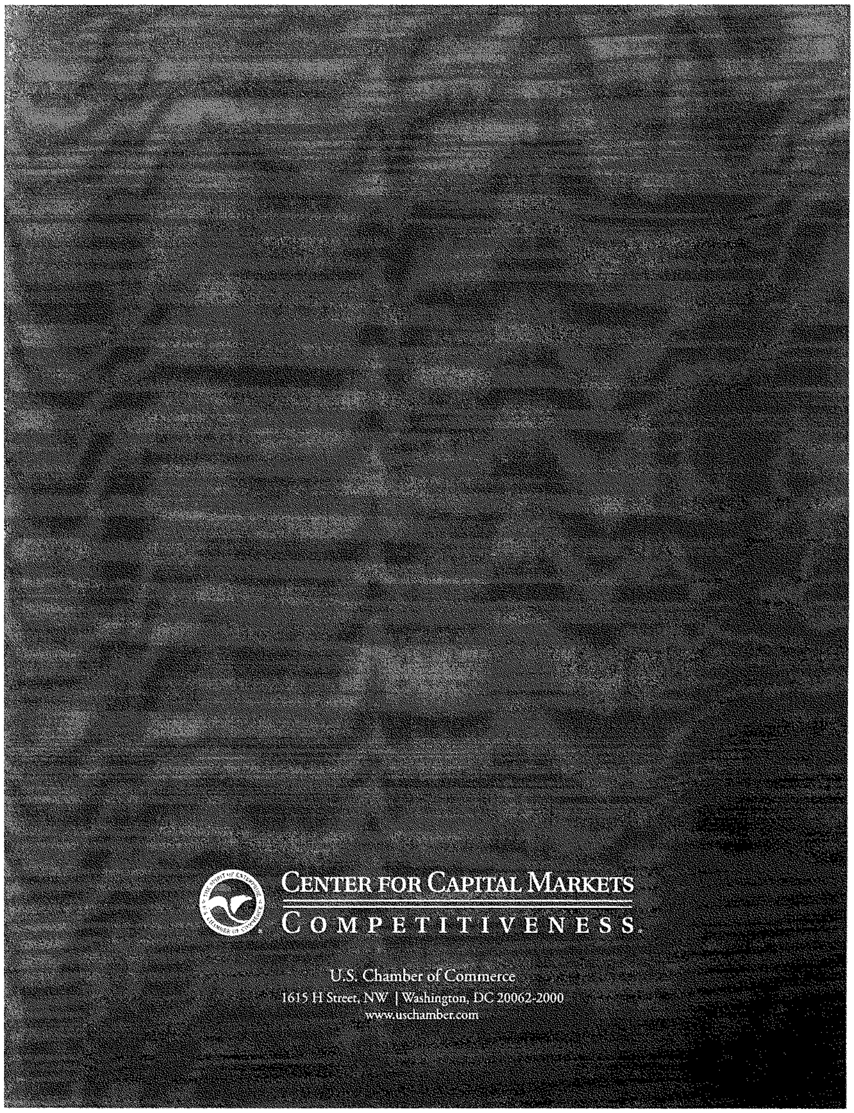
- Support appropriate corporate governance and executive compensation provisions and disclosures that promote long-term shareholder value and allow for reasonable risk-taking while replacing ones, such as CEO-Chairman and Pay-Ratio disclosures, that do little for shareholders.

Financial Reporting: Mandatory Auditor Rotation Is Unworkable

- U.S. and foreign regulators have been considering a mandatory audit firm rotation, which would reduce audit quality, diminish the role of audit committees, increase the incidence of undetected fraud, and raise costs. Regulators on both sides of the Atlantic should abandon this proposal.

Financial Transaction Tax: Stop Disincentives for Investment and Retirement Savings

- Oppose legislative and regulatory actions that would impose a tax on financial transactions, disproportionally hurting Main Street investors and the ability of businesses to raise capital.


CENTER FOR CAPITAL MARKETS
COMPETITIVENESS.
U.S. Chamber of Commerce
1615 H Street, NW | Washington, DC 20062-2000
www.uschamber.com

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D.C. 20062-2000
202/463-5310

May 20, 2013

The Honorable Bill Huizenga
U.S. House of Representatives
Washington, DC 20515

The Honorable Scott Garrett
U.S. House of Representatives
Washington, DC 20515

Dear Reps. Huizenga and Garrett:

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and dedicated to promoting, protecting, and defending America's free enterprise system, thanks you for introducing H.R. 1135, the "Burdensome Data Collection Relief Act."

This bill would repeal section 953(b) of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") requiring businesses to disclose a ratio of the median compensation of all employees to the compensation of the Chief Executive Officer.

The Chamber believes the pay ratio does not provide investors with information relevant to the long-term performance of a company. Section 953(b) also imposes costly, burdensome data collection requirements upon businesses. It requires companies that operate in multiple nations to reconcile differing definitions and practices of compensation. According to the Center On Executive Compensation, one company has estimated that it would cost $7.6 million and take 26 weeks to compile this information, and another has estimated that it would cost $2 million dollars to determine the actuarial benefit of pension benefits for employees alone.

Disclosure requirements that fail to convey relevant information to investors and impose costly burdens on companies are by definition immaterial and antithetical to productive capital formation.

The Chamber strongly supports H.R. 1135 and looks forward to working with you on this important issue.

Sincerely,

R. Bruce Josten

January 19, 2012

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Chairman Schapiro:

The undersigned organizations, institutions, and nonprofits interested in fostering entrepreneurship represent hundreds of thousands of businesses, small and large, and their professionals, from all sectors of the economy employing tens of millions of Americans. We write to you today to encourage the Securities and Exchange Commission ("SEC") to engage in expanded public outreach and consideration of alternatives before moving forward with a public release of proposed rules implementing Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). We specifically recommend that the SEC:

- Hold a roundtable discussion of experts and stakeholders to better understand the potential issues and unintended consequences that may flow from the implementation of the pay ratio disclosure requirements outlined in Section 953(b);

- Consider engaging in negotiated rulemaking to ensure thorough and well-balanced input that minimizes unintended consequences;

- Follow the requirements as outlined in Executive Orders 13563 and 13579 to identify alternative approaches and choose the least burdensome means of implementing the rule;[1] and

---

[1] On September 6, 2011 the SEC issued a press release stating that it would comply with the retrospective look back provisions outlines in Executive Orders 13563 and 13579. It is unclear if the SEC will abide by the prospective rulemaking requirements embodied in these Executive Orders.

- Submit the proposed rule to the Office of Information and Regulatory Affairs ("OIRA") review process to better understand the cost-benefit implications of the pay ratio disclosure requirements.

A more thorough discussion of our concerns is provided below.

Section 953(b) and Current Legislative Activities

Section 953(b) of the Dodd-Frank Act requires a new corporate disclosure stating:

1) The median of the annual total compensation of all employees of an issuer, except the Chief Executive Officer ("CEO"), as calculated in accordance with Item 402(c)(2) of Regulation S-K of the Securities Exchange Act;

2) The annual total compensation of a CEO; and

3) The ratio of the median annual compensation of all employees to the CEO compensation.

It should be noted that Section 953(b) was inserted into the Dodd-Frank Act without any hearings to discuss the matter. Representative Nan Hayworth proposed a bill, H.R. 1062, the Burdensome Data Collection Relief Act, to repeal Section 953(b) in light of the concerns noted below. H.R. 1062 was reported out of the House Financial Services Committee by a bipartisan vote and is currently awaiting action by the full House of Representatives.

Regulatory Burdens and Cost-Benefit Analysis

The corporate disclosure regime is designed to provide information that is useful to investors when making investment decisions. While it may be of general interest to some investors for much different purposes, it is unclear how the pay ratio disclosure will be material for the reasonable investor when making investment decisions. The ratio will inevitably vary widely among industries or businesses without any relevance to the financial performance of a company. Accordingly, additional consideration of any possible benefit to be provided by this disclosure must be considered in the rulemaking process and weighed against the costs discussed below.

The Honorable Mary Schapiro
January 19, 2012
Page 3

Moreover, while compliance with the pay ratio provision may seem straightforward, there are significant hurdles and burdens faced by the business community in attempting to comply with it. In order to promulgate thoughtful rules, the undersigned Associations encourage the SEC to engage the business community in order to determine the full impact that this future rule may have on operations, budgets and corporate resources. There is a widespread misperception that this information is readily available at the touch of a button. This could not be further from the truth.[2] Investors who have taken the time to educate themselves on how companies would have to comply with the rule are beginning to understand this. Accordingly, we ask that you use your authority to host a roundtable discussion to gather information from the people that will handle the practical compliance with this rule. This roundtable discussion should be designated part of the rulemaking record.

Companies may have tens of thousands of employees stretched out over dozens of countries. This is especially the case for our country's largest companies with operations around the world. Obtaining the data will be difficult and time-consuming as the definition of compensation among countries will vary widely, and companies will face difficulties attempting to rationalize compensation with currency fluctuations.

Given the lack of discussion about the practical implications of Section 953(b) prior to its enactment, it is of utmost importance during these difficult economic times that implementing regulations are carefully and thoughtfully proposed. Furthermore, the SEC should use caution during the rulemaking process to ensure that the economic consequences do not outweigh the objectives of the rule.[3]

---

[2] The sheer administrative burden to compile this data has been covered extensively in other comment letters. *See, e.g.*, Comment letter from Tim Bartl, Center On Executive Compensation, to SEC (Nov. 11, 2011). To provide an idea of the significant expenses related to this administrative burden, a member company of one of the undersigned Associations has estimated that to produce the pay ratio disclosure, it will cost roughly $7.6 million and take approximately 26 weeks. Additionally, a separate member company has been unable to produce a complete cost estimate for the pay ratio, but has estimated that determining just one component—the actuarial value of the various pension benefits its employees receive—will cost approximately $2 million annually.

[3] President Obama has acknowledged the importance of approaching regulations carefully with his January 2011 Executive Order encouraging a regulatory process that "protects public health, welfare, safety, and our environment while promoting economic growth, innovation, competitiveness, and job creation . . . [using] the least burdensome tools for achieving regulatory ends." *See* Executive Order 13563, Improving Regulation and Regulatory Review (Jan. 18, 2011); *see also* Barack Obama, "Toward a 21st-Century Regulatory System," WALL ST J. (Jan. 18, 2011).

Unlike many mandates in Dodd-Frank, Section 953(b) does not include a deadline for promulgating regulations. Since there is no statutory deadline, we strongly urge the SEC to resist rushing into proposing regulations, given the substantial cost and implementation burdens that are likely to be imposed on companies. We acknowledge that Section 953(b) is more prescriptive than many Dodd-Frank requirements, but the SEC has been afforded the time to thoroughly analyze the economic impacts different alternatives will have on the U.S. economy at large. Thus, the SEC should consider how to provide the most flexibility for the least cost and minimize the disadvantages that unnecessary regulatory expenditures like this have on American businesses.

In addition, we urge using a negotiated rulemaking process that will allow a representative group of stakeholders on a negotiated rulemaking advisory committee to join with the SEC in developing a balanced and thoughtful rule that can both minimize the burdens and achieve that congressional intent of Section 953(b).

Furthermore, submitting a proposed rule thorough OIRA review will allow for increased scrutiny to better understand the cost and benefits of the pay ratio rules and aid the SEC in choosing the least burdensome means of implementing Section 953(b). This will ensure that the best and most practical approaches can be included in a proposed rule that will balance the perceived benefit of this disclosure against the implementation costs.

Conclusion

Thank you for your consideration of our request to carefully study the impact of any potential proposed rule implementing Section 953(b) of the Dodd-Frank Act as well as our request for an SEC roundtable discussion on this issue, submission of the proposed rule for OIRA review, and for the SEC to use the negotiated rulemaking process. While we understand that Section 953(b) represents a congressional mandate, the rulemaking to implement the pay ratio provisions needs to minimize the regulatory burdens upon the business community and promote investor protection by insuring that disclosures provide relevant information useful to investors when making investment decisions.

We are happy to meet with you or your staff to discuss our concerns in greater detail and assist the SEC in meeting these goals.

Sincerely,

American Benefits Council
American Insurance Association
American Petroleum Institute
Business Roundtable
Center On Executive Compensation
Competitive Enterprise Institute
The Financial Services Roundtable
HR Policy Association
National Association of Manufacturers
National Association of Real Estate Investment Trusts
National Association of Wholesaler-Distributors
National Investor Relations Institute
National Restaurant Association
National Retail Federation
Property Casualty Insurers Association of America
The ERISA Industry Committee
The Real Estate Roundtable
Retail Industry Leaders Association
Securities Industry and Financial Markets Association
Society of Corporate Secretaries & Governance Professionals
Society for Human Resource Management
U.S. Chamber of Commerce
WorldatWork

cc: Securities and Exchange Commission:
Hon. Elisse B. Walter, Commissioner
Hon. Luis A. Aguilar, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Daniel Gallagher, Commissioner

Securities and Exchange Commission – Division of Corporation Finance:
Ms. Meredith Cross
Mr. Lona Nallengara

Ms. Paula Dubberly
Ms. Felicia Kung
Ms. Christina Padden

United States Senate
Hon. Tim Johnson
Hon. Richard Shelby

United States House of Representatives
Hon. Spencer Bachus
Hon. Barney Frank
Hon. Scott Garrett
Hon. Maxine Waters
Hon. Nan Hayworth

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D.C. 20062-2000
202/463-5310

March 12, 2013

The Honorable Robert Hurt
U.S. House of Representatives
Washington, DC 20515

Dear Representative Hurt:

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector and region, thanks you for reintroducing the "Small Business Capital Access and Job Preservation Act."

This bill would amend the Investment Advisers Act of 1940 to exempt private equity fund investment advisers from registration and reporting requirements, provided that each private equity fund has not borrowed, and does not have outstanding, a principal amount exceeding twice its invested capital commitments. This bill would enhance capital formation opportunities to build new businesses, expand existing businesses, and create jobs.

Companies small and large, particularly new businesses, need a mix of capital sources to meet short-term and long-term growth needs. Diversity of capital has provided the liquidity needed for different sized firms to achieve success. The Small Business Capital Access and Job Preservation Act is an important legislation that would help insure that small businesses continue to have access to diverse forms of capital formation.

The Chamber supports the Small Business Capital Access and Job Preservation Act and looks forward to working with you on this important issue.

Sincerely,

R. Bruce Josten

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D.C. 20062-2000
202/463-5310

April 8, 2013

The Honorable Robert Hurt
U.S. House of Representatives
Washington, DC 20515

The Honorable Gregory W. Meeks
U.S. House of Representatives
Washington, DC 20515

Dear Representatives Hurt and Meeks:

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and dedicated to promoting, protecting, and defending America's free enterprise system, supports strong corporate governance and financial reporting policy and thanks you for introducing the Audit Integrity and Job Protection Act.

The Chamber strongly supports this bill, which would ban mandatory audit firm rotation. Implementation of mandatory audit firm rotation would harm investors, endanger the competitive position of American public companies, and degrade audit quality. The General Accounting Office has estimated that mandatory audit firm rotation could increase audit costs by as much as twenty percent. Also, academic research indicates that the costs of audit firm rotation would outweigh the benefits since fraudulent financial reporting is more likely to occur within the first three years of an audit-client relationship and there is no evidence that fraud is more likely with longer audit tenure. Indeed, mandatory audit firm rotation would reduce the supervision and oversight of the audit committee and management, rolling back strong corporate governance policies.

The Securities and Exchange Commission and Congress have rejected mandatory audit firm rotation in the past, and last year, with the passage of the Jumpstart our Businesses Startups Act ("JOBS Act"), Congress explicitly banned firm rotation for emerging growth companies.

The Chamber strongly supports the Audit Integrity and Job Protection Act and looks forward to working with you on this important issue.

Sincerely,

R. Bruce Josten

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
VICE PRESIDENT

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber.com

October 5, 2012

Mr. James R. Doty
Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: **Information for Audit Committees about the PCAOB Inspection Process (PCAOB Release No. 2012-003, August 1, 2012).**

Dear Chairman Doty:

The U.S. Chamber of Commerce (the "Chamber") is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The Chamber has supported increased communication between the Public Company Accounting Oversight Board ("PCAOB"), the business community, as well as with audit committees. In that regard we are very appreciative of the PCAOB's proactive release of *Information for Audit Committees about the PCAOB Inspections Process* ("Release") to help facilitate communications between audit committees and their auditors.

The CCMC would like to take this opportunity to express concerns about the communication and portrayal of inspection findings and how it may undermine public confidence in financial reporting. Accordingly, the CCMC believes that the PCAOB should pursue proposals to boost public confidence in financial reporting including:

Mr. James R. Doty
October 5, 2012
Page 2

1. **Appropriately Define Audit Failure;**

2. **Facilitate PCAOB-Audit Committee-Audit Firm Dialogue;**

3. **Provide Context and Guidance on Differences in Judgment; and**

4. **Develop and Publish PCAOB Policy on Auditors Judgment**

***

PCAOB Mission

The PCAOB articulates its mission as follows:

> The PCAOB seeks to be a model regulatory organization. Using innovative and cost-effective tools, the PCAOB aims to improve audit quality, reduce the risks of auditing failures in the U.S. public securities market and promote public trust in both the financial reporting process and auditing profession.[1]

The CCMC is supportive of that mission and believes that it is an important one for efficient capital markets. Clearly, an effective inspection and compliance program is important for the PCAOB to be an effective regulator. Nevertheless, we are concerned the portrayal of inspections may be undermining public trust in financial reporting and harming the PCAOB's mission.

Definition and Use of Audit Failures

Starting in 2011, the PCAOB began to refer to Part I inspection deficiencies as audit failures. This use of the term audit failures was also included in speeches, public statements and releases. The manner and usage of the term audit failures with Part I inspection findings is contrary to the accepted definition of an audit failure. The PCAOB's current use of the term audit failure may misinform market participants as evidenced by its comparison to the definition employed by the General Accounting

---

[1] From the PCAOB website as of August 28, 2012.

Office in its 2003 surveys ("GAO Report") and report to Congress on the mandatory audit firm rotation concept.

The GAO report defined the term as follows:

> **"audit failure"** refers to audits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud, and reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was not conducted in accordance with GAAS, and, therefore, the auditor failed to appropriately detect and/or deal with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC.[2]

Therefore, a pre-condition for an audit failure is a material misstatement of the financial statements.

The use of the term has become so pervasive that the CCMC last year raised the issue that the PCAOB's use of the term audit failure was in fact not describing a failure. In commenting on the *Concept Release on Auditor Independence and Audit Firm Rotation and Notice of Roundtable* the CCMC stated:

> ...the PCAOB attempts to equate Part I inspection deficiencies to audit failures, although the Concept Release acknowledges that the use of the term "audit failure" describes a situation of not obtaining (or not documenting the evidence to support) the reasonable assurance that a financial statement is free of material misstatement.

---

[2] GAO 04-217 *Public Accounting Firms Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (2003) (pp. 6).

It does not mean that a financial statement is in fact materially misstated.[3]

So an "audit failure" as used in the Concept Release is actually not a failure per se regarding the accuracy of financial reports, but rather the identification of what the PCAOB determines to be a deficiency in the process of an audit, which itself may involve a difference of professional views as to what constitutes appropriate evidence to support reasonable assurance.[4]

It would seem that the term audit failure is being used to describe a deficiency rather than an outright failure. The facts also seem to bear this out.

An analysis of the PCAOB inspection reports of the largest audit firms shows the following:

B4 Inspection Reports

	Number of Issuer Audits			Rate for	
	Part I Findings	Inspected	Restatements	Deficiencies	Restatements
2006	29		4		
2007	29		3		
2008	20		5		
2009	37	267	2	13.9%	0.75%
2010	79	250	2	31.6%	0.80%

While the number of inspections and deficiencies rose, actual restatements in this context, or "failures" declined by 60% as compared to 2008 and declined by 83% as compared to 2004.[5]

[3] Concept Release *Concept Release on Auditor Independence and Audit Firm Rotation and Notice of Roundtable* (PCAOB Release No. 2011-006, August 16, 2011, PCAOB Rulemaking Docket Matter No. 37) Page 5.
[4] *See* letter to the PCAOB from the U.S. Chamber CCMC on *Concept Release on Auditor Independence and Audit Firm Rotation and Notice of Roundtable* (PCAOB Release No. 2011-006, August 16, 2011, PCAOB Rulemaking Docket Matter No. 37) Page 5.
[5] The 83% is based on 12 restatements from the four largest firm inspection as reported in "PCAOB Inspections and Large Accounting Firms," by B. K. Church and L. B. Shefchik in *Accounting Horizons* (March 2012, p. 52).

This steady decline of restatements is a testament to the work of the PCAOB. However, in using the term audit failure to more closely align with the definition in the GAO report the facts also illustrate that the rate and actual number of audit failures is dropping at the same time that the PCAOB is stating the opposite. Indeed proclamations that the audit failure rate is exploding is belied by the fact that the actual failure rate found in inspections is 0.8%. A mismatch between language and facts creates a distortive picture that undermines confidence in financial reporting.

Further, this low rate should be considered in light of the fact that engagements selected by the PCAOB for inspection are not a representative sample—but generally involve the firm's most risky engagements. Typically the PCAOB inspection of those most risky engagements focuses on the auditing of the most difficult or inherently uncertain areas of the financial statements.

Equating Part I inspection findings with audit failures is inconsistent with the PCAOB's own statements in other sections of inspection reports. To illustrate, the section on "Notes Concerning this Report" in the 2010 inspection reports includes the following statement:

> Board inspections encompass, among other things, whether the firm has failed to identify financial statement misstatements, including failures to comply with Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements, in its audits of financial statements. This report's descriptions of any such **auditing failures** (emphasis added) necessarily involve descriptions of the apparent misstatements or disclosure departures.[6]

Audit failures as used by the PCAOB in this context recognizes that misstated financial statements (albeit ones that are materially misstated) are necessary for an audit failure.

To summarize, the current use of the term "audit failure" in conjunction with Part I inspection findings not only runs the risk of causing confusion about the quality

[6] The statement goes on to explain that the PCAOB has no authority to make binding determinations concerning whether an issuer's financial statements are misstated or fail to comply with Commission disclosure requirements. Rather, that authority rests with the SEC.

of audits but undermines confidence in the financial reporting process and the auditing profession. Thus, it contravenes the PCAOB's own vision statement. In addition, it casts doubt on the PCAOB's claim that it has been effective in improving the quality and credibility of audits.[7]

Differing Views and Use of Judgment

Other statements in the Release also contribute to undermining confidence in financial reporting by casting doubt on the veracity of audit firm responses to PCAOB inspection findings. The Release urges audit committees to view with skepticism audit firm responses to PCAOB inspection findings that say: "It was just a documentation problem;" or "There was a difference in professional judgment." While the CCMC appreciates that not all Part I deficiencies can be characterized in these terms, some of them certainly can and audit committees deserve to understand the nature of the issues involved and any difference in views between the PCAOB and the auditor on these issues. The PCAOB cannot maintain the credibility of its inspection process by silencing other views. Meritorious inspection findings should be able to stand on their own and withstand any dissenting views.

It is important to recognize that the Sarbanes-Oxley Act ("SOX") provides for differences in views and audit firms should be able to avail themselves of the processes and protections intended by SOX. Thus, the CCMC is likewise concerned with the implication articulated in the Release:

> "Whether stated or unstated in a firm's response to a draft [inspection] report, if a firm takes a position contrary to the criticism described in the public portion of a report, the matter may not end there as a matter of the Board's processes. While a firm is entitled to disagree with an inspection criticism, the substance of that disagreement can influence various Board judgments, including judgments relating to the firm's quality controls, the timing or scope of the next inspection of the firm, or the possibility of a disciplinary

[7] *See* PCAOB *Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2011-2015* (November 30, 2011), p. 8.

> proceeding to adjudicate the disagreement and, if determined against the firm, to impose sanctions for the failure in the inspected audit[8]

Further, the CCMC would like to point out that the PCAOB's own inspection reports for 2010 contain the following statement with respect to Part I findings and documentation that is inconsistent with the Release:

> In some cases, the conclusion that the Firm failed to perform a procedure was based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claimed to have performed the procedure;

On the matter of judgment, the Release states that: "The PCAOB bases deficiency findings only on failures to obtain sufficient audit evidence, not on disagreements when reasonable judgments appear to have been made about such matters." This statement fails to appreciate that judgment is pervasive throughout an audit. In particular, judgment is essential in a number of the riskier, more complex, and difficult areas of financial reporting that the PCAOB chooses to focus on in its inspections, such as fair values and accounting estimates.

The PCAOB should also acknowledge to audit committees that Part I inspection findings involve differences in audit judgments between auditors and inspectors. Indeed, audit committees need to understand any such differences when they exist. Thus, the Release would have been more helpful if it provided guidance on how to dialogue constructively about any differences in judgment between the firm and the PCAOB inspectors on inspection findings, rather than to deny such differences can possibly exist by maintaining inspectors are right and auditors always simply wrong.

Maintaining Confidence and Public Trust

Audits are complex processes, sometimes involving large teams of people with global reach, and each of these people is required to make a large number and variety of judgments that must consider accounting, auditing, and firm guidance. Given such

---

[8] Release, Page 7

complex processes, it is reasonable to expect that some portion of the engagements inspected by the PCAOB would have room for improvement.

Given this perspective, it is concerning that the PCAOB uses inspection findings to broadly criticize all auditors. Essentially, inspection findings from a few engagements are used to indict the many without context. This approach is undermining public trust and confidence in both the financial reporting process and auditing profession and the PCAOB's claims that audit quality has improved.

Further, the current approach is in marked contrast to that used by the PCAOB initially in framing its inspection findings. For example, the Inspection Report Overview section of the inspection reports from the limited inspections for the largest accounting firms in 2003 included the following:

> The reports' emphasis on these criticisms, however, should not be understood to reflect any broad negative assessment. The four firms inspection in 2003 are made up of thousands of audit professionals, have developed multiple volumes of quality control policies, and perform audits for a combined total of more than 10,000 public companies. It would be a mistake to construe the Board's 2003 inspection findings as suggesting that any of these firms is incapable of providing high quality audit services.
>
> Moreover, the Board does not doubt that the bulk of the firms' audit professionals consist of skillful and dedicated accountants who strive—at times against the competing priorities of the large and complex business of the firms—to make audit quality their top priority. The Board is encouraged by the increasing tendency of persons at the highest levels of the firms to speak of the need for a renewed commitment to audit quality as the firm's top priority. The Board is also encouraged by the firms' recognition of the value of the Board's inspection process. The Board will continue to use its inspection authority to focus the firms on aspects of their practice that may stand as an impediment to the highest quality audit performance.

Given that the PCAOB maintains that audit quality has improved over the last decade, these statements by the PCAOB should be truer today. Providing context such as this for PCAOB inspection findings would go a long way towards maintaining public trust and confidence in the quality of auditing, the financial reporting process and the auditing profession.

Proposals to Facilitate Audit Committee Understanding and Improve Public Confidence

The CCMC believes that the following proposals can resolve these concerns, facilitate audit committee understanding of the inspections process and findings and promote public trust in financial reporting.

1. **Define Audit Failure**: The PCAOB should define audit failure so that it is known with certainty by capital market participants what is meant by the term. This will allay any confusion. Such a definition should include a material misstatement as a precondition of an audit failure.

2. **Facilitate PCAOB-Audit Committee-Audit Firm Dialogue**: To promote the information available to audit committees, PCAOB inspectors should engage in a 3-way dialogue with audit committees and audit firm personnel before completing fieldwork on an inspection. This should be done if the inspection team has any concerns about the audit that are expected to result in Part I findings and it should be noted that audit committee members have called for such a dialogue.

3. **Provide Context and Guidance on Differences in Judgment**: Guidance should be give to audit committees on how to understand and engage in constructive dialogue about any differences in judgment between the firm and the PCAOB inspectors on inspection findings. The inspection findings should also give the context of those differences.

4. **PCAOB Policy on Auditors Judgment**: The Final Report of the Advisory Committee on Improvements to Financial Reporting to the U.S. Securities and Exchange Commission ("CIFIR") included a recommendation that the PCAOB develop a statement of policy articulating how it evaluates the

reasonableness of auditing judgment and include factors that it considers when making this evaluation.[9] This will provide auditors and audit committees with certainty of how and when judgment may be exercised. Such a policy will also provide additional context for a difference of views and a better understanding of any Part 1 findings.

Conclusion

The CCMC believes that effective and fair regulators are a necessity for efficient capital markets. While we have concerns that the loose use of the term audit failure undermines public confidence in financial reporting harming capital markets, we believe that the proposals outlined in this letter can reverse that trend and promote effective audit regulation.

Thank you for your consideration of these views and we are happy to meet with you to discuss these views further.

Sincerely,

Tom Quaadman

Cc: Lewis Ferguson, Public Company Accounting Oversight Board
Jeanette Franzel, Public Company Accounting Oversight Board
Jay Hanson, Public Company Accounting Oversight Board
Steven Harris, Public Company Accounting Oversight Board
Paul Beswick, Chief Accountant, Securities and Exchange Commission
Brian Corteau, Deputy Chief Accountant, Securities and Exchange Commission

[9] Recommendation 3.5 of the CIFIR report found on pages 13-14.

1

SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

Statement for the Record

By Mr. Marc A. Reich
President, Ironwood Capital

On behalf of:
Small Business Investor Alliance
1100 H Street, Suite 610
Washington, D.C. 20005
(202) 628-5055
www.SBIA.org

Hearing entitled "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators"
House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Enterprises
2128 Rayburn House Office Building at 9:30AM, May 23, 2013

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee, thank you for the opportunity to testify today.

My name is Marc Reich, and I'm president of Ironwood Capital, a private equity firm in Avon, Connecticut, with over $500 million of capital under management. I am here today representing the Small Business Investor Alliance, which is the trade association of lower middle market private equity funds and our institutional investors. SBIA members provide vital capital to small and medium sized businesses nationwide.

My firm manages six private equity funds, four of which are organized as Small Business Investment Companies (SBICs). We provide subordinated debt and equity securities to privately held small businesses in amounts ranging from $5 million to as much as $12 million. These investments support small business owners and financial sponsors in growth financings, recapitalizations, and buyouts. In addition, we seek to invest 50% or more of our total capital in businesses owned or managed by women or minorities and businesses located in low- and moderate-income communities.

I'm here to strongly support a bipartisan bill called the Small Business Capital Access and Job Preservation Act (H.R. 1105), introduced by Representatives Robert Hurt of Virginia, Jim Himes of Connecticut, Scott Garrett of New Jersey and Jim Cooper of Tennessee. Thank you to the Committee for examining this bill today, and especially to the sponsors of the legislation for working so diligently to bring it to this point.

SBIA advocates for a healthy capital markets ecosystem in which every market segment needs to work efficiently in order for the ecosystem to function well. In the private equity marketplace, the market needs to be healthy for the whole investing continuum – from seed and early stage to venture to growth to mezzanine to buyout firms. Fortunately, my firm and the lower middle market private equity industry weathered the global downturn in good shape - a clear indicator that middle market private equity does not pose any systemic risk to the financial system. In fact, private equity saved many small businesses when the financial crisis froze many of their access points to credit.

H.R. 1105 strengthens the ecosystem of the private equity marketplace by reducing over-regulation that threatens capital access for small businesses. This bill will help private equity funds by removing unnecessary regulatory burdens that are tying up precious resources and wasting investor capital which would otherwise be directed towards growing small businesses.

My testimony today will concentrate on four major areas on why the lower middle market should be exempt from SEC registration: 1) lower middle market and middle market funds are not a systemic risk to the financial system; 2) SEC compliance and regulatory costs are high especially for small business investment funds; 3) advisers that manage multiple funds such as Small Business Investment Companies (SBICs) and non-SBICs face a double regulation; and 4) many SEC rules are one-size-fits-all and inapplicable to the private equity industry.

The Investment Advisers Act of 1940, as modified by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), requires private fund advisers to register with the SEC if the investment advisers manage more than $150 million in assets under management ("AUM"). Since the Act became effective, over 1,500 new private fund advisers have registered with the SEC as investment advisers. Many SBIA members are SEC-registered.

In January 2013, SBIA surveyed its members to identify their "top pain points in complying with SEC rules".[1] The survey results pointed to many common themes, some of them I quote below:

- "Cost associated with the registration of our size fund"
- "Several layers of paperwork"
- "Rules are not as clear as they could be"
- "Many rules not applicable to private equity especially smaller firms"
- "Double regulation by federal and state agencies"
- "How can the data of a small fund be a systemic financial risk to the economy"
- "Cost of and time to implement and monitor a mandatory compliance program"
- "Hiring of additional personnel to comply"
- "Outside counsel costs"
- "Lack of understanding of what the SEC wants to see in an inspection"
- "Time and paperwork to respond to requests and audits"

The themes highlighted above need to be examined in more detail and my testimony will highlight how my firm and hundreds of other small funds are negatively impacted by SEC registration. I will present for you cost issues, double regulation, inapplicable rules, and many other themes because these are comments from small business investors about how to reduce over-regulation and allow us to do what we do best: invest in our nation's small businesses.

Private Equity – A Systemic Risk?

The investment adviser threshold of $150 million of assets under management by an adviser to private funds is entirely too low, simply because it does not accomplish the Act's stated purpose of helping identify and reduce systemic risk in the U.S. financial system. Private funds, especially private funds with assets under management of less than $500 million and unlevered funds, did not cause or contribute to the financial crisis.

I'm asking you to support the Small Business Capital Access and Job Preservation Act first and foremost because you agree that my industry is not systemically risky. The typical private fund in the lower middle market invests over the course of three to five years in a portfolio of ten to twenty companies. Our portfolio company investments are spread out among many growing

[1] SBIA Member Survey 2013; Internal Document.

businesses. Even if several of them failed or underperformed, the overall fund performance should still be acceptable because the risk is spread among investments in many companies.

We don't create systemic risk by trading in synthetic financial instruments, we don't speculate on currencies or commodities, we don't put the retirement funds of individuals at risk, we invest directly in small businesses, the backbone of our economy and the growth engine for job creation. Unlike many hedge funds and some mutual funds, private equity funds are long term investors and investors in such funds understand that capital will be committed for an extended period of time and is not subject to quarterly redemption events that can have a cascading effect in a systemic market breakdown. The only way for our funds to make money is to find and grow businesses. Our country needs more focus on this type of investment and the growth it enables.

Regulatory Costs Higher for Smaller Funds

The lower middle market of the private equity fund space is especially vulnerable to regulatory costs. Smaller funds are highly unlikely to have legal departments, compliance teams, regulatory compliance software regimes and other forms of overhead that the new regulatory system assumes we have or will require. Lower middle market private equity funds generally only specialize in finding and growing small businesses. For most of these funds the idea of adding regulatory compliance staff is largely a foreign concept. While Small Business Investment Company (SBIC) funds need to comply with SBA regulations, their compliance staff are small and compliance is often sent out to specialists. However, the standards of the SEC for reporting and compliance differ from those required by the SBA. SBA reports and filings are not accepted, despite the fact that SBIC filings are designed specifically for private equity.

The cost is relatively high for smaller funds because their management fees (which are a function of assets under management) are low when compared to much larger funds; however, smaller funds face many of the same compliance and reporting levels as larger funds. Absent the compliance infrastructure of larger funds smaller funds often have to pay outside counsel to help with initial and ongoing compliance costs. The effect of the relatively high compliance expense leaves managers of smaller funds with two choices – raise far more capital for their next fund to get fees to pay for the added compliance costs or exit the business. Larger funds invest in larger companies, generally not small businesses. Neither option is good for the prospect of a continuing flow of capital to small businesses.

For every $1 that we spend on compliance issues, there is $1 less that we have to invest in our nation's small businesses. And all the money that is tied up by regulatory compliance will not be able to be released into the capital markets, which will hinder economic growth and job creation. H.R. 1105 fixes this by exempting private equity funds from SEC registration, unleashing capital that would have been tied up and places it into the hands of our best job creators. Reporting would still be required under H.R. 1105 so Congress should ensure that reporting requirements are not onerous or costly.

Annual SEC Compliance Costs

At Ironwood Capital, we spend approximately $250,000 annually on compliance costs. This includes complying with the regulations of both the SBA and the SEC but does not include the additional compliance and reporting expenses associated with our investors. Remember, we have four SBIC funds and two non-SBICs funds, so the double regulation that hits Ironwood Capital is multiplied and costly. The SEC estimates that annual SEC costs could be as low as $50,000 for a small firm and as high as $500,000 for a middle market private equity fund.[2] These expenses include paying outside counsel, hiring an internal Chief Compliance Officer and paying other service providers. The cost of an SEC examination adds to this cost. The expense to prepare for an SEC examination includes attorney preparation fees and the cost of internal staff and management that must be deployed to exam preparation from their normal duties. One SBIA member noted that the cost to prepare for an exam totals approximately $25,000.

In addition to the actual dollar costs of compliance the regulations consume time and remove the focus of fund managers from growing businesses. While this is true for both large and small funds, there is a particularly meaningful drag on smaller funds that generally have smaller teams and operate in very lean environments.

Cost of Calculating Assets Under Management
For many smaller funds, the process is expensive and complicated to calculate assets under management (AUM) to determine if they have to register as an investment adviser. The AUM calculation uses the market value of private fund assets, or the fair value of private fund assets where market value is unavailable. Many private equity funds already value their some of their portfolio companies on a periodic basis as a business practice, but the requirement by the SEC is mandatory and requires full reporting of all the assets under management. Moreover, many SBICs must use a different valuation methodology that is mandated by the SBA, with a resulting doubling of the cost. The SEC estimates that registered advisers would incur costs as a result of the fair market value requirement of $37,625.[3] We believe this number is too low.

Fluctuating Above and Below the Thresholds
The triggering thresholds for adviser registration or reporting falsely assume a static size of the fund. The value of a fund fluctuates over its life. One year a fund may be $140 million in AUM and the next be $160 million in AUM. The following year the fund may again change to $145 million. These normal fluctuations can cause legal and regulatory problems for funds hovering around the triggering thresholds. The triggering thresholds are too low and do not take into account the normal variability of a fund's value.

---

[2] Securities and Exchange Commission; Final Rule on Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with less than $150 million in Assets Under Management, and Foreign Private Advisers; Pg. 153. http://www.sec.gov/rules/final/2011/ia-3221.pdf
[3] SEC Final Rule; Pg. 177. http://www.sec.gov/rules/final/2011/ia-3222.pdf

Cost of Initial Registration
The process of registering is not as easy as filling out a one page form, writing a check, and sending it in the mail to the SEC. After the process of figuring out if you need to register by calculating your AUM, the act of registering is a one-time added expense to a firm. The process to fill out form ADV and complete the private fund reporting requirements is estimated by the SEC to cost $15,077.[4] The SEC expects each adviser to spend approximately 40 hours filing their initial reports on Form ADV. This process also requires "preparing and filing interim updating amendments to the form, preparing brochure supplements and delivering codes of ethics to clients."[5]

Cost to Establish and Maintain Compliance Program
For many smaller firms, the cost to establish and maintain the statutorily mandated investment adviser compliance program can be daunting. It includes hiring additional personnel to comply and monitor new regulations and paying an outside counsel to provide advice on rules that are complicated. The SEC estimates the one-time costs to new registrants to establish a compliance infrastructure would be as high as $45,000. The estimation is based on $20,000 in professional fees and $25,000 in internal costs including staff time.[6] Estimated costs for establishing and maintaining a compliance program, as calculated by SEC, are way below actual costs of compliance. In large measure this is due to the lack of clarity to date from the SEC in terms of how it will apply the rules. Greater transparency from the SEC is necessary to the smooth operation of fund managers. In the absence of such clarify and in the face of the SECs current one size fits all approach, private equity mangers are spending time and money on compliance that would be better directed to investment in small businesses.

Inapplicability of SEC Rules to Private Equity Funds

Being an investment adviser comes with a high level of regulatory scrutiny and a body of rules and regulations to follow. Many SEC rules related to registration requirements are based upon mutual fund adviser registration requirements and are not relevant to private equity fund managers. Passage of H.R. 1105 would be the best way to get rid of these costly rules that should not apply to the private equity industry.

Below are some of the most cited rules by SBIA members that are not applicable to private equity funds:

Custodian Requirement Rule
From a logistical and practical standpoint, the custodian rules make little sense for lower middle market and middle market funds. Our "Securities" are little more than a stack of documents specific to a transaction. They are generally not an easily transferable or negotiable document

[4] SEC Final Rule; Pg. 151, http://www.sec.gov/rules/final/2011/ia-3222.pdf
[5] SEC Rules Implementing Amendments to the Investment Advisers Act of 1940; Pg. 147. http://www.sec.gov/rules/final/2011/ia-3221.pdf
[6] SEC Final Rule; Pg. 152. http://www.sec.gov/rules/final/2011/ia-3221.pdf

that would have some potential value in the hand of an unscrupulous third party. The custodian rule requires private funds to spend time and resources hiring a third-party custodian to hold onto unrestricted, untradeable securities. We are not stock brokers or mutual funds and we do not hold publically tradable securities. We are private equity funds and we hold untradeable securities that are prepared by our attorneys. There is no added security for our investors to have the documents held by a custodian, only incremental expense.

Email Screening

In accordance with SEC guidelines, all email messages of SEC-regulated private equity firms are automatically retained and archived so that they may be retrieved, searched and reviewed by the Chief Compliance Officer or a regulator. On at least a monthly basis, the Chief Compliance Officer conducts reviews of all electronic communications sent by firm personnel to detect illegal activities such as insider trading in publically traded securities. Given that middle market private equity firms generally do not deal in or otherwise purchase or sell publically traded securities since they normally invest in privately-held companies, such email screening is purely a regulatory exercise with no benefit to investors nor does it contribute to the safety and integrity of the overall financial system. This is a time consuming and irrelevant compliance procedure that serves only to "paper" the compliance files.

Monitoring of Employee Brokerage Activity

One of the rules that may be applicable to funds focused on publicly traded businesses but small private equity funds is the requirement that they monitor employee (and familial) brokerage activity. While this might make sense if an existing portfolio company is publicly traded (in regards to trading activity in that specific company), it otherwise requires hours of employee time to sort through brokerage statements, record transactions and confirm that the various transactions had been approved prior to execution. One firm has put into place a "gray list" of companies in which employees must not make investments. For example they put public companies on the gray list if they have knowledge of a buyout opportunity, and make sure their employees avoid purchasing public stock in those companies.

Form PF

SEC-registered investment advisers are required to fill out lengthy forms called the PF form.[7] Most private equity funds are required to make annual filings of Form PF. Form PF requires private equity funds to collect and report data that many have never collected, making it a very labor intensive and expensive process. Form PF requires an investment adviser to calculate and report data on the following: 1) total regulatory assets under management[8] and total net assets under management; 2) gross asset value[9] and net asset value of fund; 3) value of the reporting

[7] Form PF is designed to assist the Financial Stability Oversight Council in assessing systemic risk in the U.S. financial system posed by investment funds.
[8] The cost to calculate AUM is estimated to be as high as $75,000 on an annual basis, as reported by the SEC in SEC Final Rule; Pg. 178. http://www.sec.gov/rules/final/2011/ia-3221.pdf
[9] This calculation is also made on Form ADV Section 7.B.1.

fund's borrowings and types of creditors; 4) summary of the fund's assets and liabilities; and 5) performance of the fund during each month of the fiscal year calculated by gross performance and net of management fees and incentive fees and allocations.

We strongly believe that private equity funds, especially smaller funds, do not pose a systemic risk. With that said, even if they were a systemic risk, some of the required responses on Form PF would not help the Financial Stability Oversight Council determine systemic risk. For example, it is not clear how the calculation that requires month-to-month fund performance, broken down by gross performance and net of management fees, will be used to determine if the fund is a systemic risk.

Double Regulation

The Small Business Investment Act of 1958 effectively created the market for small business investing by establishing a program to stimulate and supplement the flow of private equity capital for the sound financing of business operations for growth and expansion.[10] Since the creation of the SBIC program, the Small Business Administration has established a sound regulatory structure, designed for private equity investing, that provides a robust body of rules and safeguards for the industry. For example, the conflict of interest rules that govern SBICs have been developed over the past 50 years and represent historical real world examples of what is and what is not a conflict of interest.

In recognition of the SBA already providing a regulatory structure for SBICs, Congress provided an exemption from investment adviser registration for SBICs. The Act states, in summary, that an investment adviser that solely advises a licensed Small Business Investment Company is exempt from registration under the Advisers Act.[11]

SBICs Trigger the $150 Million AUM Threshold
However, if an adviser advises for SBICs and any other private funds and the total assets under management exceed the $150 million registration threshold (as it does for Ironwood Capital) the threshold for full registration is triggered. The double counting of capital, even otherwise exempt capital, causes double regulation for advisers that advise SBICs and any other private funds (non-SBICs). Firms should not be required to count the SBIC exemption as part of the $150 million threshold. Congress did not intend for firms to face the threat of double regulation, and it is important to remove the double regulation of SBICs and non-SBICs. H.R. 1105 is one way to address this issue.

[10] P.L. 85-699, as amended.
[11] See Section 203(b)(7) of the Advisers Act. In addition to licensed SBICs, entities that have received from the SBA notice to proceed to qualify as an SBIC, and applicants that are affiliated with one or more licensed SBICs and that have applied for another SBIC license, are also exempt from registration under the Advisers Act.

Conflict between SBIC Statutory Accounting and GAAP Accounting
Many firms are experiencing a mountain of new paperwork and auditing burdens on already regulated private funds. One issue we are hearing about is the conflict between SBIC statutory accounting and GAAP accounting. SEC registered investment advisers must get a GAAP audit for all their funds. This is in addition to the already required financial and compliance audits (using statutory accounting) required by the SBA. One SBIA member with SBIC funds and one non-SBIC fund is being told to re-audit all the SBIC funds using SEC standards at a cost of about $600,000. So now the SBIC funds will have two sets of books and two sets of audits to comply with two sets of regulators. This is effectively throwing money down the drain instead of investing in domestic small businesses. Given that SBIC reporting is designed for private equity and has been developed for private equity for over 50 years, the SEC ought to accept the financial reporting that is already required to maintain an SBIC license.

SBICs can be Registered by the States
Congress exempted SBIC fund managers but inadvertently triggered double regulation via state regulation. There is not any explicit language in the Dodd-Frank Act, the Advisers Act or the new regulations promulgated by the SEC that prevents any state from requiring the registration of an adviser that solely advises SBICs. Even if such an SBIC adviser had assets under management of $150 million or more, it is unclear in the Act whether the SEC would permit the adviser to register with the states. Because of this drafting oversight in the Act, it is possible that SBICs would have to register with multiple states and multiple territories despite being licensed and regulated at the Federal level by SBA. A technical correction in the Dodd-Frank Act is needed to remove this unintended double regulation so that SBICs are only regulated by the SBA.

SBICs can be leveraged up to 3:1 leverage ratio
It is important to note that statutory rules permit SBICs to borrow up to three times the amount they raised from private investors. This amount is leveraged by an SBA-backed credit facility and is only approved by the SBA after a thorough evaluation of the status of the SBIC. Advisers that manage more than one fund including an SBIC and a non-SBIC also need an exemption from SEC registration because they are already regulated by the SBA.

Reduce Burdens for Small Business Investment Funds

Small business investment funds are especially vulnerable to the burdens of over-regulation. We agree with the intent of H.R. 1105 that private equity funds can provide basic and limited information to the SEC, provided that this takes into account fund size, governance, investment strategy, risk, other regulation, and other factors. But it is critical to remember that the cost of compliance on smaller funds is disproportionate to their size. We ask the SEC and the Committee to consider reducing the regulatory burden for funds investing in small and medium sized businesses. The SEC should refer to the Small Business Investment Act of 1958, which indicates that the Administration should include full and detailed accounts relative to a report from the Securities and Exchange Commission enumerating actions undertaken by that agency to simplify and minimize the regulatory requirements governing small business investment companies under the Federal securities laws and to eliminate overlapping regulation and jurisdiction as between the SEC, the Administration and other agencies of the executive branch.[12]

Conclusion

Thank you to the Committee for holding this hearing on HR 1105, a bill that removes over regulation of small business investors so that we can focus our time and capital on investing in and growing small businesses. Some small technical changes could be made to the underlying legislation and we look forward to working with you to advance this bill into law. I am happy to answer any question you may have.

[12] P.L. 855 699 as amended, Section 308 (g)(2)(h)

Testimony of Damon A. Silvers

Policy Director and Special Counsel

American Federation of Labor and Congress of Industrial Organizations

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on Legislative Proposals to Relieve the Red Tape Burden

on Investors and Job Creators

May 23, 2013

Good morning, Chairman Garrett, and Ranking Member Maloney. I am Damon Silvers, and I am the Policy Director and Special Counsel of the AFL-CIO. In addition, I serve on the Office of Financial Research's Financial Research Advisory Committee, a body devoted to assessing systemic risk in the financial system; the Securities and Exchange Commission's Investor Advisory Committee; the Standing Advisory Group of the PCAOB; and I served as the Vice Chair of the Congressional Oversight Panel for TARP during the aftermath of the 2008 Financial Crisis. My testimony today though is solely on behalf of the AFL-CIO.

The AFL-CIO is a Federation of 57 member unions representing 12 million working people. Union members participate in benefit plans with over $4 trillion in assets, and unions and employers jointly sponsor retirement funds with over $550 billion in assets.

Since 1980, the United States has gone through several cycles of financial deregulation, followed by speculative bubbles. The first of these episodes led to the savings and loan fiasco of the early 1990's, the second to the tech bubble collapse in 2000 and the wave of corporate scandals and bankruptcies that began with Enron in 2001. And the third, and by far the most devastating, was the residential real estate bubble driven by a deregulated banking sector through the use of mortgage backed securities, and the subsequent collapse of that bubble starting in 2007. The Bank of England has estimated that the worldwide cost of the collapse of the most recent U.S. centered financial bubble is in excess of $60 trillion.[1]

Today, this Committee is considering a package of bills each of which is wrongheaded in its own peculiar way, and which taken as a package are a clear indication that the House of Representatives is actively seeking to initiate another round of financial deregulation. This effort is not limited to the bills under consideration today, but includes the recently passed JOBS Act, a number of bills designed to deregulate the over the counter derivatives business, bills designed to

[1] Andrew Haldane, *The $100 billion question*, Mar. 30, 2010 *available at* http://www.bis.org/review/r100406d.pdf?frames=0.

weaken the Consumer Financial Protection Bureau, and bills designed to repeal those portions of Dodd-Frank that address the problem of how to wind down "too big to fail" financial institutions.

Predictions are a dangerous business, but the recent history of financial markets strongly suggests that this legislative effort, should it prove successful, will seriously increase the risk of another cycle of financial bubble and bust, with serious implications for the larger U.S. economy.

I would now like to turn to the specifics of the bills before this subcommittee.

H.R. 1135, "The Burdensome Data Collection Relief Act"

H.R. 1135, the "Burdensome Data Collection Relief Act," seeks to keep secret the relationship between CEO pay and the median pay of other employees at public companies, by repealing section 953(b) of the Dodd-Frank Act, which requires such disclosure. The AFL-CIO strongly opposes H.R. 1135. It is a bill designed to hide material information from investors, encourage runaway CEO pay and increase economic inequality.

Despite the fact that the Dodd-Frank Act passed three years ago, the Securities and Exchange Commission has failed so far to carry out its statutory obligation to issue implementing rules for Section 953(b) of the Act. In the absence of the firm specific information required by the Act, Bloomberg News recently conducted a study comparing CEO pay to the pay of the average US worker in the same industry. Bloomberg found that the average CEO-to-worker pay ratio for S&P 500 companies is 204-to-1. The average ratio for the top 100 paid executives in the S&P 500 was 495-to-1.[2]

But the real numbers investors need are still completely secret. We live in a globalized environment. America's public companies employ people around the world, and the true nature of the disparities between CEO's and their employee teams would be revealed by Section 953(b).

And this is precisely the information investors need—company specific, company wide data. Why?

Investors have long had multiple concerns about CEO pay—starting with the raw numbers that come out of investors' pockets. Top executives at large public companies now keep for themselves an average of 10% of their companies' net profits, approximately double the rate in the early 1990s.[3]

CEO pay levels are currently often based on "peer group analysis" that has contributed to CEO pay inflation, by encouraging the "all CEO's are above average" phenomenon. CEO-to-worker

[2] Elliot Blair Smith and Phil Kuntz, *Disclosed: The pay gap between CEOs and Employees*, Bloomberg Businessweek (May 2, 2013) *available at* http://www.businessweek.com/articles/2013-05-02/disclosed-the-pay-gap-between-ceos-and-employees
[3] Lucian Bebchuk and Yaniv Grinstein, The Growth of Executive Pay, Oxford Review of Economic Policy, Vol 21 (2005).

pay ratio disclosure will enable investors and boards to also consider the relationship of CEO pay to other company employees.

But CEO pay disclosure is about much more than the raw wealth transfer. CEO pay in relation to compensation throughout the firm is a key indicator of the quality of the firm's culture and management. Jim Collins, author of the international bestselling book *Good to Great*, conducted an exhaustive survey to identify companies that are truly "great." "Great" companies were defined as those which generated, over fifteen years, cumulative stock returns that exceeded the market by at least three times. Of the nearly 1,500 companies that Collins surveyed, not one of the "great" companies had a high-paid, celebrity CEO.[4] Such celebrity CEOs turn a company into "one genius with 1,000 helpers," taking focus away from the motivation and creativity needed from all of a company's employees.[5]

Organizations with a high disparity of pay between top paid employees and lower paid workers suffer a decline in employee morale and commitment to the organization.[6] Extreme disparities between CEO and employee pay produce significant deterioration in the quality of products produced by employees.[7] Strongly disproportionate CEO compensation compared to other employees results in higher employee turnover and lower job satisfaction.[8] Finally, firms with high levels of CEO pay relative to other top executives have reduced performance.[9]

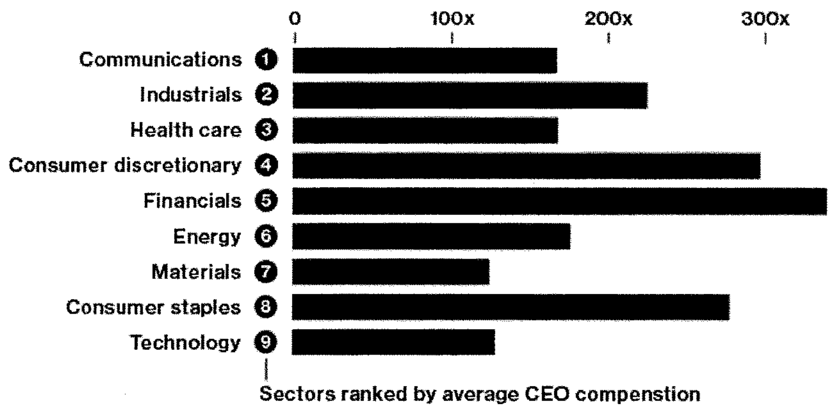
Section 953(b) gives investors and boards the data they need to act on the insight of the late management theorist Peter Drucker, who thought "excessively high multiples undermine teamwork and promote a winner-takes-all, 'did-it-because-I-could' culture that's poison to a company's long-term health." And his idea of excessively high was more than 25-1.[10]

---

[4] Jim Collins, Good to Great: Why Some Companies Make the Leap . . . and Others Don't, (HarperBusiness, 2001).
[5] Interview with Jim Collins, Great Answers to Good Questions, Fast Company, August 31, 2001.
[6] See e.g. Jeffrey Pfeffer, Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained, Journal of Economic Perspectives, Vol. 21 (2007).
[7] Douglas Cowherd and David Levine,Product Quality and Pay Equity Between Lower-Level Employees and Top Management, Administrative Science Quarterly, Vol. 37 (1992).
[8] Matt Bloom and John Michel, The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover, Academy of Management Journal, (2002). See also James Wade, Charles O'Reilly III, and Timothy Pollock, Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation, Organization Science (2006), finding the same effects stretching down at least five levels down the chain of command.
[9] Lucian Bebchuk, Martijn Cremers, and Urs Peyer, The CEO Pay Slice, September 2010, Journal of Financial Economics.
[10] Elliot Blair Smith and Phil Kuntz, *Disclosed: The pay gap between CEOs and Employees*, Bloomberg Businessweek (May 2, 2013) *available at* http://www.businessweek.com/articles/2013-05-02/disclosed-the-pay-gap-between-ceos-and-employees

Pay Gap by Industry Sector

Ratio of CEO compensation to average worker pay for S&P 500 companies



GRAPHIC BY BLOOMBERG BUSINESSWEEK. DATA: COMPANY REPORTS. DATA COMPILED BY BLOOMBERG

<u>H.R. 1105, "The Small Business Capital Access and Job Preservation Act."</u>

This Act has nothing to do with small business and everything to do with ensuring some of the richest and most powerful, and most tax subsidized, Wall Street firms are allowed to continue to operate, and build up system-wide leverage, in secret.

H.R. 1105 would exempt all private equity fund advisers from the registration and reporting requirements in the Dodd-Frank Act, unless each fund has outstanding borrowings that exceed two times the fund's invested capital commitments.

This would be a bad idea even if this bill meant what it appears to mean. But it has embedded in it two fundamentally misleading concepts. The first is the very idea of a "private equity fund." There is no fundamental legal distinction between private equity funds, hedge funds and venture capital funds. These are terms that describe broad investment strategies, not legal structures. So the bill directs the SEC to define what a private equity fund is. And there is no telling how broad or narrow, or gameable, such a definition will be. So if Congress enacts this bill, it will be potentially opening a loophole in the hedge fund registration requirement big enough for every hedge fund billionaire in Greenwich willing to pay a lawyer to drive through.

Then there is the leverage limitation. This limitation is also an illusion, clearly drafted in bad faith, because it applies to leverage at the fund level, and only to "private equity funds." Investment partnerships that pursue private equity strategies—which is public relations code for leveraged buyouts rarely utilize debt at the fund level. The vast majority of borrowing in private equity transactions occurs at the portfolio company level, in their operating subsidiaries, not at the fund level.[11] Often advisers are subject to explicit contractual limitations on leverage at the fund level that are agreed to with tax-exempt investors to allow them to avoid paying "unrelated business income tax" (UBIT).[12]

Investment partnerships that pursue hedge fund strategies typically incur debt at the fund level, which is why the SEC's current definition of a hedge fund includes all investment partnerships that incur significant debt.

The impact of this bill would be to prevent the SEC from collecting the information necessary to monitor a significant source of systemic risk. Section 404 of the Dodd-Frank Act gave the SEC authority to establish recordkeeping and reporting requirements "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council." H.R. 1105 would exempt private equity funds from this recordkeeping and reporting framework and direct the Commission to replace it with one that omits consideration of potential systemic risks and is exclusively for use by the Commission. The Commission has already finalized a disclosure regime for private funds as was required by Title IV of Dodd-Frank.[13] The disclosure requirements distinguish among funds by type and size. The frequency and content of reporting vary depending on these factors.

An appropriate examination of the potential systemic risks associated with leveraged buyout activities must consider the financial system's exposure to leveraged buyout debt from the perspective of the leveraged buyout fund that controls the entities that have incurred the debt. According to the Financial Times, "covenant-lite loans that strip out safeguards for investors,

[11] "A significant source of capital for venture capital and other private equity funds is pension plans, individual retirement accounts, foundations, and endowments. These are all tax-exempt entities under the Internal Revenue Code. Tax-exempt organizations, including "qualified" pension plans, individual retirement accounts, foundations, and endowments, are subject to "unrelated business income tax" (UBIT) on their "unrelated business taxable income," often referred to as UBTI. In connection with their investments in private investment funds, many tax-exempt investors seek to avoid or limit the funds' generation of UBTI.
Fund sponsors commonly accommodate tax-exempt entities by covenanting not to incur, or to limit or minimize, UBTI. Practically speaking, a covenant to avoid UBTI means that the fund cannot incur indebtedness and cannot invest in flow-through operating entities, except through "blocker" structures." Accommodating Tax-Exempt Investors: Understanding UBTI, Morgan Lewis *available at* http://www.morganlewis.com/documents/VCPEFdeskbook/VCPEFdeskbook_AccommodatingTaxExemptInvestors.pdf

[12] *Id.*

[13] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 221, 71127 (Nov. 16, 2011) (to be codified at 17 C.F.R. pts. 275 & 279).

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."[14]

Earlier this month, *CNNMoney* reported, in an article entitled, "Waiting for the bond bubble to pop," that junk bond yields are at their lowest point in history and that "[l]enders are not only doling out lower rates but in the case of refinancing, they're also willing to let companies skip out on most covenants that attach strings to how much a company must earn to stay up to date with these loans."[15] According to the article, covenant lite loans "are nearing levels last seen during the financial crisis." [16] This is cause for particular concern in light of Moody's analysis that "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."[17]

Finally, H.R. 1105 would deny investors in private equity funds, including workers' pension funds, the protections of investing with a registered investment adviser. 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 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.

H.R. 1105 is a bill that would increase systemic risk, weaken investor protections, and offer regulatory subsidies to a portion of Wall Street that is already the beneficiary of inexcusable tax subsidies. It is legislation written not for the top 1%, but for the top 1/100 of one percent. And it is drafted in a manner aimed at misleading members of the House into thinking the bill has meaningful protections against excessive leverage when it does not. For all these reasons the AFL-CIO strongly opposes H.R. 1105.

[14] 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.

[15] Maureen Farrell, *Waiting for the bond bubble to pop*, CNNMoney (May 3,2013) *available at* http://money.cnn.com/2013/05/03/investing/bond-bubble/index.html

[16] *Id.*

[17] 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.

<u>Draft Legislation to Amend Section 913 of the Dodd-Frank Act</u>

This bill is designed to place a number of unusual procedural obstacles in the way of the Securities and Exchange Commission by changing the standard of conduct that is applied to broker-dealers' treatment of their clients. This bill must be understood against the backdrop of recent enforcement actions by the Commission against broker-dealers for violating the current standards of broker-dealer conduct, and the defenses mounted by broker-dealers to these actions. Many investors, particularly less sophisticated retail investors, might be surprised to learn that brokers have no legal duty to give investors advice that is actually in the client's interest. They merely have a duty to ensure that the securities they recommend are "suitable" for the client. By contrast, investment advisors have a fiduciary duty to act in their client's interest. This distinction got a fair amount of public attention in the context of the Commission's case against Goldman Sachs for selling credit default swaps to clients without telling them the swaps had been designed by the party on the other side of the transaction. In a sense, this bill is designed to facilitate Goldman Sachs continuing treatment of its less favored clients as feedstock for its more favored clients.

The draft bill would require the Commission, before promulgating a rule changing the nature of brokers' duties to their clients, to identify whether the different standards of conduct that apply to broker-dealers and investment advisers result in harm to retail investors. In addition, the bill requires the Commission's Chief Economist to conduct a cost benefit analysis of such a change, make a formal finding that the rule would reduce investor confusion, and coordinate with other federal regulators. Finally, the bill would prohibit the SEC from proposing rules applicable to broker-dealers' standard of conduct without simultaneously proposing rules that would "address any harm to retail customers resulting from differences in the registration, supervision, and examination requirements applicable to brokers, dealers, and investment advisers."

Obviously these unusual requirements are designed to slow down and make procedurally burdensome any effort to strengthen investor protections vis a vis broker dealers. But the procedures envisioned in this bill have a more devious purpose as well—they are designed to generate multiple excuses for the Federal Appeals Court for the DC Circuit, which has long ago abandoned any notion of deference to regulatory agencies, to overturn any rules they wish.

The coordination section of the bill is particularly peculiar. It requires coordination with other federal agencies, but not with state securities regulators. This is odd because state securities regulators have shared responsibilities to regulate broker-dealers with the Securities and Exchange Commission, and no federal regulator has such responsibilities. This language would appear to be a backdoor effort on the part of the sponsors of this legislation to constrain the U.S. Department of Labor, which has parallel responsibilities for regulating ERISA fiduciaries, but not shared responsibility for broker-dealers.

This bill comes at a time when the SEC has been reviewing its regulation of broker-dealers. The SEC is currently in the process of collecting data to support an economic analysis of a new fiduciary duty rule to help it determine whether new regulations are necessary and how to best structure new regulations if deemed appropriate. The SEC has already conducted extensive analysis of the nature that would be required by this bill, including the 2008 Rand study and the study required under Section 913 of Dodd-Frank.

Meanwhile, the case for a unified regulatory regime covering both broker-dealers and investment advisors keeps building. In its 2008 study for the Commission, the Rand Corporation found that, "the evolution of the financial service industry has blurred traditional distinctions between broker-dealers and investment advisers and made it difficult to design appropriate regulatory schemes for their professional services."[18] Investors are confused by the differing standard of care between broker-dealers and investment advisers and many investors assume that both are required to act in investors' best interest.[19]

The SEC should be free to improve investor protections in relation to broker-dealers without having to deal with special procedures designed to paralyze the Commission in its pursuit of its mission. Consequently, the AFL-CIO strongly opposes this bill.

H.R. 1564, "The Auditor Integrity and Job Protection Act,"

H.R. 1564 seeks to prevent the Public Company Accounting Oversight Board (PCAOB) from placing limits on the length of time a public company can use the same audit firm, referred to as auditor rotation. H.R. 1564 amends Sarbanes-Oxley by adding a limitation on PCAOB authority which states, "The Board shall have no authority under this title to require that audits conducted for a particular issuer in accordance with the standards set forth under this section be conducted by specific auditors, or that such audits be conducted for an issuer by different auditors on a rotating basis."

H.R. 1564 both substantively weakens the ability of the PCAOB to play its role in protecting our economy against systemic risk, and it weakens the independence of auditor regulation. Both results are contrary to the public interest, and consequently the AFL-CIO opposes this bill.

The AFL-CIO has a long-standing position in support of mandatory audit firm rotation. A new audit firm brings a fresh perspective and, often fresh skepticism, that may be missing when an auditor has a long-standing relationship with the firm. Longtime auditors may come to believe they understand the totality of the client's issues, and may look for those issues in the next audit

---

[18] Angela A. Hung, et. al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008) *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf

[19] SEC, Study on Investment Advisers and Broker-Dealers as Required By Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011) *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf

rather than staying open to other possibilities. Auditors tend to rely on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern. Finally, when an audit firm has the opportunity to retain their position with, and income from, an individual client indefinitely, there may be an incentive to avoid escalating problems identified during the audit process out of fear of angering the client and losing its business. Mandatory auditor rotation could mitigate this possibility by requiring that potential income from the client could not flow indefinitely.

Currently, regulators with inspection authority, both here and abroad, have expressed widespread concern over the consistent failures they are seeing by auditors to remain independent of their clients. Currently, Congress does not have access to PCAOB inspection reports. As such, at a minimum, Congress should add itself to those groups with whom the PCAOB can share its inspection results. Congress could then consider these findings for themselves before they choose to have the federal government get in the business of writing accounting and auditing standards.

The issues raised by this bill are however, more complex than those raised by the other bills the subcommittee is considering today, as a result of the oligopolistic market for audit services. Since the collapse of Arthur Anderson in early 2002 there are only four global audit firms that are plausible auditors for large global businesses. Some have observed that auditor rotation may not be practical in a world of only four major global audit firms. Our view is that the opposite is true, that after more than ten years have passed since the collapse of Anderson, there is no sign of any new viable entrants into this market, and many signs that the lack of competition for audit firms has contributed to audit firms not asking the tough questions that might have given us better early warning over the financial crisis that began in 2007. Against this background, mandatory audit firm rotation may be the only effective tool regulators possess to encourage real competition in the audit of large capitalization public companies. In this respect, I would call the Subcommittee's attention to the work of the Bush Administration's Treasury Department's Committee on the Future of the Auditing Profession.[20]

But ultimately, whether audit firm rotation is or is not the right solution, the decision should be left with the PCAOB, the independent public company auditor regulator created by Congress in the Sarbanes-Oxley Act. H.R. 1564 seeks to place Congress in the position of the independent regulator. This approach is unlikely to yield a better substantive outcome, and if followed through upon, would fundamentally weaken the PCAOB not just in this area, but in all areas, and do so just at the time when the PCAOB is pursuing its mission with renewed vigor and independence.

[20] Advisory Committee on the Auditing Profession Final Report, Oct. 5, 2008 *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.

Conclusion

There is an urgent unfinished financial regulatory agenda—it includes completing the Dodd-Frank rulemaking process, really taking on the problem of the too big to fail institutions as Senators Brown and Vitter are attempting to do, and fairly taxing the financial sector, starting with ending the carried interest loophole and enacting a Financial Transaction Tax.[21]

But the bills today's hearing addresses are all headed in the opposite direction. They seek to undo, overtly or covertly, much needed reforms enacted in the Sarbanes-Oxley Act and the Dodd-Frank Act. Along with other deregulatory bills enacted or in process in this Congress, these bills seem designed to increase systemic risk, increase economic inequality, and decrease investor protections.

We know where this type of policymaking leads. It leads to bubbles and collapses, to financial instability and to mass unemployment. And after the party is over, workers will once again be presented with the bill in the form of lost retirement savings, falling wages, job loss, and reductions in public services.

The AFL-CIO hopes this Subcommittee will instead move away from yet another indulgence in the delusions of deregulation, and focus on how to strengthen our statutory and regulatory protections against systemic risk and the exploitation of investors.

On behalf of the AFL-CIO, I wish to again thank the Subcommittee for the opportunity to appear to discuss these vital issues, and I look forward to your questions.

[21] S. 410, H.R. 880, 113th Cong. (2013).

SOCIETY
of Corporate Secretaries
& Governance Professionals

Written Testimony

Robert Smith

Corporate Secretary, Vice President &
Deputy General Counsel
NiSource, Inc.

Chair, Policy Advisory Committee
Society of Corporate Secretaries and Governance Professionals

May 23, 2013

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

Hearing on "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators"

Introduction

My name is Robert Smith and I am currently the Corporate Secretary, Vice President & Deputy General Counsel of NiSource, Inc., a mid-cap energy holding company, providing natural gas, electricity, and other products and services. It operates in three segments: Gas Distribution Operations, Gas Transmission and Storage Operations, and Electric Operations.

I also Chair the Policy Advisory Committee of the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,000 members who serve more than 1,500 public, private and non-profit organizations. At our companies we seek to develop corporate governance policies and practices that support our boards to foster the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. More than half of our members are from small and mid-cap companies.

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

Background

The Subcommittee has asked for our views on any of the following four legislative proposals on which we have expertise, H.R. 1135, the Burdensome Data Collection Relief Act, H.R. 1105, Small Business Capital Access and Job Preservation Act, H.R. 1564, Audit Integrity and Job Protection Act, and a bill to amend Section 913 of the Dodd-Frank Act. The Society's testimony will be limited to H.R. 1135 and H.R. 1564. H.R. 1135 seeks to repeal Section 953(b) of the Dodd-Frank Act which requires companies to disclose the median of annual total compensation (as calculated under Item 402 Reg S-K) 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"). This testimony will also address H.R. 1564, which seeks to prevent the PCAOB from requiring that companies' audits be performed by specific auditors or that they be performed by specific auditors on a rotating basis ("Auditor Rotation").

Summary Comments on Pay Ratio

We acknowledge a public policy concern on pay gaps in the United States; however, 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. We also 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.

We note also that the SEC faces challenges in implementing the many Dodd-Frank Reforms as well as the JOBS Act. The SEC must prioritize and focus on the most important issues facing investors and the securities markets. SEC Commissioner Dan Gallagher raised this issue last week in his "Remarks at 12th European Corporate Governance & Company Law Conference" in Dublin:

> The question that policymakers need to answer at the end of the day is: do all of these mandates aid the average investor? At best, it is questionable. For example, an unintended consequence of the disclosure requirements imposed at the federal level in the U.S. over the past 15 years is that proxy statements now resemble law school text books. Who can blame an investor for not voting when reading a proxy and voting a proxy card evoke memories of studying for a final exam?

And as noted by former SEC Commissioner Harvey Pitt in a speech earlier this month to the U.S. Chamber of Commerce titled "Shareholder Activism: A Cost-Benefit Analysis":

> [T]he SEC should stick to its knitting, delay (or cease) implementing those elements of Dodd-Frank that force it to abandon its mandate to promote shareholder value, and petition Congress to undo the mischief it's foisted on all of us by virtue of Dodd-Frank. In these interesting and perilous times, with perseverance, creativity and a sense of humor, we can overcome these Congressionally-mandated assaults on American Capitalism.

The Pay Ratio Would Not Provide Meaningful Information to Investors

The Society does 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, as Commissioner Gallagher laments, 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 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]

---

[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 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.

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 the vast majority of investors are not interested in obtaining such pay ratio information from companies. We are aware of votes in 2010 on 9 shareholder proposals requesting reports on pay disparity. On average, the proposals were supported by only 6.1% of the shares voted. In 2012, one proposal received 7.2% support and in 2013, we are aware of only two such proposals. One has been voted on--it received only 6.7% of the vote. The level of interest by investors is therefore extremely low.

Finally, since the enactment of Dodd-Frank, companies have been required to solicit investor votes on their executive compensation in what is commonly called the "say-on-pay" vote. This mechanism has been used in the last few years and has generated increasing levels of engagement by companies with their shareholders and others and continues to evolve. If investors are concerned that they need additional disclosure on pay equity from a particular company, they can (and do) use say-on-pay votes under Dodd-Frank to express their views. And, they still may submit shareholder proposals requesting such information, as noted above. With the evolution of the say-on-pay vote, however, we see fewer such proposals, leading us to conclude that Pay Ratio disclosure is a solution in search of a problem that does not exist.

The Pay Ratio Disclosure Requirement is Burdensome Well Beyond Any Potential Benefit

Not only is the Pay Ratio disclosure requirement unnecessary and not meaningful, it also would be highly burdensome. While it appears to some observers to be a trivial addition to existing disclosure requirements, that is not the case. It is in fact highly prescriptive, which has hampered the SEC in its efforts to draft an implementing rule. Commissioner Gallagher made note of this in his Key Note address at the "Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States" in March in Switzerland:

> Indeed, Dodd-Frank marked a tremendous expansion of prescriptive financial regulation, with much of the law's rulemaking burden, including about 100 of its 400 rulemaking mandates, falling on the SEC. The very volume of Dodd-Frank's prescriptive mandates to the SEC has had the unintended effect of significantly limiting the agency's ability to bring its traditional expertise and judgment fully to bear in the rulemaking process. In that sense, it has had a negative impact on the Commission's ability to develop sound, sensible regulation and to adapt quickly

> and flexibly to the continuing transformation of global capital markets.

Commissioner Paredes also recognized this difficulty, as well as the particular burden in with Pay Ratio disclosure, in his Remarks at the Society's 66th National Conference on "The Shape of Things to Come" in July 2012:

> First, regulation needs to be workable in practice for those who have to comply with it. This seems to be a particular concern when it comes to the CEO pay ratio disclosure. Having to compile extensive data for their employees in the U.S., let alone around the globe, and then ensure that the data is standardized so that the ratio can be calculated would seem to present significant practical difficulties that could be quite costly for companies. Developing the data to calculate the Pay Ratio would require much time by companies and would add a cost to the already high compliance burdens they face.

Then-SEC Corporation Finance Director Meredith Cross also testified in 2010 that she had 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. The difficulty mentioned then has not changed. And anecdotal evidence from one member of the Society with about 100,000 employees operating in 100+ countries estimated that costs to comply could run into the tens of millions of dollars. Another estimated $5 million in costs plus 5-10 hours per employee, so more than 500,000 man hours for a company with 100,000 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 generally report aggregated figures to the parent company for inclusion in consolidated financial reports for public filings. Thus, the parent company that files SEC reports often 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?

Summary Comments on H.R. 1564, Mandatory Audit Firm Rotation

The Society also supports H.R. 1564, the Audit Integrity and Job Protection Act. Mandatory auditor rotation interferes with the relationship between the audit committee and its audit firm and we believe it would not be beneficial to audit quality and would not enhance auditor independence, objectivity or skepticism. Moreover, it would be costly and burdensome to companies without a corresponding benefit. On December 11, 2011, The Society commented on PCAOB Rulemaking Docket Matter No. 37 Concept Release on Auditor Independence and Audit Firm Rotation (the "Release"). A copy of that letter is attached as Exhibit B, and set forth below in substantial part but with citations omitted.

Mandatory Auditor Rotation Has Been Considered On Several Occasions and Never Adopted

The notion of requiring public companies to periodically rotate their independent audit firms is not new. In fact, the Release itself notes various instances in which this concept has been considered by both Congress and the SEC over the last 40 years. Each time, mandatory rotation has been rejected, principally due to the increased costs and risks caused by rotation coupled with the lack of any significant benefit to investors. According to the Release, in 1994, an SEC study concluded that "the [profession's] requirement for a periodic change in the engagement partner in charge of the audit, especially when coupled with the requirement for second partner reviews, provides a sufficient opportunity for bringing a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms."

Congress considered mandatory rotation when it made sweeping reforms in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). However, at that time, instead of requiring rotation, Sarbanes-Oxley commissioned a study and review of the potential effects of requiring mandatory rotation. The United States General Accounting Office's ("GAO") report concluded:

> We believe that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality, considering the costs of changing the auditor of record and the loss of auditor knowledge that is not carried forward to the new auditor. We also believe that the potential benefits of mandatory audit firm rotation are harder to predict and quantify while we are fairly certain there will be additional costs. In that respect, mandatory audit firm rotation is not a panacea that totally removes pressures on the auditor in appropriately resolving financial reporting issues that may

materially affect the public companies' financial statements. Those pressures are likely to continue even if the term of the auditor is limited under any mandatory rotation process.

Instead of mandating rotation, Sarbanes-Oxley Section 301 required the rotation of the lead audit partner every five years and other audit firm employees with significant involvement in the audit every even years. The Society believes that these existing requirements, *particularly partner rotation*, adequately address the concerns of professional skepticism and ongoing objectivity.

As Contemplated by Sarbanes-Oxley, Audit Committees Should Have Sole Responsibility for Auditor Selection

Perhaps the most significant auditor independence and audit quality enhancement adopted pursuant to Sarbanes-Oxley was Rule 10A-3 under the Securities Exchange Act, which made the appointment, compensation and oversight of independent auditors the sole responsibility of a company's audit committee. In adopting this Rule in 2003, the SEC noted that "[o]ne of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting... One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders."

We believe that these considerations remain valid and that, as a result, the audit committee should continue to have sole responsibility for selecting a company's audit firm, and the audit committee is best able to judge if the audit firm is bringing the right level of technical competence, objectivity and professional skepticism to its work. Under mandatory rotation, however, the committee would be required to select another firm, even if it believed that another firm may not discharge its responsibilities as effectively and independently as the current firm.

Sarbanes-Oxley's numerous audit committee requirements were furthered by subsequent rules of self-regulatory organizations that strengthened the committee's responsibilities for oversight of the audit firm, including requirements entailing heightened levels of independence and expertise of audit committee members. These and other safeguards strengthen the audit committee's oversight of audit firms, and requiring audit firm rotation would undermine the critical role played a company's audit committee in ensuring the independence and objectivity of a company's audit firm as well as interfering with this body of rulemaking developed by the SEC and self-regulatory organizations.

Public company directors have fiduciary duties that require a high degree of diligence in gathering and considering the information necessary to make informed decisions, including those in selecting a company's independent auditor. In discharging these responsibilities, there may be many valid reasons for an audit committee to determine that rotation to a new audit firm is not in the best interests of its company at a particular point in time. Therefore, mandatory rotation would unnecessarily impinge on the audit committee's independent decision-making and implement a one-size-fits-all approach over the informed business judgment of a company's audit committee based on relevant facts and circumstances.

The Costs of Mandatory Rotation Clearly Outweigh Any Benefits

The Society believes that a change as significant as mandatory audit firm rotation must be based on clear objective data showing that mandatory audit firm rotation will achieve a benefit. First, there must be evidence of a link between audit firm failure and long-term tenure and second, there must be evidence that rotation will consistently result in measurably improved audit quality that justifies the increase in direct, indirect, and ancillary costs. Past studies have never yielded definitive proof that rotation would achieve the PCAOB's stated aims of enhancing auditor independence in mental attitude, objectivity or professional skepticism or otherwise improving audit quality. In contrast, as detailed below, there is evidence of increased risk of audit failure and reduced audit quality from auditor rotation.

The costs underlying a rotation requirement for both audit firms and public companies exist at the various stages of the process: the search for and selection of the new audit firm, the costs of changing firms and finally the costs of rotating the audit firms after a certain amount of time.

Society Members Surveyed Estimate 20% Increase in Costs

Based on a survey of our members and discussion with member companies that have changed their audit firms, the direct, indirect and ancillary costs associated with mandatory auditor rotation would be considerable. Our survey revealed that over 70% of those companies that could estimate additional costs resulting from mandatory rotation believe that costs in the initial year would increase by at least 20%.

Selection of New Audit Firm. Each time an audit firm rotation occurs, the company's audit committee, management and employees in its finance, legal, tax, accounting, and internal audit organizations, across all the jurisdictions in which the company operates, must invest significant amounts of time and money to ensure selection of an appropriate new audit firm. The complex process in evaluating a potential new audit firm includes consideration of numerous factors, including the firm's reputation; the firm's knowledge and experience in the company's current and prospective industries and lines of business; the proposed new lead partner's overall business acumen, knowledge and experience in these industries and businesses; the depth of expertise, experience and knowledge of the prospective engagement team; potential conflicts of interest or independence issues with the Board; the scope of the audit firm's international network in the countries and regions in which the company operates, and the firm's ability to provide quality services across those countries and regions; the firm's quality control procedures; findings from recent firm inspections, peer reviews or other oversight reviews; and whether the firm will be able to meet the auditor independence requirements. The consideration of each of these factors would likely necessitate thousands of hours of work and analysis and concomitant expenditures.

To illustrate, one of our members, a large global company that voluntarily rotated its audit firm within the past ten years, estimated that the time expended from the start of the request for proposal process through retaining its new audit firm entailed approximately 100 hours of audit committee time, 500-600 hours of senior management time and between 2,000-3,000 hours of finance, legal, tax, accounting, and internal audit employees' time, in addition to the associated administrative and productivity costs. It would be inefficient to require thousands of company hours every five or ten years to assess an audit firm change, especially when such a change may not be needed or be in the best interests of a company or its shareholders.

Transition to New Audit Firm. Once an audit firm has been retained, a significant amount of company management time and attention is required to provide the successor firm with the information needed to plan its audits and to support the new firm while it gains familiarity with the company; its history, businesses, operations and facilities; its accounting systems and records; its accounting policies and methodologies; its internal control systems and processes; its information technology systems and applications; and other necessary systems, processes and personnel. In addition, a change in audit firm requires management to respond to an increased volume of audit firm staff requests, including requests for documentation that supports accounting positions that may have been in place for a number of years. A company's audit committee must maintain an appropriate level of oversight throughout the entire process.

The global member company referenced above estimated that the support required to orient the new firm and ensure a successful transition during the first year of its engagement encompassed approximately 20% of the work time hours of over 100 people throughout the organization.

The Society believes that mandatory auditor rotation will lead to both increased audit costs as well as increased costs for audit-related services. This is supported by the GAO's 2003 Report, which found that nearly all of the larger audit firms surveyed estimated that initial year audit costs would be more than 20% higher than subsequent years' costs; the responses from the Fortune 1000 public companies were similar. As discussed above, our members' estimates of increased first year costs are comparable.

The GAO survey also addressed the overall costs to both audit firms and Fortune 1000 public companies, including estimated indirect and ancillary costs, consisting of marketing costs (i.e., the costs incurred by the audit firm related to their efforts to acquire or retain financial statement audit clients), selection costs (i.e., the internal costs incurred by a public company in selecting a new public accounting firm as the public company's auditor of record), and support costs (i.e., the internal costs incurred by a public company in supporting the public accounting firm's efforts to understand the public company's operations, systems, and financial reporting practices). The GAO estimated additional first year audit-related costs (inclusive of the foregoing costs as well as audit costs) would be 43% to 128% (and, on a weighted average basis, 102%) higher than the likely recurring audit costs had there been no change in the audit firm.

The Society members' experience is that audits in the initial years after a change in audit firm are less efficient and more expensive. Audit fees are generally based on the expected hours needed to complete the scope of work set out in the audit plan. Initial years' audits and audit related services take more time and are inherently less efficient, and thereby more expensive, than subsequent years' services. Among other matters, the new audit firm must review the predecessor auditors' documentation, obtain a complete understanding of historically significant events, and gain an understanding of the company's business model, control environment and reporting practices, in order to appropriately determine the scope and conduct of its audit. It takes time before an auditor can appropriately coordinate with a company's internal audit staff and ascertain the appropriate staffing and conduct of its audit, which impacts both the direct costs of the audit and the quality of the audit. Appropriate reliance on internal audit staff and knowledge gained from its prior work enable an outside auditor to focus its audit personnel on the higher risk areas of an audit.

Rotation Would Negatively Affect Audit Quality and Would Have Minimal Benefits, if Any

While the Release suggests several potential benefits associated with rotation, the Society believes that mandatory auditor rotation will introduce significant issues that would likely contribute to an actual *decrease* in audit quality.

Evidence in the Release indicates that audit quality in the first years of an engagement tends to be lower, and therefore could lead to a greater risk of audit failure. With a mandatory rotation rule in place, companies will spend more time in a short-tenure audit situation, and overall audit quality will be negatively impacted. More than 85% of our members surveyed were "very concerned" about the loss of its audit firm's institutional knowledge if required to switch auditors.

Finally, incoming auditors, unfamiliar with the details of a new client's business, will be less likely to identify fraud or deception on the part of a company's management and employees. The accumulated experience of a longer audit tenure helps a firm better spot and account for these issues. Studies conducted in 1987, 1999 and 2010 revealed numerous audit failures involving companies that recently changed auditors – and the

2010 study concluded that the topic needed to be studied more.

It seems likely that audit firm rotation will lead to a merry-go-round in provision of audit-related services, as there are limits on non-audit work that can go to the audit firm. This has various ramifications, among them that the outgoing audit firm is likely to be among those acquire newly-available non-audit engagements previously fulfilled by the incoming audit firm. The same concerns presented by advocates of mandatory rotation – reduced professional independence – will manifest here, as there is a risk that an incumbent audit firm may seek to placate management in order to obtain non-audit business upon rotation.

Given the inability to date to demonstrate the link between mandatory auditor rotation and enhanced auditor independence, objectivity and professional skepticism (and thus, presumably, increased audit quality), costs of the magnitude discussed above clearly are not justifiable, particularly in the context of information and projections indicating that such a requirement may in fact result in reduced audit quality in the earlier years of an engagement. (See M. Cameran, A. Prencipe, and M. Trombetta, *Auditor Tenure and Auditor Change: Does Mandatory Rotation Really Improve Audit Quality?*, Proceedings of the Annual Meeting and Conference on Teaching and Learning in Accounting, New York 1-61, at p. 19-20 (2008).)

The Concept Release outlines two commonly-argued "fresh look"-related benefits, but does not present any empirical evidence that these benefits actually exist. Because clients utilize different accounting methods depending on industry sector and company preferences, an incoming auditor will need to become familiar with the client company's individual practices and control structure. Even among similar or identical accounting procedures, an auditor must gain familiarity with the particular business and internal operations of the client, and must rehash the solutions developed by the predecessor.

Suggested remedies for this some of the problems presented by mandatory rotation would exacerbate other detriments of the regime. For example, mandatory auditor rotation is already anti-competitive because it decreases the opportunity costs of cartel-like behavior and reduces the incentives for audit innovation. Reduced quality in initial years of audit engagements could be mitigated by mandatory standardization of audit practices and techniques between audit firms and clients. However, this would exacerbate the anti-competitive effects of mandatory auditor rotation by either preventing innovation entirely, or speeding up the transfer of innovation from the innovator to the rest of the industry, resulting in a disincentive to make such improvements and thereby harming audit quality.

When mandatory auditor rotation forces an audit firm to lose an engagement for which it has developed a specialized audit unit, it will not have the convenience of simply shifting those specialized resources to another, similarly-specialized project. While this effect may be ameliorated in a larger market, it will be magnified in smaller markets in less densely-populated areas.

The PCAOB's Inspection and Enforcement Powers are Sufficient to Ensure Professional Skepticism

The Society supports H.R. 1564 because mandatory audit rotation is not necessary to ensure professional skepticism. In fact, the PCAOB's existing powers are adequate. This includes the authority to (i) regulate audit firms, (ii) publicize a firm's audit failures and (iii) assess penalties (both financial and professional) on auditors they judge to be lacking in professional skepticism. These tools provide an effective arsenal to address issues with the firms through monetary penalties, professional penalties and by publicity of failures that would adversely impact their customer base and, ultimately, an audit firm's ability to retain clients. In this regard, we believe that the PCAOB is in a unique position to speak out on the need for auditor skepticism and thereby heighten sensitivity to the topic.

On the other hand, mandatory rotation of external auditors would be an ineffective means of addressing the risk of inadequate professional skepticism, primarily because it fails to consider that *an auditor can be more skeptical when he or has a full understanding of the facts and circumstances related to their clients' businesses.* Mandatory rotation of external auditors will not cure this purported problem.

Mandatory Audit Firm Rotation Would Leave Public Companies with Few Experienced and Eligible Audit Firms

Many public companies—large multinational companies in particular—have very limited choices for audit firms. In fact, many of these public companies can, as a practical matter, only use one of the four large audit firms known as the "big four" to provide audit services.

The "big four" audit firms are unique in their scale and scope. As the Concept Release acknowledges, even among the "big four" audit firms, a company's choice may be further limited because different audit firms have various capacities in different parts of the U.S. and world with differing areas of expertise. And Society members consider these factors critical in considering the selection and retention of an audit firm. In fact, nearly 90% of our members surveyed concluded that its company's audit committee evaluates audit firms based on industry knowledge or international scope and considered these items "very important" in the selection of the audit firm.

For instance, a company may need an audit firm with expertise in a particular industry or geographic area, and even the largest audit firms do not necessarily have the requisite specialized knowledge in every location in the world or even in the U.S. It is also not clear whether the "big four" audit firms or the smaller audit firms would be able or willing to devote the necessary resources to build expertise in new geographic locations or in new industries.

Further complicating this issue are other auditor independence standards that would often preclude at least one firm from being selected as the independent audit firm. For example, if an immediate family member of a company's director is an employed by one of the big accounting firms, the NYSE's independence rules may preclude that company from engaging the audit firm during the entire director's tenure on a company's board.

Additionally, independent auditors are prohibited from performing certain non-audit services, such as valuation work for their audit clients, and therefore most large public companies engage one or more of the remaining three of the "big four" audit firms to perform these non-audit services. Our survey revealed that over 83% of companies used at least one additional "big four" firm for non-audit services and a majority of companies utilized at least two additional "big four" firms. Over 85% of our members indicated that mandatory audit firm rotation would limit the company's ability to use other audit firms to provide non-audit services. If such companies wished to retain a firm within the "big four" and avoid the risk of auditor independence problems, they would be required to refrain from using at least one of the remaining three audit firms for non-audit services.

In addition, if they are currently using each of the remaining three audit firms to provide non-audit services, to identify and attempt to unwind all of the contracts for the non-audit services with at least one of such firms before the change in auditors. To state this is to show how difficult, risky and cumbersome it would be. This is a major issue for a significant number of our members and a mandatory audit rotation rule would disrupt many of the engagements and relationships that companies currently have with audit firms.

Also, many large public companies also engage one or more of the remaining three of the "big four" audit firms for tax compliance and consulting work, even though these are not prohibited services under Sarbanes-Oxley, the Exchange Act or applicable accounting standards. These companies believe that there are strong governance reasons for engaging a firm that is not their auditor to perform these services.

As a consequence of all of these limitations, if required to rotate, an audit committee will be significantly restricted in its selection of a new audit firm.

Mandatory Auditor Rotation would Impose a Disparate Burden on Small- and Mid-Cap Public Companies

Finally, the Society believes that mandatory audit firm rotation would pose a disparate burden on small- and mid-cap public companies. Generally, these additional burdens would manifest themselves by either straining already resource-limited accounting and legal staffs of these companies and/or by decreasing the attention an auditor would pay toward these companies. For smaller companies, having to assist in the "ramp up" learning period every five or ten years (or other mandated period) may well cause an a bigger hardship than for larger companies. For many small- and mid-cap public companies, the audit engagement team interacts primarily with the Chief Financial Officer, Controller, Director of Financial Reporting (if there is one), and the General Counsel (again, if there is one). While learning a smaller company's business, industry, and accounting systems and processes may be less complex than at a larger issuer, small- and mid-cap public companies have significantly less resources to devote to educating a new audit team every few years. As a result, either the auditor will not be as "up to speed" as it could be or the financial and legal staff of the issuer will not have as much time in fulfilling their own responsibilities with regard to the audit. In either case, a higher risk of audit failure is the result.

While strained resources are a very significant risk, the greater risk may be the likelihood that auditors will decrease their focus on small- and mid-cap public companies. The Society is concerned that the smaller fees necessarily charged for smaller company audits coupled with a limited client retention period might cause the "big four" firms to avoid bidding on audit engagements for small- and mid-cap companies, limiting the pool of auditors available to these companies.

We believe that mandatory auditor rotation will lead to decreased attention and focus of audit firms, higher audit fees than exist today, but not high enough to support a large pool of auditor choices for small- and mid-cap public companies.

Summary

In summary, we believe that the Dodd Frank Pay Ratio provision is simply unworkable and would produce information that is not meaningful to investors. Similarly, we believe that imposing mandatory audit firm rotation on companies is also unworkable and would not enhance auditor independence, objectivity or skepticism but could in fact jeopardize audit quality.

I want to thank the Subcommittee again for the opportunity to provide testimony, and indicate the willingness of the Society to answer questions on either of these resolutions now or in the future.

THE DODD-FRANK PAY RATIO IS UNJUSTIFIABLY BURDENSOME AND CONTRARY TO SOUND DISCLOSURE POLICY

Hearing on Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators

Subcommittee on Capital Markets and Government Sponsored Enterprises

House Committee on Financial Services

May 23, 2013

Written Testimony of
Charles G. Tharp
Chief Executive Officer
Center On Executive Compensation

Center On Executive Compensation

1100 THIRTEENTH STREET | SUITE 850
WASHINGTON DC 20005
202.408.8181 | FAX 202.789.0064 | WWW.EXECCOMP.ORG

Chairman Garrett, Vice Chairman Hurt, Ranking Member Maloney and Members of the House Financial Services Committee:

My name is Charlie Tharp, and on behalf of the Center On Executive Compensation, I am pleased to provide our views on section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, known as the pay ratio mandate, and our strong support for Congressman Huizenga's bill, H.R. 1135, the Burdensome Data Collection Relief Act, which would repeal the pay ratio provision. The Center believes that this mandate would impose significant costs on public companies, especially large global public companies, causing them to redirect resources from more productive uses, such as job creation or investment, without providing meaningful or material information to investors. For this reason, the Center urges that Subcommittee repeal the pay ratio provision and thereby free up SEC resources to ensure that existing disclosures provide a clear explanation of the link between executive compensation and performance.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 340 large companies, and the Center's more than 100 subscribing companies are HR Policy members that represent a broad cross-section of industries. Because chief human resource officers oversee human resource policies globally, including compensation, payroll, and benefits, and also support the compensation committee chair with respect to executive compensation matters, we believe that our Subscribers' views can be particularly helpful in understanding the complexities that would be required to implement the pay ratio requirement and why repeal of this provision is the best solution.

I. Overview of the Pay Ratio Disclosure Requirement

The pay ratio provision in Section 953(b) of the Dodd-Frank Act directs the SEC to draft rules requiring all public companies to disclose in their proxy statements the ratio of the median pay of all employees (except for the chief executive officer ("CEO")) to the total pay of the CEO. Unlike many other provisions in Title IX of the Dodd-Frank Act, which give the SEC a fair amount of discretion in implementation, the statutory language of the pay ratio is overly prescriptive, and requires the following:

- Unduly Complex Calculation of the Median. The Dodd-Frank pay ratio requires companies to find the median—not the average—compensation for all employees other than the CEO. The median is the number that is exactly in the middle of a group of numbers. Under the pay ratio requirement, companies will likely be required to calculate compensation for all employees the same way that companies calculate pay for their named executive officers, which includes:
    - Cash compensation;
    - Equity compensation;
    - Benefits that are not received by the general employee population; and
    - Other compensation.

- All Employees. The statute refers to the pay of "all employees" and it is likely that companies would be required to calculate the pay of every employee globally, including part-time employees, in the same manner as compensation is calculated for the named executive officers. As discussed below, large employers do not keep pay data centrally housed in a format that would facilitate calculation of the required ratio.
- Compensation Calculated Under SEC Rules That Apply to Proxy Officers as of July 9, 2010. As if to add a further burden to companies, the statute requires companies to calculate the pay ratio based on the SEC's disclosure rules as they existed prior to the enactment of the Dodd-Frank Act. Thus, as the SEC's rules change, the pay ratio will need to be calculated based on the rules in effect in 2010.

Former SEC officials from Chair Mary Schapiro to the Director of the Division of Corporation Finance Meredith Cross indicated in their previous appearances before Congressional committees that due to the prescriptive nature of the provision, the SEC has very little interpretive authority and thus would interpret it narrowly. Last week, SEC Chair Mary Jo White reiterated that the pay ratio provision was proving difficult for the staff to implement.

Costs of the Pay Ratio Requirement Far Outweigh Its Benefit

The burden of calculating this median pay ratio requirement is significant and will typically be more costly for companies with broad global workforces, as is the case for most large corporations. It would require a company to gather and calculate compensation information for each employee as required for senior executives under the SEC disclosure rules, determine the pay of each employee from highest to lowest, and then identify the employee whose pay is at the midpoint between the highest- and lowest-paid employee. However, no public company currently calculates each employee's total compensation as it calculates total pay for CEOs on the proxy statement.

The Center engaged its Subscribers to gain a better understanding of the burden and difficulty in gathering and calculating this information through qualitative discussions and a 2011 survey of Subscribers and HR Policy Association members. We summarized these findings in comments submitted to the SEC, and attached the detailed survey results. Our findings reinforce the fact that the costs of implementing the ratio will outweigh any potential benefits of doing so.

Diverse Operations. The survey showed that most respondents are global and have a large number of employees all over the world. More specifically:

- Number of Employees. Over three-quarters of the respondents (78.7%) have over 10,000 employees globally and over a third (37.2%) has over 50,000 employees globally.
- Number of Countries. Three-quarters of respondents (74.5%) have employees in more than 10 countries. Based on the qualitative responses, it appears that

many large companies have employees in at least 30 countries.

- Global Locations. Over 70% of respondents have at least hundreds of locations and nearly 30% have thousands of locations.

Dispersed Information Requires Manual Calculations. Even though most of our Subscribers are large, sophisticated global companies, their HR, payroll and benefits systems are not often centralized and the calculation of the pay ratio is not available at the touch of a button. This holds true even if it was assumed that the ratio would be based on cash compensation alone (in reality it is more broadly defined). Among our survey respondents, 84% indicated that just obtaining annual cash compensation globally on an individualized basis was not easily accomplished, and 70% of those indicated that gathering the information would be very difficult. An illustration of some of the comments issuers made in explaining why the determination would be difficult include:

- "Cash comp[ensation] in the US and Canada can come from our [human resources information system]. For the other 30 countries, we would have to go to each local payroll and define the types of pay we would need for each employee (which I'm sure are all coded differently in each different payroll system). And that would only give us base & incentives and some other special payments."

- We "currently have approximately 3 dozen payroll systems/vendors globally. Not all locations have a centralized HR shop either, so we would have to devote a lot of people/time."

- "90 different payrolls . . . in different systems or statutory [requirements]; currency conversions difficult. Very difficult as cash compensation has different components in different markets."

- "Cash compensation is handled by each country individually with little oversight in terms of delivery between the local HR staff and the country-specific payroll system. To get accurate data, we would likely have to work with every payroll vendor globally to request records for the prior year from which we can generate the total cash compensation figures for employees. Since payroll systems are outsourced outside of North America, this would likely be both time consuming and costly to complete. Depending on the definition of cash compensation, it may be next to impossible to certify that the information is accurate across all the countries in which we pay employees."

- "Small populations spread across the world with varying international pay plans."

- "The level of economic development varies significantly amongst our sites (developing to modern), with significant differences in amounts and forms of compensation, as well as currency values, economic/tax/social structures."

- "First, we have no existing way of calculating the annual total compensation of every employee around the world. ... We have 101 payroll systems worldwide. We have approximately 3,600 international assignees, and these assignees get paid in two places (home and host country). ... We have six countries that use non-calendar tax years. Not only do we have numerous part-time employees, but we have many different employee types; e.g., multiple types of supplemental employees, different types of inactive employees, and employees who work for wholly owned and less than wholly owned subsidiaries. In addition to the challenge of making an accurate calculation, privacy regulations in certain areas around the world make the data difficult to even obtain. Also, it would be impossible to anonymize data for international assignees because they end up with an identification number for both their home and host country, so there isn't a way to tie the employee to both payments."

Under the pay ratio provision, the scope of the information-gathering requirement presents significant hurdles for companies. Accuracy is a significant concern, since compensation data is housed in dozens of computer systems and subject to the compensation and benefits rules of different countries worldwide. Furthermore, these illustrations say nothing with respect to the impact that exchange rate fluctuations will have on the calculations. Companies would be required to develop and coordinate a consistent calculation across all countries and then ensure that the results were accurate since Section 302 of Sarbanes-Oxley requires the CEO and the CFO to sign the proxy statement certifying its accuracy.

Half of Respondents Would Need at Least Three Months to Calculate the Ratio. In our survey, nearly half of all respondents (49.5%) stated that it would take their companies at least three months to calculate median employee compensation. Nearly another 20% (18.7%) indicated that it would take their companies five months or more to do the calculation.

The cost of implementing the requirement for many companies is likely to be in the millions of dollars. One company estimated that the total cost of calculating the pay ratio, including systems changes, would be at least $7.6 million. Another estimated that the cost of calculating just the pension component of total compensation across all payroll systems would be $2 million. Clearly, given that few shareholders are interested in the information, the cost of generating the pay ratio does not generate sufficient benefit to justify the mandate.

Based on the information above, most employers would have to calculate the median employee pay for the preceding fiscal year, because they would not have the raw compensation data in a timely manner to include the ratio in their annual proxy statement. As discussed below, this reinforces the argument that the information produced will not be useful for investors, since the ratio would be one year behind the rest of the proxy statement data.

II. The Pay Ratio Requirement Would Not Provide Material Information and Is Inconsistent With Purposes of Proxy Statement Disclosure

The pay ratio mandate would not provide information useful to investors, and for this reason, is inconsistent with the purpose of the SEC disclosure rules. The SEC generally requires that companies disclose in the proxy statement all material information necessary to inform an investor of how and why a company compensates its named executive officers. Material information is that which would impact an investor's decision to invest in the company or its vote for directors. Therefore, the addition of nonmaterial information simply lengthens the disclosure and dilutes the impact of material information. Further, the inclusion of this ratio could mislead investors who seek to compare ratios between companies.

The ratio would not be comparable between companies as the pay of employees at all levels of an organization is based on the company's size and global reach, competitive and geographic labor market forces, the industry in which a company operates, the mix of jobs within a company, and other factors which reduce the comparability of such disclosures across companies. Companies employing more highly paid employees will likely have a smaller ratio due to the structure of their workforce as opposed to those employing a larger share of lower paid employees, such as retail clerks. However, the difference would not tell investors whether the company with the lower ratio is a better investment.

Moreover, the ratio does not account for a company's global operational structure or business strategy, which would certainly have an impact. One company may rely on third parties for certain services like manufacturing or information processing whereas another company may use their own employees to perform such work, thereby distorting the comparison between companies. Again, comparing the ratios between two such companies would provide little useful information. Contrary to the arguments of some activists, differences in pay ratios would not reflect differences in risk between companies. Instead, different ratios would merely reflect differences in market rates of pay for various positions across geographic areas and neither a higher nor lower ratio is indicative of a greater or lesser investment risk.

CFO Magazine recently ran a column on the pay ratio provision calling it a "net zero" and not worth the cost. Editor David McCann, who identified himself as a Democrat in the column, stated, "while shareholders are very hot on pay for performance, they don't give a whit about pay ratio" because the "so-called 'pay ratio' does not tell investors anything useful about a company."

Since 2006, the SEC has made significant changes to its executive compensation disclosure rules in an effort to expand the material information that is available to investors. Because of these rules and other changes since then, independent executive compensation information provider Equilar recently calculated that the median word count of an S&P 1500 company's explanation of its executive compensation programs has increased by 26% between 2008 and 2012, from 6,080 words to 7,665 words (or about four pages of typewritten text). The addition of nonmaterial information in the form of the ratio and any narrative disclosure to explain the ratio would only add to the length and make it more difficult for investors to digest the material information.

Moreover, shareholders have not supported disclosure of this information when given the opportunity to vote for it. In 2010, nine shareholder resolutions calling for disclosure of a pay ratio received an average support of 6.4%. To date, there have only been two resolutions dealing with the pay ratio voted on since 2010, with an activist investor submitting the same proposal to a single company in both 2012 and 2013. Neither fared well, with the 2013 proposal receiving 6.7% support, a drop from the 7.2% support the proposal received a year earlier. The message is clear: investors are not asking for this information, and its inclusion would only make unduly long disclosures even longer.

The Center continues to oppose the pay ratio requirement because the calculation of the median compensation of all employees globally using the statutorily mandated SEC definition of compensation is unjustifiably complex. Based on feedback from our Subscribers, we believe the costs and burdens of calculating the ratio would be excessive relative to the information it would provide. In addition, the pay ratio is the result of different market rates of pay for various positions in different locations, and therefore does not reflect differences in risk but rather differences in markets.

Conclusion

In sum, the pay ratio requirement would not provide material information, would be extremely costly to implement and is inconsistent with the reasons for disclosing compensation in the proxy statement.

The Center appreciates the opportunity to provide its views on this extremely important policy matter. We look forward to working with you and members of your staffs to ensure that the Dodd-Frank Act will lead to the positive reform that was intended when it was enacted.

ACG®
Association for Corporate Growth

May 22, 2013

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and
Government-Sponsored Enterprises
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Capital Markets and
Government-Sponsored Enterprises
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Hearing on Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators

Dear Chairman Garrett, Ranking Member Maloney and members of the Capital Markets and Government Sponsored Enterprises subcommittee:

This letter is submitted on behalf of the Association for Corporate Growth (ACG), in response to the House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises request for comments for the hearing titled "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators." Founded in 1954, ACG is an organization with 47 chapters in the United States representing 14,000 professionals from private equity firms, corporations and lenders that invest in middle-market companies, as well as from law, accounting, investment banking and other firms that provide advisory services.

ACG and its members have long been supportive of financial regulatory enhancements and applauds financial policies, such as the JOBS Act, that will improve the deal making climate for the middle market. When provided with efficient capital flow, ACG members are able to invest in and grow small and mid-sized businesses, create jobs and sustain economic growth. Private equity funding is a critical form of financing for smaller businesses that are trying to expand and grow. In fact, between 1995 and 2010, more than 23,000 companies employing three million people were backed by private capital. These firms grew jobs at a rate of 64% compared to other companies in the U.S. which only grew jobs at a rate of 18%.

ACG applauds the Chairman and Ranking Member for their efforts in considering several legislative proposals that would provide a measured response to onerous requirements imposed by the 2010 Dodd-Frank Act. Notably, middle-market private equity funds have not been shown to add to the systemic risk of the global financial system and it is important that the application of Dodd-Frank uphold the original spirit and intent of the legislation, which is to safeguard our financial system without constraining capital and the middle-market's ability to flourish and to contribute to economic growth and job creation. Yet, the Dodd-Frank Act requires that virtually all private equity firms must register with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, despite the fact that private equity funds are structured and operate almost identically to venture capital funds, which under the Dodd-Frank Act are exempted from having to register.

H.R. 1105, the Small Business Capital Access and Jobs Preservation Act would amend the Investment Advisers Act of 1940 to exempt private equity fund investment advisers from its registration and reporting requirements, so long as the fund has not borrowed and does not have an outstanding principal amount of debt exceeding twice its invested capital obligations. Since private equity funds were not a cause of the financial crisis and its business model does not pose any interconnected risk to the economy, ACG believes H.R. 1105 is a necessary piece of legislation that will help ensure the continued flow of capital to businesses.

In addition to the imposed SEC registration requirements, the regular reporting on Form PF is time-intensive, costly and requires the regular valuation of privately held portfolio companies. These requirements are not only inordinate; they were intended for firms that engage in publicly-traded securities and are ill-suited for investors in privately held companies. Thus the requirements are a mismatch for the private equity investment model. Moreover, the costs of these requirements can be prohibitive for firms that invest in the middle market and harm businesses that need assistance to grow.

The bi-partisan Small Business Capital Access and Job Preservation Act will preserve private equity funding as a pipeline of capital for growing businesses. In addition, ACG is supportive of the Committee's efforts for quick implementation of the JOBS Act.

ACG stands ready to assist and serve as a resource to Chairman Garret, Ranking Member Maloney and members of the Subcommittee in efforts to achieve sound financial policies and enhancements of the Dodd-Frank Act that accomplishes continued growth in the middle-market. ACG appreciates the opportunity to contribute to the efforts of your Committee. If you have any questions or require any additional information, please do not hesitate to contact Christine Melendes, CAE, Vice President for Marketing and Communications at (312) 957-4277.

Sincerely,

Gary LaBranche

Gary LaBranche, FASAE, CAE
President and CEO
Association for Corporate Growth

INVESTMENT COMPANY INSTITUTE

IDC INDEPENDENT DIRECTORS COUNCIL

Statement of the Investment Company Institute and the Independent Directors Council Hearing on "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators"

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
May 23, 2013

The Investment Company Institute[1] and the Independent Directors Council[2] are pleased to provide this written statement in connection with the hearing on "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators." One such proposal, H.R. 1564, the "Audit Integrity and Job Protection Act," introduced by Representatives Hurt and Meeks, would amend the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) to prohibit the Public Company Accounting Oversight Board (PCAOB) from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis—commonly known as mandatory audit firm rotation.[3]

ICI and IDC strongly support the legislation.[4] While ICI and IDC support the PCAOB's focus on strengthening the quality and integrity of the audit process and would be open to considering

---

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.96 trillion and serve over 90 million shareholders.

[2] IDC serves the fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of ICI-member funds. There are almost 1,900 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[3] In August 2011, the PCAOB published a concept release asking for views on mandatory rotation or other measures to enhance auditor independence, objectivity, and professional skepticism. Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-06 (August 16, 2011) (Release). The PCAOB received over 600 comment letters on this proposal, with over 90 percent opposed to it. Since then, the PCAOB held public meetings on the topic in Washington, DC (March 2012), San Francisco, CA (June, 2012), and Houston, TX (October 2012). Again, participants expressed overwhelming opposition to mandatory audit firm rotation.

[4] ICI and IDC submitted comment letters to the PCAOB strongly opposing a mandatory audit firm rotation. *See* Letter from Gregory M. Smith, Director – Fund Accounting, ICI, to Mr. J. Gordon Seymour, Secretary, PCAOB, regarding Concept Release on Auditor Independence and Audit Firm Rotation; PCAOB Rulemaking Docket Matter No. 37 (Dec. 14, 2011) (ICI Comment Letter); Letter from Dorothy A. Berry, Chair, IDC Governing Council, to Mr. J. Gordon

alternative proposals, we strongly oppose mandatory audit firm rotation for investment companies (funds). With no empirical basis for the mandate, and in light of the negative consequences, an audit firm rotation requirement would be a costly and disruptive solution in search of a problem. Indeed, the PCAOB has not cited any concerns with respect to fund audits, nor are we aware of any. Moreover, there is no clear correlation between any fund audit deficiencies and a lack of auditor independence.

As discussed more fully below, a mandatory audit firm rotation requirement for funds would impose unnecessary burdens on fund boards and fund managers, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs, all to the detriment of fund shareholders. Also, an audit firm rotation mandate would be impracticable for funds given the limited number of qualified audit firms. Finally, a mandatory audit firm rotation requirement would inappropriately marginalize the role of fund boards and their audit committees.

Existing Safeguards in the Fund Industry Promote the Integrity of Fund Audits

We firmly believe, and history has shown, that existing safeguards are more than adequate to assure the independence of auditors. The Investment Company Act of 1940 (1940 Act) and SEC rules have long required funds to have strong systems of controls and procedures in place to protect investors and to ensure the integrity of financial statements. The Sarbanes-Oxley Act bolstered these protections.[5] In 2003, the SEC, in implementing various sections of the Sarbanes-Oxley Act, adopted a variety of rules designed to strengthen auditor independence.[6] For instance, the rules expand the types of non-audit services that, if provided to an audit client, would impair an audit firm's independence. The rules also establish a "cooling off" period before a member of the audit engagement team could work at the audit client. Most notably, though, the rules impose rotation requirements for lead audit partners and concurring review partners.

In adopting these reforms, the SEC worked to "strike a balance between the need to achieve a fresh look on the engagement and a need for the audit engagement team to be composed of competent accountants."[7] We agree with the SEC's balanced approach and believe that requiring the audit partner, rather than the audit firm, to rotate best promotes the twin goals of an independent audit performed by qualified and experienced auditors. For this reason, we also agree with the GAO's

---

Seymour, Secretary, PCAOB, regarding Concept Release on Auditor Independence and Audit Firm Rotation; PCAOB Rulemaking Docket Matter No. 37 (Dec. 14, 2011) (IDC Comment Letter) (together, the Comment Letters).

[5] We note that the SEC's Chief Accountant expressed his belief that "auditor performance and the reliability of financial reporting have improved significantly in the past decade." Speech by James L. Kroeker, SEC Chief Accountant, Remarks Before the 2011 AICPA National Conference on Current SEC and PCAOB Developments (December 5, 2011).

[6] *See Strengthening the Commission's Requirements Regarding Auditor Independence*, SEC Release No. 33-8183 (January 28, 2003).

[7] *Id.*

conclusion that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional costs it would entail and the other reforms being implemented at the time.[8] More recently, in its comments on the Release, the GAO indicated that the PCAOB has not provided compelling evidence that the root cause of audit quality issues is related to a break down in auditor independence. The GAO goes on to state that even if such a link could be established, it is unclear that the problem would be prevented or mitigated by mandatory audit firm rotation.[9]

Moreover, fund independent directors provide a critical safeguard with regard to the fund's auditor under the 1940 Act and the rules thereunder. Specifically, the statute requires independent directors to select the fund's auditor.[10] The importance of this responsibility is underscored by the fact that the selection of a fund's auditor is one of only four responsibilities specifically assigned by the 1940 Act to independent directors. Funds are exempt from seeking shareholder ratification for the selection of the auditor if, among other things, the fund's board has an audit committee composed solely of independent directors. Virtually every fund's audit committee is composed entirely of independent directors. This has been adopted as a best practice even though funds are not required to do so unless relying on certain SEC rules.[11] The vast majority of fund boards (97%) also have an audit committee financial expert.[12] In addition, fund independent directors are guided by their own responsibilities and duties—namely, their fiduciary duty to protect the interests of fund shareholders—to promote the integrity of fund audits. This strong oversight mechanism provides ample protection and further renders an audit firm rotation requirement unnecessary.

There also are a number of other incentives, such as the PCAOB's own inspection and enforcement programs, as well as the ever-present threat of litigation, that help to ensure the independence, objectivity, and professional skepticism of audit firms.

Finally, there are less onerous mechanisms for continuing to enhance the quality and integrity of fund audits, and IDC and ICI both offered suggestions in our Comment Letters. The IDC Comment Letter encouraged the PCAOB to study ways to improve its communications with and education of audit committee members and the ICI Comment Letter made specific standard-setting

[8] *See* U.S. General Accounting Office, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (November 2003) (GAO Report).

[9] *See* Letter from James R. Dalkin, Director – Financial Management and Assurance, GAO to the Office of the Secretary, PCAOB, regarding PCAOB Rulemaking Docket Matter 037 (December 14, 2011).

[10] Section 32 of the 1940 Act.

[11] *See* ICI Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 24, 1999).

[12] ICI/IDC Overview of Fund Governance Practices, 1994-2010.

recommendations that could enhance independence, objectivity and professional skepticism.[13] The PCAOB made progress in that regard in August 2012 when it issued a release intended to inform audit committees about its inspection of audit firms and the meaning of reported inspection results.[14] According to the PCAOB, the objective of the release was to better equip audit committees to engage in meaningful discussion with their auditor about its inspection findings. In addition, the PCAOB recently approved an audit standard intended to improve audit quality by enhancing communications between auditors and audit committees.[15] The audit standard establishes requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. Finally, ICI and IDC, in collaboration with a number of other financial organizations, published a tool to assist audit committees, including fund board audit committees, in performing an annual evaluation of the external auditor in order to make an informed recommendation to the board whether to retain the auditor.[16] These developments work to even further promote the quality and integrity of fund audits.

Mandatory Rotation Would Likely Have Adverse Effects on Fund Audits

An audit firm rotation requirement would likely have adverse effects on fund audits. Specifically, mandatory rotation would impose unnecessary burdens on fund boards and fund managers, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs. We do not believe that the PCAOB fully considered the important differences between funds and operating companies with respect to a mandatory audit firm rotation and the impact that such a requirement would have on funds.[17]

Funds can and do change audit firms under circumstances appropriate for the particular fund, but replacing one of a fund's principal service providers is a significant undertaking and one that funds do not typically undergo without serious consideration.[18] First, the process of selecting a new audit firm

[13] *See* Comment Letters, *supra* note 4.

[14] PCAOB Release No. 2012-003, *Information For Audit Committees About the PCAOB Inspection Process* (August 1, 2012) is available on the PCAOB's website at www.pcaobus.org.

[15] PCAOB Release No. 2012-004, *Auditing Standard No. 16 – Communications with Audit Committees* (August 15, 2012) is available on the PCAOB's website at www.pcaobus.org.

[16] *Audit Committee Annual Evaluation of the External Auditor* (October 2012) is available on IDC's website at http://www.idc.org/pdf/pub_12_audit_eval.pdf.

[17] The United States Court of Appeals for the District of Columbia vacated the SEC's proxy access rule, finding that with regard to the application of the rule to investment companies, the SEC had failed to failed adequately to address whether the regulatory requirements of the 1940 Act reduce the need for, and hence the benefit from, proxy access for fund shareholders and whether the rule would impose greater costs upon investment companies by disrupting the structure of their governance. *Business Roundtable et. al v. SEC*, No. 10-1305 (D.C. Cir. Decided July 22, 2011).

[18] *See* IDC Task Force Paper on Board Oversight of Certain Service Providers (June 2007).

can be burdensome to both the fund's board and the fund's manager. This process includes interviewing auditors and evaluating a significant amount of information regarding the resources, capabilities, reputation, and independence of each audit firm under consideration. Once selected, the new auditor would need to spend additional time working with the fund's manager to understand and document the fund's structure, trading strategy, operations, and internal controls to enable it to develop its initial audit plan. This process could be complicated by the extent to which fund operations are outsourced. A new audit firm's lack of familiarity with the fund also could increase the risk of problems with the audit.

The new audit firm's initial review, as well as the transition process, would be disruptive and time-consuming, and likely distract the fund manager and board from other important responsibilities. The disruption of changing audit firms would be particularly acute for fund complexes that stagger the fiscal year ends of their funds and, thus, are in a "continuous audit cycle."[19] Moreover, the additional time and effort involved in "getting up to speed" could translate into an unnecessary increase in audit costs, which ultimately would be borne by fund shareholders.[20]

Another negative impact on audit quality and cost may occur by virtue of the fact that audit firms will know their client relationships will end at a set time. If an audit firm knows its relationship with a client will sunset at a predetermined time, the auditor may be more focused on looking over the horizon for its next client and less focused on the existing client's audit. Likewise, if an audit firm knows its engagement is for only a limited period, the auditor may have less incentive to negotiate its fees. Higher audit fees would likely have a disproportionate impact on smaller fund complexes, and in particular new complexes, that struggle to compete with more established and larger fund complexes.

Our Concerns are Heightened by the Limited Number of Qualified Audit Firms

Our concerns about a mandatory audit firm rotation are heightened in the fund context due to the limited number of audit firms that are qualified—in terms of expertise and independence—to audit funds. If funds are forced to rotate audit firms and engage a firm that does not have sufficient experience and expertise in auditing fund financial statements, the impact on audit quality, risk, and cost would be that much more severe, to the detriment of fund shareholders.

Auditing fund financial statements requires specialized industry and regulatory expertise. Only a limited number of audit firms currently possess this expertise. Firms that perform fund audits

---

[19] The use of staggered fiscal years is a mechanism to help manage the workflow associated with the end of each fund's fiscal year, which includes the update to the fund's registration statement as well as the preparation and audit of its financial statements.

[20] Indeed, in a study by the GAO, large audit firms estimated that, under mandatory audit firm rotation, initial year audit costs would increase by more than 20 percent over subsequent year costs because of the need to acquire the knowledge necessary to perform the audit. *See* GAO Report, *supra* note 8.

typically have personnel dedicated to the asset management industry who are knowledgeable about the industry-specific accounting model required by FASB Topic 946, the special tax status afforded funds under Subchapter M of the Internal Revenue Code, and the overlay of SEC regulation imposed by the 1940 Act. In addition, because SEC rules require the auditor to independently verify the valuation of 100 percent of the fund's securities at the balance sheet date, the audit firm would likely need a dedicated team of valuation experts, who can value complex or thinly traded securities where market quotes are not readily available.[21] A "deep bench" of audit partners with this expertise is oftentimes necessary for complexes with continuous audit cycles for funds with staggered fiscal years.

Moreover, the prevalence of mutual funds as investment options in 401(k) plans, including those plans offered to audit firm employees, may limit choice in hiring a new auditor. For example, if a particular fund family's funds are offered through an audit firm's 401(k) retirement plan to the audit firm's employees, then that audit firm likely would not be willing to audit those funds because of the independence issues it would raise.[22] While the audit firm could cause its employees (and their immediate family members) to sell their investments in the funds in order to cure the independence problem, we believe that the audit firm would be unlikely to do so because of the disruption it would cause its employees and their retirement planning. Indeed, we understand that certain audit firms have identified specific fund families that they will not audit, so as to ensure funds from these families are available to their employees for investment through the audit firm's 401(k) plan. In addition, audit firm personnel may hold investments outside of tax-deferred accounts in those funds and any forced divestment could impose significant tax consequences on the audit firm personnel.

The limited number of qualified audit firms in the fund industry is evidenced by informal ICI data, which reveal that only four accounting firms serve as auditors to 94% of funds and that these funds represent about 99% of industry assets. In addition, the remainder of the funds in the industry, which are among the smallest funds in the smallest complexes, are audited by only a handful of other accounting firms. Some believe that mandatory audit firm rotation could present an opportunity for accounting firms other than the few large audit firms to compete more effectively.[23] But these firms currently do not have the expertise and experience typically necessary to audit fund financial statements. Assuming that they would be able to develop this expertise is speculative and fails to take into account the significant time and resources necessary to do so.

The Authority and Discretion of Fund Boards and Audit Committees Would Be Undermined by Mandatory Audit Firm Rotation

---

[21] Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970).

[22] We recognize the concept of "covered person" within rule 2-01 of Regulation S-X affords employees not associated with the engagement, in the engagement office, or in the chain of command to invest in the funds. We understand, however, that audit firms may adopt more restrictive policies that prohibit *all* employees from investing in the funds.

[23] *See* Release, *supra* note 3.

A mandatory audit firm rotation would ignore both the important role of fund boards and their audit committees in overseeing fund audits and the unique statutory and regulatory framework for funds established by Congress in the 1940 Act and by SEC rules. We firmly believe that the PCAOB should not infringe upon this long-standing and successful framework by imposing a mandatory audit firm rotation requirement.

A primary duty of a fund board audit committee is to recommend to the board's independent directors the selection of the fund's auditor. A mandatory rotation of audit firms would undermine the authority and discretion of the committee, which works diligently to oversee the auditor and make determinations that are in the best interest of the fund and its shareholders. Determining whether to retain the fund's current auditor and, if not, the most appropriate time to replace the auditor is a decision best left to the judgment of a fund's independent directors, taking into account the particular facts and circumstances of the fund.

* * * * *

We appreciate your consideration of our views.

Legislative Proposals to Relieve the Red Tape
Burden on Investors and Job Creators

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

Statement of
Anne Simpson
Senior Portfolio Manager, Investments
Director of Global Governance
California Public Employees' Retirement System

May 23, 2013

Chairman Garrett, Ranking Member Maloney, and Members of the Committee, on behalf of the California Public Employees' Retirement System (CalPERS), we thank you for convening this hearing. CalPERS is pleased to submit testimony for the record to reassert our strong support for efficient and effective financial regulation, as enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

This statement includes a brief overview of CalPERS, including how we benefit from effective financial markets regulation and the role that shareowner rights and corporate governance play in building investor confidence. It also includes a discussion of our views on HR 1135, HR 1105, and HR 1564.

Some Background on CalPERS

CalPERS is the largest public pension fund in the United States with approximately $266 billion in global assets and equity holdings in over 9,000 companies. CalPERS pays out over $14 billion annually in retirement benefits to more than 1.6 million public employees, retirees, their families and beneficiaries. This is not only an important source of daily income for those individuals; it also provides a positive economic multiplier to the local economy.[1] We fully understand the virtuous circle between savings, investment and economic growth. That is at the heart of the CalPERS agenda.

As a significant institutional investor with a long-term investment time horizon, CalPERS fundamentally relies upon the integrity and efficiency of the capital markets. For every dollar that we pay in benefits to our members, 64 cents are generated by investment returns. The financial crisis hit us hard with $70 billion wiped from CalPERS assets. While we are pleased that have been able to recover these losses over the last several years, we simply cannot afford another drawdown on our fund.

---

[1] *See* "The Economic Impacts of CalPERS Pension Payments in 2010", Dr. Robert Fountain, Regional Economic Consultants, (July 2011). ("Every California County benefits from CalPERS retirement payments. In larger urban counties impact is greatest on the total dollar amount of gross regional product. In smaller, rural counties the percentage increase in the gross regional product is greatest. CalPERS payments have a positive impact on jobs throughout the state and in 17 counties they supported more than one percent of the total jobs in their communities.")

We rely upon the safety and soundness of capital markets, and more broadly, sustainable economic growth, to provide the long term returns that allow us to meet our liabilities. However, there is still much to be done to bring about smart regulation.

In our view, smart regulation should be structured as follows:

First, regulation needs to be complete and coordinated. Innovation in financial markets has led to the development of new financial instruments and pools. Regulation needs to keep pace with financial innovation and the attendant risks in order to be relevant. (Derivatives are an example of that innovation, but it is innovation that has been outside the reach of regulation historically.)

Second, regulation needs to allow market players to exercise their proper role and responsibilities. Capitalism was designed to allow the providers of finance a market role in allocating investment, and then holding boards accountable for their stewardship of those funds. This is why shareowner rights are vital to the functioning of markets, including the ability of investors to propose candidates to boards of directors (known in short as 'proxy access') and to remove directors who fail.

Third, regulation needs to ensure transparency, so that markets can play their vital role in pricing risk. Timely, relevant and reliable information is the currency of risk management. Those agencies which have a role in channeling that information need to be fit for that purpose. (Credit ratings agencies were found wanting in this regard.)

Fourth, regulation needs to address conflicts of interest and perverse incentives which can undermine the market's ability to allocate capital effectively. (Short term, risk-free compensation for executives has fueled poor decision taking, as one of example of this).

Fifth, regulation needs to ensure it does not prevent institutional investors from financing legitimate strategies, and taking advantage of new opportunities. Regulation is not there to prevent risk taking, it is there to ensure that risks are disclosed, and can be managed.

Finally, regulation needs to be proportionate. For CalPERS, we balance the additional costs that are required with the potential for financial ruin. To those who question whether we can afford to invest in smart regulation, we reply, how can we afford not to? The financial crisis dealt a crippling blow to many investors, and the underlying sub-prime mortgage scandal triggered widespread loss for ordinary people throughout the country. The devastating impact on the real economy is still with us. The costs of regulation need to be weighed against this loss.

We see smart regulation as an investment in safety and soundness of financial markets which generate the vast bulk of the returns to our fund. Smart regulation is an investment in the effective functioning of capital markets, which is critical not just to our fund, but to the recovery of the wider economy.

<u>HR 1135</u>

It is widely acknowledged that the 2008 financial crisis represented a massive failure of oversight.[2] Too many CEOs pursued excessively risky strategies or investments that

[2] *See* Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xviii* (Jan. 2011), http://www.gpoaccess.gov/fcic/fcic.pdf ("We conclude dramatic failures of corporate governance and risk

bankrupted their companies or weakened them financially for years to come.[3] Boards of directors were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind.[4] And too many boards approved executive compensation plans that rewarded excessive risk taking.[5]

Accountability is critical to motivating people to do a better job in any organization or activity.[6] An effective board of directors can help every business understand and control its risks, thereby encouraging safety and stability in our financial system and reducing the pressure on regulators, who, even if adequately funded, will be unlikely to find and correct every problem.[7] Unfortunately, long-standing inadequacies in investor protection have limited shareowners' ability to hold boards accountable.[8]

Fortunately, Dodd-Frank contains a number of reforms that when fully implemented and effectively enforced will provide long-term investors like CalPERS with better tools, including better information, to hold directors more accountable going forward.[9] These included a provision that requires additional disclosure involving the ratio between the CEO's total compensation and the median total compensation for all the other company employees. To be clear, section 953(b) as currently enacted is unartful and its critics properly identify a number of potential ambiguities. However, we strongly support the spirit of the disclosure and believe that the SEC has the regulatory flexibility to provide companies with guidance on how to comply with this section.

However, if Congress believes the SEC is unable to implement section 953(b) as currently written, we would encourage Congress to amend the section and retain the requirement. HR 1135 seeks only to repeal this requirement and for the reasons discussed above, we would strongly discourage the committee from advancing this bill.

---

management at many systemically important financial institutions were a key cause of this crisis") [hereinafter FCIC Report. IWG Report, *supra* note 1, at 22.

[3] IWG Report, *supra* note 1, at 22.

[4] *See* Staff of S. Permanent Subcomm. on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse 185-86 (Apr. 13, 2011), http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf (providing evidence that board oversight of Washington Mutual, Inc., including oversight of enterprise risk management, was "'less than satisfactory'"); IWG Report, *supra* note 1, at 22.

[5] FCIC Report, *supra* note 1, at *xix* ("Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences); *see also* Deputy Secretary of the Treasury Neal Wolin, Remarks to the Council of Institutional Investors 4 (Apr. 12, 2010), http://www.ustreas.gov/press/releases/tg636.htm (noting that ""irresponsible pay practices . . . led so many firms to act against the interests of their shareholders"); IWG Report *supra* note 1, at 22.

[6] Press Release, *supra* note 5, at 2.

[7] *Id.*

[8] IWG Report, *supra* note 1, at 22 ("shareowners currently have few ways to hold directors' feet to the fire").

[9] S. Comm. On Banking, Housing, & Urban Affairs, Rep. On The Restoring American Financial Stability Act 30 (Mar. 22, 2010), http://banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf (Noting that the Senate version of Dodd-Frank contained provisions designed to give investors "more protection" and shareholders "a greater voice in corporate governance") [hereinafter S. Rep.].

HR 1105

Prior to the enactment of Dodd-Frank, we testified that the fundamental risk posed by private pools of capital is that they can choose to operate outside the regulatory structure of the United States.[10] CalPERS Chief Investment Officer Joe Dear warned the Senate Securities Subcommittee of the overall risks to the financial system "when these entities operate in the shadows of the financial system" and when "regulatory authorities lack basic information about exposures, leverage ratios, counterparty risks and other information." Less than three years after the enactment of Dodd-Frank, these risks have been mitigated by the requirement for private fund advisors to register and be subject to reasonable regulation.

Although HR 1105 would only exempt funds with low leverage ratios, it would constitute a large step away from the comprehensive regulation of market participants that Dodd-Frank sought to impose. Dodd-Frank has already provided small private fund advisors an exemption to registration and regulation, and we believe it is therefore unnecessary large, albeit unleveraged, fund advisors.

HR 1564

The issues surrounding auditor independence and audit firm rotation are of great importance to CalPERS.

Clearly, auditors play a vital role in the integrity of financial reporting and the efficiency of the capital markets. As a long-term investor, and a strong advocate of reform we believe independence of an auditor is critical to investor confidence and the stability and effective functioning of the capital markets. It is the important role of auditors that brings standardization and discipline to corporate accounting which in turn enhances investor confidence.

CalPERS Global Principles of Accountable Corporate Governance[11] (Principles) highlight the importance of auditor independence requiring audit committees to assess the independence of their external auditor on an annual basis. Also, as part of the engagement we recommend that audit committees require written disclosure from the external auditor of:

- all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit clients or persons in a financial reporting oversight role that may have a bearing on independence;
- the potential effects of these relationships on the independence in both appearance and fact of the registered public accounting firm; and
- the substance of the registered accounting firm's discussion with the audit committee.

CalPERS expressly supported mandatory rotation in the wake of the scandals which led to the Sarbanes-Oxley Act of 2002. CalPERS communicated its view[12] to the European Parliament

[10] *See* Testimony of Joseph A. Dear, Chief Investing Officer, CalPERS, July 10, 2009. http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e83f7ca1-6f94-4854-8aa9-ef0ac11b4bb0

[11] *See* Item 4.8, CalPERS Global Principles of Accountable Corporate Governance http://www.calpers-governance.org/docs-sof/principles/2011-11-14-global-principles-of-accountable-corp-gov.pdf

[12] CalPERS Comment Letter to European Parliament Committee on Legal Affairs, *RE:DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL SPECIFIC REQUIREMENTS REGARDING STATUTORY AUDIT OF PUBLIC INTEREST ENTITIES AUDIT REFORM,* November 5, 2012.

Committee on Legal Affairs, that "mandatory auditor rotation is an effective means of increasing auditor independence". CalPERS Principles state that "Audit Committees should promote the rotation of the auditor to ensure a fresh perspective and review of the financial reporting framework."

We believe that audit committees should endorse expanding the pool of auditors for the annual audit to help improve market competition and minimize the concentration of audit firms from which to engage for audit services. We support audit committees having the ability to determine audit independence by requiring auditors to provide 3 prior years of activities, relationships and services (including tax services) with the company, affiliate of the company and persons in financial reporting oversight roles that my impact the independence of the audit firm.

Additionally, we would note that the Public Company Accounting Oversight Board's (PCAOB) Investor Advisory Group (IAG), of which I am a member, urged the agency to consider firm rotation in the context of lessons learned from the financial crisis.[13] The PCAOB IAG indicated that the purpose of an audit is to provide confidence to investors that an independent set of eyes have looked at the numbers reported by management and objectively without bias determined they can indeed be relied upon. If investors' confidence in this process is diminished or lost, the benefits of the audit and its costs may be questioned.

Over the last two years, the PCAOB has thoughtfully reviewed auditor independence and mandatory rotation, holding a series of roundtables on the issues. We note the issue of mandatory rotation has been addressed by the European Commission (EC). The EC has voted to draft law to open up the European Union audit services market and improve audit quality and transparency including mandatory rotation of the auditor whereby an auditor may inspect a company's books for a maximum of 14 years. We believe that it is essential and beneficial for the PCAOB to collaborate with non-U.S. regulators and standard-setters on this matter.

Ultimately, we believe that audit committees are in the best position to select the auditor. However, we are strong supporters of the PCAOB and have faith in their thoughtful approach to the regulation of the audit profession. If they ultimately conclude that mandatory rotation is appropriate, we will support this judgment consistent with our support for the position taken by the EC. Accordingly, because HR 1564 would eliminate the PCAOB's discretion in this area, we cannot support the measure.

Regulatory Agency Funding

Finally, although the hearing has not focused directly on the funding for the SEC, we would be remiss if we didn't highlight the vital role of the SEC and PCAOB in fostering capital formation and protecting investors in financial markets. CalPERS has long recognized that for financial regulators to achieve their stated objectives, they must be well-managed, well-staffed and that means they must be well-funded. Rules without enforcement are little better than useless. In 2001, CalPERS testified in support of legislation that would put SEC staff salaries on par with other financial regulators[14] and was pleased that pay-parity provisions were enacted into law that year. More recently, we called for lawmakers to provide the SEC and U.S. Commodity

[13] *See* "Improving Global Audit Quality and Transparency," Presentation of the Subcommittee on Global Networks and Audit Firm Governance, PCAOB Investor Advisory Group, May 11, 2011. http://pcaobus.org/News/Events/Documents/03162011_IAGMeeting/Audit_Quality_Slides.pdf

[14] *See* Prepared Testimony of James E. Burton, Chief Executive Officer, CalPERS, May 14, 2001. http://www.banking.senate.gov/01_02hrg/021401a/burton.htm.

Futures Trading Commission (CFTC) with stable, independent funding. Although no such mechanisms were included in Dodd-Frank, it remains imperative that the SEC and CFTC be given sufficient resources to effectively police the U.S. capital and futures markets.

We believe the SEC FY2014 funding request reflects the importance of their traditional core responsibility, as well as the new authority granted it in Dodd-Frank, and we urge you to support their funding requests.

Thank you in advance for considering the views of a long-term investor like CalPERS when you decide on how to proceed with these important issues.