CONTINUED OVERSIGHT OF THE SEC'S OFFICES AND DIVISIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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CONTINUED OVERSIGHT OF THE SEC'S OFFICES AND DIVISIONS

Thursday, April 21, 2016

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 9:14 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Neugebauer, Huizenga, Duffy, Hultgren, Ross, Wagner, Messer, Schweikert, Poliquin, Hill; Maloney, Sherman, Hinojosa, Lynch, Himes, Foster, Sewell, and Murphy.

Also present: Representative Fitzpatrick.

Chairman GARRETT. The Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. Today's hearing is entitled, "Continued Oversight of the SEC's Offices and Divisions."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee may sit on the dais and participate in today's hearing.

At this point, I will now recognize myself for 3 minutes for an opening statement.

Today, the subcommittee will continue its efforts to conduct vigorous oversight of the SEC, and in particular, the individual offices which make up the SEC.

In the last 2 years, our subcommittee has heard testimony from the Directors of the Trading and Markets, Corporation Finance, Enforcement, and Investment Management Divisions at the SEC. These hearings have allowed us to take a more thorough look at the agencies' operations, their rulemaking agenda, and enforcement practices so that we can better understand whether the SEC is appropriately carrying out its three-fold mission to: protect investors; maintain fair and orderly, efficient markets; and last but certainly not least, facilitate capital formation.

So I welcome our witnesses today. I look forward to hearing their testimony, and I hope between the four of you who are here on the panel that we are able to cover a lot of ground in the time we have.

If you go back, in the year 2000 the SEC's operating budget was about $369 million. Today, the SEC's budget authority for Fiscal

Year 2016 is a little over $1.6 billion. And the SEC has recently submitted a request for the Fiscal Year 2017 budget coming up of $1.8 billion.

So during much of the time when Congress has been accused of starving the SEC of funds it needs to fulfill its mission, its budget has actually quadrupled and has done so in less than—a little over a dozen years.

It would be one thing if this four-fold increase's funding coincided with an agency that has become 4 times more effective. Instead, we are likely to look back at this as a period of time when the SEC missed some of the greatest frauds in history, when it was ill-prepared for the financial crisis of 2008, and when it failed to properly incorporate economic analysis into its rulemaking and, more recently, has oftentimes been complicit in advancing the priorities of special interests.

So, unfortunately, instead of addressing some of the fundamental structural issues at the SEC, the Dodd-Frank Act has created even more offices within the agencies, two of which are with us here today. Dodd-Frank also granted the agency vast new rulemaking authority that the SEC has oftentimes simply struggled to implement appropriately. For example, while the SEC has made strides towards improving the economic analysis that underlies its rulemakings, there is still much more work that can be done in this area.

And so it is not acceptable for the SEC to simply say, "Well, Congress made me do it," and therefore assume that rulemaking is beneficial in all cases, as the SEC recently did with its pay ratio rule last year. It is also incumbent upon the SEC to clearly articulate a problem, or a market failure, if you will, that the rules are intended to address, which should be obvious, but it is still, unfortunately, lacking in many of the Dodd-Frank rules that have been implemented.

So I am eager to hear about the steps the SEC is taking to further improve its economic analysis.

Finally, I also continue to have concerns over recent rulemakings related to credit rating agencies. While there is broad agreement that certain provisions in Dodd-Frank, such as the removal of references to credit rating agencies' regulations, were much needed and directly address one of the causes of the financial crisis, I worry that many of the other micromanaging rules included in Dodd-Frank have had the effect of further stifling competition in the credit rating industry.

So again, I want to thank all the witnesses for their testimony, and I will yield to the ranking member of the subcommittee, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. Good morning, and thank you so much, Mr. Chairman, for holding this important hearing. I also thank all of our participants today. This hearing will continue our subcommittee's series of oversight hearings on the SEC.

Today, we are focusing on four divisions or offices in the SEC: the Office of Compliance, Inspections, and Examinations; the Office of Credit Ratings; the Office of the Whistleblower; and the Division of Economic Risk and Analysis, or DERA. All four of these offices play a critical role in policing our Nation's securities markets.

The Office of Credit Ratings oversees the registered credit rating agencies such as Moody's, S&P, and Fitch. The financial crisis revealed the importance of credit rating agencies, but physically it revealed the catastrophic consequences that can result when the rating agencies all get their ratings wrong.

In response, Dodd-Frank created the Office of Credit Ratings in order to increase the level of oversight of credit rating agencies. One of the principal missions of this office is to ensure that inappropriate conflicts of interest at the rating agencies do not influence the ratings that the firms assign to different securities.

The Office of the Whistleblower was also created by Dodd-Frank and is intended to encourage whistleblowers from the industry to come forward with specific and timely information about wrongdoing. In return for tips that lead to significant punishments of over $1 million, whistleblowers are entitled to a monetary reward, which incentivizes industry employees to blow the whistle before fraud gets too large and too devastating.

Already, this office has received thousands of tips from potential whistleblowers, which is striking. In fact, in 2015 the office received over 4,000 tips from whistleblowers.

The Division of Economic Risk and Analysis, or DERA, is the data arm of the SEC. It supports all of the other divisions in the SEC by conducting cost-benefit analysis of potential rulemakings, developing models that help focus the Commission's resources on the riskiest practices, and even calculating the appropriate punishment for bad actors.

Finally, the Office of Compliance, Inspections, and Examinations, or OCIE, is one of the largest and most underfunded offices in the SEC. It has over 1,000 employees who examine registered investment advisers, broker-dealers, exchanges, mutual funds, and mutual advisers. This sounds like a lot of examiners, but it pales in comparison to the number of market participants that the office has to examine.

The office oversees more than 26,000 market participants, including over 12,000 investment advisers, 11,000 mutual funds, 4,000 broker-dealers, 800 municipal advisers, and 18 securities exchanges. As a result, the Commission is only able to examine about 10 percent of all investment advisers each year, which is a terrifying thought. This means that roughly 40 percent of investment advisers have never been examined.

What makes this even scarier is that in 2015, a whopping 77 percent of the Commission's examinations identified deficiencies at investment advisers, and 11 percent resulted in referrals for enforcement action. If those numbers are constant, that means that of the 5,000 investment advisers that have never been examined, a little under 4,000 have deficiencies that have not been uncovered. This is a scary thought for investors who rely on those advisers to manage their savings.

So I look forward to hearing from all of our witnesses today, and I look forward to your testimony. Thank you for your work.

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

Chairman GARRETT. Thank you very much.

The gentlelady yields back.

The gentleman from Virginia, Mr. Hurt, the vice chairman of the subcommittee, is recognized for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman.

And welcome, to our panel.

I represent a rural district in Virginia, Virginia's 5th District. It stretches from the northern Piedmont in Virginia to the North Carolina border. So as I travel across my district, I regularly hear from my constituents that they are concerned about jobs and the economy, and that they are concerned with the seemingly new normal administrative state here in Washington that makes it more difficult for our Main Street and small businesses to access capital and to be successful.

While this committee has been laser-focused on producing legislation that would help our Nation's small businesses thrive, that would ease the access to capital, and that would build upon the bipartisan success of the JOBS Act, an equally important function is fulfilling Congress' duty to conduct vigorous oversight over Executive Branch agencies.

Just as my constituents are concerned about our ever-expanding administrative state, I, too, am concerned that the SEC often deviates from its three-part mission: to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.

Hearings such as this allow Congress to exercise its responsibility of proper oversight over how the SEC allocates its resources in fulfilling its three-part mission. I look forward to the testimony of our witnesses.

I thank the chairman for holding this hearing, and I yield back the balance of my time.

Chairman GARRETT. Great. The gentleman yields back.

And now, I welcome the members of the panel before us. Without objection, your joint written statement will be made a part of the record.

You will be recognized for 5 minutes. I know most of you have not been here before, but you know the drill, I assume.

In front of you are the lights, which are green, yellow, and red. The yellow light should come on when you have 1 minute remaining, so we would ask you at that time to begin to wrap up, and the red light means your time has expired.

And with that, Mr. Butler, you are recognized for 5 minutes.

STATEMENT OF THOMAS J. BUTLER, DIRECTOR, OFFICE OF CREDIT RATINGS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. BUTLER. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for inviting me to testify on behalf of the U.S. Securities and Exchange Commission regarding the activities and responsibility of the Office of Credit Ratings.

The office supports the Commission's three-part mission: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. It does this by overseeing credit rating agencies that are granted registration as nationally recognized statistical rating organizations, or NRSROs.

In 2006, the Credit Rating Agency Reform Act established the regulatory framework and gave Congress the authority to implement a myriad of rules for the oversight of NRSROs. The Dodd-Frank Act expanded the Commission's authority and mandated the creation of an office, the Office of Credit Ratings, dedicated to the oversight of NRSROs.

The office's activities generally fall within three areas: examinations; NRSRO monitoring and constituent monitoring; and policy and rulemaking.

Examinations of NRSROs for compliance with Federal securities laws and Commission rules accounts for the majority of the office's activities. The Dodd-Frank Act requires the office to conduct an examination of each NRSRO at least annually, and the scope of the annual examinations covers eight required review areas.

Further, the office employs a risk-based approach to exam planning, identifying different risks for different NRSROs. This improves the efficiency and the effectiveness of the examinations as resources are prioritized and focused on areas of higher risk. In addition to the annual examinations, the office conducts sweeps and targets examinations to address credit market issues and concerns and to follow up on tips, complaints, and self-reported incidents.

The NRSROs have been responsive to the staff's findings and recommendations. Many have implemented fundamental changes such as increasing surveillance activities; strengthening policies and procedures for managing conflicts of interest; adding staff to compliance and oversight functions; investing in multiyear technology initiatives; and enhancing disclosure, transparency, and governance.

The annual examinations that are currently under way include a comprehensive review of compliance with the significant new rules and rule amendments that were adopted by the Commission in August 2014, all of which became effective by June 2015. As required by the Dodd-Frank Act, the office prepares an annual examination report summarizing the essential findings of the examinations. In December 2015, the office published a fifth annual examination report.

The NRSRO monitoring and constituent monitoring groups within the office gather, analyze, and assess data and identify trends across the industry. NRSRO monitoring conducts periodic meetings with NRSROs and also meets on an ad hoc, proactive basis as necessary to respond to industry developments. And importantly, NRSRO monitoring meets with certain boards of directors, including a separate discussion with the independent directors.

Constituent monitoring holds meetings with investors, issuers, arrangers, and trade organizations. The group conducts ad hoc research as warranted by industry or credit market conditions. The information obtained by the monitoring group provides useful input for examinations and for guiding the direction of any future rulemakings.

The policy and rulemaking group within the office is responsible for developing rule recommendations, conducting studies, drafting reports, and including those required by the Credit Rating Agency Reform Act and the Dodd-Frank Act.

New rules adopted by the Commission in August 2014 address, among other things, reporting on internal controls; conflicts of interest, including an absolute prohibition requiring the separation of sales and marketing activities from analytics; procedures to protect the integrity and transparency of rating methodologies; a requirement for the board of directors to approve a methodology before it is used; and standards of training, experience, and competence for credit analysts. The rules also provide for an annual certification by the CEO as to the effectiveness of internal controls and additional certifications to accompany credit ratings affirming that no part of the credit rating was influenced by any other business activities.

While the Commission has broad authority to examine all books and records of an NRSRO, and to impose sanctions for violating statutory provisions in the Commission's rules, the Commission is not permitted to regulate the substance of credit ratings or the procedures and methodologies used to determine credit ratings.

Thank you again for having me here today, and I would be pleased to answer any questions.

[The joint statement of Mr. Butler, Mr. Flannery, Mr. McKessy, and Mr. Wyatt can be found on page 46 of the appendix.]

Chairman GARRETT. Great. Thank you, Mr. Butler.

Mr. Flannery, welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF MARK J. FLANNERY, DIRECTOR, DIVISION OF ECONOMIC AND RISK ANALYSIS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. FLANNERY. Thank you. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. It is my pleasure to be here today to talk about the responsibilities and recent activities of the Division of Economic and Risk Analysis, which we call DERA.

DERA supports the Commission's mission through data-driven, high-quality economic analyses. Over the past several years, we have grown from approximately 96 employees in 2013 to a projected workforce of 175 by the end of this fiscal year.

By that time, we anticipate employing 88 Ph.D.s, mostly in economics or finance, but also some accountants, and we even have two Ph.D. physicists. These Ph.D.s will be supported by 22 research associates by the end of the year. DERA staff also includes a diverse team of other technical experts and professional staff.

The division's rapid growth and resultant depth of expertise has allowed DERA to expand its support across an ever-increasing range of Commission activities.

Our most well-known function is to provide economic analyses in support of Commission rulemaking and other priority initiatives. DERA economists examine the need for regulatory action, analyze the potential economic effects of the proposed and final rules, and evaluate public comments on those rules.

We provide theoretical and data-driven economic analyses of potential new policies and changes to existing policies. We work closely with staff from elsewhere in the Commission from the earliest

stages of policy development through the finalization of a particular rule.

In the course of assisting other divisions and offices, staff routinely prepares White Papers, or staff studies—White Papers and other documents that present novel economic analyses of specific policy issues or rulemakings. For example, last year DERA staff produced White Papers relating to the liquidity requirements for open-ended mutual funds' operation, the funds' derivative usage, voluntary clearing activity in the single-name credit default swap market, and another paper on the market for unregistered security offerings.

In addition to research performed in conjunction with particular rules, DERA staff regularly published their research in refereed journals, and staff papers are posted on the DERA webpage to provide the public with access to our current research on financial markets.

DERA's analytical capabilities extend not just to rulemaking, but also to risk assessment. We provide financial and risk modeling expertise to other divisions and offices in support of their supervisory, surveillance, and investigative programs. Our data analysis helps SEC staff with examination prioritization and scoping, including providing guidance on which entities to examine and what to look for during the examinations.

One example is our broker-dealer risk assessment tool, which was developed in close collaboration with OCIE staff. This tool analyzes how a firm's behavior compares to its peers to identify anomalous behavior that might indicate risks in a broker-dealer's operations, financing, workforce, or structure.

We also have a new corporate issuer risk assessment tool, developed in conjunction with the Division of Enforcement, that allows enforcement attorneys to examine over 200 custom metrics that help them to assess corporate issuer risk by identifying financial reporting irregularities that may indicate fraud.

We also work with the Division of Enforcement. During Fiscal Year 2015, DERA staff provided export assistance in over 120 new enforcement matters. Those staff helped identify securities law violations, quantify the harm to investors, calculate ill-gotten gains, and evaluate economic-based claims of the defendant.

For cases that go to trial, DERA helps to prepare the Commission's outside experts and to critique or challenge the work of opposing experts. In certain instances, DERA staff have recently testified on behalf of the Commission.

None of this work can be performed without high-quality data. DERA, thus, acts as a central data hub for the intake, processing, and use of data throughout the Commission. DERA's data oversight falls into two distinct but related categories.

First, we work closely with other SEC divisions and offices to design data structuring approaches for required disclosures. DERA supports the SEC's data collections and data usage by designing taxonomies, validation rules, data quality assessments, and data dissemination tools to facilitate high-quality data analysis.

Second, DERA is responsible for the day-to-day management of many Commission databases. We routinely generate summary information and statistics, which are provided to Commission staff

within DERA and elsewhere within the Commission. We also develop and refine datasets that are purchased from outside.

In sum, I believe DERA staff are delivering high-quality, data-driven analyses that are critical to the SEC's mission, and we look forward to continuing this work in the future.

Thank you again for inviting us, and I am looking forward to answering your questions.

[The joint statement of Mr. Butler, Mr. Flannery, Mr. McKessy, and Mr. Wyatt can be found on page 46 of the appendix.]

Chairman GARRETT. Thank you, Mr. Flannery.

Mr. McKessy, good morning, and welcome to the panel.

STATEMENT OF SEAN MCKESSY, CHIEF, OFFICE OF THE WHISTLEBLOWER, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. MCKESSY. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for inviting me to testify on behalf of the United States Securities and Exchange Commission regarding the responsibilities and activities of the Office of the Whistleblower.

The Office of the Whistleblower is a separate office within the Division of Enforcement currently comprised of 13 attorneys, 5 legal assistants, and an administrative assistant, all of whom are tasked to administer the whistleblower program.

The whistleblower program was designed to incentivize individuals to provide the Commission with specific, timely, and credible information about possible securities law violations, enhancing the Commission's ability to act swiftly to protect investors from harm and bring violators to justice. Under the program, individuals who voluntarily provide the Commission with original information that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million may be eligible to receive an award equal to 10 to 30 percent of the monies collected.

One of our primary activities is to evaluate whistleblower award claims and make recommendations as to whether claimants satisfy the eligibility requirements for receiving an award. We continue to receive a significant number of award claims, including over 120 claims in Fiscal Year 2015 alone. As of the end of Fiscal Year 2015, preliminary determinations and/or final orders have been issued with respect to nearly 400 claims for whistleblower awards.

Since the whistleblower program went into effect, the Commission has awarded more than $57 million to 27 whistleblowers, including more than $37 million in Fiscal Year 2015 alone. The efforts of these 27 whistleblowers have resulted in orders against individuals and companies totaling over $400 million in sanctions, including over $325 million in disgorgement ordered to be paid to compensate harmed investors. Because all our whistleblower award payments are made out of our investor protection fund, the amounts ordered to be returned to harmed investors have not been affected in any way by the awards paid to our whistleblowers.

Thanks in part to the positive attention the program attracted in connection with our whistleblower awards, the number of whistleblower tips we receive has increased each year. In Fiscal Year 2015, the Commission received nearly 4,000 whistleblower tips, a 30 percent increase over the number received in Fiscal Year 2012.

Since the program's inception, we have received more than 16,000 tips from whistleblowers in every State in the country as well as the District of Columbia, and from individuals in 95 countries outside of the United States. Our office is also actively involved with enforcement staff in helping to ensure that employees feel secure in reporting wrongdoing either internally or to the Commission without fear of retaliation.

In June 2014, the Commission brought its first enforcement action under the anti-retaliation provisions of the whistleblower program, sending a strong message to employers that retaliation against whistleblowers in any form is unacceptable. Through interpretive guidance and amicus briefs, the Commission has expressed its view that the anti-retaliation protections under the whistleblower program extend to those who report potential securities law violations internally, regardless of whether they separately reported the information to the Commission.

Additionally, our office continues to assist enforcement staff to prevent companies from coercing their employees not to report possible wrongdoing to the Commission. In April 2015, the Commission brought its first enforcement action against a company that required its employees to sign broad confidentiality agreements in contravention of our Rule 21F-17(a). This rule prevents any person from taking any action, including enforcing or threatening to enforce a confidentiality agreement, to impede an individual from reporting information about a possible securities law violation to the Commission.

Protecting whistleblowers from retaliation and safeguarding whistleblowers' rights to report possible securities law violations to the Commission continues to be among our top priorities. In the less than 5 years since the implementation of the whistleblower program, we have demonstrated that we can and will protect the confidentiality of whistleblowers, take action against employers who retaliate against or interfere with their employees' ability to report wrongdoing, and award tens of millions of dollars to whistleblowers whose information leads to successful enforcement actions.

Given this strong track record, we expect that the Commission will continue to receive high-quality tips that can be leveraged to detect and halt fraud earlier and more efficiently. We fully expect that the whistleblower program will continue to be a game-changer in the enforcement of the securities laws to protect investors and ensure the fairness and efficiency of the marketplace.

Thank you again for the invitation, and I am happy to respond to your questions.

[The joint statement of Mr. Butler, Mr. Flannery, Mr. McKessy, and Mr. Wyatt can be found on page 46 of the appendix.]

Chairman GARRETT. Thank you. Thank you, sir.

Finally, last but not least, Mr. Wyatt, you are recognized for 5 minutes.

STATEMENT OF MARC WYATT, DIRECTOR, OFFICE OF COMPLIANCE, INSPECTIONS, AND EXAMINATIONS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. WYATT. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to dis-

cuss the SEC's Office of Compliance, Inspections, and Examinations, which we call OCIE, with you today.

OCIE, through our national examination program, advances the SEC's mission through examinations that improve compliance, prevent fraud, monitor risk, and inform policy.

With a staff of just over 1,000 employees, OCIE has examination responsibility for registered entities consisting of more than 12,000 investment advisers, 11,000 mutual funds and ETFs, over 4,000 broker-dealers, more than 400 transfer agents, and over 650 registered municipal advisers. We also have oversight responsibility for 18 national securities exchanges, 6 active registered clearing agencies, FINRA, the MSRB, SIPC, and the PCAOB.

Recent legislative changes, such as the Dodd-Frank Act and the JOBS Act, have expanded OCIE's responsibility to include examinations of security-based swap market participants, including dealers, repositories, and execution facilities, as well as crowdfunding portals. Compounding the challenges in the sheer number of registrants we oversee is the continued growth in the financial markets and the complexity of market participants. In order to maximize the use of our limited staff, OCIE is in the formative stages of reallocating examiners to increase coverage of investment advisers.

To meet the challenges posed by a registrant population that far exceeds our resources, we have adopted a risk-based framework for examinations, we have increased our utilization of advanced data analytics, and we promote compliance through transparency. We have adopted our risk-based framework to identify business practices or activities which may harm investors.

We aggregate and analyze internal and external data sources to find operational red flags in our registrant population. This analysis enables examiners to identify higher-risk firms when selecting candidates for examination and in determining the areas that will be reviewed in the course of an examination.

Over the past 5 years, OCIE has recruited industry experts, enhanced our technological capabilities, and increased our use of data analytics to further refine our risk-based program. For example, in the last fiscal year OCIE developed a new version of the national exam analytics tool, or NEAT. NEAT enables examiners to access and systematically analyze a year's worth of trading data much faster than we ever could before.

Our quants have also developed techniques and technologies that help examiners detect suspicious activity in areas such as money laundering and high-frequency trading. These ongoing efforts will further enhance and expand our capabilities to prevent fraud and monitor risk.

OCIE strives to improve compliance with Federal securities law through greater transparency. We engage in extensive communication and outreach initiatives with the industry and other regulators.

Through this process, we provide registrants the opportunity to self-assess and remediate noncompliant behavior on their own. For example, each year OCIE publishes our annual statement of examination priorities to inform registrants about areas that staff believes represent heighted risk and may warrant examination.

As outlined in our recent priorities, we are pursuing several key initiatives that are critical to the protection of investors. For example, in 2015 OCIE launched the ReTIRE Initiative, a multiyear examination effort focused on investment advisers and broker-dealers and the services they offer to investors with retirement accounts. We remain focused on retirement-based savings because retail investors are faced with a complex and evolving set of factors when making critical investment decisions.

Another priority we have announced is cybersecurity. Over the last 2 years, we have conducted examinations to identify cybersecurity risks and assess cybersecurity preparedness among broker-dealers and investment advisers.

As another example of our transparency, prior to initiating these exams we published our intended areas of focus, and after conducting the exams, OCIE published a summary of our observations. In 2016, we are continuing to conduct cybersecurity examinations, including testing and assessment of firms' access and control rights, data loss prevention, vendor management, and incident response.

The final priority I will mention is liquidity. In light of changes in the fixed-income markets over the past several years, OCIE is examining advisers to mutual funds, ETFs, and private funds that have exposure to potentially illiquid fixed-income securities. These examinations include a review of various controls including liquidity management, trading activity, and valuation policies.

Thank you for inviting me to testify today, and I would be happy to answer any questions.

[The joint statement of Mr. Butler, Mr. Flannery, Mr. McKessy, and Mr. Wyatt can be found on page 46 of the appendix.]

Chairman GARRETT. Thank you for your testimony.

And I thank all the members of the panel.

At this point I will recognize myself for 5 minutes to begin questioning.

I will begin over here, Mr. Butler, with regard to credit rating agencies. So one of the areas that there was actually bipartisan support on in Dodd-Frank was with regard to the removal of references to credit rating agencies, 939A. And that was an area, actually, that I worked on with Chairman Frank at the time to get included in the Dodd-Frank Act and remove references at NRSROs.

And the purpose of putting that in Dodd-Frank was to say that investment decisions should not be, as they had been prior to that, relying entirely upon credit rating agencies. But we have seen since then, despite the removal at NRSROs in specific—in the regulations that pension funds—some pension funds are still including them; some pension funds are still specifically including the names of two of the large agencies in their investment guidelines.

So in 30 seconds, can you say, has 939A been effective, as far as what the intention was here?

Mr. BUTLER. 939A spoke with regard to the removal of references with regard to Federal statutes, and the SEC has actually worked, although it wasn't the Office of Credit Ratings responsible for the removal—

Chairman GARRETT. Right.

Mr. BUTLER. —the offices and divisions that were responsible completed the work there, and so all references have been removed from Federal statute—

Chairman GARRETT. Right.

Mr. BUTLER. —in the work that was done.

Chairman GARRETT. But has that been effective? I understand that there are certain pension funds which are actually suing two of the larger credit rating agencies, saying that their opinions in the past were widely inaccurate on the one hand, but on the other hand they actually are still using them as far as their investment guidelines, which seems counterintuitive or perhaps opposed to their fiduciary duty. Would you agree?

Mr. BUTLER. I am aware of the fact that there are pension funds, as well as State and local laws, that require specific references to credit ratings by name oftentimes, or actually by reference to "the big three."

Chairman GARRETT. And is that a problem?

Mr. BUTLER. I wouldn't necessarily characterize it as a problem. I would say that the 939A statute didn't allow for us to do more, other than remove references within Federal statute.

Chairman GARRETT. That is a good segue. Is there something more that should be done—either that Congress should be doing in this regard, or that the SEC can be, or should be, directed to?

Mr. BUTLER. 939A, as I mentioned, was not within the ambit of what the Office of Credit Ratings oversees. That was the Division of Corporation Finance, Trading, and Markets, and Investment Management. I would be happy to take the question back—

Chairman GARRETT. So is there anything else that we should be doing in this regard, in light of my opening position on this?

Mr. BUTLER. With regard to the Office of Credit Ratings, we are comfortable with the authority we have with regard to examinations.

Chairman GARRETT. Okay. Is there anything else that you would recommend, though, that we should be doing in light of the fact that funds are still relying upon them?

Mr. BUTLER. With regard to the Office of Credit Ratings, we are comfortable with the authority we have. Beyond that, I really wouldn't want to comment.

Chairman GARRETT. Okay.

Mr. Flannery, when it comes to certain issue regulations, economic benefit analysis in one form or another is conducted by the agency, correct?

Mr. FLANNERY. Yes.

Chairman GARRETT. Right. When you came to the issue of the pay ratio rule, that was done?

Mr. FLANNERY. Yes.

Chairman GARRETT. And in that analysis, did they find that—is it true that they found that they cannot quantify a benefit?

Mr. FLANNERY. Yes, I think that is right. Ultimately, the justification, the benefit for the pay ratio rule was tied to informing investors about the possible advisability of their say on pay votes.

Chairman GARRETT. Right. But at the end of the day, the SEC could not find—quantify a benefit, correct?

Mr. FLANNERY. Yes, sir. I think there is a difference between "quantify" and "find"—

Chairman GARRETT. Okay.

Mr. FLANNERY. —but certainly. So a lot of what we do is very difficult to quantify even though it is very important.

Chairman GARRETT. So in the decision-making process of which regulations you will go forward to, why was this one done rather than other areas when you can quantify a benefit?

Mr. FLANNERY. DERA responds to the rules as they come up, as they are treated by the Commission. We try to explain and clarify to them what the economic facets of the decision are, and then they are free to weigh those benefits and costs against the other considerations.

Chairman GARRETT. Is it fair to say that this was done because it was a mandate of Congress, as opposed to the SEC recommending that it be done?

Mr. FLANNERY. I believe it was a mandate of Congress. I believe it was in Dodd-Frank, yes, sir.

Chairman GARRETT. And it is a "shall" situation as opposed to a "may" situation. But of course, there was no time limit on this, so within a whole gamut of things that the SEC could be working on, there were other areas where you could quantify a benefit, correct?

Mr. FLANNERY. We can probably do more quantification then in that case, yes.

Chairman GARRETT. Right. So is there a reason that we see in areas where you can quantify, the SEC goes ahead and does so, and where you can't quantify, vice-versa?

Mr. FLANNERY. We are in many ways a reactive division in the sense that we are asked to weigh in on a rule that is to be considered; we don't actually control when the rules are considered.

Chairman GARRETT. But do you make recommendations at the end of your report?

Mr. FLANNERY. About the order of consideration?

Chairman GARRETT. Yes.

Mr. FLANNERY. No, sir, we don't.

Chairman GARRETT. Okay.

Of course, my time is already up.

The gentlelady from New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman.

Dr. Flannery, it is very good to see you again. And as you know, I am a big fan of structured data, especially the use of XBRL. It certainly makes it easier for investors to locate good investments, diamonds in the rough, and makes it easier for startups and new businesses, if they have a good story, to get it out and let investors know where they can make a good investment.

In your testimony, you described DERA as the hub of information within the Commission, so can you talk a little bit about why structured data like XBRL is useful to the investor, and useful to the SEC, and exactly where does the implementation of it stand now with the SEC?

Mr. FLANNERY. Yes. We have an Office of Structured Disclosure inside of DERA, and the purpose of that office is to advise where and what and how data should be structured. So when there is a

new rule, when there is a revised form, these folks evaluate what can be captured and what is the best technical way for it to be captured, of which XBRL is one good possibility.

A good example of what that does for us, the XBRL, is we now publish on our website quarterly financial reports for all registrants. So we have about 8,000 registrants, and the small ones don't get a lot of attention from the commercial data services, the commercial data providers.

So we have a complete set of information, and that is useful to investors for the purposes you said. It is useful for us when we do a rule or when we do a risk analysis because we have a more complete and a much better grasp of the information that is most relevant to the firms that have the hardest time raising capital. So it is a very valuable resource for us and we provided the data to the public.

One of the things about XBRL is that the data are to be filed by the end of the quarter, and usually within the next week we have those data sets up and available for people to use.

Mrs. MALONEY. Some people say they don't use it because there is no enforcement on the accuracy of the XBRL. And aren't you dependent on what the industry hands you?

The company hands you their data. You don't check to make sure that data is correct. Is that correct?

Mr. FLANNERY. There are various internal consistency checks that can be done pretty easily with an XBRL taxonomy. This whole—

Mrs. MALONEY. But you do rely on the industry giving you the information, correct?

Mr. FLANNERY. Yes, we do. And there has been a learning process since 2009 when we first required the largest registrants to report using XBRL.

Mrs. MALONEY. How could you enforce the accuracy more? That is the one complaint that I hear from investors, that they would like it to be accurate and there is no guarantee that it is accurate so they say they don't use it because there is no really check on the accuracy. How could we improve the accuracy and the enforcement of accuracy on the data you receive?

Mr. FLANNERY. That is a primary objective of our Office of Structured Disclosure, and as I mentioned, within XBRL there are various mechanisms for at least assuring the internal consistency of the data. Now, if somebody files an incorrect number, whether that is in XBRL or it is on paper, there is nothing we can do about that as long as it is not inconsistent with other parts of the report.

But our OSD people, Office of Structured Disclosure, are investigating at all times—when I said, "how the data get reported," they are investigating how we can most parsimoniously and efficiently assure increased compliance.

Mrs. MALONEY. They say that one of the best ways to get accurate data is, when the sale takes place on the exchange, just being able to capture that, as opposed to depending on private industry. What is your response to that?

Mr. FLANNERY. That would be a stock sale.

Mrs. MALONEY. Yes.

Mr. FLANNERY. Yes. And the data I have been thinking about, I thought you were talking about, was the financials provided by registrants in XBRL, so that wouldn't be in the same venue.

Mrs. MALONEY. Yes. But the stock sales.

Mr. FLANNERY. Yes. The stock sales, we have direct feeds, and of course there are direct feeds that go to various private participants, but we have direct feeds. And the CAT, consolidated audit trail, which is to be considered by the Commission next Wednesday, I believe, will eventually make those audit trails extremely accurate and extremely detailed.

Mrs. MALONEY. Now, how does your work differ from the Office of Financial Research, which is also capturing this information? Do you share your information with them or—

Mr. FLANNERY. Yes, we absolutely do. The Office of Financial Research is, of course, responsible to the FSOC, and we have collaborated with them on a couple of important data sets. One is Form PF, which is hedge fund data—very confidential data but very valuable data. The other is money market mutual fund data. They have been involved in helping us design taxonomies, and we look forward to continuing a fruitful relationship with them.

Chairman GARRETT. I thank you. The gentlelady's time has expired.

And we are going to be coming up on votes. I am going to try to keep things within time, so Mr. Hurt is now recognized.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Flannery, I have some questions for you. As you know, the President signed Executive Order 13579, that required all agencies to perform an analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with that which has been learned.

It seems to me your division is uniquely qualified to perform research for the SEC, and that is the purpose of your division, correct?

Mr. FLANNERY. It is certainly one of the purposes, yes.

Mr. HURT. Has your division participated in any of these retrospective reviews, so to speak?

Mr. FLANNERY. We are committed under the Regulatory Flexibility Act to examine existing rules, as you know. They usually get examined after about 10 years after their instance, and we do that in conjunction with the General Counsel's Office.

I think rather than taking credit for finding potential things that can be improved in these rules, I should share it with some of the other divisions, because a lot of information comes into the other divisions from the industry, either in the form of inquiries or complaints. And there are frequently things that can be—where the burden can be reduced by staff guidelines, by no-action letters, and a lot of the kinks, if you will, that might be in an initial rule can be worked out that way, by staff interaction with the registrants.

Mr. HURT. But since the President signed this order, can you think of any example in which a rule has been repealed, such as it is, because it was excessively burdensome, ineffective, or outmoded?

Mr. FLANNERY. I can give you an example of a proposed rule in the mutual fund space that is based on a need for better information and a reduction in the frequency of reporting, and that would have to do with what we call N-PORT, which is the mutual fund asset composition reports that are going to be filed if the rule is approved. So we were trying to take advantage of better information, tagging the data, and we were trying to reduce the burdensomeness of the—

Mr. HURT. And that was done through staff—

Mr. FLANNERY. Yes.

Mr. HURT. —guidelines?

Mr. FLANNERY. Yes, with—

Mr. HURT. But again, just to be clear, there—you know, modify, streamline, expand, or repeal. There is not an instance that you can think of where a rule has been repealed based on this analysis that is taking place in the agency?

Mr. FLANNERY. I cannot remember one, no, sir.

Mr. HURT. All right.

Another question that I have deals with the issue of regulations that are developed, some pursuant to Dodd-Frank, with joint participation from individual agencies. And obviously, there is a requirement of review by your office, in terms of cost-benefit analysis, the economic impact, economic effects of these rules.

But there are some who suggest that when it is a joint rulemaking, that cost-benefit analysis is not required. What is your take on that, and have you all had pushback from the other agencies that you have had to develop rules with on that specific issue? How do you deal with that?

Mr. FLANNERY. Yes, of course, you are right. We have a securities law requirement that we consider, among other things, efficiency, competition, and capital formation, which is unique to the SEC. So there are instances where we will do a joint rule, most often with the banking regulators, and ours will be the only economic analysis.

There is one that we are involved in now where we—

Mr. HURT. So is the analysis that you do used in the promulgation of the rule in the process?

Mr. FLANNERY. Yes. We do an analysis as it affects our registrants because, of course, the rule that we promulgate affects only—

Mr. HURT. The banking regulators don't do that.

Mr. FLANNERY. I believe that is correct. They are not required. I don't know what they do inside, but they are not required to put an economic analysis out with the rule text for public comment.

Mr. HURT. Do you see a problem there, where you have extensive work done by your agency evaluating the costs and benefits on your side as it relates to your registrants, but not as it relates to those who are regulated by the other agency? Is that a problem?

Mr. FLANNERY. I don't know whether there is a problem in that regard. What I know is that we have different statutory and regulatory constraints that we operate under. We have developed our guidance on economic analysis to take advantage of our specific expertise and to take—and to fit with the specific institutions and parts of the capital markets we work with.

Mr. HURT. Okay.

Mr. FLANNERY. Whether that should transplant elsewhere is beyond my expertise.

Mr. HURT. Okay.

Thank you. My time has expired.

Chairman GARRETT. Thank you.

Mr. Hinojosa is now recognized for 5 minutes.

Mr. HINOJOSA. Thank you, Mr. Chairman.

My first statement is to thank you and to thank our distinguished panel of witnesses for their appearance and testimony today.

My first question is to Mark Flannery.

Mr. Flannery, as you are aware, the Department of Labor issued a rule earlier this month regarding the fiduciary standard of care that is owed to investors when providing them personalized investment advice about their retirement accounts. This standard of care ensures that financial advisers providing advice act in their client's best interest.

Chair White has publicly stated that she would like the SEC to implement its own fiduciary duty rule. My question to you is, has the SEC studied whether conflicts of interest in the provision of investment advice hurts investors?

Mr. FLANNERY. As you say, this is a major objective of the Chair, and she has people in Trading and Markets who oversee brokers and dealers; she has people in I.M., Investment Management, who oversee registered investment advisers; and staff from DERA, collaborating on developing a rule. For reasons that surprised me very much because I was new to the SEC, that turned out to be a very difficult problem. It is taking a long time to get it right, and we want to make sure that we get it right when we get something out.

Mr. HINOJOSA. This committee has considered bills that would impose a cost-benefit analysis on the SEC, and I believe these bills would favor industry over investors and open the SEC up to increased litigation risks. Can you please describe all of the economic analysis obligations that the SEC undertakes when it looks to propose a new rule or an amendment to an existing rule?

Mr. FLANNERY. Yes. As I said, we have a 15- or 20-page document that we refer to as the "guidance," which is about 4 years old and lays out the content of what should go into an economic analysis at the SEC.

The first thing we do is we establish what is called a baseline. We try to document what is the state of the market, what is the state of the affected players if we don't introduce the rule.

So we start with a baseline. We spend a lot of time trying to document that with statistics. And that gives everybody involved in the discussion an opportunity or perhaps an obligation to work off of the same baseline.

Then, we are interested in identifying who will be affected by the rule, who is likely to be affected by the rule, and what would be the benefits and costs to the various people who are affected, the various firms and individuals.

One of the things that we find is that there are many cases where we cannot quantify a benefit, so I would love for someone to explain to me how, for example, I could quantify the benefit of

a more informed investor. I know it is positive, but I don't know how big it is compared to a dollar.

Mr. HINOJOSA. I can't answer your question, but I am very much in favor of that rule that the Secretary of Labor has recommended and has had hearings on for a long time, and that I think would certainly help investors.

My next question is to Mark Wyatt.

Mr. Wyatt, the Office of Compliance, Inspection, and Examinations completed approximately 2,000 examinations by 11 regional offices. Is the current agency budget sufficient to keep pace with the increasing number of examinations that need to be conducted?

Mr. WYATT. We certainly are trying to use our limited resources as effectively as possible. We are trying to endeavor to increase our examinations. Last year, Fiscal Year 2015, was a 4-year high for the examinations.

That said, we are striving to conduct additional examinations and increase our coverage in the investment adviser space, which currently is around 10 percent. On the broker-dealer side, together with FINRA, we get to roughly 50 percent of those registrants.

So we certainly welcome additional resources and information that can help us develop our exam program and our risk-based program to conduct further exams.

Mr. HINOJOSA. How do the SEC's resources to examine registrants compare to the resources of some of the large broker-dealers, banks, or other public companies that the SEC is supposed to hold accountable?

Chairman GARRETT. Very quickly, please.

Mr. WYATT. OCIE has 1,011 examiners. There are some large global registrants who have over 3,000 alone in their compliance program—for a global compliance program, I will highlight.

Mr. HINOJOSA. Thank you.

I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Royce is now recognized.

Mr. ROYCE. Thank you, Mr. Chairman.

And thank you, to the witnesses, for joining us today.

Experts have deemed the United Kingdom's retail distribution review as being effectively identical to the Labor Department's rule. In the eyes of not just industry but the British government itself, implementation of that RDR review created what they called an advice gap that locked out middle- and lower-income savers from investment advice.

And I have studied the Johnson report about the Department of Labor's communications with the SEC during the lead-up to the rules release. I share the Senator's frustration with the Department's lack of cooperation in releasing all of its communication with the Commission regarding its rule.

So I am just going to ask Mr. Flannery, did the DOL and the SEC communicate about the impact of Great Britain's RDR on British consumers? And if so, to what extent? And if not, why did the SEC not think it relevant to reference the fact that a developed economy has already implemented a rule similar to the DOL's rule and this was no longer a hypothetical situation?

Mr. FLANNERY. The retail distribution review, which I think took effect at the beginning of 2013, we viewed—in the SEC, we viewed that as an extraordinarily interesting policy step. We could call it an experiment because it didn't involve us.

I undertook a couple of conference calls with people over in the regulatory agencies there. With me on those conference calls was one of my staff who was involved in dealing with the Department of Labor economists, so we certainly conveyed that information to them.

I don't know in what form. I am not familiar with the details. But certainly, the information was conveyed through that individual.

Mr. ROYCE. But information coming back the other way about the advice gap that they were experiencing in Britain with middle-income and lower-income savers from investment advice—that information was being collected or—

Mr. FLANNERY. It was certainly conveyed to the Department of Labor. When we are asked to provide technical advice to any organization, we provide technical advice based on our expertise with our institutions and our space.

So if we send over comments or suggestions, those people are operating in a different regulatory environment under different legislation, and it is therefore their decision which of our comments is most appropriate to their situation.

Mr. ROYCE. I was going to ask Mr. McKessy a question, and this goes to the issue of the office's creation under an amendment that I offered in this committee. It came as a result, actually, of Harry Markopolos' struggle, which he explained to us, his decade-long travail to bring Bernie Madoff's Ponzi scheme to the attention of the SEC, and in particular, his frustration year after year after year about the failure of the SEC to take any action against Bernie Madoff.

So the idea in a nutshell was that by establishing a separate office within the Commission, the SEC would be better situated to protect whistleblowers and ensure that their concerns are, in fact, acted on and not handled as that previous situation was.

Do you think the new structure is working? And what could be done to improve it?

And I am also concerned that not unlike the gaps in coordination we had between regional offices and divisions in the SEC before your office was created, there may be gaps in coordination with other parts of the government. How does your office coordinate with other Federal agencies that allege conduct that is beyond the SEC's jurisdiction? That is the thrust of what I am concerned about.

Mr. MCKESSY. I think the creation of the Office of the Whistleblower—by the way, I am very grateful for it because it created my job—has been effective in encouraging whistleblowers to come forward. I certainly have had a number of meetings now with Mr. Markopolos and gathered his thoughts on how we can be as effective in advocating for whistleblowers.

I think beyond the Office of the Whistleblower, there are other structure changes in the agency that have been effective in dealing with issues like information gaps. The creation of the Office of

Market Intelligence, which is the centralized office that centralizes all the intelligence that comes into the agency to make sure that when we get a tip from a whistleblower, if it is related to something that somebody is already looking at, that it finds the right home and that we don't have competing offices working on the same matter.

And at the end of the day, I think the fact that the Whistleblower Office provides three benefits to whistleblowers—confidentiality, anti-retaliation protections, and the ability to be paid—has created real incentives to allow people to come forward if they otherwise were unwilling to or reluctant to. I think we are seeing the results of that in the fact that we have solicited over 16,000 tips since the program went into effect.

Mr. ROYCE. Good.

Thanks again, Chairman Garrett. Thank you.

Chairman GARRETT. The gentleman's time has expired.

The gentleman from Massachusetts is recognized for 5 minutes.

Mr. LYNCH. Good morning, and thank you, Mr. Chairman.

I want to thank the witnesses for their help on this issue.

Mr. Butler, I was a member of this committee during the financial crisis going back to 2008, and I think it is beyond any reasonable doubt that the rating agencies played an important role as a facilitator of that crisis, and they not only amplified the intensity of the crisis, but also, I think, facilitated the wider scope of that crisis, as well.

And independent researchers and investigators as well as the Justice Department have basically said that the sort of pay-to-play role or system that has been in place, where customers pay for ratings and that the conflict of interests on the part of the rating agencies contributed greatly to the problems we had back then, and that model has to change.

Now, since the crisis, your agency hasn't instituted any fundamental changes in the credit agency business model that created those conflicts of interest, and credit rating agencies have returned to record profits. Your own most recent examinations, however, found severe failures by major credit agencies to comply with their own stated policies and procedures.

Yet, you have not levied any fines or penalties on rating agencies. You have not used your statutory authority under Section 15E of the Security Exchange Act to suspend agencies or individuals from ratings.

And the Office of Credit Ratings' public examinations do not even identify the specific rating agencies that violate procedural rules. You don't even call them out. No name and shame.

It seems to me that the system is designed really to shield the rating agencies from any accountability. We don't even identify the people. We use terms like, "one of the larger rating agencies," which I assume is one of the big three.

Your testimony states that the OCR attempts to serve the public interest and protect users of credit ratings, but I have to ask you, do you really believe that we can get to that place without eliminating the conflict of interest that currently exists where companies pay the rating agencies for favorable credit ratings, and that the companies are in competition with each other?

There is a great segment in, "The Big Short," that movie, where they are talking to one of the folks from Standard & Poor's and the analyst asks, "Why aren't you tougher or more demanding on these guidelines?"

And the woman from Standard & Poor's says, "Well, if we do, they will just go to Moody's." That sort of encapsulates the problem here.

So what is the answer here? As long as we have that conflict of interest, are we ever going to get to a place where we are actually, as your mission states, going to be able to protect the users of credit ratings?

Mr. BUTLER. In my estimation, compliance is not a destination but it is a journey, and we are well along on that journey with regard to the rating agencies and infusing in them the importance of compliance, enhanced governance, transparency, training, and other methods to build rigor within the rating process and to establish integrity.

To address specifically your question with regard to the issuer pays conflict, in August 2014 the Commission adopted a new set of rules, and the rules were effective fully in June 2015. Importantly, within that set of rules there is a requirement for a complete separation of the sales and marketing function from the analytical function, and that is accomplished by prohibiting rating analysts or developers of methodology from participating in sales or marketing activities or from being influenced by other business considerations.

And apart from the prohibition—

Mr. LYNCH. Let me just stop you there because I only have 30 seconds left. Your report says that they are departing from their own policies and that they are not following their own programs, and those companies are not being held accountable under your system, the one you have right now. And that is after this last iteration of changes has gone forward.

They are still paying for ratings. The rating agencies know where their deals flow comes from, and they are acting accordingly. I don't see any changes here compared to what we were doing before.

Chairman GARRETT. I thank the gentleman for his questions, and I would ask everybody not to end with a question since we are trying to get in before the vote is called.

Mr. Hill is recognized for 5 minutes.

Mr. HILL. Thanks, Mr. Chairman.

And I thank the panel. Thanks for your service at the Commission.

Dr. Flannery, I took a question you answered a few minutes ago about the DOL rule and your work and the Chair's commitment to a fiduciary rule at the Commission. The SEC has 80 years of experience in overseeing broker-dealers and investment managers and doing economic analysis on that, and you made the statement that it is really, really hard to get it right.

And obviously, this was something that the Commission was asked to study back in 2010 as a part of Dodd-Frank. And yet, the Department of Labor has rushed into this rule—not rushed; that is not fair to the DOL, because they have worked on it for 2 or 3 years.

But my biggest complaint about the fiduciary rule is that it wasn't done in conjunction with the Commission and the Commission didn't take the lead on it to get it right on behalf of all market participants.

Since it is hard, what do you think are the hardest things about it when you look at it from an economic, analytic point of view of trying to "get it right?" Obviously, FINRA and the SEC have led the way in designing suitability standards and best interest standards, and if we manage money on a discretionary basis, it is subject to a fiduciary standard in the industry. So what do you rank as the most difficult challenges there? You can answer that question because you are not commenting on the Department of Labor, I think.

Mr. FLANNERY. No, in the context of the SEC—

Mr. HILL. Yes.

Mr. FLANNERY. —and in the context of combining the standards to which—the fiduciary standards to which broker-dealers and investment advisers have been held historically, they are different standards. In the old days, broker-dealers sold things to people and got compensated via commissions; investment advisers gave advice, didn't get compensated via commissions, but got compensated via fees.

Now, the broker-dealers have moved into the advice-giving space. And they bring with them a compensation arrangement that was designed and that survived in a somewhat different environment.

So one of the first questions that comes up here is, what does it mean to give financial advice? If I am a broker, I have to make sure that the security is suitable for my customer, but after the customer has bought the security, I don't have any further responsibility to monitor the customer's portfolio.

Mr. HILL. That is not true, is it? They have an obligation to make sure that the financial disclosure and their situation is reviewed at least annually in most firms' policy manuals for net worth, earnings, suitability, changing circumstances, marriage, having children, having an estate plan. They do have a continuing obligation to their client, don't they, under all policies of FINRA and the SEC?

Mr. FLANNERY. I believe that the broker-dealer has an obligation that is transactions-oriented, as opposed to life change. So if there is a life change and the customer comes back, there could be a different definition of suitability. But if there is a life change and the customer doesn't come back, there is no responsibility, as I understand it, for a broker to call up and say, "Hey, now that you are remarried you ought to do something different."

Mr. HILL. We don't have to debate that here. I would very much disagree with that based on looking at firms' policies and procedures manuals for a couple of decades.

But what else do you think is challenging about getting it right, from the Commission's point of view?

Mr. FLANNERY. One of the things that is surprising to me is how difficult it is to disclose information effectively. The broker-dealer and the investment adviser rules and standards are based on disclosure, and there is sometimes a difference between disclosure and the transmission of information.

So we have, in DERA, just started a small behavioral finance unit to try to understand how people process information that is maybe second nature to those in the finance industry but new and confusing to those outside.

Mr. HILL. Couldn't the Department of Labor's approach, though, of creating one set of approaches for a retirement account versus another set of approaches executed by the SEC and FINRA on behalf of all other account categories lead to investor confusion?

Mr. FLANNERY. I suppose it could. Certainly, there is some inevitable confusion, I suppose, because the Department of Labor rules are promulgated under a different set of statutes, a different set of considerations than the securities laws under which we operate.

Mr. HILL. And hence, that is why I really think that in an ideal circumstance the OMB, the Administration would have insisted that the Commission take the leadership role in harmonizing this approach.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from Connecticut is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

And thank you, gentlemen, for being with us today, and for your good work.

I have two questions, which I recognize are a little tangential to your offices and divisions, but both pertain to topics which I have been concerned about, what I perceive as silence on the part of the SEC, so I am hoping I can get at least some provisional feedback on these two topics.

The first pertains to insider trading. As you all know, the 2nd Circuit on the *Newman* decision, apart from overturning two very high-profile insider trading convictions, put a great deal of uncertainty into future prosecutions of insider trading.

I think we could all agree on two things. First, we now don't have a good definition of insider trading, and I, for one, am a believer that if we are going to send people to jail, we should have pretty good statutory definitions for why we are sending them to jail. Second, without getting into the guts of *Newman,* as you know, the decision really was around whether a tippee can be held liable, unless the tippee knows of the personal benefit received by the tipper in exchange for the disclosure.

So if I am a corporate insider and I tell you, "Hey, I shouldn't be telling you this, it is probably illegal, but you could make a lot of money," and you trade on it, so long as you don't know that I have received some tangible personal benefit, you are not prosecutable. You are not liable under the *Newman* decision.

So I am looking for, I guess, a little bit more clarity from the SEC about whether there should, in fact, be a statutory definition of insider trading.

I would point out that my colleague, Mr. Lynch, and I have also put forward some legislation; two Senators, Senators Menendez and Reed, have put forward legislation. But I am looking, I guess, for a little bit more guidance from the SEC about whether the uncertainty introduced by *Newman* is, in fact, a problem that we should address.

Mr. MCKESSY. I believe as the only member of the Enforcement Division, I am probably the best-qualified to talk about this. But that beingsaid, I think the *Newman* decision raises issues that are extraordinarily nuanced, and I think—I want to be as helpful as I can, but I think to get a real appreciation for the considerations that go into how *Newman* affects our Enforcement Division and our ability to bring insider trading cases is best addressed by someone who has more background in that.

And, of course, I would be happy to take any questions back and have the right person get back to you. Obviously, we are well aware of the *Newman* decision and the nuances of it, but I think you probably would be better served by hearing from people who more appreciate the nuances of how it impacts our enforcement efforts.

Mr. HIMES. I appreciate that. I recognize this isn't exactly the panel that is right on point for that.

I am sensing a certain amount—and I understand this. We have a vast body of case law associated with insider trading; we have a lot of ambiguity that stems from no direct statutory definition of insider trading.

I would really appreciate it if the Commission would, in fact, focus on nuance and getting us a more clear message and maybe try to get away a little bit from what is bureaucratic—or what is case law tradition and maybe a little bit of bureaucratic inertia. Because again, under the example that I gave on the question of tipper to tippee liability, at some level, yes, it is nuanced, but at some level, it is also kind of common-sensical.

Second question: We have been doing a lot of work on the JOBS Act, which I supported, and now we are sort of looking at a bunch of additional changes, expansions to the JOBS Act. And the whole idea of the JOBS Act, of course, is that young companies shouldn't bear the full burden of Sarbanes-Oxley compliance.

I have had estimates anywhere between $1 million and $2 million a year for the cost of Sarbanes-Oxley compliance, and we are spending a ton of time on that issue. I think that is good.

But I can't seem to get enough attention drawn to the odd fact that one of the biggest sources of cost for our young companies going public is a remarkably consistent gross spread of 7 percent. Let's just say that the average IPO is in the neighborhood of $200 million; 7 percent, that means $14 million in the IPO out the door.

We are spending a ton of time on that $1 million or $2 million a year associated with Sarbanes-Oxley compliance, but I am having trouble sort of really understanding why we are not focused more on the odd fact that 95 percent of all IPOs that have occurred, at least in the 10-year period after 1998 to 2007 in the United States, 95 percent had a 7 percent gross spread. Exactly.

In Europe, there is no such clustering. And in fact, in Europe, IPOs' gross spread average about 4 percent, and you almost never see a gross spread as high as 1 percent.

Does that clustering at 7 percent over such a persistent period of time strike you as odd and perhaps worthy of investigation?

Mr. FLANNERY. Let me try that.

Another industry, which is not nearly so germane to the issues you express, but another industry that has the same phenomenon

is real estate brokers, where I believe there the number is more likely to be 6 percent. That has always puzzled me.

There are some economic analyses for both of these cases about why this might actually be a good contract. But you can also find arguments that are equivalent to what is implicit in your comment, that maybe there is something nefarious going on.

So you can find economic arguments on both sides.

Chairman GARRETT. Thank you. Thank you for the question.

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

Chairman GARRETT. Mr. Hultgren is now recognized.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all so much for being here. I appreciate your work and your testimony today.

Mr. Wyatt, Harry Markopolos, who initially warned the SEC about Bernie Madoff's Ponzi scheme, recently revealed that he is working to uncover three multibillion-dollar schemes, including one that will be bigger than Madoff's. As you know, many of the failures that allowed Bernie Madoff to continue his Ponzi scheme for as long as he did can be traced to the failures of OCIE examinations to connect the very apparent dots. Multiple SEC offices, including OCIE, were unaware of parallel investigations into Madoff's entities.

Do you believe the institutional changes implemented by OCIE since 2009 are sufficient to stop future fraud? And if not, what else needs to be done?

Mr. WYATT. I do believe that the changes we made after Madoff have significantly enhanced our ability to detect those types of activities: the streamlining of our TCR program to ensure that there are no silos in the regions, as well as the connectivity that we have amongst the regions to ensure if we see a theme or a risk throughout we can act on it accordingly and bring the resources to bear.

So we are continuing to run a risk-based program. Part of evaluating our risks is continuing to look for any emerging risks and connecting the dots, as you say, with the TCR program and other areas, including information gathered from other divisions, such as DERA.

Mr. HULTGREN. Okay.

Mr. Wyatt, the SEC did not and still does not have a standardized identification code that consistently identifies all the entities it regulates and makes connections between them. I believe the Madoff failure was in part a data standards failure.

Last year Congressman Issa, myself, and a number of other members of this committee introduced legislation called the Financial Transparency Act to direct all financial regulators, including the SEC, to adopt data standards for information they collect with the hope of transforming the current landscape of disconnected documents into open, searchable data. In fact, the original name of the bill was the Madoff Transparency Act.

This means, for instance, that the SEC would adopt the legal entity identifier to consistently identify all the entities it regulates and affiliations between them so in the future parallel investigations into related entities like Madoff's will be electronically visible. For all information required by other laws to be made public, the

bill directs each agency to public such information as open data, machine-readable, and freely downloadable.

Won't an open data initiative like this help prevent future failures, like we saw with the Bernie Madoff scheme?

Mr. WYATT. We certainly have adopted strategies to enhance our use of data analytics and to capture all the data that is available to us, as I mentioned, from internal and external sources. We have also centralized all the information we have regarding examinations, so anyone throughout OCIE can go in, look at a given registrant, see what activities have been involved in an examination or even a non-exam review for that registrant.

So we are certainly applying the data analytics and would welcome anything that could give us additional insight into the activities of the registrants that we are examining.

Mr. HULTGREN. Thanks.

I believe we have to do better. We can do better. With incredible technologies and connectivity, we ought to be able to recognize this a lot sooner.

Let me switch to Mr. Flannery, if I could. The Department of Labor's proposed fiduciary rule, which was recently finalized, mentions annuities 172 times, but the regulatory impact analysis does not examine the impact of the rule on annuities, advisers, insurers, or the retirement savers using them.

Last October, David Grim, from the SEC's Division of Investment Management, testified that, "A lot of what we have been talking about with them"—the Department of Labor—"has been on impacts, the impacts of choices that they are making on investors." What impact is Mr. Grim describing, and did your office conduct any cost-benefit analysis?

Mr. FLANNERY. We did not directly do a cost-benefit analysis. We are involved in advising and providing comments—technical comments. And I'm sorry, I am not familiar with what Mr. Grim was—

Mr. HURT [presiding]. The gentleman's time has expired—

Mr. HULTGREN. My time has expired. I yield back.

Mr. HURT. —and we are getting ready to vote.

The Chair now recognizes Mr. Foster for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

And my questions, I guess, will be directed to Mr. Flannery.

I would like to first and foremost congratulate you on your hiring of two physics Ph.D.s. As the only physicist in Congress—in fact, the only Ph.D. scientist of any kind—I recognize the complexities of things like structured financial products, the technology that is involved in high-frequency trading. All these are the sort of things where you need that kind of expertise, and I am very glad to see that you are recognizing that, too.

Mr. FLANNERY. Thank you.

Mr. FOSTER. I am also the author of the contingent capital requirements in the Dodd-Frank bill, and as someone who is widely credited with having invented the concept back, I guess in 2002, and then now we have seen it adopted really worldwide, I think, with what I see as a lot of success.

You have seen, for example, the Swiss banking regulators, which are faced with a problem that their economy is not big enough to backstop the size banks that they have. They have used contingent

capital to make those viewed as very solid counterparties, even in contemplated times of financial stress.

We have seen the whole Deutsche Bank ongoing saga where Deutsche Bank is aggressively restructuring, deleveraging, cutting bonuses, and so on, driven in large part by the worries that the contingent convertible coupons will not be paid more than a year away. So it is, to my mind, working very successfully at providing the early warning signal that is one of their main merits.

And then finally, I guess most recently, Canada—the new government in Canada announcing that they are going to use contingent capital instruments to make sure the Canadian taxpayer is not on the hook if their big banks get in trouble.

So I view this as a very successful thing, and I have continued to try to get them adopted, which they have full regulatory authority but we are not seeing very aggressive adoption. So I was wondering if you could just give your take on what you see as the lessons learned in the worldwide thing and the way forward for potentially getting those lessons used in the United States.

Mr. FLANNERY. First of all, it is a pleasure to meet you. Contingent capital is something that I personally, and in my academic career, spent a fair amount of time talking about.

I think you put your finger on what I view to be the biggest advantage of contingent capital instruments, which is that rather than wait until the last minute when a firm is close to insolvency, contingent capital instruments address that possibility, keep us away from that possibility, and give the managers and the shareholders of the firm an incentive to stay away from certain trigger points.

When I first started talking about this, the crisis was fresh in our minds, and people who had this vision that capital would be almost zero, then there would be a conversion. But by the time capital is almost zero, all sorts of bad things have started to happen to these firms.

I am sure you are correct when you say that they could be permitted as part of the capital stack in the United States. They haven't been, and I think there are people who feel that higher capital—formal equity requirements are safer, more protective than contingent capital requirements are. And then how one comes out on that is based on how one—what one believes is the effect of higher capital requirements on the operation of the firm and the pricing of its products.

Mr. FOSTER. Do you think at this point there are good examples of trigger mechanisms that have proven workable in times of stress, or is that still an ongoing experiment?

Mr. FLANNERY. I believe that is a problem. The securities in Europe and Asia that have been so successful have book value trigger mechanisms, and one of the characteristics of firms that get into trouble is that their market value deteriorates much more quickly than their book value does. In other words, the market loses confidence in the firm despite the fact that it may be showing strong book-capital relations.

And so the triggering of these CoCos, contingent capital instruments, off of book capital ratios, I view as sort of problematic and likely to interfere with their value.

Mr. FOSTER. And are there issues just related to the SEC, how they would be registered under the 1933 act, or are those—if you go to the European websites with the thought of investing in contingent capital, there is this big warning, as if you are a U.S. citizen, forget it. And I was just wondering if there is a clear regulatory path or whether you would see SEC issues involved in making these widely used?

Mr. FLANNERY. I am not aware of any considerations actively going on inside the SEC, but it would focus on disclosure of the risk so that investors could understand what was likely to happen and accept the risks for the compensation they are being given.

Chairman GARRETT. I thank you. The gentleman's time has expired.

Mr. Duffy is now recognized.

Mr. DUFFY. Thank you, Mr. Chairman.

Welcome, panel. It is great to have you here.

I am just a warm-up act for Mrs. Wagner, who is going to go in a second on the DOL fiduciary. Obviously many of us, as you are well aware, have concerns about the rule. And it is my understanding that the SEC also shared some concerns about the proposed rule and now the actual rule.

Mr. Flannery, is it fair to say that the Department of Labor, for the most part, disregarded much of the advice that the SEC gave to them in regard to this rule?

Mr. FLANNERY. The advice that was given, I think of it more as technical comments. Some of it was incorporated into the final rule and some was not. I don't know about the preponderance.

Mr. DUFFY. Okay.

One of our concerns, for example, would be that one of your economists suggested that the Department of Labor should measure improper activity of advisers through measuring conflict of interest, the proposed—or the purpose of the rulemaking process, not projected investment returns. And it seems like the DOL didn't take that advice. Is that fair to say?

Mr. FLANNERY. I am not familiar with the final DOL rule. It is 395 pages and I look forward to reading it, but I haven't yet, so I can't be sure.

Mr. DUFFY. Have you undertaken any analysis of the impact of this rule on investors?

Mr. FLANNERY. We have not yet gotten to that point because our internal deliberations—again, in a different securities space—have not gotten to the point of generating a rule. So we have not yet done that sort of economic analysis.

Mr. DUFFY. Tell me if you share my concern, because I come from central, western, and northern Wisconsin—not a really wealthy part of the world. We don't have a lot of people who have $500,000 or $750,000 in their retirement accounts. We have people who have $30,000 and $50,000 and $80,000 in their retirement accounts.

There is some concern that we are going to migrate those folks from getting advice from someone that they have worked with and that they know and trust to a different computer model: the roboadviser. Do you foresee that happening, as well?

Mr. FLANNERY. I think you can look at the robo-adviser in the way you have. You can also look at it as an opportunity for people who are just getting into retirement savings, people who are generally more comfortable taking advice from computers than I might be or you might be.

Mr. DUFFY. So let's actually play that out a little bit, because it might not be just the person who just started to invest. Now, the first-time investor in Washington, D.C., might start after a couple of years and have $80,000 in their retirement account; but in my community, it is after 25 years, they have $80,000 in their account.

And maybe this is open to the panel—do you think that maybe someone who is not an expert in investing, their life focus has been elsewhere but they have been responsible, they have put a little bit of money away—do you think that, say, look back to last August, that that person, when the markets start to move, is going to be more compelled to look at their computer screen and make the right choice as opposed to calling their investment advisers and trying to sell their investments and their adviser is going to say, "Whoa, hold on a second. Whoa, whoa, whoa, whoa, whoa. That is not the right call right now. We should actually ride out this storm. That is not part of our plan. We know there are peaks and we know there are valleys. We ride it out. Don't sell."

Are they going to get the same advice from the computer? And I guess my question is, aren't they going to make really bad choices for their future if you have a robo-adviser as opposed to a financial adviser?

Mr. FLANNERY. I suspect that there were a lot of people in the world in Wisconsin who didn't even know what was happening that day, didn't look at their financial statements. In general, I agree with you entirely that good financial advice is valuable. I think that good financial advice also sometimes comes with conflicts, and—

Mr. DUFFY. I don't dispute that, but does good financial advice come from a computer?

Mr. FLANNERY. I don't know enough about those computers so I can't tell you that.

Mr. DUFFY. If I am able to get 8 or 10 questions about some of my goals, some of my income, how many kids I have, what I want at retirement, I put it in and it hits an algorithm and it spits out some advice, do you think that just because I am a low-income individual, I am a low-dollar saver, that I shouldn't be entitled to the advice that comes from someone who makes $800,000 a year?

Mr. FLANNERY. I guess we don't know—certainly the point you make is widely discussed—for a fact what is going to happen.

Mr. DUFFY. So do you have a study in the works so that we can know?

Mr. FLANNERY. We will know when we take up a rule at the SEC—

Mr. DUFFY. And isn't it too late? Isn't it too late? Because my people are already going to be kicked out of personal advice and they are going to be relegated to their computer.

Do you share that concern? They are already out once you do your study and the rule is implemented.

Mr. FLANNERY. Again, the rules under which the DOL operate are different from those—and the legislative authorities are different from those under which we operate—

Mr. DUFFY. I can't wait to see how we navigate both an SEC and a DOL rule and how that is going to play out on the expense side and how—

Chairman GARRETT. The gentleman's time—

Mr. DUFFY. I know. Sorry, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman from California is recognized.

Mr. SHERMAN. Thank you.

I would point out that I think it was Congress' intention that the SEC and the Department of Labor have very similar identical roles. It is absurd to think that IRA accounts would have one set of protections and non-IRA, non-pension accounts would have another. And it is even more absurd to say that the IRA accounts typically controlled by those in their 50s and 60s should have more protection than widows and widowers and elderly people who typically, in middle-class families, control the larger accounts. So I share some of the last gentleman's concerns.

Mr. Chairman, the one part of the SEC we don't have before us are those concerned with accounting standards. I would like to enter into the record my letter of earlier this month demonstrating the incredible harm that is being done to our economy by the—well, the departure from accepted accounting theory that requires companies to write off their research and experimentation costs.

Chairman GARRETT. Without objection, it is so ordered.

Mr. SHERMAN. Thank you.

Mr. Butler, we have just—we are still suffering from this 2008 downturn. I think it was mostly caused by the credit rating agencies.

We still have a system where the umpire is paid by one of the teams and selected by that team. And the SEC has decided, instead of being an agency that favors transparency for investors, to conceal this by such relatively meaningless so-called protections. It says, "Well, the sales force can't talk to those who do the ratings."

The people who do the ratings are compensated by the company; their promotions depend upon the company; they want the company to be successful. Is there any rule that those engaged in rating debt obligations cannot receive stock options, bonuses, or any benefit from the success of a company they work for?

Mr. Butler?

Mr. BUTLER. Each of the companies have different compensation arrangements—

Mr. SHERMAN. I asked, is there any SEC prohibition?

Mr. BUTLER. With regard specifically to rating analysts and compensation?

Mr. SHERMAN. Yes.

Mr. BUTLER. I would have to take that back—

Mr. SHERMAN. Okay. So if you give great inflation, the company makes money, your stock options do better, and the SEC has no rule of which you are aware—and if you are not aware of the rule, it would be very hard to think the rule is being enforced, since you are the one who would be enforcing the rule.

The debt markets are obviously far more important to the economy, or at least involve far more capital, than the stock markets. Those who invest are basically entirely dependent upon the ratings. Even if you know better—you are managing, say, the T. Rowe Price bond fund—if you decide to forgo buying a AA-rated bond that pays 20 basis points more, then I am going to invest in Vanguard because all I am going to be able to do as an investor is decide which has the highest rating and the highest yield.

I want to talk to you about one particular problem. That is the Peruvian agrarian reform bonds.

Obviously, the way to make money is to try to get Peru as a client. It is a significant country. And one way to do that is to avoid even offering to rate these agrarian bonds that seem to be a part of a selective default.

Is there any rule that says that a credit rating agency can't refuse to rate bonds because they can make more money by—they are paid off one way or another not to rate them?

Mr. BUTLER. I am generally familiar with the media coverage on the Peruvian bonds, and I can't obviously discuss the specifics of a—

Mr. SHERMAN. Is there any rule that says you can—that you enforce that would prohibit Peru from saying, "Please don't comment on our agrarian bonds and we will make sure to give you a contract worth millions of dollars in some other part of our financial dealings?" Is there any rule that you can point to which prohibits that?

Mr. BUTLER. The rules provide specifically for an absolute prohibition of rating analysts to be involved in sales and marketing activities.

Mr. SHERMAN. This is whether you take the engagement. It doesn't involve the rating analysts; it involves the sales force.

Mr. BUTLER. The rule prohibits rating—the analysts—the analytical function from being involved in the sales and marketing function. That is achieved by prohibiting analysts from being involved in sales and marketing or from being influenced—

Mr. SHERMAN. That is not what I am asking.

Mr. BUTLER. —consideration.

Mr. SHERMAN. The sales force decides whether to take the engagement. So if Peru pays them a few million dollars to say, "Just don't even get your credit rating analysts involved; don't let them look at it; don't take the engagement—"

Chairman GARRETT. He has the question. Do you have the answer?

Mr. BUTLER. In addition to the rule, there is a required certificate to accompany each rating action that says there was no influence of the analyst—

Mr. SHERMAN. This is a non-rating action, sir. You are avoiding my question and the answer is obvious.

Chairman GARRETT. Okay. Thank you. The gentleman's time is up.

Mr. SHERMAN. I yield back.

Chairman GARRETT. Mrs. Wagner is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman.

Director Flannery, as part of last year's transportation bill, one of my bills was included that would allow small reporting compa-

nies to incorporate by reference any post-effective amendments on the Form S-1. The SEC, when implementing this provision in January, estimated that over 70,000 work hours and $85 million would be saved annually by small business. Clearly, this is a huge benefit for small companies.

However, in February I wrote a letter to the SEC asking for a similar analysis on the effects of expanding the availability of Form S-3 for small reporting companies regardless of public float or exchange-traded status. This is a provision of a piece of legislation that I sponsored and which has been passed out of this committee. Unfortunately, the response that I received to my letter was wholly inadequate and didn't indicate whether such a review or study would actually be done.

Dr. Flannery, would you commit today to performing that kind of analysis of the benefits of this provision for small companies and providing a more detailed response?

Mr. FLANNERY. I'm sorry, but I never saw your letter. I don't know what went into the response.

One of the things that concerns me about reducing reporting from small companies is certainly there is room for there to be waste, but there is also evidence that companies that go to the markets with less information are less likely to be traded, and a secondary market trading for stock is ultimately what companies would like to have if they are going to have access to capital.

To get back to your immediate point, I have a number of current policy things that we need to deal with. I would be more than happy to consider doing that—

Mrs. WAGNER. I would really like you to take a—

Mr. FLANNERY. —among those things.

Mrs. WAGNER. —a look at this. Facilitating capital formation obviously is part of the SEC's mission, and this is a provision that has appeared in that SEC's form on small business capital formation annual report several times. I think we can really find common ground here, and I would ask, Dr. Flannery, that you all commit to performing this kind of analysis. I will make sure that you get a copy of my original letter; I will make sure I send it directly to you.

Moving on, I would like to obviously discuss the extent to which the SEC and the Department of Labor coordinated in crafting their recently finalized fiduciary rule. According to e-mail records outlined in a recent Senate report—and Mr. Chairman, I would like to have these entered into the record—it seems that the Department of Labor disregarded advice from the SEC, specifically regarding concerns raised by the Division of Economic and Risk Analysis.

Chairman GARRETT. Without objection, it is so ordered.

Mrs. WAGNER. In fact, a specific quote—and these are fascinating reads—from an economist at the Department of Labor states, "We have now gone far beyond the point where your input is helpful to me." These exchanges between the SEC and the DOL should make for very interesting reading.

From your perspective, over the past year, sir, from the proposed rule to the recently issued final rule, how well has the Department of Labor coordinated with the SEC?

Mr. FLANNERY. We certainly had opportunities to provide technical assistance. I am familiar with the e-mail you described because it involved one of my staff.

Mrs. WAGNER. Yes.

Mr. FLANNERY. The staffer from DOL had also been a friend and a professional acquaintance of this fellow for a while, so I think what you are seeing is the culmination of a long stream of e-mails.

Economists can be pretty direct. If somebody says, "I understand what you are saying but it is not applicable to my case; I don't want to hear any more about it," that is kind of the way I interpret that e-mail.

Mrs. WAGNER. There are others here, too. And I don't see the Department of Labor being open to any of your advice from, I think, a very fine office that you run.

And certainly, I have great concerns. I want the DERA to do an analysis and an impact of this DOL rule as it stands right now. Is that forthcoming?

Mr. FLANNERY. When and if—and I hope it is when—the Commission considers a rule for fiduciary standards in our space, we will look carefully at the DOL rule because that will be part of the baseline. We always start with the baseline; what is in existence—

Mrs. WAGNER. It is your jurisdiction, sir. Honestly, it is, as is laid out very perfectly in Dodd-Frank Section 913. And we want you to do your own uniform fiduciary rulemaking here.

This is your purview, your space. You are the regulators, including FINRA. And I really encourage and would like to get a commitment that you are willing to do a cost-benefit analysis when doing this.

Mr. FLANNERY. Yes. Absolutely. That is always part of one of our economic analyses for a rule.

Mrs. WAGNER. Thank you very, very much. I look forward to working with you as we move forward.

Mr. FLANNERY. I look forward to getting that. Thank you.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Texas, Mr. Neugebauer, is now recognized.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Butler, could you please describe the statutory requirements for the annual examinations for NRSROs?

Mr. BUTLER. Yes, sir.

The annual examination is required to cover eight specific review areas, and it also requires that we conduct an exam of each of the NRSROs registered with the SEC. The eight required review areas are informed by the risk assessment process that we use internally.

The risk assessment process takes a variety of inputs: information from the prior exams; inputs from the media; inputs from the other offices and divisions of the SEC; as well as tips, complaints, and referrals that we receive on the SEC's TCR line. The risk assessment process is then used to effectively differentiate risks by registrant, which are then informing the exam scoping, which allows for our exam teams to then be most effective as they go their examination process.

We also have examination teams arrayed in such a way that we have, if you will, larger examination teams examining the larger

registrants and smaller examination teams with smaller registrants, so that we have an effective allocation of resources.

As a result of the examinations, there is a report given to each of the registrants specifically identifying the deficiencies that we have noted, and there is also a summary report that is required to be put together by the office, which is assembled and reports publicly a summary of all the essential findings that we found in the examinations.

Mr. NEUGEBAUER. Do you think there is room for improvement on the present requirements?

Mr. BUTLER. I think we are doing a very good job and a very effective job with what we have. I also believe that we can always do better, which is one of the reasons why from the budget request we have added an additional request for two head count in Fiscal Year 2017 who would be used as specialized examiners, because I think having specialized examiners would allow for us to be able to go narrow and deep, specifically on particular issues that arise perhaps during the course of an examination, perhaps at other times during the course of the year.

Mr. NEUGEBAUER. Do you think it is necessary for those exams to be annual and for your folks to be present?

Mr. BUTLER. I think it is important at the stage that we are right now with regard to oversight of the credit rating agencies. We have seen real change as a result of the examinations conducted and real change implemented at the firms as a result of the recommendations that accompany our findings. And but for the fact that we are in there with the regularity that we are, I would not be able to sit here today and say with such conviction that there was real change.

I think the annual requirement, though, is one that allows for us to bring a different approach each year to focus on different areas within the firm so that we are not going in on a predictable basis, but rather on a more tailored basis for a particular firm with regards to risks that have been identified to us or that we have seen.

Mr. NEUGEBAUER. If you could scale or tailor the current requirements, what would you do?

Mr. BUTLER. I'm sorry. Could you repeat the question?

Mr. NEUGEBAUER. If you could scale or tailor the current structure, what would you do?

Mr. BUTLER. I am comfortable with the structure as it is currently crafted.

Mr. NEUGEBAUER. And, Mr. McKessy, the written statement notes that your office authorized to award whistleblower is in the range of 10 to 30 percent. Why is the threshold not zero?

Mr. MCKESSY. I think if the intention is to incentivize individuals to come forward if they are aware of wrongdoing, I think if—the calculus that individuals go through to decide whether they are going to report something to a regulator is very complicated and has a lot of factors, and amongst them, I think, is, "How much is in it for me?" or could be, "How much is in it for me?"

And if it is true that when a person is making the calculus of whether they should approach a regulator, one of the outcomes could be that they get zero, that could change and affect negatively their incentive and their enthusiasm about coming forward. And

so, I think it is appropriate to not have zero as the baseline so that individuals who may otherwise be reluctant to come forward know that there is at least a possibility of some monetary award.

Mr. NEUGEBAUER. What is the current value of the whistleblower fund?

Mr. MCKESSY. Just over $400 million.

Mr. NEUGEBAUER. $400 million?

Mr. MCKESSY. Correct.

Mr. NEUGEBAUER. What kind of internal controls do you have in place with respect to that fund? That is a pretty sizeable amount of money.

Mr. MCKESSY. We can only make payments when the Commission approves it, and there is a process by which we pay only against what we can confirm has been collected. And so we have internal controls to make sure that the cases that have been deemed to be worthy of an award, we have the documentation requirements; that we receive documentation either from the court or from the appropriate person inside the SEC to verify that we have actually collected the money, and then we multiply that against what the percentage that the Commission has approved.

Mr. NEUGEBAUER. Does the SEC Inspector General or the Government Accountability Office (GAO) audit those funds?

Mr. MCKESSY. Yes. On an annual basis, the GAO audits the investor protection fund.

Mr. NEUGEBAUER. Thank you.

Mr. Chairman, I yield back.

Chairman GARRETT. The gentleman's time has expired.

We have been called for votes. We have 5 minutes left on the vote, so Members should run over. This is on passage of the bill.

I think there are only two votes, if I am not mistaken, and I believe there is one or perhaps two other Members who were here and will be returning after votes for final questioning. The subcommittee is adjourned, to be reconvened immediately after votes.

[recess]

Chairman GARRETT. Good afternoon. I hope you appreciated your little break.

The subcommittee is called back into session, and at this time I recognize the gentleman from Pennsylvania for 5 minutes.

Mr. FITZPATRICK. Thank you, Chairman Garrett, for permitting me to participate in this hearing.

This is a really important hearing, SEC oversight of the credit rating agencies and the United States Congress oversight over the SEC, especially as it relates to consumer protection. Because each of the witnesses in their opening statements pretty much indicated one of the foundational principles of, whether it is the whistleblower section, Office of Credit Rating Agencies, and investor protection is sort of central to what you do.

I have been following a couple of issues that are the subject of the hearing today.

The first actually slightly separate issue has to do with foreign companies that somehow get listed on the stock exchanges of our Nation. They end up being fraudulent companies, many of them Chinese companies. We then find out that they are nothing but shell entities. A lot of U.S. investors have been hurt significantly.

I am not going to ask the members of the panel to address this, but with the chairman's permission I would like to write to the members. I will do it through the chairman's office. I am concerned that either the SEC and/or the United States Congress or us working together are not doing enough to protect investors, and so I want to follow up on that issue.

But today, I want to follow up on the issues that were raised by Mr. Lynch and Mr. Sherman. Mr. Lynch is concerned, as am I, that we are not doing enough to stamp out conflicts of interest within the credit rating agency sector of our economy or the financial services industry. We have a lot of work to do there.

Mr. Butler, in response to Mr. Lynch's questions, you indicated that in terms of full compliance with new regulations that are being issued by the SEC, that you see this more as—I think you said a journey rather than a destination. I would hope the destination is full compliance with all the new regulations, including stamping out all conflicts of interest.

Maybe you can explain what you mean by a journey rather than a destination? I hope the journey is pretty quick and that we are not adrift in that journey. What did you mean by that, that it is more of a journey than a destination?

Mr. BUTLER. What I meant by that, Congressman, is compliance isn't an end state that companies achieve and then compliance is over. I view compliance as something that is needed every single day.

The firms have large compliance staffs. They have been adding significantly to the numbers of their compliance staffs. They have been conducting reorganizations internally to effect enhanced compliance.

And what I meant by saying it is a journey not a destination is that this is a continually evolving necessity. As the industry changes, as the types of products change, the types of compliance that is necessary within the firms may itself need to change.

Mr. FITZPATRICK. Certainly, you are concerned about conflicts within especially the big three of the credit rating agencies, since those big three account for, what, 80 percent of the market?

Mr. BUTLER. We have been very concerned about conflicts of interest across all the 10 registrants that are registered with the SEC—

Mr. FITZPATRICK. I want to follow up on Mr. Sherman's questions about this Peruvian issue. Certainly, you have seen the newspaper stories and the advertisements about the agrarian land bonds. Are you familiar with that?

Mr. BUTLER. I am familiar with some of the media coverage about the bonds, yes, sir.

Mr. FITZPATRICK. Can you explain to the committee what your understanding is of the conflict at this point?

Mr. BUTLER. With regard to the Peruvian bonds, I really don't have any particular details other than what the media reported, and it had to do with two of the rating agencies, one of which is registered with the SEC for sovereigns and one of which is not.

Mr. FITZPATRICK. I am looking at a Standard & Poor's rating services. This appears to be an analysis of the Republic of Peru done about 6 months ago, September 2015. It seems to have rated

as investment grade with a stable outlook—the sovereign debt or the bonds of the Republic of Peru.

But you are aware that there are other bonds issued by the government a couple of decades ago that are in default? You have heard that, correct?

Mr. BUTLER. I have seen the media articles on it. It has been a while since I read the media articles on it.

Mr. FITZPATRICK. And you are aware that these same rating agencies are not willing to rate that debt for some reason? Are you aware of that?

Mr. BUTLER. Again, it has been a while since I read the media coverage on it—

Mr. FITZPATRICK. With respect to this particular issue, what are the circumstances that a rating agency should be permitted to rate new sovereign debt, get paid to do that—and that is part of their business model; I understand that—but ignore the requests of the investor community to rate other debt issued by the government that is in default?

How is it the rating agencies get to pick and choose what debt they are going to rate and what debt they are not going to rate, especially when it affects small investors in the United States of America?

Mr. BUTLER. The rating agencies are required to establish, maintain, and enforce policies and procedures to address their conflicts of interest. And within that, there are conflicts of interest identified which would be disclosure-based, and others that are absolutely prohibited. And prohibited conflicts would include the separation—

Mr. FITZPATRICK. But what kind of discretion does a credit rating agency have to just decide on their own what they are going to rate and what they are not going to rate?

Mr. BUTLER. With regard to our oversight, Congressman, we look at the work and the work product that has been done. We don't have authority with regard to the substance of ratings or the procedure or methodology—

Mr. FITZPATRICK. I'll tell you what my concern is. My concern is that there are pension funds in half of the States in this country that have invested the retirements savings of police officers, of firefighters, of building construction trades workers, average everyday Americans who are losing money in certain investments where Standard & Poor's, in this particular case, has said, "Yes, the Republic of Peru is investment-grade," but they are in default on other bonds.

And I am concerned that they are deciding what bonds they are going to rate and what bonds they are not going to rate, because if they rated these land bonds that were issued a couple of decades ago and found out that they are all in default, that would affect all of the other ratings that they have issued. And that may have an effect on the ratings not just of the Republic of Peru, but other corporate bonds that they have rated also within that governmental area.

So I would ask you to take a look at that and question the rating agencies—four or five or however many there are, not very many; not enough, I would say—and question them as to how they are using the discretion what to rate, what not to rate, whether there

is a conflict inherent in that decision, and how many small investors, how many working-class Americans are being affected, negatively impacted, losing retirement savings as a result. Would you do that for me?

Mr. BUTLER. Thank you, sir.

Mr. FITZPATRICK. Would you do that?

Mr. BUTLER. I am not at liberty to discuss the substance of an examination, but I am happy to take your comment under advisement.

Mr. FITZPATRICK. I will follow it up with you. Thank you.

Thank you, Mr. Chairman.

Chairman GARRETT. Thanks.

And before I call on the gentleman from Maine, I just want clarity as to one of the answers on that.

When you say that there are already rules in place as far as the conflict of interests for what—the decision by the rating agency, I think I understand what you are saying. But the conflict that they have is on the—that conflict that they have to make sure that there isn't a conflict of interest is on the—going forward, the decision—on the entity that they are going to be rating tomorrow. So if they are rating the XYZ country or entity over here, they have to make sure there is no conflict in that decision, right, is what you are saying?

Mr. BUTLER. The new rules that were adopted in August 2014, effective June 2015, require—there is a certificate with regard to any rating action. The rating action could be either a new issuance or a surveillance of an old rating.

Chairman GARRETT. Right. But it doesn't really go to the point that the gentleman from Pennsylvania was making as far as their decision not to rate someone. There is no question, you don't look to see whether there was a conflict of interest when they decided, "We are not going to rate X, Y, and Z." Is that correct?

Mr. BUTLER. As it is currently crafted today, we are looking for surveillance activities and new issuance activities.

Chairman GARRETT. Okay. Thank you.

With that, last, but certainly not least, the gentleman from Maine is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much.

Mr. Wyatt, you represent or you are the Director of the Office of Compliance, Inspections, and Examinations for the SEC, correct, sir?

Mr. WYATT. That is correct.

Mr. POLIQUIN. Okay. And the SEC has about 4,000 employees and a budget of about $1.6 billion the last time I looked?

Mr. WYATT. SEC-wide, that is correct.

Mr. POLIQUIN. Yes, exactly. And of those 4,000 employees, 1,000 work for you.

Mr. WYATT. 1,011, yes, sir.

Mr. POLIQUIN. Okay.

I represent Maine's 2nd District. This is western, central, northern, and down east Maine. It is the most wonderful part of the world. If you haven't vacationed there, Mr. Wyatt, I know you are going to want to take your other associates with you to go vacation

there this summer, which is upon us. We have a little bit of snow in Aroostook County, but it is melting.

Now, we are a district of small business owners. We are a district of small savers—hardworking people; honest people; people putting aside $50, maybe $100 a month to save for their kid's college education or maybe for their retirement.

Now, your job at the SEC—and all your jobs—is to make sure that there is integrity with respect to our publicly traded and other securities to make sure our investors have a fair shake at knowing what they are investing in.

Now, help me out, if you don't mind, Mr. Wyatt. Your budget goes up for the entire—not just yours, but your part of it—for the SEC you always come back to us every year for more money. And I think you asked for another 10 or 15 percent from last year to this year.

So my question is, with 1,000 folks on your staff, how many examinations per inspector do you folks conduct for our registered investment advisers, the folks who manage our pension funds and our 401K funds and IRAs? How many examinations per inspector per year?

Mr. WYATT. The average is six to nine per examiner. So I would highlight that we do not conduct examinations on an individual basis; our examiners go out and examine investment advisers in teams.

Mr. POLIQUIN. Right. Okay.

Six to nine, okay. But you ask for an increase in your budget every year. What was the number—how many examinations did your teams conduct the year before?

Mr. WYATT. Last year, we conducted 1,992—

Mr. POLIQUIN. No, how many per inspector, Mr. Wyatt?

Mr. WYATT. Per inspector it was—we have had a 23 percent increase in the number of exams per examiner in the past 3 years.

Mr. POLIQUIN. Okay. Thank you. I appreciate that very much.

Let's continue to drill down a little bit on these examinations, sir. I know that the Administration's financial regulations ask you to make sure that you conduct robust examinations of the investment advisery space. And if I am not mistaken, there are about 14,000 registered investment advisers in America. Did I get that right?

Mr. WYATT. Roughly 12,000, yes, sir.

Mr. POLIQUIN. Roughly. Okay.

Do you think that you folks have spent a disproportionate amount of time recently on the private equity space—in other words, the type of investment adviser that deals with more accredited investors, larger investors, more sophisticated investors, as compared to folks who don't make a living investing but might be nurses or teachers or folks who work in the forest products industry in our districts?

Do you spend a disproportionate amount of your time, sir, on the private equity examinations for large investors, as compared to the investment adviser space for smaller investors?

Mr. WYATT. I would suggest that those large investors that you are referring to are the endowments institutional investors and pension funds. Those pension funds are investing on behalf of the firefighters, the police officers, and the teachers.

Mr. POLIQUIN. Yes.

Mr. WYATT. I would say with regards to our examinations of private funds, we have been very efficient in the resources we have dedicated to them. When they came into registration with the SEC as a result of Dodd-Frank, we conducted the presence exam initiative, when we had focused, limited-scope examinations of private funds. Those funds uncovered some activities regarding fees and expenses and allocation of trades that resulted in funds being returned to those institutional investors who, again, are investing on behalf of the firefighters—

Mr. POLIQUIN. Sure.

Mr. WYATT. —policemen, and teachers.

Mr. POLIQUIN. But I think you would—and I appreciate that you want to make sure that your scope of examination expands all investment types, and I understand that.

Mr. Wyatt, wouldn't you agree that it is incumbent upon us to make sure we look out for the small saver, the small investor, whereas those who make a living in that business are usually better able to get the information they need to make their investments?

Mr. WYATT. We certainly want to protect investors. We certainly are doing our utmost to increase our exam coverage.

I would highlight to you, as a result of our examinations of the private fund, many of those institutional investors have come to OCIE and asked for our assistance in how they can improve their due diligence because we got access to information that they otherwise wouldn't get in the course of their due diligence.

So we are sharing that information so those institutional investors can be more informed when they make investments, and we are also doing our utmost to expand our coverage ratio within the investment adviser space to get to roughly 10 percent a year, roughly 30 percent of the assets under management.

We hit a 4-year high with regards to the number of examinations we have done, but in a 2-year period we have had a net increase of advisers of roughly 1,000. So we are continuing to increase our numbers.

We certainly want to dedicate resources to improve our efficiencies. We certainly want to make sure we are doing our utmost to protect investors.

Mr. POLIQUIN. Thank you, Mr. Wyatt.

Mr. Chairman, if I may just continue one line of questions, please, sir? I am the last one here.

Chairman GARRETT. You have more questions?

Mr. POLIQUIN. Yes, sir. I do.

Chairman GARRETT. Go ahead.

Mr. POLIQUIN. Thank you very much. Thank you, Mr. Chairman.

And thank you, Mr. Wyatt. Mr. Wyatt, what would be a great help to me and my office in representing our 2nd District of Maine, and also, I am sure, to our committee and the rest of the country, is when you are dealing with such an important part of our capital markets, you must have in your department a written set of procedures such that we, who are responsible for oversight for your entity, can make sure that we know exactly how you are conducting your business, exactly how you make your decision on what inspec-

tors go where and what the expectation is for the number of examinations, just to make sure when you folks come back to us and ask for more money, we know that the taxpayers are getting the right bang for the buck. Would you be able to provide those procedural guidelines to us?

Mr. WYATT. We are doing our utmost to be as transparent as possible about—

Mr. POLIQUIN. Do you have a set of written guidelines, sir, that we—

Mr. WYATT. We have a guideline—we have an exam manual that we use that is private.

Mr. POLIQUIN. Yes, but that is for the examinations. I am talking about for Congress, that represents the people. Do you have a set of procedures that articulate exactly how you conduct your examinations?

Mr. WYATT. That is our exam manual that guides how we conduct our examinations, yes—

Mr. POLIQUIN. Okay. And can you add an addendum to that such that we know what kind of activity—the amount of activity for the money that we are spending on behalf of your organization such that taxpayers know that they are getting their money's worth?

Mr. WYATT. We can certainly liaise with your office to try to provide you with the information that you are seeking.

Mr. POLIQUIN. That would be great. And we will be in touch with you—what is today? Today is Thursday? We will be in touch with you tomorrow.

Mr. WYATT. I look forward to it. Thank you.

Mr. POLIQUIN. Thank you, Mr. Wyatt. I appreciate it.

And thank you very much, Mr. Chairman.

Chairman GARRETT. Thank you.

Since no one else is here, I could just go on for hours here, but I won't. I will just ask two quick questions, just to drill back down a little bit on something else.

I think Vice Chairman Hurt raised this question, Mr. Flannery, as far as taking a look back at—doing a look back at past rules and how that is all supposed to work and what have you, can you just spend 30 seconds? What is your game plan, what is your goal, to look backwards towards the last half a dozen years of rules that have been promulgated over the last half a dozen years and just see whether they are all working?

Mr. FLANNERY. Of course, one of the biggest sources of rules over the past half dozen years has come out of the Dodd-Frank Act.

Chairman GARRETT. Right.

Mr. FLANNERY. And I know that the Congress is concerned about the cumulative effect of the Dodd-Frank rules and regulations on liquidity in financial markets. So DERA has been charged with doing a study on that very thing.

I think it is a terrific study to be doing. We have started. We haven't gotten deeply into it.

But the question of how liquid are our financial markets, particularly maybe the debt markets, I think has very important policy implications both here and around the world, and so we are looking forward to doing that.

And the impact of these cumulative regulations on that liquidity is going to be an important conclusion. An assessment of that is going to be an important conclusion of our study.

Chairman GARRETT. Okay. And, of course, that always begs the question as to when?

Mr. FLANNERY. You have told us, which is that we will get back to you within a year of the omnibus act last year being passed. I think that is our first draft, and 18 months is the final draft.

Chairman GARRETT. And that will look into also, besides those two points, will look into the—I will say the cost, economic impact on the industry and the marketplace?

Mr. FLANNERY. On the liquidity, as I understand it, is what you are primarily interested in.

Chairman GARRETT. Well, yes. That I get. It will look at the liquidity.

But will it also look at the overall cost? What is the economic cost measured in dollars and cents to the industry, per se? It is costing us—this firm X millions of dollars to do it and this firm X millions of dollars, what the total cost—that may or may not impact always upon liquidity I presume, right? It costs another $10 million to do so, but liquidity stays the same.

Mr. FLANNERY. Right.

Chairman GARRETT. So you are doing liquidity over here. That is good. Are you also looking out to the overall nominal cost, I guess is the word?

Mr. FLANNERY. Yes. I think the nominal cost would be the word. And that would certainly be a part of that study. A part of any economic analysis is to set a baseline, and the baseline would include considerations of the costs of operating today, absolutely.

Chairman GARRETT. Yes. And I will end here where you began, with one of my very first questions.

I have heard some good things as far as what you are talking about here from industry and otherwise, as far as in your—one of your opening comments, and it was talking about how this—some of this information is now being put out, as far as your studies and what you have presented.

I will put it this way: Is that as far as you can go, or can you improve that? Can you reveal—I don't know what the right word is here—more information as far as the methodology, the data points, and everything else that goes into it? And I ask that question because some folks look here and say, "Good," but look at other agencies and how they do their analysis that you do in their area and they put out a fuller, more complete, more in-depth background, if you will, onto that.

Do you see a comparison—maybe I should put it that way—do you see a comparison to other ones at how—what you do, and do you see that you could do a little bit more or more in these areas?

Mr. FLANNERY. Yes. I have been—

Chairman GARRETT. That is my last question to you.

Mr. FLANNERY. One of the things I have been working on in the past year-and-a-half since I got there—

Chairman GARRETT. Yes.

Mr. FLANNERY. —is the idea that we bring in all this registrant information, it is treated as confidential and private because the

registrants don't wish to be identified for obvious reasons, but that shouldn't interfere with our ability to provide information about various aggregated forms of that information.

Chairman GARRETT. Okay.

Mr. FLANNERY. If we are going to be useful, we have to tell people how we made the decision about the aggregation, so I agree with you entirely about that.

Chairman GARRETT. Okay. And so you are going to be working on—

Mr. FLANNERY. Yes.

Chairman GARRETT. Okay.

Mr. FLANNERY. Yes.

Chairman GARRETT. That is good.

So with that all being said, I thank the members of the panel and all the witnesses here today.

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.

And I would be remiss if I did not add this, that if you can't make the trip all the way up to Maine, the snow is already gone in New Jersey and things are blooming already in New Jersey. It will be another 6 months before the snow and the ice melts in Maine.

So with that, this hearing is adjourned.

[Whereupon, at 11:44 a.m., the hearing was adjourned.]

A P P E N D I X

April 21, 2016

Testimony on Continued Oversight of the SEC's Offices and Divisions

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

Washington, D.C.
April 21, 2016

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee:

Thank you for your invitation to testify on behalf of the U.S. Securities and Exchange Commission (SEC or Commission) about the responsibilities and recent activities of the Division of Economic and Risk Analysis (DERA), the Office of Compliance Inspections and Examinations (OCIE), the Office of Credit Ratings (OCR), and the Office of the Whistleblower (OWB).

In recent years, the SEC has made substantial progress in strengthening its operations and programs. The agency has proposed or adopted nearly all of the mandatory rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Jumpstart Our Business Startups Act (JOBS Act), in addition to advancing other key rules in mission critical areas that protect investors and our markets. In addition to implementing congressionally mandated rules, the SEC has also advanced other important policy objectives, including rules to enhance oversight of high-frequency traders and the agency's supervision of investment advisers and mutual funds, including reforms to money market mutual funds; as well as adopting requirements for comprehensive new controls at critical market participants to strengthen key technological systems.

Beyond the rulemakings, the SEC has intensified its review of equity and fixed income market structure issues, undertaken a disclosure effectiveness initiative seeking ways to improve the public company disclosure regime for investors and companies, and continued to act aggressively to hold securities law violators accountable. Broad, systemic enhancements in the SEC's National Examination Program (NEP) – including increased recruitment of industry experts, the augmentation of data analytics capacities, and enhanced training programs – have led to a more effective, efficient program. The agency also is increasingly harnessing technology to better identify risks, uncover frauds, sift through large volumes of data, inform policymaking, and streamline operations, while at the same time improving internal collaboration and recruiting more staff with specialized expertise and experience. While these and other critical improvements have been made, challenges remain in the Commission's efforts to address the growing size and complexities of the securities markets and fulfill the SEC's broad mandates and responsibilities. Our testimony will discuss the role each of our divisions and offices play in fulfilling the important mission of the Commission, developments in our respective areas, and some of our recent work.

To continue and expand on our efforts, as set forth in the SEC's FY 2017 budget request, the SEC is requesting $1.781 billion in support of 5,196 positions and 4,870 full time equivalents (FTE).[1] This requested budget level is essential to support the agency's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Specifically, as described in more detail below and consistent with the planning reflected in our recent requests, the budget for FY 2017 seeks to:

- Increase examination coverage of investment advisers and other key entities who interact with retail and institutional investors;
- Further leverage cutting-edge technology to permit the SEC to better keep pace with the entities, markets, and products we regulate;
- Protect investors by enhancing our enforcement program's investigative capabilities and strengthen our ability to litigate against wrongdoers;
- Further bolster the SEC's economic and risk analysis functions; and
- Hire market and other experts to enable the SEC to more expertly and efficiently discharge its current rulemaking and oversight responsibilities.

As you are aware, the SEC's funding is deficit-neutral, which means that any amount appropriated to the agency will be offset by modest transaction fees (approximately $.02 per $1,000) and therefore will not impact the deficit or the funding available for other agencies. Our appropriation also does not count against the FY 2016 or FY 2017 caps set in the Bipartisan Budget Act of 2015.

DIVISION OF ECONOMIC AND RISK ANALYSIS

Director and Chief Economist, Mark J. Flannery

The Division of Economic and Risk Analysis supports the Commission's mission through data-driven, high-quality economic analyses. Over the past several years, DERA has grown from approximately 96 employees in 2013 to a projected workforce of 175 by the end of 2016. By that time, DERA anticipates employing 88 Ph.D.s — mostly in economics or finance, but also accountants and two physicists. This set of social scientists is supported by 22 research associates. DERA staff also includes a diverse team of other technical experts and professional staff. The Division's rapid growth and resultant depth of expertise has allowed DERA to expand its support across an ever-increasing range of Commission activities.

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[1] A copy of the SEC's FY 2017 Congressional Budget Justification is available at http://www.sec.gov/about/reports/secfy17congbudgjust.shtml

Rulemaking and Policy Support

DERA's most well-known function is to provide economic analyses in support of Commission rulemaking and other priority initiatives. DERA economists examine the need for regulatory action, analyze the potential economic effects of proposed and final rules, and evaluate public comments. DERA provides theoretical and data-driven economic analyses of potential new policies and changes to existing policies, working closely with staff from other Commission divisions and offices from the earliest stages of policy development through the finalization of a particular rule. DERA staff also provides analysis, where appropriate, to support the Commission's consideration of self-regulatory organization (SRO), Municipal Securities Rulemaking Board (MSRB), and Public Company Accounting Oversight Board (PCAOB) rules.

In the course of assisting other divisions and offices, staff routinely prepares white papers and other documents that present novel economic analyses of specific policy issues or rulemakings. For example, last year DERA staff published two white papers in conjunction with two of the Division of Investment Management's recent rulemakings — one related to liquidity requirements for open-end mutual funds, and another about funds' derivatives usage. Staff also produced a white paper on voluntary clearing activity in the single-name credit default swap market and a white paper analyzing the market for unregistered securities offerings.

Risk Assessment

DERA also provides financial and risk modeling expertise to other divisions and offices in support of their supervisory, surveillance, and investigative programs related to corporate issuers, broker-dealers, investment companies, and exchanges and trading platforms. Our data analysis helps SEC staff with examination prioritization and scoping, including providing guidance on which entities to examine, and what to look for during the examinations.

DERA recently developed a "Broker-Dealer Risk Assessment" tool in close collaboration with OCIE staff that analyzes how a firm's behavior compares to its peers to identify anomalous behavior that might indicate risks in a broker-dealer's operations, financing, workforce, or structure. The tool also provides predictors of potential misconduct based on risk factors developed using OCIE's historical exam findings. These results help OCIE to prioritize inspections, as well as to focus examiners' attention during an inspection to increase the likelihood of detecting misconduct.

Another recent project — the Corporate Issuer Risk Assessment tool (CIRA) — helps expert staff to assess corporate issuer risk by identifying financial reporting irregularities that may indicate financial fraud. Developed in coordination with the Division of Enforcement, CIRA produces over 200 custom metrics that the staff can use in analyzing issuer behavior and in identifying companies that may warrant further inquiry.

Litigation Economics

DERA staff also support the Division of Enforcement by applying economic theory and statistical methods to answer key questions that arise during investigations, settlement

negotiations, and litigation. In fiscal year 2015, DERA staff provided expert assistance in over 120 new enforcement matters, including accounting fraud, insider trading, and market manipulation cases. DERA staff assists Enforcement staff in identifying securities law violations, quantifying the harm to investors, and calculating ill-gotten gains. DERA staff also evaluate economic-based claims of the defendant — for example, that a penalty would cause a company undue harm. For cases that go to trial, DERA staff work with Enforcement's Trial Unit to help prepare the Commission's outside experts and to challenge the work of opposing experts. In certain cases, DERA staff have testified on behalf of the Commission.

Data Oversight

Along with performing complex data analytics, DERA acts as a central hub for the intake, processing, and use of data within the Commission. DERA's data oversight activities fall into two distinct, but related, categories.

First, DERA works closely with other SEC divisions and offices to design data structuring approaches for required disclosures, and supports the SEC's data collections and data usage by designing taxonomies, validation rules, data quality assessments, and data dissemination tools to facilitate high-quality data analyses. DERA also works with investors, regulated entities, and the public to support the submission and use of structured data.

Second, DERA is responsible for the day-to-day management of many Commission databases. DERA staff routinely generates summary information and statistics about key aspects of the financial markets, and provide Commission staff with direct access to the underlying data. DERA also develops and refines financial market datasets gathered from sources both internal and external to the Commission.

Research

DERA encourages its staff to be active participants in the academic community, particularly as it investigates and debates topics relevant to the SEC's mission. Staff regularly have their research papers published in refereed publications that cover finance, economics, and accounting, and staff papers are posted on the DERA webpage of the SEC website to ensure the public can access current research on the financial markets.

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

Director, Marc Wyatt

OCIE, through its National Examination Program, protects investors, ensures market integrity, and supports responsible capital formation through risk-focused strategies that: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy. The results of OCIE's examinations are used by the Commission to inform rule-making initiatives, identify and monitor risks, improve industry practices, and identify misconduct.

With a staff of over 1,000 employees, OCIE has examination responsibility for registered entities consisting of more than 12,000 investment advisers, 11,000 mutual funds and exchange-

traded funds, over 4,000 broker-dealers, more than 400 transfer agents and more than 650 registered municipal advisors. OCIE also has oversight responsibility for 18 national securities exchanges, the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board, the Securities Investor Protection Corporation (SIPC), six active registered clearing agencies, and the PCAOB. Recent legislative changes by the Dodd-Frank Act and the JOBS Act have expanded OCIE's responsibilities to include examinations of, among others, security-based swap dealers, security-based swap data repositories, major security-based swap participants, securities-based swap execution facilities and crowdfunding portals. Compounding the challenges in the sheer number of registrants is the continued growth in the financial markets and complexity of its participants. For example, over the past fifteen years, assets under management of SEC-registered advisers grew by approximately 210 percent to approximately $66.8 trillion, and assets under management of mutual funds grew by almost 125 percent to over $15 trillion today. In order to maximize the use of our limited staff, OCIE is in the formative stages of reallocating examiners across its program to increase coverage of investment advisers.

In fiscal year 2015, examiners in 11 regional offices and headquarters conducted nearly 2,000 examinations, including: 484 examinations of broker-dealers; 1,221 examinations of investment advisers; 137 examinations of investment company complexes; 53 examinations of transfer agents; 6 examinations of clearing agencies; and 50 examinations of municipal advisors. The staff also conducted 21 SRO program examinations and 20 Technology Controls Program examinations, which are inspections of the regulatory operations and automated trading and clearing processes of markets and clearing organizations. Approximately 77 percent of all fiscal year 2015 examinations identified deficiencies and approximately 11 percent resulted in referrals to the Division of Enforcement.

To meet the challenges posed by a registrant population that far exceeds OCIE resources, OCIE has adopted a risk-based approach to examinations, utilized data analytics, and promoted compliance through transparency.

Risk-Based Approach

OCIE has adopted a risk-based examination approach with respect to the firms selected for examination, the areas of the firm examined, and the issues covered. OCIE's Office of Risk Assessment and Surveillance (RAS) aggregates and analyzes data from SEC filings from registrants and individuals to identify activity that may warrant examination. In fiscal year 2015, RAS significantly expanded its data analysis and monitoring efforts to incorporate data from sources internal and external to the Commission, including, for example, data collected by or filed with other regulators, SROs, and exchanges, as well as information that registrants provide to data aggregators regarding, for example, their business activities and marketing-related efforts. This expanded data collection and analysis enhances OCIE's ability to identify operational red flags throughout entire industries – such as firms with aberrant swings in reported assets under management, changes in key individuals, business activities, and affiliates, migration of bad actor industry participants and other possible indicia of heightened risk – and enables examiners to develop a better understanding of firms prior to launching an examination.

Data-Driven

Over the past five years, OCIE has recruited experts to enhance OCIE's technology and its use of data analytics to improve its risk-based examination approach. For example, last fiscal year, OCIE's Quantitative Analytics Unit (QAU) improved the National Exam Analytics Tool, which enables examiners to access and systematically analyze years' worth of a registrant's trading data much faster than ever before. QAU has also been developing technologies to help examiners detect suspicious activity in areas such as money laundering and high frequency trading that will further expand and enhance OCIE's capabilities to fight and deter fraud.

OCIE's Risk Analysis Examination (RAE) Team also uses technology to conduct examinations of some of the nation's largest broker-dealers. By analyzing transactions cleared by firms over several years, RAE has identified possible problematic behavior across multiple firms, including unsuitable recommendations, misrepresentations, inadequate supervision, churning, reverse churning, and load waivers.

Enhanced Transparency

OCIE improves industry compliance with the Federal securities laws and promotes better industry risk management practices through examinations and greater transparency. OCIE engages in extensive communication and outreach initiatives with the industry and other regulators. By communicating with registrants through outreach and published material, OCIE provides registrants with tools to self-assess and remediate any non-compliant behavior on their own. For example, each year, OCIE publishes its annual public statement of examination priorities to inform investors and registrants about areas that the staff believes present heightened risk and to support the SEC's mission.[2]

In addition, OCIE conducted 129 outreach and educational program events in fiscal year 2015, including Compliance Outreach seminars, targeted sessions with never-before-examined advisers, and other outreach initiatives with registrants, regulators, and industry groups. As part of this effort, OCIE also issued six Risk Alerts (among other significant published materials) on such topics as investment advisers and funds that outsource their chief compliance officer function, broker-dealer controls regarding retail sales of structured securities products, and never-before-examined registered investment companies.

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[2] *See* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

Select Priority Initiatives

Currently, OCIE is pursuing several key initiatives that are critical to the protection of investors.

ReTIRE Initiative

In June 2015, OCIE launched a multi-year examination initiative (ReTIRE), focusing on SEC-registered investment advisers and broker-dealers and the services they offer to investors with retirement accounts.[3] OCIE is focusing on retirement-based savings because retail investors are faced with a complex and evolving set of factors when making critical investment decisions. Some of these factors include the broad and changing array of investments available, the variety of services offered, the changing market environment, and commissions and sales charges associated with these investments. OCIE has and will continue to focus its examinations on certain higher-risk areas of registrants' sales, investment, and oversight processes, with particular emphasis on select areas where retail investors saving for retirement may be harmed, including: the reasonable basis for recommendations; conflicts of interest; supervision and compliance controls; and marketing and disclosure. As of March 10, 2016, OCIE had initiated approximately 200 examinations pursuant to this initiative, which will continue to be a priority in 2016.

Cybersecurity

In the last two years, OCIE has conducted examinations to identify cybersecurity risks and assess cybersecurity preparedness among broker-dealers and investment advisers.[4] These examinations focus on: governance and supervision of information technology systems; operational capability; information security; preparedness for cyber-attacks; access rights and controls; data loss prevention; vendor management; training; and incident response. OCIE made public a summary of its observations and findings. Notable among these was the observation that the vast majority of examined firms conduct periodic risk assessments, on a firm-wide basis, to identify cybersecurity threats, vulnerabilities, and potential business consequences, but fewer firms conduct a similar analysis of vendors.[5] In 2016, OCIE is continuing this effort, including

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[3] *See* OCIE Risk Alert, "Retirement-Targeted Industry Reviews and Examinations Initiative," June 22, 2015, http://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

[4] *See* OCIE Risk Alert, "OCIE's 2015 Cybersecurity Examinations Initiative," Sept. 15, 2015, https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf; OCIE Risk Alert, "OCIE Cybersecurity Initiative," Apr. 15, 2014, http://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf.

[5] *See* OCIE Risk Alert, "Cybersecurity Examination Sweep Summary," Feb. 3, 2015, https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

testing and assessments of firms' implementation of procedures and controls. As of March 11, 2016, OCIE had initiated over 160 examinations pursuant to this initiative.

Liquidity Controls

Amidst the changes in fixed income markets over the past several years, OCIE is examining advisers to mutual funds, ETFs, and private funds that have exposure to potentially illiquid fixed income securities. OCIE will also examine registered broker-dealers that have become new or expanding liquidity providers in the marketplace. These examinations include a review of various controls in these firms' expanded business areas, such as controls over market risk management, valuation, liquidity management, trading activity, and regulatory capital. As of March 11, 2016, OCIE had initiated 193 such examinations. This priority builds on a 2015 priority related to fixed income investment companies.

OFFICE OF CREDIT RATINGS

Director, Thomas J. Butler

With the enactment of the Credit Rating Agency Reform Act of 2006 (CRA Reform Act), Congress provided the Commission with express authority to implement a registration and oversight program for credit rating agencies that elect to be treated as "nationally recognized statistical rating organizations (NRSROs)." As mandated by the Dodd-Frank Act, the Office of Credit Ratings (OCR or the Office) was established at the Commission in June 2012.[6]

OCR is charged with administering the rules of the Commission with respect to the business practices of NRSROs. OCR monitors the activities and conducts examinations of NRSROs to assess and promote compliance with statutory and Commission requirements. OCR collaborates and coordinates with other Commission offices and divisions as warranted to enhance its ability to serve the public interest and protect users of credit ratings.

Pursuant to the Dodd-Frank Act, OCR staff includes persons with knowledge of and expertise in corporate, municipal and structured debt finance. OCR is currently comprised of approximately 50 staff members located in New York and Washington, D.C. OCR's activities fall within the following areas: Examinations; NRSRO Monitoring and Constituent Monitoring; and Policy and Rulemaking, each of which is briefly described below.

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[6] Prior to the establishment of OCR, examinations of the NRSROs were conducted by the Office of Compliance Inspections and Examinations, and NRSRO monitoring was undertaken by the Division of Trading and Markets.

Examinations

Examinations of NRSROs for compliance with federal securities laws and Commission rules account for the majority of OCR's activity. The Dodd-Frank Act requires that OCR conduct an examination of each NRSRO at least annually.

The scope of the annual examinations covers eight review areas prescribed by the Dodd-Frank Act. Further, OCR employs a risk-based approach to exam planning, identifying different risks for different NRSROs. This improves the efficiency and the effectiveness of the NRSRO examinations, as resources are prioritized and focused on areas of higher risk. The examinations of the NRSROs may include a quantitative analyst to provide analytical support directly alongside the examination teams. In addition to the annual examinations, OCR conducts sweeps and targeted examinations to: (1) address credit market issues and concerns; and (2) follow up on tips, complaints, and NRSRO self-reported incidents.

In conducting an NRSRO examination, OCR staff reviews, among other things: (1) the implementation of policies and procedures to assess compliance with the rules; (2) selected ratings files in connection with ratings issuances and surveillance activities; (3) internal controls and governance activities; and (4) internal compliance reports. As part of the examination, OCR examiners travel onsite to an NRSRO and conduct interviews of management and staff, including credit rating analysts, as well as members of the NRSRO's board of directors.

To date, the NRSROs have been generally responsive to the Commission staff's findings and recommendations. Many have implemented fundamental changes, such as: increasing surveillance activities; strengthening policies and procedures for managing conflicts of interest; adding compliance staff and restructuring oversight functions within the organization; investing in multi-year technology initiatives; and enhancing disclosure, transparency and governance. The annual examinations that are currently underway include a comprehensive review of NRSROs' compliance with the significant new rules and rule amendments that were adopted by the Commission in August 2014, most of which became effective in June 2015.

As required by the Dodd-Frank Act, OCR prepares an annual public examination report summarizing: (1) the essential findings of the examinations; (2) responses by the NRSROs to any material regulatory deficiencies identified by the Commission; and (3) whether the NRSROs have appropriately addressed previous examination recommendations. In December 2015, OCR published the fifth annual public examination report.[7]

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[7] http://www.sec.gov/ocr

One important area complementing OCR's examinations is the potential for referral to the Commission's Division of Enforcement of any of the staff's findings. Past examinations have, in certain instances, led to enforcement referrals.

NRSRO Monitoring and Constituent Monitoring

The NRSRO Monitoring and Constituent Monitoring groups gather, analyze and assess data and identify trends across the industry. This information provides useful input for examination scoping, determining and communicating best practices for NRSROs and guiding the direction for any future rulemakings related to NRSROs. Both groups also work collaboratively with, and serve as a resource to, other divisions and offices throughout the Commission.

NRSRO Monitoring conducts periodic meetings with NRSROs separate from the examination function, and may also meet on an *ad hoc* basis at an NRSRO's request or proactively as necessary to respond to NRSRO or industry developments. The group meets with certain NRSRO boards of directors (including a separate discussion with the independent directors), in addition to the meetings with the directors that the OCR examiners conduct, in an effort to engage the directors in broader policy discussions. NRSRO Monitoring is also responsible for reviewing the annual and periodic registrant updates submitted on Form NRSRO, reviewing the NRSRO Employment Transition Reports for former employees of NRSROs, and receiving tips from NRSROs that are reported pursuant to Section 15E(u) of the Securities Exchange Act.

Constituent Monitoring holds meetings with investors, issuers, arrangers, and industry trade groups. The group conducts *ad hoc* research as warranted by industry or credit market conditions. The group also discusses matters of common interest with other U.S. government agencies. Constituent Monitoring analyzes the differences in types of investors that affect their reliance on credit ratings and their views of NRSROs, the profiles of investor organizations and regulatory issues faced by other industries (*e.g.*, investment banking, commercial banking, and accounting) that are akin to NRSRO issues, and how other industries may have addressed similar issues.

Policy and Rulemaking

The Policy and Rulemaking group is responsible for developing rule recommendations for the Commission's consideration. The group also reviews requests for Commission exemptive relief or staff "no-action" relief from existing rule requirements. The group is instrumental in formulating staff guidance and other interpretive positions for OCR. The group receives feedback from the NRSRO examinations and from OCR's monitoring activities to help inform its policy recommendations. The Policy and Rulemaking group also reviews initial applications for NRSRO registration and applications from existing NRSROs for registration in additional ratings classes.

Pursuant to the CRA Reform Act, the Commission adopted rules establishing a regulatory oversight program for NRSROs and thereafter adopted amendments to several of those rules. The Commission's rules established a registration program for NRSROs and imposed disclosure, recordkeeping and reporting requirements. The Commission has broad authority to: (1) examine all books and records of an NRSRO; and (2) impose sanctions for violating statutory provisions and the Commission's rules. However, the Commission is not permitted to regulate the substance of credit ratings or the procedures and methodologies used to determine credit ratings.

As required by the Dodd-Frank Act, the Commission adopted a comprehensive set of new rules and rule amendments to strengthen the integrity and improve the transparency of credit ratings.[8] The rules address, among other things: reporting on internal controls; conflicts of interest with respect to sales and marketing practices, including the requirement to separate sales and marketing activities from analytics; disclosure of credit rating performance statistics; procedures to protect the integrity and transparency of rating methodologies, including the requirement for the NRSRO's board of directors to approve a methodology before it is used; disclosures to promote the transparency of credit ratings; and standards for training, experience and competence of credit analysts. The requirements provide for an annual certification by the CEO as to the effectiveness of internal controls and additional certifications to accompany credit ratings attesting that no part of the credit rating was influenced by any other business activities.

The Policy and Rulemaking group in OCR is responsible for conducting studies and drafting reports, including those required under the CRA Reform Act and the Dodd-Frank Act. In December 2015, OCR published the eighth Annual Report on NRSROs, as required under the CRA Reform Act.[9] The report provides a snapshot of the industry, including staff views on competition, transparency and conflicts of interest.

OFFICE OF THE WHISTLEBLOWER

Chief, Sean McKessy

Pursuant to the Dodd-Frank Act, the Commission established the Office of the Whistleblower (OWB), a separate office within the Division of Enforcement, to administer the whistleblower program. OWB is currently comprised of 11 staff attorneys, 5 legal assistants, and an administrative assistant.

The whistleblower program was designed to incentivize individuals to provide the Commission with specific, credible and timely information about possible federal securities law

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[8] http://www.sec.gov/rules/final/2014/34-72936.pdf.

[9] http://www.sec.gov/ocr

violations, and thereby enhance the Commission's ability to act swiftly to protect investors from harm and bring violators to justice. Under the program, individuals who voluntarily provide the Commission with original information that leads to a successful enforcement action resulting in monetary sanctions over $1 million, may be eligible to receive an award equal to 10-30% of the monies collected by the Commission or in a related action.

Since the whistleblower program went into effect in August 2011, the Commission has awarded more than $57 million to 27 whistleblowers. In Fiscal Year 2015 alone, more than $37 million was paid to reward whistleblowers for their provision of original information that led to a successful Commission enforcement action with monetary sanctions totaling over $1 million. All payments are made out of an investor protection fund established by Congress that is financed entirely through monetary sanctions paid to the Commission by securities law violators.

Because of the information and assistance provided by the 27 whistleblowers who received awards under the program, the Commission was able to bring successful enforcement actions where over $400 million was ordered in sanctions, including over $325 million in disgorgement for harmed investors. Over $350 million has been collected in connection with these Commission actions as well as successful related actions.

One of the primary activities of OWB is to evaluate whistleblower award claims and to make recommendations as to whether claimants satisfy the eligibility requirements for receiving an award. The Claims Review Staff, designated by the Director of Enforcement, considers OWB's recommendations in accordance with the criteria set forth in the Dodd-Frank Act and the Commission's final rules, and issues a Preliminary Determination. All Preliminary Determinations involving an award, as well as contested denials, are forwarded to the Commission for consideration, which then issues a Final Order. By the end of Fiscal Year 2015, the Commission and Claims Review Staff had issued Final Orders and Preliminary Determinations with respect to over 390 claims for whistleblower awards.

The number of whistleblower tips received by the Commission has increased each year of the program's operation. In Fiscal Year 2015, the Commission received nearly 4,000 whistleblower tips, representing a 30% increase over the number of tips received in Fiscal Year 2012, the first year for which OWB had full-year data. Since August 2011, the Commission has received more than 14,000 whistleblower tips. OWB has received whistleblower tips from individuals in every state in the country, as well as the District of Columbia, and from individuals in 95 foreign countries.

OWB also continues to receive a significant number of award claims. In Fiscal Year 2015 alone, OWB received more than 120 whistleblower award claims. OWB believes the uptick in whistleblower award claims and whistleblower tips is likely attributable to the increased public awareness of the Commission's whistleblower program and in response to the tens of millions of dollars that have been paid to whistleblowers under the program.

In addition to managing the awards program, OWB is actively involved with the investigative staff in helping to ensure that employees feel secure in reporting wrongdoing to the

Commission, without fear of reprisal from their employers. In June 2014, the Commission brought its first enforcement action under the anti-retaliation provisions of the Dodd-Frank Act.[10] The Commission's action sent a strong message to employers that retaliation against whistleblowers in any form is unacceptable. The Commission also has filed several *amicus curiae* briefs in private cases pending in the federal courts to address the scope of the anti-retaliation employment protections established by the Dodd-Frank Act. The Commission argued that the employment protections should be understood to protect individuals at publicly-traded companies from employment retaliation who internally report potential securities law violations, regardless of whether they have separately reported the information to the Commission.

In April 2015, the Commission brought its first enforcement action against a company for including language in confidentiality agreements that impeded whistleblowers from reporting to the Commission.[11] Exchange Act Rule 21F-17(a) provides that no person may take any action to impede an individual from reporting information about wrongdoing to the Commission. This includes, for example, by enforcing, or threatening to enforce, a confidentiality agreement with respect to such reporting. Protecting whistleblowers' rights to report possible securities law violations to the Commission, and protecting whistleblowers from retaliation, continues to be a top priority for OWB.

By protecting the confidentiality of individuals who report to the Commission pursuant to the whistleblower program, taking action against employers who retaliate against or interfere with their employees' ability to report wrongdoing to the agency, and awarding whistleblowers whose information leads to successful enforcement actions, OWB expects that the Commission will continue to receive high-quality tips that can be leveraged to detect and halt fraud earlier and more effectively. OWB anticipates that the whistleblower program will continue to be a game changer in the enforcement of the federal securities laws and the protection of investors and the marketplace.

Conclusion

In many ways the division and offices we supervise represent the evolving approach to securities regulation and oversight compelled by the recent financial crisis and guided by Congress. The Commission continues to make progress in adapting its operations to rapidly changing market conditions with the knowledge that our efforts will be ongoing. We look forward to continuing to work with Congress in this endeavor and we are happy to answer any questions you may have.

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[10] *In the Matter of Paradigm Capital Mgmt., Inc.*, File No. 3-15930, Rel. No. 72393 (June 16, 2014).

[11] *In the Matter of KBR, Inc.*, File No. 3-16466, Rel. No. 74619 (Apr. 1, 2015).

BRAD SHERMAN
UNITED STATES CONGRESS

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April 18, 2016

The Honorable Mary Jo White
Chair
The Securities and Exchange Commission
100 F St. NE
Washington, D.C. 20549

re: Research Expenses

Dear Chair White:

As we discussed during your November 18, 2015 testimony in front of the House Financial Services Committee, the Financial Accounting Standards Board (FASB) has not responded adequately to my concerns regarding its Statement of Financial Accounting Standards No. 2 ("FASB No. 2"). I urge you to use your oversight authority to prompt action to modernize FASB No. 2.

As you know, I have been among the strongest proponents for FASB independence, both among members of the Financial Services Committee and the Congress as a whole. Nonetheless, FASB's continued inaction in addressing FASB No. 2, an issue I consider of the utmost importance, has brought me near to questioning my faith in FASB. I must also question the SEC decision to rubber-stamp and enforce FASB pronouncements without any apparent concern for the impact of these pronouncements on the public interest.

FASB No. 2 requires accounting for expensing research and development expenditures in the year in which they are incurred. As a Certified Public Accountant, this rule has been an absurdity ever since its inception in 1974.

To quote my old accounting text, *Accounting Theory* by Eldon Hendrikson, "To the extent that R&D activities are carried out to develop new products, improve old ones, or reduce future operating costs, they are expected to benefit future periods rather than only the current period. Because future periods are expected to be benefitted, the knowledge gained is either an asset of the firm or an increase in the value of existing assets or of the firm as a whole. Therefore, according to the matching concept, the R&D costs should be capitalized and amortized over the period benefited." Virtually every accounting theorist would reach a similar conclusion.

FASB No. 2, however, fails to treat research expenditures as an asset of the firm. Instead of recognizing the obvious benefit that research expenditures bring to both a company and the economy as a whole, FASB No. 2 concludes that research cannot be expected to bring a future benefit, and must be expensed. FASB's policy, ultimately, is to treat all research expenditures as a failure from the outset, regardless of the eventual benefit we know these projects often produce.

FASB No. 2 represents both bad accounting policy and poor common sense. If a company builds a new state-of-the-art research facility, it may capitalize the bricks and mortar that go into the building. It cannot capitalize the research done in the building. If a company spends billions to research a process that leads to a valuable new patent, it must expense every penny that goes into developing the patent. If they then choose to sell that patent, the purchaser is allowed to capitalize and amortize the purchase price. These outcomes make no sense, and worse, may create strong disincentives against companies making research investments.

When you want to get less of something, you penalize it. When you want to get more of something, you incentivize it. Congress wants companies to conduct more research, which is why we have incentivized research with the establishment of the Research Tax Credit in the Tax Code (26 U.S.C. § 41). FASB, on the other hand, penalizes research by departing from good accounting theory – every dollar spent on research forces a reduction in reported earnings.

Nonetheless, Congress is spending $7.63 billion over ten years in Research Tax Credits to mitigate the harm done by FASB with FASB No. 2.[1] FASB No. 2, under the auspices of the SEC, requires a federal tax credit roughly the size of the SEC's budget. Of course, no one can determine whether FASB No. 2 does more or less harm to total research than the benefits provided by the Research Tax Credit, but it appears that FASB's continual mistake in its treatment of research probably does at least as much to decrease total research expenditures as the Research Tax Credit does to increase expenditures.

In the area of leasing, FASB departed from 200 years of tradition in the name of accounting theory. In the area of research, FASB clings to approximately 40 years of tradition and stands strong behind the mistake they made in 1974, even though it diverges from accounting theory. Sometimes FASB prefers accounting theory; sometimes it prefers tradition. The only consistency between these two mistakes is that both harm the national economy by deterring research on one hand and commercial construction on the other hand.

Do not believe statements by FASB that development costs may eventually be capitalized. I am not concerned about development costs. I am concerned about research costs. Congress wants to encourage research costs, which is why the Research Tax Credit exists.

Also, do not be led astray by FASB's statements that they will make changes to FASB No. 2 in conjunction with the ongoing convergence discussions between FASB and the International Accounting Standards Board (IASB). FASB has been providing this response for over a decade. To be sure, any change as a result of discussions with the IASB will be a tiny tweak, not a real change.

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[1] *See* https://www.jct.gov/publications.html?func=download&id=4677&chk=4677&no_html=1.

I urge you to use your oversight authority to prompt FASB to modernize FASB No. 2.

Sincerely,

Brad Sherman
Member of Congress

cc: Senator Mike Enzi
Senator Ron Johnson
Rep. Mike Conaway
Rep. Bill Flores
Rep. Lynn Jenkins
Rep. Patrick Murphy
Rep. Steven Palazzo
Rep. Collin Peterson
Rep. James Renacci
Rep. Tom Rice
Tom Quaadman

THE LABOR DEPARTMENT'S FIDUCIARY RULE: HOW A FLAWED PROCESS COULD HURT RETIREMENT SAVERS

A Majority Staff Report of the
Committee on Homeland Security and Governmental Affairs
United States Senate
Senator Ron Johnson, Chairman

February 24, 2016

EXECUTIVE SUMMARY

For millions of Americans, retirement saving is an important step in ensuring a comfortable standard of living well past employment. However, the process of saving for retirement can be difficult, confusing, and scary. To navigate the wide array of saving plans and options, individuals often turn to investment advisors for advice. A 2015 study reported that receiving investment advice significantly increases retirement savings.[1] According to the report, among individuals with $100,000 or less in annual income, individuals who receive investment advice save at least 38% more than individuals who do not receive investment advice.[2] For individuals of retirement age (65 and older), the disparity increases: advised individuals have more than double the assets of non-advised individuals.[3]

The Department of Labor issued a proposed rule ("rule," "proposed rule," or "proposal") on April 20, 2015, which would expand the definition of a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA). The Labor Department's proposed rule redefined the term "investment advice" to encompass activities that occur within pension and retirement plans, but that do not constitute investment advice under the existing definition of investment advice. The Labor Department touts its rule as a necessary reform to the investment advice industry to ensure that investment advisors avoid conflicts of interest and act in the best interest of their clients.

In February 2015, Senator Ron Johnson, Chairman of the Senate Committee on Homeland Security and Governmental Affairs, initiated an inquiry to examine the Labor Department's fiduciary rulemaking. This inquiry found that career, non-partisan professional staff at the Securities and Exchange Commission (SEC); regulatory experts at the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget (OMB); and Treasury Department officials expressed numerous concerns to the Labor Department about its proposed rule. Documents obtained by the Committee also indicate that officials at the Labor Department disregarded many of these concerns and declined to implement recommendations from the SEC, OIRA, and the Treasury Department. The majority staff found that the Labor Department frequently prioritized the expeditious completion of the rulemaking process at the expense of thoughtful deliberation. Additionally, the majority staff found indications that political appointees at the White House played a key role in driving the rulemaking process at the inception of the redrafting effort.

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[1] OLIVER WYMAN, THE ROLE OF FINANCIAL ADVISORS IN THE US RETIREMENT MARKET 16 (2015)
[2] *Id.*; *Restricting Advice and Education: DOL's Unworkable Investment Proposal for American Families and Retirees, Hearing Before the Subcomm. on Emp't & Workplace Safety of the S. Comm. on Health, Educ., Labor & Pensions*, 114th Cong. (2015) [hereinafter Senate HELP Committee Hearing] (statement of Peter Schneider, President, Primerica, Inc.).
[3] WYMAN, *supra* note 1; Senate HELP Committee Hearing (statement of Peter Schneider), *supra* note 2.

Specifically, the report's findings include the following information:

- Despite public assurances that the Labor Department had collaborated with the SEC, emails between a Labor Department employee and an SEC expert reveal discord between the agencies about the rulemaking. The Labor Department employee wrote to his SEC counterpart: "Well, I hate to break it to you, but you're wrong," and "**We have now gone far beyond the point where your input was helpful to me. . . . If you have nothing new to bring up, please stop emailing me**." The SEC staffer responded: "**I am now also utterly confused as to what the purpose of the proposed DOL rule is** . . . ."[4]
- Career, non-partisan SEC staff identified at least 26 items of concern related to the substantive content of the proposed rule, and the Labor Department declined to fully resolve all of the concerns.[5]
- After the Labor Department sought to address to the SEC's stated items of concern, a senior SEC official emphasized to the Labor Department that concerns remained:

  > *[W]e continue to believe that commentators are likely to raise concerns that the proposal may result in reduced pricing options, rising costs and limited access to retirement advice, particularly for retail investors. Commentators also may express concerns that broker-dealers, as a practical matter, may be unlikely to use the exemptions provided and may stop providing services because of the number of conditions imposed, likely compliance costs, and lack of clarity around several provisions.*[6]

- The Labor Department rejected the SEC's recommendation and ignored the requirements of Executive Orders 12866 and 13563 to quantify the costs and benefits of alternative approaches. As a Labor Department employee explained, "**We think this would be extraordinarily difficult and would appreciably delay the project for very little return . . . .**"[7]
- Treasury officials voiced concerns that the Labor Department's proposal, by attempting to regulate IRAs through the proposed rule, "fl[ies] in the face of logic" and was contrary to Congressional intent. The Labor Department promulgated the proposed rule less than two weeks after circulating this draft, undoubtedly limiting the extent to which the Department considered the comments it received from the Treasury Department.[8]
- The Administration was predetermined to regulate the industry and sought evidence to justify its preferred action. In emails to senior White House advisors, a Labor Department official wrote of the "**challenges in completing the [regulatory impact**

[4] *Infra* Part II(a).
[5] *Infra* Part II(a).
[6] *Infra* Part II(a).
[7] *Infra* Part II(a)(iv).
[8] *Infra* Part II(d).

analysis]" and of the need to find literature and data that **"can be woven together to demonstrate that there is a market failure and to monetize the potential benefits of fixing it."** In another email, a Labor Department official discussed **"building the case for why the rule is necessary."**[9]

- The Labor Department rejected OIRA's recommendation to add language stating that the rule would "permit firms to continue *to rely on all* common fee and compensation practices . . . ." The Labor Department responded that "[n]ot all fee practices will be permitted by the exemptions" and that "[b]y deleting 'all' we slightly soften this by leaving it at 'common fee and compensation practices.'"[10]

Investment advisors, in general, do not dispute the importance of acting in the best interest of their clients, and many advisors already abide by a best interest standard.[11] However, experts have criticized the proposed rule as burdensome and complex,[12] and have challenged the Labor Department's claims that the rule will generate benefits for investors.[13] They contend that the Administration has reported inflated numbers for the harm that results from investors relying on "conflicted advice,"[14] with one expert opining "[y]ou don't have to be an economist to recognize the Administration's $17 billion talking point significantly overestimates the costs, if any, to investors relying on the 'conflicted advice' of brokers."[15] Experts also caution that the proposal's conditions and requirements would create uncertainty for investment advisors and would increase compliance costs and litigation risks. They warn that the Labor Department's analysis overstates the rule's benefits and that the rule could actually result in net losses to retirement savers.[16] These experts emphasize that the rule would actually harm the investors it is supposed to protect; the rule would drive up the price of investment advice and would ultimately decrease the availability of advice for low- and middle-income investors.

A 2015 report estimates that the rule will cause a loss of retirement savings of $68–80 billion per year, and will "jeopardize retirement readiness for 11.9 million IRA and retirement participants."[17] Robert Litan, an economist and attorney who served as the associate director of

[9] *Infra* Part IV.
[10] *Infra* Part II(c).
[11] *E.g.*, Senate HELP Committee Hearing, *supra* note 2 (statement of Robert Litan).
[12] *Id.*
[13] *Id.* (statement of Peter Schneider); QUANTRIA STRATEGIES, LLC, UNINTENDED CONSEQUENCES: POTENTIAL OF THE DOL REGULATIONS TO REDUCE FINANCIAL ADVICE AND ERODE RETIREMENT READINESS 1 (2015) (prepared for Davis & Harman).
[14] EXEC. OFFICE OF THE PRESIDENT, THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS (2015).
[15] Craig M. Lewis, *An Inflated $17 Billion Talking Point From the DOL*, FORBES (Dec. 16, 2015, 12:30 PM), http://www.forbes.com/sites/realspin/2015/12/16/an-inflated-17-billion-talking-point-from-the-dol/#782b028439e1.
[16] QUANTRIA STRATEGIES, *supra* note 13, at 1; Senate HELP Committee Hearing, *supra* note 2 (statement of Robert Litan).
[17] QUANTRIA STRATEGIES, *supra* note 13, at 1; Senate HELP Committee Hearing, *supra* note 2 (statement of Peter Schneider).

the White House budget office in the Clinton Administration, predicts that seven million or more small investors could lose their brokers as a result of the rule.[18] This would be costly to investors, who may make worse investing decisions when they do not receive human investment advice.[19]

Some observers suggest that this is actually an *intended* effect of the rule, and that the Labor Department believes that low- and middle-income investors should receive advice primarily from robo-advisors to avoid conflicts of interest.[20] If accurate, it is alarming that the Labor Department is intentionally restricting low- and middle-income investors to robo-advice based on a presumption that those investors lack the sophistication to interact with an individual investment advisor and to understand options presented to them.

As the majority staff puts forward its findings, it is important to note that Chairman Johnson performed this oversight in the face of continuous obstruction from the Labor Department. In February 2015, Chairman Johnson requested documents, including communications between the Labor Department and the White House and between the Labor Department and the SEC. However, to date, the Labor Department has not fulfilled Chairman Johnson's requests. The Labor Department has produced no material responsive to Chairman Johnson request for communications between the Department and the White House. The Department initially claimed that no responsive documents existed, but refused to provide Chairman Johnson with information about how Labor Department officials searched for documents. Chairman Johnson later received, from the SEC, communications between the Department and the White House. Additionally, the Department has produced only a limited subset of self-selected communications between the Department and the SEC and provided short briefings to the Committee. These productions fall short of full compliance. Most egregiously, the Labor Department even urged the SEC to similarly hinder Chairman Johnson's oversight work by asking the SEC to reject the Chairman's separate requests to the SEC for documents in the control and possession of the SEC.

Due to the Labor Department's obstructionism, Chairman Johnson and the majority staff have not had the opportunity to review the full universe of documents and communications related to the rule. The analysis and findings in this report are based on the information received. However, the information that Chairman Johnson was able to obtain strongly suggests that the Labor Department engaged in a flawed rulemaking process to craft a rule that will hurt millions of American retirement savers.

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[18] Senate HELP Committee Hearing, *supra* note 2 (statement of Robert Litan).
[19] *Id.*
[20] *Id.*

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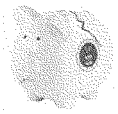

I. INTRODUCTION

On April 20, 2015, the Department of Labor issued a proposed rule to expand the definition of a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA).[21] The Labor Department's proposed rule redefined the term "investment advice" to encompass activities that occur within pension and retirement plans, but do not constitute investment advice under the existing definition of investment advice.[22] The Labor Department's promulgation of this rule was the culmination of a years-long effort by the Department's Employee Benefits Security Administration (EBSA).[23]

Even before the latest proposal was announced, stakeholders began raising concerns that the rule would adversely affect access to investment advice for low- and middle-income Americans.[24] Additional questions were raised about the close involvement of the White House in shaping the proposal.[25] In light of these concerns, Senator Ron Johnson, Chairman of the Senate Committee on Homeland Security and Governmental Affairs, initiated an inquiry in early February 2015.[26]

Under Senate rules and precedent, the Committee has legislative jurisdiction over intergovernmental relations and the regulatory process of the federal government. The Committee also has specific authority to examine "the efficiency and economy of all branches and functions of Government with particular references to the operations and management of Federal regulatory policies and programs."[27] Chairman Johnson initiated the inquiry pursuant to these authorities.

Chairman Johnson sought to examine the Labor Department's rulemaking process to ensure that the Department solicited and fully considered advice from career, non-partisan professionals with expertise in the proposal's subject matter.[28] As part of its inquiry, Chairman Johnson requested information and documents from the Securities and Exchange Commission

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[21] CONG. RESEARCH SERV., R44207, DEPARTMENT OF LABOR'S 2015 PROPOSED FIDUCIARY RULE: BACKGROUND AND ISSUES 1 (2015).
[22] *Id.*
[23] Mark Schoeff, *DOL Proposal of Fiduciary-Duty Rule Delayed Again*, INVESTMENT NEWS (May 28, 2014, 8:30 AM), http://www.investmentnews.com/article/20140528/FREE/140529932/dol-proposal-of-fiduciary-duty-rule-delayed-again.
[24] *Id.*
[25] *E.g.*, Melanie Waddell, *White House Getting Involved with DOL Fiduciary Redraft*, THINK ADVISOR (July 1, 2014), http://www.thinkadvisor.com/2014/07/01/white-house-getting-involved-with-dol-fiduciary-re.
[26] Appendix A, Ex. 1, Letter from Hon. Ron Johnson, Chairman, S. Comm. on Homeland Sec. & Governmental Affairs (HSGAC), to Hon. Thomas E. Perez, Sec'y, U.S Dep't of Labor (DOL) (Feb. 5, 2015).
[27] S. Res. 73 § 12, 114th Cong. (2015).
[28] *See* Appendix A, Ex. 1, Letter from Chairman Johnson to Sec'y Perez, DOL (Feb. 5, 2015); Appendix A, Ex. 2, Letter from Chairman Johnson to Sec'y Perez, DOL (Mar. 17, 2015).

(SEC),[29] the Financial Industry Regulatory Authority (FINRA),[30] the Office of Information and Regulatory Affairs (OIRA),[31] the Department of the Treasury,[32] and the Labor Department.[33] In response, the SEC provided three document productions to the Committee.[34] These productions, which the SEC made despite the Labor Department's attempt to persuade the SEC to reject the Chairman's requests,[35] shed significant light on the recommendations and concerns that career, non-partisan, professional staff at the SEC provided prior to the release of the proposal. The SEC documents also shed light on aspects of the recommendations and concerns offered by regulatory experts at OIRA and from Treasury Department officials. FINRA additionally provided two document productions to the Committee.[36] OIRA provided one document production, although it was largely nonresponsive to Chairman Johnson's requests.[37] Finally, the Committee received a limited subset of documents from the Labor Department regarding its communications with the SEC; however, the Labor Department continues to withhold other responsive documents from the Committee.[38]

Based on the information received by the Committee, the majority staff has found that career, non-partisan, professional staff at the SEC, regulatory experts at OIRA, and Treasury Department officials expressed concerns to the Labor Department about its proposed rule. While Chairman Johnson and the majority staff do not have access to the entirety of Labor Department records, it appears that the Labor Department ignored and rejected many concerns and recommendations by subject-matter and regulatory experts.

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[29] Appendix A, Ex. 3, Letter from Chairman Johnson to Hon. Mary Jo White, Chair, SEC (Apr. 21, 2015); Appendix A, Ex. 4, Letter from Chairman Johnson to Chairwoman White, SEC (May 20, 2015); Appendix A, Ex. 5, Letter from Chairman Johnson to Chairwoman White, SEC (July 13, 2015).

[30] Appendix A, Ex. 6, Letter from Chairman Johnson to Richard Ketchum, Chairman, FINRA (Sept. 16, 2015).

[31] Appendix A, Ex. 7, Letter from Chairman Johnson Hon. Howard Shelanski, Admin'r, OIRA (May 1, 2015); Appendix A, Ex. 8, Letter from Chairman Johnson to Admin'r Shelanski, OIRA (Dec. 3, 2015).

[32] Appendix A, Ex. 9, Letter from Chairman Johnson to Hon. Jacob Lew, Sec'y, Treasury Dep't (Nov. 12, 2015).

[33] Appendix A, Ex. 3, Letter from Chairman Johnson to Chairwoman White, SEC (Apr. 21, 2015).

[34] Appendix A, Ex. 10, Letter from Chairwoman White, SEC, to Chairman Johnson (May 5, 2015); Appendix A, Ex. 11, Letter from Tim Henseler, Dir., Office of Leg. & Intergovernmental Affairs, SEC, to Chairman Johnson (July 27, 2015); Appendix A, Ex. 12, Letter from Tim Henseler, SEC, to Chairman Johnson (Sept. 15, 2015); Appendix A, Ex. 13, Letter from Tim Henseler, SEC, to Chairman Johnson (Nov. 25, 2015) (complete document productions on file with Committee).

[35] Appendix A, Ex. 14, Letter from Adri Jayaratne, Acting Asst. Sec'y, Office of Cong. & Intergovernmental Affairs, DOL, to Chairman Johnson (July 8, 2015).

[36] Appendix A, Ex. 15, Letter from Robert Colby, Exec. VP & Chief Legal Officer, FINRA, to Chairman Johnson (Oct. 15, 2015); Appendix A, Ex. 16, Letter from Robert Colby, FINRA, to Chairman Johnson (Oct. 29, 2015).

[37] Appendix A, Ex. 17, Letter from Admin'r Shelanski, OIRA, to Chairman Johnson (May 18, 2015); Appendix A, Ex. 18, Letter from Admin'r Shelanski, OIRA, to Chairman Johnson (Jan. 20, 2016).

[38] Appendix A, Ex. 19, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (Feb. 9, 2015); Appendix A, Ex. 20, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (Feb. 23, 2015);Appendix A, Ex. 21, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (Mar. 23, 2015); Appendix A, Ex. 22, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (Apr. 3, 2015); Appendix A, Ex. 23, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (June 15, 2015); Appendix A, Ex. 14, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (July 8, 2015); Appendix A, Ex. 24, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (July 27, 2015).

The Department's proposal appears to be a solution in search of a problem, driven by ideology rather than a market need. As a result, some studies suggest that the proposal could result in losses to retirement savers of $68–80 billion each year and will drive smaller investment advisors out of the marketplace.[39] Experts have criticized the Labor Department's rule as burdensome and complex and caution that the rule's conditions and requirements will create uncertainty for investment advisors and drive up compliance costs and litigation risks.[40] Ultimately, the rule will likely prompt investment advisors to increase the price of services they offer to investors and to reduce the services they provide to middle-income investors.[41]

II. THE LABOR DEPARTMENT DECLINED TO INCORPORATE RECOMMENDATIONS FROM SUBJECT-MATTER AND REGULATORY EXPERTS

a. The Labor Department Declined to Incorporate Recommendations from Career Experts at the SEC into the Proposed Rule

Under the Dodd-Frank Act, the SEC has authority to regulate standards of care for broker-dealers and investment advisers.[42] Section 913 of the Dodd-Frank Act directed the SEC to examine existing regulations, evaluate their potential effects on retail customers, and to recommend fiduciary standards to govern the industry.[43] Additionally, based on the authority granted by the Investment Advisers Acts in 1940, the SEC has historically regulated the investment industry.[44] The SEC is, therefore, the proper entity with the appropriate securities law expertise, to consider issues such as requiring a best interest standard for investment advisors. The SEC has reported plans to issue a uniform regulation governing retail investment advice, which could result in "two incredibly burdensome and redundant rules"[45] disseminated by the Labor Department and the SEC.[46]

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[39] QUANTRIA STRATEGIES, *supra* note 13, at 1.
[40] *Infra* Part III.
[41] *Infra* Part III.
[42] The Dodd-Frank Wall Street Reform and Consumer Protection Act § 913, 124 Stat. 1376 (2010).
[43] *Id.*; MEGAN MILLOY, AM. ACTION FORUM, DOL'S PROPOSED FIDUCIARY RULE: NOT IN THE BEST INTEREST OF INVESTORS (2015).
[44] Investment Advisers Act of 1940, 15 U.S.C. § 80b-1.
[45] Appendix A, Ex. 25, Letter from Daniel Gallagher, Comm'r, SEC, to Sec'y Perez, DOL (July 21, 2015).
[46] SEC Office of Mgmt. & Budget Fall Agenda, Personalized Investment Advice Standard of Conduct, *available at* http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201510&RIN=3235-AL27 (scheduling a notice of proposed rulemaking for October 2016); Mark Schoeff, Jr., *SEC's Mary Jo White Says Agency Will Develop Fiduciary Rule for Brokers*, INVESTMENT NEWS (Mar. 17, 2015, 12:31 PM), http://www.investmentnews.com/article/20150317/FREE/150319919/secs-mary-jo-white-says-agency-will-develop-fiduciary-rule-for.

The Labor Department has authority under ERISA to regulate private-sector, employer-provided benefit plans. However, according to the former head of EBSA, the Labor Department has significantly departed from its traditional view of its jurisdiction by attempting to regulate compensation and conduct for *all* types of financial advisors, including registered investment advisors and registered representatives of broker dealers.[47] At a minimum, given the SEC staff's expertise in securities regulation and the potential for conflict between the two rules, the Labor Department should have ensured that its rule incorporated recommendations and addressed concerns voiced by professional experts at the SEC.

However, former SEC Commissioner Daniel Gallagher emphasized that the Labor Department did not collaborate with the SEC in the rulemaking process.[48] Commissioner Gallagher called the rulemaking a "fait accompli" and criticized the comment process for being "merely perfunctory."[49] Commissioner Gallagher dispelled Department of Labor Secretary Thomas Perez's claims that the Labor Department "met substantively" with career, non-partisan staff at the SEC, pointing out that Commissioner Gallagher was not included in any such conversations.[50] Commissioner Gallagher wrote that, in contrast to Secretary Perez's claims, "the [Labor Department's] actions, and the substance of the [Labor Department] Fiduciary Proposal, reflect a lack of concern for the [SEC's] views on these issues."[51] He continued:

> Strikingly, the Fiduciary Proposal does not contemplate or even mention potential SEC rules or the SEC's existing regime for regulating broker-dealers and investment advisers. If the DOL were actually serious about working together with the SEC on an implementable standard, it could have—and should have—included in its proposal some type of substituted compliance mechanism, in which compliance with an SEC fiduciary standard would satisfy the DOL rules.[52]

Chairman Johnson has obtained information that supports Commissioner Gallagher's position that the Labor Department failed to work in good faith with the career, non-partisan, professional staff at the SEC. For more than a year preceding the Labor Department's promulgation of the proposed rule, SEC staff received draft portions of the proposed rulemaking package, including a draft regulatory impact analysis, draft global exemption (Best Interest Contract Exemption), and background on the point of sale disclosure.[53] Communications between the Labor Department and the SEC staff reveal numerous instances in which the Labor Department requested advice from SEC staff on fundamental aspects of the proposal, but

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[47] *Hearing on the Department of Labor's Proposed Fiduciary Rule Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 114th Cong. (2015) [hereinafter House Ways & Means Committee Hearing] (statement of Bradford Campbell).
[48] Appendix A, Ex. 25, Letter from Comm'r Gallagher, SEC to Sec'y Perez, DOL (July 21, 2015).
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] Briefing by Staff, DOL, to Committee Staff, HSGAC (Aug. 28, 2015) (notes on file with Committee).

disagreed with the SEC's recommendations and, in doing so, disregarded the SEC staff's subject-matter expertise.

Although Secretary Perez publicly assured stakeholders that the Labor Department collaborated with the SEC and "worked extensively with colleagues throughout the government, including and especially the [SEC],"[54] documents obtained by the Committee paint another picture. A series of emails in July and August 2012 reveal disagreements between Labor Department staff and SEC staff about the type of improper activity the proposal should measure. The SEC staff suggested that the proposal should measure conflicts of interest, whereas the Labor Department sought to measure investment returns.[55] These men were apparently classmates in a PhD program—which may account for the candid tone of the emails—but the email exchange suggests that the Labor Department disregarded an SEC expert's serious concerns about the rule.[56] In one email, after a lengthy discussion of the proposal, a Labor Department staffer wrote to an SEC staffer:[57]

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[54] Senate HELP Committee Hearing, *supra* note 2 (statement of Thomas Perez, Sec'y of Labor).

[55] Appendix B, Ex. 1, Emails between Matthew Kozora, SEC, and Keith Bergstresser, U.S. Dep't of Labor (July 2012), SEC-DOL008040–008052.

[56] The Labor Department represented to Committee staff that the Labor Department employee, Keith Bergstresser, and the SEC employee, Matthew L. Kozora, attended school together. Mr. Bergstresser received a Ph.D. in Economics from the University of Maryland, College Park, in 2009, and has been an economist at the Labor Department since June 2009. *See* Linkedin.com, Keith Bergstresser, https://www.linkedin.com/in/keith-bergstresser-10651482. He serves in the Office of Policy and Research within the Employee Benefits and Security Administration. *In re: Conflict of Interest Proposed Rule, Related Exemptions, and Regulatory Impact Analysis Hearing*, U.S. Dep't of Labor, Employee Benefits Security Admin. (Aug. 11, 2015). Mr. Bergstresser reports to the head of EBSA, Assistant Secretary Phyllis Borzi, a presidentially appointed official who has been described as the "main architect" of the fiduciary rule. Melanie Waddell, *DOL to 'Simplify and Streamline' Fiduciary Rule: Borzi*, THINKADVISOR (Oct. 20, 2015). Mr. Kozora received a Ph.D. in Finance from the University of Maryland, College Park, in 2010, and has been a financial economist at the SEC since 2010. *See* Matthew L. Kozora, Financial Economist, Office of Asset Management, SEC.gov, http://www.sec.gov/divisions/riskfin/economistbios/matthew-l-kozora.shtml. Mr. Kozora serves in the Office of Asset Management within the Division of Economic and Risk Analysis. *Id.* As the SEC's "think tank," the Division provides "detailed, high-quality economic and statistical analyses, and specific subject-matter expertise . . . ." *About the Division of Economic and Risk Analysis*, SEC.GOV, https://www.sec.gov/dera/about. Ultimately, the SEC's regulatory authority is vested in a bipartisan, five-member commission who serve staggered terms—in the words of the SEC, "ensuring non-partisanship." *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC.GOV, https://www.sec.gov/about/whatwedo.shtml. While both men possess financial expertise, the different structures of their respective agencies and the Labor Department's advocacy for the rulemaking appear to have caused the men to adopt differing opinions about the Labor Department's proposal.

[57] Appendix B, Ex. 1, Email from Keith Bergstresser, U.S. Dep't of Labor, to Matthew Kozora, SEC (July 31, 2012, 1:49 PM), SEC-DOL008057–008058.

From: Bergstresser, Keith - EBSA [redacted]@dol.gov]
Sent: Tuesday, July 31, 2012 1:50 PM
To: Kozora, Matthew
Subject: RE: question

Well, I hate to break it to you, but you're wrong. People do not respond to fees or any other costs, but they do chase returns. This and our other reasons for choosing the disclosure that we have developed are laid out in the document that we've already sent over to you (attached). You might try reading the paragraph labeled "Portfolio Returns" on page 4. And do look into the references. They are very convincing.

In a later email, Labor Department staff dismissively wrote to the SEC financial economist:[58]

From: Bergstresser, Keith - EBSA[redacted]@dol.gov]
Sent: Tuesday, July 31, 2012 3:23 PM
To: Kozora, Matthew
Subject: RE: question

See my responses below. We have now gone far beyond the point where your input was helpful to me. You keep circling back to the same statements, many of which are unsupported conjectures on your part, and most of which I have addressed even before you brought them up. Yet, your statements do not seem to even acknowledge the points that I already made (with supporting evidence) in the document we sent. If you have nothing new to bring up, please stop emailing me about this topic.

[58] Appendix B, Ex. 1, Email from Keith Bergstresser, U.S. Dep't of Labor, to Matthew Kozora, SEC (July 31, 2012, 3:22 PM), SEC-DOL008056.

The SEC financial economist responded, expressing confusion about the fundamental purpose of the Labor Department's proposal:[59]

From: Kozora, Matthew [redacted]@SEC.GOV]
Sent: Tuesday, July 31, 2012 3:43 PM
To: Bergstresser, Keith - EBSA
Subject: RE: question

I apologize if I have overstepped my boundaries. This is a difficult topic for sure, and I was under the impression that my opinion was a. helpful and b. wanted.

I am also now utterly confused as to what the purpose of the proposed DOL rule is then, if not to limit advisor conflicts when providing retirement advice? Considering that my prior is that the DOL wants to reduce advisor conflicts, it just seems logical to me that the end result should measure advisory conflicts.

Good luck with your rulemaking.

Matt

Finally, SEC staff expressed concern about "intent of the measure itself," and wrote that the SEC and the Labor Department "just have two opposing viewpoints on the matter."[60] Labor Department staff deferred continuing the conversation to a later date,[61] but documents the Committee received provide no indication of future discussion on this topic. The SEC staff also raised concerns about the Labor Department's reliance on psychology literature to draft the rule, which would result in comparisons that "have very little economic meaning and thus no value to consumers."[62]

[59] Appendix B, Ex. 1, Email from Matthew Kozora, SEC, to Keith Bergstresser, U.S. Dep't of Labor (July 31, 2012, 3:42 PM), SEC-DOL008055–008056.
[60] Appendix B, Ex. 1, Email from Matthew Kozora, SEC, to Keith Bergstresser, U.S. Dep't of Labor (Aug. 2, 2012, 11:57 AM), SEC-DOL008054–008055.
[61] Appendix B, Ex. 1, Email from Keith Bergstresser, U.S. Dep't of Labor, to Matthew Kozora, SEC (Aug. 2, 2012, 2:00 PM), SEC-DOL008054.
[62] Appendix B, Ex. 1, Email from Matthew Kozora, SEC, to Keith Bergstresser, U.S. Dep't of Labor (Aug. 2, 2012, 11:57 AM), SEC-DOL008054–008055.

From: Bergstresser, Keith - EBSA [redacted]@dol.gov]
Sent: Tuesday, July 31, 2012 4:15 PM
To: Kozora, Matthew
Subject: RE: question

I would be happy to have a phone conversation to discuss the purpose of the rule, the purpose of the exemption conditions and distinctions between the two. don't think I want to try to have that conversation via email. I might have some time tomorrow, but I'm at a conference Thursday and Friday and then on vacation next week.

From: Kozora, Matthew [redacted]@SEC.GOV]
Sent: Thursday, August 02, 2012 11:57 AM
To: Bergstresser, Keith - EBSA
Subject: RE: question

Dear Keith,

There is a fundamental difference between price variation and the risk investors bear. For instance, prices may not change over a given period of time but yet investors might still bear much risk. There will also be problems with respect to measuring price variation with respect to illiquid securities or securities that are not traded very often (muni bonds, structured products, real estate). You are also treating systematic risk with idiosyncratic risk equally. Literature tells us (Sharpe (1964), Lintner (1965)) that such risks are not the same and should be treated much differently.

I understand you want to measure returns due to the psychology literature, however, I am quite concerned your benchmarks based on ex-post price variation will make such comparisons have very little economic meaning and thus no value to consumers. I am also concerned as to the intent of the measure itself. Do you want to "weed out" bad providers of advice by reporting performance measures? Or do you want to "protect participants from conflicts of interest" as proposed rule suggests? Those are two separate and different intents.

If/when you have a formal rule proposal that you want comments on, I will be more than happy to share my thoughts and views. Otherwise, I think we just have two opposing viewpoints on the matter.

Matt

It is evident from these emails that the SEC's expert staff had serious concerns about the rule. The financial economist at the SEC emailed Labor Department staff repeatedly and expressed serious concerns about fundamental principles of the rule. However, not only did the Labor Department dismiss the concerns, but the Department went a step further by actually demanding that the SEC expert stop emailing about the proposal.

The Labor Department restricted the Committee's review of these emails to a limited *in camera* review.[63] The Committee, however, ultimately obtained the communications from another source.

The SEC received the full proposed rulemaking package from the Labor Department in November 2014 and exchanged edits and comments with the Labor Department in January 2015.[64] Career, non-partisan SEC staff identified at least 26 items of concern related to the substantive content of the proposed rule.[65] The SEC staff's concerns included issues of clarity in the rule's "best interest" standard, inadvertent consequences of a *de minimis* breach, conflicts with federal securities laws and FINRA rules, and a lack of cost-benefit analysis of alternatives.[66] The SEC's point of contact in transmitting these concerns to the Labor Department was Sharon Block, a Senior Counselor to the Secretary of Labor, who formerly served as a political advisor in the Obama Administration, and whom President Obama recess appointed to be a member of the National Labor Relations Board, an appointment ultimately struck down by the Supreme Court.[67] The Labor Department repeatedly provided an incomplete response, declined to accept the SEC staff's recommendations, or incorrectly implemented the SEC expert's recommendations.[68] Specifically, in response to eight recommendations, the Labor Department declined to edit the operative language of the proposal, and instead merely modified or added language in the proposal's preamble.[69] The Labor Department outright rejected the SEC's two recommendations related to providing a quantitative cost-benefit analysis of considered alternatives to the rule.[70] Finally, the Labor Department implemented incorrect or

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[63] The Department of Labor provided Committee staff with an *in camera* review of a limited subset of self-selected documents on August 28, 2015. Notes are on file with the Committee.
[64] *See* Appendix B, Ex. 2, E-mail from Lona Nallengara, SEC, to Sharon Block, DOL (Jan. 26, 2015, 7:36 PM), SEC-DOL003234–003239 [hereinafter Items of Concern Chart] (attachment is a chart containing items of concern about the proposed rule).
[65] *Id.*
[66] *Id.*
[67] Edward-Isaac Dovere, *White House Pulls Controversial NLRB Pick*, POLITICO (Nov. 12, 2014), http://www.politico.com/story/2014/11/nlrb-sharon-block-lauren-mcferran-112833; Melanie Trottman, *President Obama Taps Former NLRB Recess Appointee for Board Again*, WSJ (July 11, 2014, 3:34 PM), http://www.wsj.com/articles/president-obama-taps-former-nlrb-recess-appointee-for-board-again-1405101028.
[68] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239.
[69] *Id.*
[70] *Id.*

insufficient edits in response to at least four of the SEC's recommendations, evidenced by the SEC staff's follow-up on multiple issues of concern.[71]

Following the SEC staff's exchange of recommendations and concerns with the Labor Department, SEC experts continued to raise concerns "regarding the complexity of the proposal," and noted that the Labor Department had not fully addressed the SEC staff's enumerated issues of concern.[72] Then-SEC Chief of Staff Lona Nallengara, who has 20 years of experience in capital markets and corporate finance law,[73] explained in a January 26, 2015 email to Ms. Block:[74]

[71] Appendix B, Ex. 3, Email from Lona Nallengara, SEC, to Sharon Block, DOL (Jan. 26, 2015), SEC-DOL003274–003276.
[72] *Id.*
[73] Press Release, SEC, SEC Chief of Staff Lona Nallengara to Leave Agency (May 19, 2015).
[74] Appendix B, Ex. 3, Email from Lona Nallengara, SEC, to Sharon Block, DOL (Jan. 26, 2015), SEC-DOL003274–003276.

To: Nallengara, Lona[redacted]@SEC.GOV]
Cc: Hauser, Timothy - EBSA[redacted]@dol.gov]; Porter, Jennifer R[redacted]@SEC.GOV]
From: Block, Sharon I - OSEC
Sent: Mon 1/26/2015 7:40:58 PM
Importance: Normal
Subject: RE: EBSA responses to SEC comments

Thanks Lona. We appreciate all the time your team has put in and their thoughtful comments.

From: Nallengara, Lona[redacted]@SEC.GOV]
Sent: Monday, January 26, 2015 7:37 PM
To: Block, Sharon I - OSEC
Cc: Hauser, Timothy - EBSA; Porter, Jennifer R.
Subject: RE: EBSA responses to SEC comments

Sharon,

Thank you for sending the chart showing your responses to SEC staff comments on the rule package that we discussed with you in December.

We asked the staff to review the chart and below are a few additional thoughts from the staff on several of the items that you can consider as you prepare your proposal (the staff has identified their comments using the item numbers in your chart).

I would also like to note that although the chart shows that several changes were made to the proposal to address the potential concerns that we have discussed regarding the complexity of the proposal, we continue to believe that commenters are likely to raise concerns that the proposal may result in reduced pricing options, rising costs and limited access to retirement advice, particularly for retail investors. Commenters also may express concerns that broker-dealers, as a practical matter, may be unlikely to use the exemptions provided and may stop providing services because of the number of conditions imposed, likely compliance costs, and lack of clarity around several provisions.

We hope these comments will continue to be helpful to you as you finalize the proposed rules.

- Lona

Documents received by the Committee and language in the promulgated proposed rule indicate that the Labor Department declined to resolve these outstanding concerns.

i. The "Best Interest" Standard

SEC staff recommended that the Labor Department add language to clarify the meaning of the term "best interest" in the proposal.[75] The Labor Department disregarded the recommendation, and stated that they "would prefer to see what commenters say before adding any additional explanatory language."[76]

Indeed, commentators criticized the "best interest standard" in the promulgated proposal and recommended that the Labor Department clarify the standard's requirements.[77] FINRA, the self-regulatory organization for the securities industry, focused on language requiring an investment advisor to provide advice that is in the best interest of the investor, "*without regard to the financial or other interests*" of the investment advisor.[78] FINRA explained that the "without regard to" phrase does not provide clear guidelines on limitations on compensation that varies depending on investment advice.[79]

Additionally, FINRA criticized the "best interest" standard's requirement that financial institutions and advisors act prudently, explaining that the "prudence standard" could be "interpreted to require the financial institution and adviser to provide ongoing advice to the customer."[80] FINRA recommended that the Labor Department make clear that the best interest standard does not require ongoing monitoring, and that the terms of the contract should control whether the financial institution or advisor will provide ongoing monitoring.[81]

Finally, FINRA questioned whether the Labor Department intended the best interest standard to require an investment advisor "to recommend the investment that is 'best' for the customer."[82] FINRA reasoned that the Labor Department did intend such a result, and pointed to a statement by Secretary Perez, in which he stated:

> If you're an adviser operating under a suitability standard, once you narrow the options down to those that are suitable, you can recommend the one that is most lucrative for you—even though that might mean a lower return for the client. Under a best interest standard, you would need to choose the one that is the best for the client.[83]

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[75] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239.
[76] *Id.*
[77] Appendix A, Ex. 26, Letter from Marcia E. Asquith, Sr. Vice President & Corp. Sec'y, FINRA, to DOL, at 6–8 (July 17, 2015) [hereinafter FINRA Comments].
[78] *Id.* at 6 (emphasis added).
[79] *Id.*
[80] *Id.* at 7.
[81] *Id.* at 8.
[82] *Id.* at 7.
[83] *Id.*

FINRA cautioned that such a standard "would impose unnecessary and untenable litigation risks on fiduciaries," and explained that reasonable investment advisors may consider different factors in evaluating products and may reach different conclusions about which product is the "best" product for the customer.[84]

ii. Accidental Forfeiture of the Best Interest Contract Exemption in Case of a de Minimis Breach

SEC staff raised a concern about language in the proposal's Best Interest Contract Exemption, which required compliance with all applicable federal and state laws.[85] SEC staff warned that this requirement "could result in loss of exemption for trivial breaches," and suggested that the Labor Department clarify that a *de minimis* breach would not disallow the exemption.[86] According to this language, if an advisor violated a state law unrelated to the contract or to the service of providing investment advice, the advisor would not be compliant with applicable state laws, which could technically result in loss of the exemption. For example, an advisor's violation of a state law requiring a handicap-accessible ramp at the entrance to the building could result in loss of the exemption. The Labor Department attempted to implement the SEC staff's suggestion,[87] but failed to resolve the problem. The SEC staff again recommended that the Labor Department make additional changes to this provision of the rule.[88] Career experts at the SEC later advised Labor Department officials that this problem had not been resolved, but the Labor Department failed to address the issue in the final proposal.[89]

Specifically, Section II(a) of the Best Interest Contract Exemption in the proposal requires that "the Advisor and Financial Institution enter into a written contract with the Retirement Investor that *incorporates the terms required by Section II(b)–(e).*"[90] Section II(d), in turn, requires that "[t]he Adviser, Financial Institution, and Affiliates will comply with all applicable federal and state laws."[91] As such, by its terms, the Section could cause an advisor to forfeit the exemption for a small breach of state contract law.

Despite feedback from career, expert SEC staff regarding the inadequate revision three months in advance of the promulgation of the proposed rule,[92] the Labor Department declined to

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[84] *Id.*
[85] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239.
[86] *Id.*
[87] *Id.* (responding that "as a result, failure to comply with law will not disallow the exemption").
[88] Appendix B, Ex. 3, Email from Lona Nallengara, SEC, to Sharon Block, DOL (Jan. 26, 2015), SEC-DOL003274–003276.
[89] *Id.*
[90] Best Interest Contract Exemption § II(a), 80 Fed. Reg. 21,960, 21,984 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550) (emphasis added).
[91] Best Interest Contract Exemption § II(d)(1), 80 Fed. Reg. at 21,984.
[92] Appendix B, Ex. 3, Email from Lona Nallengara, SEC, to Sharon Block, DOL (Jan. 26, 2015), SEC-DOL003274–003276.

update the rule. Therefore, the proposed rule contains language that requires compliance with federal and state laws for application of the exemption[93] and creates the possibility of forfeiture of the exemption in case of a trivial breach.[94]

iii. Lack of a Cost-Benefit Analysis for Alternative Approaches

The Labor Department rejected the SEC's recommendation to conduct quantitative analysis of the costs and benefits of alternative approaches to the rule, as required by Executive Orders (EOs) 12866 and 13563.[95] According to the Labor Department, expert, non-partisan, career SEC staff urged the Labor Department to "[c]onsider quantifying the costs and benefits of all the alternative approaches we considered and rejected."[96] The Department rejected the SEC expert's recommendation on the basis that its qualitative analysis sufficed:

> We think this would be extraordinarily difficult and would appreciably delay the project for very little return. The extensive *qualitative* descriptions of the bases for rejecting the alternatives included in the current [regulatory impact analysis] effectively explain the bases for rejecting the alternative approaches. We would prefer to get feedback from OMB before undertaking any additional quantitative analyses.[97]

The Labor Department informed the Committee that following OMB's review of the rule, the Department declined to complete quantitative analysis because it found the regulatory impact analysis to be sufficiently "compelling."[98]

SEC staff also recommended that the Labor Department analyze the costs and risks associated with the possibility that the rule could decrease the availability of investment advice and could drive firms to switch to registered investment advisor models from broker-dealer models.[99] The Labor Department responded that the regulatory impact analysis addressed these

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[93] Best Interest Contract Exemption § II(a), II(d)(1), 80 Fed. Reg. at 21,984.
[94] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239.
[95] Exec. Order No. 12866, 3 C.F.R. 638 (1994); Exec. Order No. 13563, 3 C.F.R. 215 (2012).
[96] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239. From the context of the document, it appears that "we" as used in this quotation refers to the Labor Department, rather than the Labor Department and the SEC collectively. The document was prepared by the Labor Department and transmitted to the SEC. *See* Appendix B, Ex. 2, Email from Sharon Block, DOL, to Lona Nallengara, SEC (Jan. 9, 2015), SEC-DOL003234. Elsewhere in the document, the drafters used "we" to the exclusion of the SEC. *See* Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239 ("We have edited the language based on our conversations with SEC staff"; "We are confident that the language in the regulation lines up with the SEC and CFTC language, but are reaching out to the SEC regulatory team . . . ."). Nowhere in the document is the Labor Department referenced similarly in the third person. Based on this contextual evidence, it appears that the phrasing of the SEC's comments is the Labor Department's articulation of the SEC's concerns, rather than the SEC's own words.
[97] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239 (emphasis added).
[98] Briefing by Staff, DOL, to Committee Staff, HSGAC (Aug. 28, 2015) (notes on file with Committee).
[99] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239.

issues, but that the Department was "reviewing to see if there is anything more . . . to say on the topic,"[100] and that it might "make additional edits after getting feedback from OMB."[101] However, the Labor Department apparently did not conduct any additional follow-up work after OMB completed its review of the proposal.[102]

EOs 12866 and 13563 were enacted to improve the regulatory process. EO 12866 requires a federal agency to "assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating," and provides that the assessment should include "quantifiable measures."[103] EO 13563, which supplements EO 12866, requires a federal agency to "tailor its regulations to impose the least burden on society," to "choos[e] among alternative regulatory approaches," and to "identify and assess available alternatives to direct regulation."[104] EO 13563 also directs an agency to include "quantify[ing] anticipated present and future benefits and costs as accurately as possible."[105] EOs 12866 and 13563 permit agencies to conduct qualitative analysis in place of quantitative analysis where the costs and benefits are "difficult or impossible to quantify."[106] EO 13563 offers guidance on the types of factors that are difficult or impossible to quantify: "human dignity, fairness, and distributive impacts."[107] Here, the costs and benefits associated with the Labor Department's proposed fiduciary rule do not seem to meet the "difficult" or "impossible" threshold.

Additionally, OIRA issued a primer on EOs 12866 and 13563 to provide guidance to federal agencies in drafting a regulatory impact analysis.[108] OIRA emphasizes the importance of providing a quantitative analysis of alternatives and provides that agencies should conduct a quantitative analysis when at all possible.[109] For factors where quantification or monetization is not possible, OIRA instructs that the agency is not exempt from providing a quantitative analysis altogether and should still "present all available quantitative information."[110] Like the Executive Orders, OIRA also provides examples of values that are not readily quantifiable, including privacy, dignity, ecological gains, improvements to quality of life, and aesthetic beauty.[111]

OIRA dedicates the large majority of the guidance to explaining, in great detail, how agencies should conduct quantitative analysis.[112] OIRA focuses in particular on factors that are

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[100] *Id.*
[101] *Id.*
[102] Briefing by Staff, DOL, to Committee Staff, HSGAC (Aug. 28, 2015) (notes on file with Committee).
[103] Exec. Order No. 12866 § 1(a), 3 C.F.R. 638 (1994).
[104] Exec. Order No. 13563 § 1(b)(3), (b)(5), 3 C.F.R. 215 (2012).
[105] *Id.* § 1(c).
[106] *Id.*
[107] *Id.*
[108] OIRA, REGULATORY IMPACT ANALYSIS: A PRIMER.
[109] *Id.*
[110] *Id.* at 12.
[111] *Id.* at 12, 13.
[112] *See id.*

not easily quantified or monetized and on future projections and uncertainties.[113] Two full sections of the guidance are dedicated to analyzing "future benefits and costs" and "forecasts about the future."[114] OIRA instructs that while forecasts about the future may be uncertain, those uncertainties should be analyzed—agencies should specify potential scenarios, calculate the benefits and costs associated with each scenario, and construct ranges of values.[115] OIRA further emphasizes that this is the minimum agencies should do, and that agencies should assign probabilities and calculate expected values based on those probabilities, if possible.[116]

The Executive Orders and the OIRA guidance do not exempt the Labor Department from conducting a quantitative analysis simply because the analysis would involve complicated calculations and future projections. The examples provided in the Executive Orders and the OIRA guidance indicate that factors that qualify as "difficult" or "impossible" to quantify are factors with inherently intangible or subjective properties.[117] Monetary costs and benefits very clearly do not fit into this category because they are both countable and objective. The fact that determining costs and benefits may involve complex calculations and future uncertainties is a distinguishable obstacle. In fact, OIRA emphasizes the importance of providing a quantifiable analysis, even when it involves complex calculations or future uncertainties.[118] While the Labor Department might not be able to capture every potential cost and benefit of the rule, OIRA's guidance to agencies indicates that the Labor Department should have provided monetary and quantitative analysis of as many factors as possible. The Labor Department's approach of determining that it would be difficult to calculate costs and benefits, and thus abandoning the effort altogether, starkly contrasts with the guidance provided by OIRA.

More broadly, the Labor Department's dismissive response of the SEC experts' recommendation calls into question the Department's priorities in the rulemaking process and its commitment to thoughtfully considering the SEC staff's input. The Labor Department's decision to not undertake additional analysis following OMB's review is indicative of the Department's prioritization of accelerating its release of the proposal at the expense of a thorough process that appropriately reflected the input of the SEC staff.

b. The Labor Department Failed to Incorporate Principles from Existing Federal Securities Laws and FINRA Rules

FINRA—the Financial Industry Regulatory Authority—is the leading non-governmental regulator of brokerage firms and exchange markets and ensures that the security industry

[113] *See id.*
[114] *Id.* at 11, 12.
[115] *Id.*
[116] *Id.* at 14–15.
[117] *Id.* at 12, 13; Exec. Order No. 12866; Exec. Order No. 13563.
[118] OIRA, REGULATORY IMPACT ANALYSIS: A PRIMER, *supra* note 108.

operates fairly and honestly.[119] FINRA writes and enforces rules for every brokerage firm and broker in the United States, and also enforces federal securities laws and Municipal Securities Rulemaking Board (MSRB) rules.[120] FINRA has authority from the SEC to discipline brokers and brokerage firms for violations of FINRA rules, federal securities laws, and MSRB rules.[121] FINRA monitors more than 3,955 securities firms with approximately 643,320 brokers.[122]

In addition to ignoring substantive suggestions from subject-matter experts at the SEC, the Labor Department likewise apparently declined to incorporate existing federal securities laws and FINRA rules. Upon review of the proposed rule, FINRA provided critical feedback, stating that the rule "established principles that employ imprecise terms with little precedent in the federal securities laws or, in many cases, ERISA," and that "[i]n some respects these principles even conflict with FINRA rules."[123]

For example, FINRA highlighted that the proposed Best Interest Contract Exemption contains a provision that directly conflicts with FINRA rules.[124] Section III(a)(1) requires, prior to the purchase of a recommended asset, that an advisor project the total cost of investing in the asset for 1-, 5-, and 10-year periods, expressed as a dollar amount.[125] Such a projection requires the advisor to incidentally project investment performance because fees are tied to an asset's value. This requirement directly conflicts with FINRA Rule 2210, which generally prohibits broker-dealers from making performance projections to the public.[126] Thus, by requiring advisors to project the future value of assets under management, the Labor Department's rule would actually require advisors to violate FINRA rules.

The Labor Department's failure to "build upon existing principles in the federal securities laws and FINRA rules"[127] is despite SEC staff urging the Labor Department to incorporate references to and aspects of federal securities laws and FINRA rules. In September and October 2014, SEC staff provided to the Labor Department, on multiple occasions, lists of relevant laws and rules, including rules from the Securities Act, Advisers Act, Exchange Act, FINRA, the National Association of Securities Dealers (NASD), and the Municipal Securities Rulemaking Board.[128]

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[119] News Release, FINRA, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA (July 30, 2007); *About FINRA*, FINRA, http://www.finra.org/about.
[120] *What We Do*, FINRA, http://www.finra.org/about/what-we-do.
[121] News Release, FINRA (July 30, 2007), *supra* note 119; *About FINRA*, *supra* note 119.
[122] *For Industry Professionals*, FINRA, https://www.finra.org/industry.
[123] Appendix A, Ex. 26, FINRA Comments, at 11.
[124] *See id.* at 14.
[125] Best Interest Contract Exemption § III(a)(1), 80 Fed. Reg. 21,960, 21,985 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550) (emphasis added).
[126] FINRA, RULE 2210; Appendix A, Ex. 26, FINRA Comments, at 14.
[127] Appendix A, Ex. 26, FINRA Comments, at 11.
[128] Appendix B, Ex. 4, E-mail from Jennifer Porter, SEC, to Timothy Hauser, DOL (Sept. 4, 2014, 3:55 p.m.), SEC-DOL001768–001771; Appendix B, Ex. 5, E-mail from Jennifer Porter, SEC, to Timothy Hauser, DOL (Oct. 8, 2014, 10:35 a.m.), SEC-DOL001900–001901.

Additionally, SEC staff identified several items of concern relating to the Labor Department's lack of incorporation of federal securities laws and FINRA rules. For example, SEC staff recommended that the Labor Department redraft definitions in the disclosure requirements and document retention provisions so that the provisions expressly referenced SEC and FINRA definitions.[129] SEC staff reasoned that this would ensure that the Labor Department would receive complete and sufficiently comparable data from investment advisors.[130] However, the Labor Department dismissed the suggestion, instead merely including in the proposal's preamble a request for comment "as to whether the terms used and definitions are sufficient so that the information received will be reasonably comparable across different financial institutions."[131]

The Labor Department's failure to incorporate fundamental principles from federal securities laws and FINRA Rules further suggests that the Department did not thoroughly consult regulatory experts. This resulted in a rule that experts have highlighted as problematic, in part because of the conflicts it creates with existing and anticipated future regulatory frameworks.[132]

c. The Labor Department Declined to Incorporate OIRA's Recommendations into the Proposed Rulemaking

OIRA employs regulatory experts who carry out the office's mission as the federal government's chief review and oversight authority on Executive Branch rulemaking measures. Career, non-partisan, professional staff at OIRA conduct reviews of draft and final regulatory proposals, coordinate interagency review of proposals, consider and review comments from outside groups on proposed rulemakings, and offer guidance on how rulemakings can best achieve the intended purpose. In several instances, it appears that the Labor Department disregarded OIRA's recommendations and concerns about the Department's fiduciary rule.

The Labor Department declined OIRA's recommendation to add clarity to a particular provision of the rule. Specifically, OIRA instructed the Labor Department to add the qualifying adjective "all" to describe the types of common fee and compensation practices that the rule would preserve as exempt from ERISA's prohibited transactions rules.[133] OIRA proposed the following language: "the Department has worked to preserve beneficial models by separately proposing new exemptions from ERISA's prohibited transaction rules that will broadly permit firms to continue *to rely on all* common fee and compensation practices . . . ."[134] The Labor

[129] Appendix B, Ex. 2, Items of Concern Chart, SEC-DOL003234–003239.
[130] *Id.*
[131] *Id.*
[132] *See* Appendix A, Ex. 26, FINRA Comments, at 11.
[133] *See* Appendix B, Ex. 6, Conflict of Interest Rule, Apr. 8, 2015 Draft, EBSA Pass Back, SEC-DOL004832.
[134] *Id.*

Department rejected OIRA's changes and deleted "to rely on all," responding that "[n]ot all fee practices will be permitted by the exemptions" and explaining that, "[b]y deleting 'all' we slightly soften this by leaving it at 'common fee and compensation practices'"[135] This edit and the Department's explanation show that the Department envisioned the proposal as prohibiting some common fee and compensation packages.

The Labor Department's deletion of the word "all" raises questions about the Department's commitment to transparency. The language in the provision emphasizes that the Labor Department is committed to preserving existing models and to permitting the continuance of common fee and compensation practices. However, this language appears to be misleading because the Labor Department surreptitiously retained its ability to exclude some fee and compensation practices from the exemption. It is difficult to understand how the Labor Department sought to preserve and permit the current compensation structure in the industry when it explicitly envisioned the possibility of prohibiting some fee and compensation packages.

In another instance, OIRA questioned the Labor Department's use of the term "incidental advice" in connection with its discussion of the rule's seller's carve-out.[136] Regulatory experts at OIRA cautioned that exempting "incidental advice" could also "carve out advice given by a broker under the [guise] of being a mere order taker"[137] and noted, "[t]hat's where the SEC muddied the waters in the first place."[138] Documents received by the Committee contain no indication that the Labor Department fully responded to this concern.[139] Furthermore, this section of the preamble in the rule contains the same language as the draft rule,[140] showing that the Labor Department did not adjust the language to accommodate OIRA's concern, and further suggesting that the Labor Department did not thoroughly consider OIRA's comments.

d. The Labor Department Did Not Fully Consider Concerns Raised by the Treasury Department

The Treasury Department has enforcement authority over Individual Retirement Accounts (IRAs), which are a creation of the tax code, and thus the Labor Department's engagement with Treasury on the proposed rule is especially important. Given Treasury's authority and expertise in enforcing rules and regulations relating to IRAs, the Labor Department should have considered and remedied any concerns raised by Treasury officials about the proposed rule.

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[135] *Id.* (emphasis added).
[136] *Id.* SEC-DOL004858.
[137] *Id.*
[138] *Id.* (emphasis added).
[139] *Id.*
[140] Conflict of Interest Rule—Retirement Investment Advice § (b)(1)(i), 80 Fed. Reg. 21,928, 21,957 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510).

Treasury officials and other experts have raised concerns about the Best Interest Contract Exemption (BIC exemption), because it would impose new requirements on fiduciaries with respect to IRAs.[141] IRAs are governed by the Internal Revenue Code, not by ERISA. Unlike ERISA, the Internal Revenue Code "does not directly impose responsibilities of prudence and loyalty on fiduciaries."[142] The Labor Department's rule, however, would create such responsibilities by requiring fiduciaries "to act in accordance with the Impartial Conduct Standards in transactions governed by the exemptions."[143] The rule's background section acknowledges that the proposal would more significantly increase requirements for advisors with respect to IRAs than it would for advisors of accounts governed by ERISA (the Employee Retirement Income Security Act) because ERISA already requires those advisors to meet prudence and loyalty standards.

Former Assistant Secretary of Labor Bradford Campbell criticized this aspect of the rule as an effort by the Labor Department to sidestep Congress, stating that "[d]espite their simultaneous creation in 1974, Congress expressly chose not [to] apply the ERISA fiduciary standard to IRAs."[144] According to Mr. Campbell, "the Department is attempting to do something through [the proposed rule] that Congress explicitly chose not to do."[145]

Treasury officials similarly voiced concerns about the Labor Department extending the reach of the rule to IRAs. Treasury officials commented that earlier amendments were made "to reflect Congressional intent," on the basis that Congressional intent was "being undermined by rules that [were] not reflective of current market practices."[146] Treasury officials argued that this amendment, by imposing requirements with respect to accounts governed by a different statute and under the jurisdiction of a different federal agency, "seems to fly in the face of the logic . . . that these amendments are necessary to reflect Congressional intent."[147] The Labor Department responded by disagreeing and effectively dismissing the Treasury Department's concern. The Labor Department wrote:

> We think there's a difference here between the regulation and the exemptions. The purpose of the regulation expanding the definition of 'fiduciary' is to reflect Congressional intent. However, the purpose of this exemption is to say that if

[141] Appendix B, Ex. 7, Proposed Amendments to Class Exemptions, Apr. 21, 2015 Draft, Treasury Comments (Mar. 21, 2015), SEC-DOL005312.
[142] *Id.* (emphasis added).
[143] CONG. RESEARCH SERV., DOL'S 2015 PROPOSED FIDUCIARY RULE ON INVESTMENT ADVICE, IN FOCUS, IF10318, Nov. 12, 2015. The Impartial Conduct Standards require an advisor to act in the best interest of the client-investor and not to accept more than reasonable compensation.
[144] House Ways & Means Committee Hearing, *supra* note 47 (statement of Bradford Campbell).
[145] *Id.*
[146] Appendix B, Ex. 7, Conflict of Interest Rule, Treasury Comments, Mar. 21, 2015, SEC-DOL005312.
[147] *Id.*

> you're a fiduciary under the [Internal Revenue Code] (and Congressional intent), and want to receive variable compensation, then you have to comply with these conduct standards, even if they are not independently imposed by Congress.[148]

IRA advisors receive variable compensation, especially when providing advice to low- and middle-income investors.[149] Thus, IRA advisors would be subject to the rule's conduct standards. Despite Congress' intent to regulate IRA advisors under a different law, the Labor Department would regulate them using variable compensation as a proxy.

In a letter to Chairman Johnson on December 14, 2015, Treasury Department Assistant Secretary for Legislative Affairs, Anne Wall, stated that "Treasury believes that DOL appropriately considered Treasury's comments on the drafts during the OIRA process, including the comments specified in your letter" (and quoted above).[150] However, based on the documents, it is unconvincing that the Labor Department fully considered the comments of the Treasury Department experts. First, documents the Committee received provide no indication that the Departments discussed the Treasury Department's concern beyond the Labor Department's initial response to the Treasury Department, where it merely disagreed with Treasury's comment. Second, the Labor Department promulgated the proposed rule less than two weeks after circulating this draft and the accompanying comments, undoubtedly limiting the extent to which the Labor Department considered the comments it received from the Treasury Department experts on the draft. Finally, the promulgated proposal does not contain language signifying that the Labor Department edited the rule in accordance with the Treasury Department's stated concerns. For these reasons, it is difficult to conclude objectively that the Labor Department fully considered the Treasury Department's comments.

III. EXPERTS HAVE EXPRESSED CONCERNS ABOUT THE RULE'S ANTICIPATED HARM TO MIDDLE-INCOME AND SMALL BUSINESS INVESTORS

Chairman Johnson's inquiry raises concerns about both the process and the substance of the Labor Department's rulemaking. The Committee has received documents that demonstrate that the Labor Department prioritized expediting the drafting process at the expense of thoughtfully considering and addressing concerns from industry experts. In multiple instances, the Department disregarded advice from the SEC, OIRA, and Treasury, and failed to undertake a thorough cost-benefit analysis of the rule. The majority staff finds these actions especially

[148] *Id.*
[149] Appendix A, Ex. 27, Letter from Commonwealth Financial Network to DOL (July 21, 2015).
[150] Appendix A, Ex. 28, Letter from Hon. Anne Wall, Asst. Sec'y for Leg. Affairs, Dep't of the Treasury, to Chairman Johnson (Dec. 14, 2015).

troubling because of the concerns raised about the risk of the rule's anticipated harm to middle-income investors.

Generally, industry experts, including investment advisors, support a best interest standard, but have criticized the rule on the grounds that it is overly complex and burdensome. For example, Peter Schneider, the President of Primerica, testified to Congress that he "agree[s] that firms and their representatives should always act in their clients' best interests."[151] He explained that he is concerned "that the requirements and uncertainties of the [Best Interest Contract Exemption] are so complex and burdensome that the exemption is n either administratively nor operationally feasible."[152]

Similarly, former SEC Commissioner Daniel Gallagher has harshly criticized the rule, calling it a "mess," in part because advisors who adhere to a best interest standard still risk noncompliance with the rule because of its many complicated requirements.[153] Commissioner Gallagher has cautioned that the Labor Department's rule would result in the "elimination of an entire class of accounts" for investors and would subject advisors to "unlimited liability."[154] Other experts and observers have also raised concerns that the conditions and requirements the rule imposes are ambiguous and unworkable, which will increase litigation risk and regulatory costs. Experts anticipate that advisors will incur initial compliance costs of $21.5 million and annual maintenance costs of $5.1 million, resulting in increased costs for retail investment advice by 73% to 196% as a result of the Labor Department's proposal.[155]

Additionally, experts contend that the Administration has inflated the harm that results from investors relying on "conflicted advice." The White House and the Labor Department claim that conflicted advice from brokers costs investors $17 billion per year.[156] Former SEC chief economist Craig Lewis has explained that the $17 billion estimate is based on a calculation that failed to account for discrepancies in the data and that used outdated data from the 1990s

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[151] Senate HELP Committee Hearing, *supra* note 2 (statement of Peter Schneider); *see also id.* (statement of Robert Litan) ("[T]he notion that all retirement investment advisers should be held to a best interest of client standard is not controversial.").
[152] *Id.*; House Ways & Means Committee Hearing, *supra* note 47 (statement of Judy VanArsdale, Co-Owner, enrich Private Wealth Management).
[153] Mark Schoeff Jr., *SEC Commissioner: DOL Fiduciary Rule Would Create "a Mess"*, INVESTMENT NEWS (Aug. 4, 2015, 1:18 PM), http://www.investmentnews.com/article/20150804/FREE/150809978/sec-commissioner-dol-fiduciary-rule-would-create-a-mess.
[154] *Id.*; Speech to the Chamber of Commerce, Daniel Gallagher, Comm'r, SEC (Aug. 4, 2015), *available at* https://www.uschamber.com/event/discussion-sec-commissioner-daniel-gallagher.
[155] MILLOY, AM. ACTION FORUM, *supra* note 43; *see also* DELOITTE DEVELOPMENT LLC, REPORT ON THE ANTICIPATED OPERATIONAL IMPACTS TO BROKER-DEALERS OF THE DEPARTMENT OF LABOR'S PROPOSED CONFLICT OF INTEREST RULE PACKAGE (2015) (reporting similar findings).
[156] EXEC. OFFICE OF THE PRESIDENT, THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS (2015).

and 2000s.[157] Mr. Lewis stated, "[y]ou don't have to be an economist to recognize the Administration's $17 billion talking point significantly overestimates the costs, if any, to investors relying on the 'conflicted advice' of brokers."[158]

Experts have focused, in particular, on the negative impact that the rule will have on small-account owners—small businesses and middle-income investors. The Small Business Administration has commented that the rule "would likely increase the costs and burdens associated with servicing smaller plans . . . [which] could limit financial advisers' ability to offer savings and investment advice to clients . . . [which] could ultimately lead advisors to stop providing retirement services to small businesses."[159] Similarly, former Assistant Secretary of Labor Bradford Campbell testified that the rule "likely will harm the very retirement investors it is intended to help."[160] Mr. Campbell echoed the Small Business Administration's concerns that the rule will increase the cost and reduce the availability of advice to small plans and small-account IRA owners.[161] Finally, experts have pointed to an "advice gap" that has developed in the United Kingdom (U.K.) as a result of a 2013 rule change in the U.K. that is effectually identical to the Labor Department's rule.[162] According to ERISA experts, it is "widely accepted in the U.K." that "middle- and lower- income savers in the U.K. are being cut off from investment advice."[163] The United Kingdom government has "launched a major review of exactly that advice gap."[164]

First, the rule contains a carve-out that will not apply to small businesses. The "Seller's Carve-Out" exempts an investment advisor from fiduciary duties when the advisor sells or markets materials, as long as the advisor discloses that the advisor is paid to sell proprietary financial product and is not providing fiduciary advice.[165] However, the proposal prohibits advisors to small businesses from using the Seller's Carve-Out based on the assumption that small businesses lack financial sophistication.[166] Small businesses and ERISA experts have voiced concerns that the rule will deprive small businesses of access to guidance on investment

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[157] Craig M. Lewis, *An Inflated $17 Billion Talking Point From the DOL*, FORBES (Dec. 16, 2015, 12:30 PM), http://www.forbes.com/sites/realspin/2015/12/16/an-inflated-17-billion-talking-point-from-the-dol/#782b028439e1.
[158] *Id.*
[159] Appendix A, Ex. 29, Letter from Claudia Rodgers, Acting Chief Counsel for Advocacy, and Dillon Taylor, Asst. Chief Counsel for Advocacy, Small Business Admin., to Hon. Phyllis Borzi, Asst. Sec'y, EBSA, DOL, at 5–6 (July 17, 2015).
[160] House Ways & Means Committee Hearing, *supra* note 47 (statement of Bradford Campbell).
[161] *Id.*
[162] KENT MASON, DAVIS & HARMAN LLP, U.K. LAUNCHES REVIEW OF "ADVICE GAP" FOR SMALL ACCOUNTS FOLLOWING A 2013 RULE CHANGE WITH EFFECTS IDENTICAL TO WHAT DOL NOW PROPOSES (2015).
[163] *Id.*
[164] *Id.*
[165] Conflict of Interest Rule—Retirement Investment Advice § (b)(1)(i), 80 Fed. Reg. 21,928, 21,957 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510) (Seller's Carve-Out); *id.* pmbl. § IV(C)(1)(a) at 21,941–42 (explaining the Seller's Carve-Out).
[166] Senate HELP Committee Hearing, *supra* note 2 (statement of Darlene Miller, President & CEO, Permac Industries, Board Member, U.S. Chamber of Commerce).

options that are otherwise permitted by the carve-out.[167] Small businesses have additionally refuted the Labor Department's flawed assumption that small businesses lack the requisite sophistication to engage with investment advisors without statutorily imposed protections.[168] At a hearing before the Senate Committee on Health, Education, Labor and Pensions, a small-business owner testified:

> I would not be able to run a successful business if I were not able to understand when I am involved in a sales discussion. . . . The assumption that small plans, participants and IRA owners cannot understand the difference between sales and advice does not match my real world experience. The [Labor] Department can protect participants, IRA owners and small plans with the same kind of disclosures that it requires of large plans under the large plan carve out, but without eliminating their right to choose the services and products that best fit their needs.[169]

Former Assistant Secretary Campbell similarly criticized the carve-out, stating "there is no clear basis to believe that plan size is a proxy for financial sophistication, and no basis to treat every IRA owner as if she is incapable of making informed choices."[170]

Additionally, experts have voiced concerns that the Best Interest Contract Exemption (BIC exemption) is unworkable and that firms will not use it. The BIC exemption allows certain broker-dealers and other fiduciaries to receive compensation that would otherwise be prohibited, such as commissions.[171] To take advantage of the BIC exemption, the investor and advisor must sign a contract acknowledging fiduciary status.[172] The advisor must act in the best interest of the client and must make numerous disclosures to the client and to the Labor Department.[173] Experts contend that the BIC exemption is unworkable and will increase the cost of investment advice and services and will, consequently, decrease access to investment services for small investors.[174] Experts explain that the BIC exemption imposes conditions and requirements for advisors that are ambiguous, creating uncertainty and putting advisors at risk for penalties and lawsuits, including class action lawsuits.[175] Industry participants caution that investment firms will consequently decline to use the BIC exemption.[176]

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[167] *Id.*
[168] *Id.*
[169] *Id.*
[170] *Id.* (statement of Bradford Campbell).
[171] CONG. RESEARCH SERV., DOL'S 2015 PROPOSED FIDUCIARY RULE ON INVESTMENT ADVICE, IN FOCUS, IF10318, Nov. 12, 2015.
[172] *Id.*
[173] *Id.*
[174] Senate HELP Committee Hearing, *supra* note 2 (statement of Darlene Miller).
[175] *Id.* (statements of Darlene Miller and Peter Schneider).
[176] *Id.*; House Ways & Means Committee Hearing, *supra* note 47 (statements of Judy VanArsdale and Bradford Campbell).

According to experts, the unworkability of the BIC exemption will inhibit middle-income, small-account owners' access to investment services. Experts explain that firms that do not use the exemption will likely convert their commission-based brokerage IRAs to fee-based accounts.[177] Fee-based accounts are more expensive to operate than commission-based accounts and, therefore, often require account minimums of $25,000 and higher annual fees.[178] Experts caution that these costs will inhibit access to investment services for small account owners and could result in losses in retirement savings of as much as $68–80 billion per year.[179] Even in the case of advisors who continue to provide services to small account owners, flat fees will present affordability challenges for middle-income investors who cannot afford to pay flat rates and currently rely on commission-based fees.[180]

Supporters of the rule have criticized large, publicly-traded investment firms for publicly predicting significant negative consequences, while simultaneously "assuring [investors] that the rule will have no significant impact on their companies" and that they "are well-positioned to 'adapt to any regulatory framework that emerges.'"[181]

However, these large investment firms are not the ones that will feel the most significant effects of the rule. Rather, the rule is likely to harm small- and mid-size investment firms. For example, Judy VanArsdale, the co-owner of a seven-employee wealth management company, testified before the House Committee on Ways and Means about her concerns about the rule.[182] As a small wealth management company, Ms. VanArsdale's company serves more than 2,500 accounts, with more than 800 accounts containing less than $25,000.[183] Ms. VanArsdale explained that the rule increases litigation risk because of its lack of clarity and its creation of state-law class action lawsuits.[184] Ms. VanArsdale stated that, as a small-business owner, she feels "great concern over subjecting [her] business to increased business and litigation risk."[185] According to Ms. VanArsdale, to avoid litigation risk, "small businesses . . . may not feel comfortable using the BIC exemption, and . . . would be restricted from serving retirement brokerage accounts."[186] While large firms may be better suited to withstand changes in the

[177] Senate HELP Committee Hearing, *supra* note 2 (statements of Darlene Miller and Peter Schneider); House Ways & Means Committee Hearing, *supra* note 47 (statement of Bradford Campbell).
[178] Senate HELP Committee Hearing, *supra* note 2 (statement of Peter Schneider); House Ways & Means Committee Hearing, *supra* note 47 (statement of Bradford Campbell).
[179] QUANTRIA STRATEGIES, *supra* note 13, at 1.
[180] Senate HELP Committee Hearing, *supra* note 2 (statement of Peter Schneider).
[181] Appendix A, Ex. 30, Letter from Hon. Elizabeth Warren, U.S. Sen., and Hon. Elijah Cummings. U.S. House of Representatives, to Sec'y Perez, DOL, and Hon. Shaun Donovan, Dir., OMB (Feb. 11, 2016).
[182] House Ways & Means Committee Hearing, *supra* note 47 (statement of Judy VanArsdale).
[183] *Id.*
[184] *Id.*
[185] *Id.*
[186] *Id.*

regulatory regime, small- and mid-size investment firms—and the middle-class consumers they service—have less tolerance to weather such changes.

IV. THE ADMINISTRATION WAS PREDETERMINED TO REGULATE THE INDUSTRY AND SOUGHT EVIDENCE TO JUSTIFY ITS PREFERRED ACTION

The Labor Department refused to provide the Committee with its communications with the White House. However, the Committee obtained some of these communications from another party. The communications indicate that the Labor Department and the White House were predetermined to regulate the industry and sought evidence to justify their preferred action. The communications also suggest that the White House may have played an outsized role in the rulemaking, in conflict with the Administrative Procedure Act.

In an email to Brian Deese—a senior political advisor in the Executive Office of the President—a Labor Department policy advisor wrote of the "challenges in completing the [regulatory impact analysis]."[187] In particular, he noted, "we need to determine whether the available literature, our work with RAND, and any other data we have not yet identified can be woven together to demonstrate that there is a market failure and to monetize the potential benefits of fixing it."[188] In another email to Mr. Deese, a Labor Department policy advisor discussed plans for packaging the rulemaking re-proposal.[189] The email noted a GAO report that the Labor Department intended to use to "build[] the case for why the rule is necessary."[190]

EOs 12866 and 13563—enacted to reform and improve regulations and the regulatory process—require agencies to identify a market failure or other compelling problem that justifies regulation before the agency begins the regulatory drafting process. Specifically, EO 12866 provides that agencies should promulgate regulations only if they are "made necessary by compelling public need, such as material failures of private markets."[191] EO 12866 further provides that "in deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating."[192] However, as evidenced by these emails, the Labor Department and the White House worked

[187] Appendix B, Ex. 8, E-mail from Zachary A. Epstein, DOL, to Brian C. Deese, Exec. Office of the President, et al. (Oct. 25, 2011, 7:30 PM), SEC-DOL005872-005873.
[188] *Id.*
[189] Appendix B, Ex. 9, Email from Chris Cosby, DOL, to Brian C. Deese, Exec. Office of the President, et al. (Nov. 2, 2011, 5:47 PM), SEC-DOL006041-006042.
[190] *Id.*
[191] Exec. Order No. 12866 § 1(a), 3 C.F.R. 638 (1994); *see also* Exec. Order No. 13563 § 1(b), 3 C.F.R. 215 (2012) (providing that an agency must "propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs").
[192] Exec. Order No. 12866 § 1(a), 3 C.F.R. 638 (1994).

backwards—they first determined that they wanted to create the rule, then searched for evidence to justify it. The way in which the Labor Department and the White House approached the regulatory impact analysis is opposite to the methodology required by executive order.

The Administrative Procedure Act vests control of a rulemaking in the agency proposing the regulation. The Executive Office of the President—including OIRA, the National Economic Council, and other entities—exists to coordinate policy broadly across the executive branch, but ultimately each agency owns its particular rulemaking. With respect to the Labor Department's fiduciary rulemaking, it appears that the White House may have played an outsized role.

Documents that the Committee received suggest that the proposal was initially driven by political appointees in the Executive Office of the President. First, the level of detail in email communications between the Labor Department and the White House indicates that White House advisors may have exceeded their coordination function in drafting the rule. For instance, in the email discussing a GAO report that the Labor Department felt could build a case for the rule, a Labor Department official provided specific page numbers and direct quotations from the report to the White House's Brian Deese.[193] Such detail suggests that Mr. Deese, and other policy advisors within the White House, were involved in crafting the basis for the rule and the regulatory impact analysis on a granular and collaborative basis.

Additionally, in October and November 2011, the White House's National Economic Council convened a series of meetings among the Labor Department, the SEC, the Treasury Department, and the White House to discuss the rule's economic analysis.[194] These discussions appear to have been more than mere coordination meetings. Rather, it seems that White House officials were involved in developing material to justify the need for the Labor Department's proposal.

Moreover, Assistant Secretary of Labor Phyllis Borzi, who has been described as the "main architect" of the fiduciary rule,[195] ranks as the twelfth most frequent visitor to the White House during the Obama Administration.[196] Since 2009, Ms. Borzi has visited the White House

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[193] *Id.*

[194] Brian Deese, then-Deputy Director of the National Economic Council, and Adriana Kugler, then-Chief Economist to then-Department of Labor Secretary Hilda Solis, hosted meetings at the White House in October and November 2011. White House staff, Labor Department staff, SEC staff, and Treasury Department staff attended the meetings. *See* Appendix B, Ex. 10, Email from Jessica Schumer, Exec. Office of the President, to Brian C. Deese et al. (Oct. 12, 2011) (October 20, 2011 meeting), SEC-DOL005698; Appendix B, Ex. 11, Email from Jessica Schumer to Brian C. Deese et al. (Oct. 25, 2011) (October 27, 2011 meeting), SEC-DOL005861; Appendix B, Ex. 9, Email from Chris Cosby, DOL, to Brian C. Deese et al. (Nov. 2, 2011) (November 2, 2011 meeting), SEC-DOL006041.

[195] Melanie Waddell, *DOL to 'Simplify and Streamline' Fiduciary Rule: Borzi*, THINKADVISOR (Oct. 20, 2015)

[196] Jason Howerton, *Here Are the 25 People Who Have Visited the Obama White House the Most* (Feb. 8, 2016, 1:38 PM), http://www.theblaze.com/stories/2016/02/08/here-are-the-25-people-who-have-visited-the-obama-white-house-the-most-no-3-is-apparently-shrouded-in-mystery/.

338 times.[197] Two other senior Labor Department officials rank as the ninth and sixth most frequent White House visitors, with 369 and 376 visits, respectively.[198]

Finally, a White House memorandum entitled "Draft Conflict of Interest Rule for Retirement Savings" further illustrates the White House's significant involvement in the rulemaking process. The memorandum, circulated by White House Council of Economic Advisors Chairman (CEA) Jason Furman and CEA member Betsey Stevenson, to the President's senior advisors including John Podesta, Susan Rice, Jennifer Palmieri, and Valerie Jarrett, criticized current regulations relating to investment advice on retirement accounts.[199] The memorandum argued that aggressive regulatory action was necessary to remedy the inadequate existing consumer protections on investment advice.[200] The Department issued its proposal just four months later.

V. THE ADMINISTRATION OBSTRUCTED CHAIRMAN JOHNSON'S INQUIRY BY LIMITING THE INFORMATION THE COMMITTEE WAS ABLE TO OBTAIN

In the course of conducting oversight on the Labor Department's rulemaking, Chairman Johnson experienced tremendous opposition and noncooperation from the Administration. The Labor Department withheld documents and even went so far as to urge the SEC—an independent agency that is designed to be bipartisan—to do the same. OIRA also withheld documents. The Labor Department's and OIRA's refusals to fully cooperate with Chairman Johnson's oversight has prevented the Committee from obtaining relevant documents and has hindered the Chairman's overall inquiry.

a. The Labor Department Remains Uncooperative with Chairman Johnson's Requests for Information and Documents from February 2015

Chairman Johnson wrote a letter to the Labor Department on February 5, 2015, requesting information and documents relating to the Department's anticipated rule.[201] After the Labor Department failed to produce communications in response to his request, Chairman Johnson reiterated the requests in another letter on March 17, 2015.[202] Chairman Johnson requested communications about the Labor Department's rulemaking between the Labor

[197] *Id.*
[198] *Id.*
[199] Memorandum from Jason Furman, Chairman, White House Council of Econ. Advisors, and Betsey Stevenson, Member, White House Council of Econ. Advisors, to White House Senior Advisors (Jan. 13, 2015).
[200] *Id.*
[201] Appendix A, Ex. 1, Letter from Chairman Johnson to Sec'y Perez, DOL (Feb. 5, 2015).
[202] Appendix A, Ex. 2, Letter from Chairman Johnson to Sec'y Perez, DOL (Mar. 17, 2015).

Department and the SEC and between the Labor Department and the White House.[203] By its own admission, the Department has not produced all material responsive to Chairman Johnson's requests.[204]

Specifically, the Labor Department has not produced any material responsive to Chairman Johnson's request for communications between the Department and the White House.[205] In August 2015, Chairman Johnson signaled his objection to Adri Jayaratne's nomination to be the Labor Department's Assistant Secretary for Congressional and Intergovernmental Affairs because of the Department's failure—under Mr. Jayaratne's time as acting head of the Office of Congressional and Intergovernmental Affairs—to respond fully to the Chairman's requests. Subsequently, the Labor Department informed the majority staff that no responsive documents existed.[206] The Labor Department, however, refused to explain how the Department came to this conclusion or what type of search the Department conducted.[207] The Committee later received, from another source, some communications between the Department and the White House about the rulemaking.[208] Still, later, in December 2015, the Labor Department again refused to provide the requested materials and declined to confirm whether it had sought consent from the White House to produce the material.[209]

The Labor Department has not fully responded to Chairman Johnson's request for communications between the Department and the SEC. The Labor Department has produced only a limited subset of self-selected communications between the Department and the SEC and provided short briefings.[210] The communications the Labor Department produced are mostly

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[203] *Id.*

[204] Chairman Johnson did not request to conduct transcribed interviews with Labor Department officials. In light of the Labor Department's repeated refusals to produce requested information and documents, its interference with the SEC's response to the Chairman's separate request to the SEC, and the Department's overall obstructive posture with respect to the Chairman's inquiry, it is likely that requests for transcribed interviews would have proved futile.

[205] Email from Committee Staff, HSGAC, to Kathryn Garza-Ahlgren, DOL (Aug. 24, 2015, 2:00 PM) (on file with Committee).

[206] Phone Call between Committee Staff, HSGAC, and DOL (Aug. 5, 2015); *see also* Email from Committee Staff, HSGAC, to Nikki McKinney, DOL (Dec. 17, 2015, 1:19 PM) (on file with Committee) (referencing the phone call); Email from Committee Staff, HSGAC, to Kathryn Garza-Ahlgren, DOL (Aug. 24, 2015, 2:00 PM) (on file with Committee) (referencing the phone call).

[207] Phone Call between Committee Staff, HSGAC, and DOL (Aug. 2015); *see also* Email from Committee Staff, HSGAC, to Nikki McKinney, DOL (Dec. 17, 2015, 1:19 PM) (on file with Committee) (referencing the phone call); Email from Committee Staff, HSGAC, to Kathryn Garza-Ahlgren, DOL (Aug. 24, 2015, 2:00 PM) (on file with Committee) (referencing the phone call).

[208] The SEC produced to the Committee on November 23, 2015, documents containing communications between the Labor Department and the White House. *See* Email from Committee Staff, HSGAC, to Nikki McKinney, DOL (Dec. 17, 2015, 1:19 PM) (on file with Committee).

[209] Phone Call between Committee Staff, HSGAC, and DOL (Dec. 17, 2015); Email from Committee Staff, HSGAC, to Nikki McKinney, DOL (Dec. 17, 2015, 1:19 PM) (on file with Committee); Email from Committee Staff, HSGAC, to Nikki McKinney, DOL (Jan. 12, 2016, 12:52 PM) (on file with Committee).

[210] Appendix C, Dep't of Labor Document Production, DOL000001–002458; Emails between Committee Staff, HSGAC, and Elva Linares, DOL (Aug. 26–27, 2015) (on file with Committee). Mr. Jayaratne's staff, moreover,

related to scheduling meetings and do not address substantive aspects of the rule drafting process.[211] Moreover, the Department only produced these documents after the Chairman made a separate but similar request to the SEC for documents.[212] Additionally, during the briefings, Labor Department lawyers unilaterally limited the subject matter and timing of the briefings, leaving many questions unanswered.

Regarding the Labor Department and SEC communications, the Labor Department refused to certify that the communications produced to the Committee constituted the full universe of communications responsive to the Chairman's request.[213] Furthermore, the Labor Department refused to provide information about the total number of responsive documents, or the methods the Department used to identify responsive material.[214] The majority staff has confirmed that these communications, in fact, do *not* constitute the full universe of responsive communications. Rather, it appears that the Labor Department combed through its communications with the SEC and deliberately omitted the large majority of communications that would inform Chairman Johnson's inquiry. The Committee has obtained documents from another source that contain many communications between the Labor Department and the SEC that the Department omitted from its production. The Labor Department has acknowledged to the majority staff that additional responsive material exists, though it refuses to produce such material.[215]

In July 2015, Chairman Johnson spoke with Secretary Perez about the outstanding document requests. The majority staff has also communicated directly with Mr. Jayaratne about the Labor Department's unsatisfactory responses. Despite these interactions, and Chairman Johnson's continued objection to Mr. Jayaratne's confirmation by the Senate, the Labor Department still refuses to comply fully with the Chairman's requests. It seems that the Labor Department has only seriously engaged in discussions about fully satisfying Chairman Johnson's requests in an effort to advance Mr. Jayaratne's nomination. Ultimately, though, the Labor Department remains unwilling to produce all responsive documents to the Committee.

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placed unilateral time and content restrictions on these briefings, refusing to answer questions that they deemed outside the scope of the briefings. Emails between Committee Staff, HSGAC, and Elva Linares, DOL (Aug. 26–27, 2015) (on file with Committee).

[211] Appendix C, Dep't of Labor Document Production, DOL000001–002458.

[212] Email from Committee Staff, HSGAC, to Adri Jayaratne, Acting Asst. Sec'y, Office of Cong. & Intergovernmental Affairs, DOL (July 8, 2015, 6:56 PM) (on file with Committee).

[213] Email from Kathryn Garza-Ahlgren, DOL, to Committee Staff, HSGAC (Aug. 21, 2015, 5:14 PM) (on file with Committee).

[214] Email from Committee Staff, HSGAC, to Adri Jayaratne, Acting Asst. Sec'y, Office of Cong. & Intergovernmental Affairs, DOL (July 8, 2015, 6:56 PM) (on file with Committee); Email from Committee Staff, HSGAC, to Kathryn Garza-Ahlgren, DOL (Aug. 24, 2015, 2:00 PM) (on file with Committee).

[215] Email from Kathryn Garza-Ahlgren, DOL, to Committee Staff, HSGAC (Aug. 21, 2015, 5:14 PM) (on file with Committee).

Finally, despite repeatedly refusing to produce responsive material, the Labor Department has not asserted any claim of privilege on the withheld material, and has refused to provide basic information about the scope, nature, and contents of the withheld material.[216] The Labor Department's stated reasons for noncompliance are all the more concerning given that its regulatory authority derives from an express grant of legislative authority from Congress to the Department. Congress—and, in particular, this Committee—retain broad oversight authority over the Labor Department's regulatory process and procedures. Ultimately, Congress also retains the authority to reject the Labor Department's rule through the Congressional Review Act.[217] Accordingly, the Committee ought to have access—and the Labor Department should be completely willing to provide access—to all documents and communications related to the rulemaking.

With little cooperation from the Labor Department, Chairman Johnson wrote to other agencies to seek information about the rulemaking. Under pressure from Chairman Johnson and after the Chairman threatened to compel production of the material,[218] the SEC ultimately provided a number of documents to the Committee that offered tremendous insight into the rulemaking. Similarly, FINRA also voluntarily assisted in providing useful information.

b. The Labor Department Attempted to Interfere with the SEC's Cooperation with the Chairman's Requests

In addition to withholding information from the Committee, the Labor Department admitted to Chairman Johnson that it had urged the SEC—an independent commission set up to be free of political pressure from the Executive Branch—to disregard Chairman Johnson's requests that he made separately to the SEC for documents in the SEC's possession and control.[219] Chairman Johnson made those requests to the SEC precisely because the Labor Department had declined to fully respond to his initial requests.

The Labor Department's interference with Chairman Johnson's request to the SEC was inappropriate and is indicative of the Department's overall posture in responding to the Chairman's inquiry into the rulemaking.[220] The Chairman had made a separate request to the SEC for documents in the possession and control of the SEC—a request for which the

[216] Email from Committee Staff, HSGAC, to Adri Jayaratne, Acting Asst. Sec'y, Office of Cong. & Intergovernmental Affairs, DOL (July 8, 2015, 6:56 PM) (on file with Committee).
[217] *See* Congressional Review Act, 5 U.S.C. §§ 801-808 (2012).
[218] Appendix A, Ex. 5, Letter from Chairman Johnson to Chairwoman White, SEC (July 13, 2015) ("If the Commission fails to immediately provide the requested documents, the Committee may consider use of the compulsory process.").
[219] Appendix A, Ex. 14, Letter from Acting Asst. Sec'y Jayaratne, DOL, to Chairman Johnson (July 8, 2015).
[220] Email from Committee Staff, HSGAC, to Adri Jayaratne, Acting Asst. Sec'y, Office of Cong. & Intergovernmental Affairs, DOL (July 8, 2015, 6:56 PM) (on file with Committee).

Department had no standing to interfere.[221] For reasons unknown to the majority staff, the Labor Department was unwilling to produce—and went out of its way to attempt to prevent others from producing—documents to the Committee about its work on this important rulemaking.

c. OIRA Declined to Provide a Full and Complete Response to Chairman Johnson's Requests

Chairman Johnson wrote a letter to OIRA on May 1, 2015, requesting information and documents relating to OIRA's review of the Labor Department's proposal.[222] After OIRA failed to provide a complete response, Chairman Johnson again wrote to OIRA on December 3, 2015.[223] To date, OIRA has provided non-specific, cursory responses to the Chairman's requests for information and produced limited materials that do not fully satisfy the Chairman's request for documents.[224]

Chairman Johnson's request stemmed from concern about whether OIRA conducted a thorough and thoughtful review of the rule. OIRA expedited its review, as evidence by the fact that the Labor Department promulgated the proposed rule just fifty days after OIRA received the proposal for review.[225] Chairman Johnson sought to ensure that OIRA conducted a thorough and thoughtful review of the proposed rule and to understand how OIRA incorporated suggestions from other Executive Branch departments and agencies and from stakeholders.[226] Specifically, Chairman Johnson asked OIRA to provide the following information:

1. Please provide all drafts of the Labor Department's proposed rulemaking, *including comments and suggestions to the drafts.*

2. Please explain why OIRA required considerably less time to review the Labor Department's proposed rulemaking than the average review time for other Labor Department regulatory proposals and other economically significant rules.

3. Please explain how OIRA incorporates suggestions from other Executive Branch departments and agencies, as well as stakeholders, into its review of the Labor Department's proposed rulemaking.

4. Please explain how the version of the proposed rulemaking incorporated OIRA's suggestions.

[221] *Id.*
[222] Appendix A, Ex. 7, Letter from Chairman Johnson to Admin'r Shelanski, OIRA (May 1, 2015).
[223] Appendix A, Ex. 8, Letter from Chairman Johnson to Admin'r Shelanski, OIRA (Dec. 3, 2015).
[224] Appendix A, Ex. 18, Letter from Admin'r Shelanski, OIRA, to Chairman Johnson (Jan. 20, 2016).
[225] Appendix A, Ex. 7, Letter from Chairman Johnson to Admin'r Shelanski, OIRA (May 1, 2015).
[226] *Id.*

5. Please explain how OIRA evaluated the Labor Department's proposed rulemaking with respect to Executive Order 13563's requirements for coordination with other agencies and consideration of flexible approaches.

OIRA's May 18, 2015 response to the Chairman provided general information about OIRA's review process that was not specific to OIRA's review of the Labor Department's proposal.[227] Regarding its review of the Labor Department's proposal, OIRA provided only vague information:

> OIRA devoted the time and resources necessary to ensure the review was consistent with EOs 12866 and 13563. This review included the participation of a number of relevant Executive Branch agencies. OIRA then concluded review of this draft on April 14, 2015. As background, EO 12866 provides OIRA up to 90 days to review significant regulatory actions, though the agency can request an extension. The amount of time needed to complete review on any given rule can vary, but OIRA does endeavor to complete the process as quickly as feasible while ensuring proper review.[228]

This answer lacked any specific information about the review process that Chairman Johnson requested.

OIRA's January 20, 2016 letter similarly lacked the specific information that Chairman Johnson requested.[229] OIRA simply stated:

> Regarding the length of time the draft proposed rule was under review, I can assure you that OIRA devoted the time and resources necessary to ensure the review was in accordance with EOs 12866 and 13563. The amount of time needed to complete review on any given rule varies, but OIRA endeavors to complete the process as efficiently as possible while ensuring proper review. The review of the *Conflict of Interest* draft proposed rule included the participation of relevant Federal agencies.[230]

Again, this response contains a conclusory statement void of any specific information about OIRA's review of the Labor Department's rule. OIRA's document production also failed to satisfy Chairman Johnson's request.[231] OIRA provided drafts of the proposal, but the drafts do not contain comments or suggestions, which Chairman Johnson had

[227] Appendix A, Ex. 17, Letter from Admin'r Shelanski, OIRA, to Chairman Johnson (May 18, 2015).
[228] *Id.*
[229] Appendix A, Ex. 18, Letter from Admin'r Shelanski, OIRA to Chairman Johnson (Jan. 20, 2016).
[230] *Id.*
[231] *Id.* (document production on file with Committee).

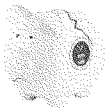
requested.[232] OIRA also provided a list of meetings it took with members of the public related to the rule, and the materials provided to OIRA at the meetings.[233] The information and productions and that OIRA provided to the Committee fail to offer any insight into OIRA's review of the Labor Department's proposal.

VI. CONCLUSION

Chairman Johnson's inquiry into the Labor Department's proposed rule has revealed that the Labor Department prioritized an expedited rulemaking process at the expense of thoughtfully considering and incorporating advice and suggestions from industry experts. Additionally, career, non-partisan, professional staff at the SEC, career, non-partisan, regulatory experts at OIRA, and Treasury Department officials expressed concerns to the Labor Department about the rule. Yet, documents that the Committee received indicate that the Department failed to implement numerous recommendations from these government officials in other agencies.

Chairman Johnson also encountered opposition and noncooperation from the Labor Department throughout its examination of the rulemaking process, calling into question the Department's commitment to transparency and accountability to Congress. From the information that the Committee was able to uncover, the Labor Department's flawed process in issuing its proposed "Conflict of Interest" rule could ultimately hurt American retirement savers. Whether intentionally or not, the proposed rule threatens to restrict access to retirement advice for those Americans who need it the most.

[232] *Id.*
[233] *Id.*



Chairman Scott Garrett
Questions for the Record for Capital Markets & GSE Subcommittee Hearing Entitled
"Continued Oversight of the SEC's Offices and Divisions"
April 21, 2016

Questions for Thomas Butler, Office of Credit Ratings:

1. **As you are aware, the SEC adopted significant new rules and rule amendments for credit rating agencies in August 2014, which you note in your testimony mostly became effective in June 2015.**

    a. **Then-Commissioner Gallagher expressed significant concerns about amendments to Rule 17g-8 in his dissent, in particular a concern that the amendments "awkwardly and ineffectually [impose] upon NRSRO's a mandate to take into consideration" a set of factors that are not explicitly identified. Given this ambiguity, how has your staff determined whether an NRSRO properly "takes into account" a set of factors and is therefore in compliance with the final rule?**

Response:

In the amendments to Rule 17g-8(d)[1], the Commission explicitly identified the following control factors that an NRSRO must take into consideration when establishing, maintaining, enforcing, and documenting an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings:

Specifically, pursuant to Rule 17g-8(d), an NRSRO when establishing an internal control structure must consider the following factors:

1. controls reasonably designed to ensure that a newly developed methodology or proposed update to an in-use methodology for determining credit ratings is subject to an appropriate review process (for example, by persons who are independent from the persons that developed the methodology or methodology update) and to management approval prior to the new or updated methodology being employed by the NRSRO to determine credit ratings;

2. controls reasonably designed to ensure that a newly developed methodology or update to an in-use methodology for determining credit ratings is disclosed to the public for consultation prior to the new or updated methodology being employed by the NRSRO to determine credit ratings, that the NRSRO makes comments received as part of the consultation publicly available, and that the NRSRO considers the comments before implementing the methodology;

[1] 17 C.F.R. § 240.17g-8(d) (Rule 17g-8(d))

3. controls reasonably designed to ensure that in-use methodologies for determining credit ratings are periodically reviewed (for example, by persons who are independent from the persons who developed and/or use the methodology) in order to analyze whether the methodology should be updated;

4. controls reasonably designed to ensure that market participants have an opportunity to provide comment on whether in-use methodologies for determining credit ratings should be updated, that the NRSRO makes any such comments received publicly available, and that the NRSRO considers the comments;

5. controls reasonably designed to ensure that newly developed or updated quantitative models proposed to be incorporated into a credit rating methodology are evaluated and validated prior to being put into use;

6. controls reasonably designed to ensure that quantitative models incorporated into in-use credit rating methodologies are periodically reviewed and back-tested;

7. controls reasonably designed to ensure that the NRSRO engages in analysis before commencing the rating of a class of obligors, securities, or money market instruments the NRSRO has not previously rated to determine whether the NRSRO has sufficient competency, access to necessary information, and resources to rate the type of obligor, security, or money market instrument;

8. controls reasonably designed to ensure that the NRSRO engages in analysis before commencing the rating of an "exotic" or "bespoke" type of obligor, security, or money market instrument to review the feasibility of determining a credit rating;

9. controls reasonably designed to ensure that measures (for example, statistics) are used to evaluate the performance of credit ratings as part of the review of in-use methodologies for determining credit ratings to analyze whether the methodologies should be updated or the work of the analysts employing the methodologies should be reviewed;

10. controls reasonably designed to ensure that, with respect to determining credit ratings, the work and conclusions of the lead credit analyst developing an initial credit rating or conducting surveillance on an existing credit rating is reviewed by other analysts, supervisors, or senior managers before a rating action is formally taken (for example, having the work reviewed through a rating committee process);

11. controls reasonably designed to ensure that a credit analyst documents the steps taken in developing an initial credit rating or conducting surveillance on an existing credit rating with sufficient detail to permit an after-the-fact review or internal audit of the rating file to analyze whether the analyst adhered to the NRSRO's procedures and methodologies for determining credit ratings; and

12. controls reasonably designed to ensure that the NRSRO conducts periodic reviews or internal audits of rating files to analyze whether analysts adhere to the NRSRO's procedures and methodologies for determining credit ratings; as well as any other controls necessary to establish an effective internal control structure taking into consideration the nature of the business of the NRSRO, including its size, activities, organizational structure, and business model.

With respect to maintaining the internal control structure:

13. controls reasonably designed to ensure that the NRSRO conducts periodic reviews of whether it has devoted sufficient resources to implement and operate the documented internal control structure as designed;

14. controls reasonably designed to ensure that the NRSRO conducts periodic reviews or ongoing monitoring to evaluate the effectiveness of the internal control structure and whether it should be updated; and

15. controls reasonably designed to ensure that any identified deficiencies in the internal control structure are assessed and addressed on a timely basis; as well as any other controls necessary to maintain an effective internal control structure taking into consideration the nature of the business of the NRSRO, including its size, activities, organizational structure, and business model.

With respect to enforcing the internal control structure:

16. controls designed to ensure that additional training is provided or discipline taken with respect to employees who fail to adhere to requirements imposed by the internal control structure; and

17. controls designed to ensure that a process is in place for employees to report failures to adhere to the internal control structure; as well as any other controls necessary to enforce an effective internal control structure taking into consideration the nature of the business of the NRSRO, including its size, activities, organizational structure, and business model.

With respect to documenting the internal control structure:

18. any controls necessary to document an effective internal control structure taking into consideration the nature of the business of the NRSRO, including its size, activities, organizational structure, and business model.[2]

Generally, the staff assesses compliance with Rule 17g-8(d) by interviewing relevant NRSRO staff and reviewing internal documentation to evidence that the firm considered each of the specified control factors. As discussed in the Adopting Release for Rule 17g-8(d), in

[2] *See* Release No. 34-72936, National Recognized Statistical Rating Organizations at 667-81 (Aug. 27, 2014); [79 FR 55077 (Sept. 15, 2014)], *available at* https://www.sec.gov/rules/final/2014/34-72936.pdf.

considering a given factor, an NRSRO should determine whether it would be appropriate for the firm's internal control structure.[3] The Commission did not mandate that a particular factor be implemented, only that it be considered by the NRSRO.

b. In his dissent, Commissioner Gallagher also used the phrase "thought crime" to describe the ultimately adopted rule text that prohibits a person within an NRSRO participating in the rating process to be "influenced by sales or marketing considerations."

i. How do you address Mr. Gallagher's notion that the Commission can basically prosecute a state of mind, given the prohibition does not require an actual action to be taken?

ii. Commissioner Piwowar also noted that this rule text "sets an impossible standard for compliance and has no limiting principle." Commissioner Piwowar also importantly noted that "it is not just management at the NRSRO whose motives could be questioned; every NRSRO employee including those involved in ratings determinations, has an interest in the success of the enterprise." How do you ensure that the SEC does not abuse this overly broad prohibition to allege violations?

Response:

Section 15E(h)(3)(A) of the Securities Exchange Act of 1934 (Exchange Act) directed the Commission to issue rules to prevent the sales and marketing considerations of an NRSRO from *influencing* the production of credit ratings by the NRSRO. Given this statutory language, the Commission included two prongs to the absolute prohibition in Rule 17g-5(c)[4] prohibiting a person within the NRSRO who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models from also: (i) participating in sales or marketing of a product or service of the NRSRO or a product or service of an affiliate of the NRSRO; or (ii) being influenced by sales or marketing considerations.

Additionally, the NRSRO must include with each credit rating action an attestation signed by a person within the NRSRO stating that the person has responsibility for the rating action and, among other things, no part of the credit rating was *influenced* by any other business activities.

The Adopting Release for Rule 17g-5(c) provided several examples of sales and marketing activities and the Commission noted that other scenarios would need to be evaluated

[3] *See* Release No. 34-72936, *National Recognized Statistical Rating Organizations* at 65 (Aug. 27, 2014) [79 FR 55077 (Sept. 15, 2014)], *available at* https://www.sec.gov/rules/final/2014/34-72936.pdf.

[4] 17 C.F.R. § 240.17g-5(c)(2015)(Rule 17g-5(c)).

based on the particular facts and circumstances.[5] In the Adopting Release, the Commission also discussed the possible channels of *influence* that should be considered, such as:

- Compensation arrangements that may incentivize analysts to produce inflated credit ratings to increase or retain the NRSRO's market share;
- Performance evaluation systems that reward analysts who produce inflated credit ratings to increase or retain the NRSRO's market share;
- Compliance personnel who unduly influence credit analysts to inflate credit ratings in response to complaints by clients;
- Clients such as rated entities who pressure analysts to produce inflated credit ratings to retain their business; or
- Managers who are not involved in sales and marketing activities but may seek to pressure analysts to produce inflated credit ratings to increase or retain the NRSRO's market share.[6]

The staff's annual examinations of NRSROs include testing compliance with Rule 17g-5(c). This includes (1) reviewing internal documentation at the NRSRO, (2) reviewing staff email or other written communications, (3) conducting interviews of persons participating in the rating process as well as persons involved in sales or marketing activities, (4) observing the physical separation of such persons, and (5) reviewing the attestation that must be included with each credit rating action.

As a component of the examination, OCR staff provides the NRSRO with recommendations relating to the findings to which the NRSRO is required to provide a response. The resulting response is then evaluated in subsequent examinations to assess whether the NRSRO has appropriately addressed the staff's finding and associated recommendation and has implemented its response. Where appropriate, OCR staff also may provide guidance to clarify a particular rule or to promote consistency across NRSROs in rule interpretation and application.

Questions for Mark Flannery, Division of Economic and Risk Analysis:

1. **Dr. Flannery, the President signed Executive Order 13579 in 2011, which requires independent regulatory agencies to perform an analysis of rules that "may be outmoded, ineffective, insufficient, or *excessively burdensome*, and to modify, streamline, expand, or repeal them in accordance with what has been learned." [emphasis added] Has DERA participated or assisted the SEC in this required analysis?**

    a. **Has DERA developed any recommendations for a set of rules that are outmoded or excessively burdensome and therefore should be amended?**

[5] *Id.* at 103-104.

[6] *Id.* at 105-106.

Response:

Executive Order 13579[7] states that "independent regulatory agencies should consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned."

The Commission has in place formal and informal processes for the review of existing rules to assess the rules' continued utility and effectiveness in light of evolution in the securities markets and changes in the securities laws and regulatory priorities, and DERA is an integral participant in many of these processes. Specifically:

- The Commission and staff review existing regulations retrospectively as part of an ongoing assessment of substantive program areas. For example, the Commission recently proposed a rule pursuant to the Disclosure Effectiveness Initiative and the FAST Act to address Commission disclosure requirements that may have become redundant, duplicative, overlapping, outdated, or superseded.
- The Commission reviews its rules pursuant to its obligations under the Regulatory Flexibility Act, with a view to identifying rules in need of modification or rescission.
- The Commission and staff frequently receive and consider suggestions to review existing rules through various types of communications from a wide variety of constituencies.
- The Commission and staff frequently discuss the need to revisit existing rules through formal and informal public engagement, including advisory committees, roundtables, town hall meetings, speeches, conferences, and other meetings.
- Commission staff may identify existing regulations that may merit review through its compliance inspection and examination functions, enforcement investigations, and the receipt of requests for exemptive relief or Commission or staff guidance.
- In considering changes to existing rules for other reasons (e.g., congressional mandates), Commission staff routinely consider related existing rules and assess whether to recommend changes to, or the elimination of, those existing rules.

The Commission has also committed in several recent rules (e.g., Regulation A+, crowdfunding, risk retention, and money market fund reform) to specified ongoing review of the effects of the rule by staff. Such data-driven analyses can assist the Commission as it monitors the market effects of its regulations, as well as any consideration of subsequent rule changes.

2. **Dr. Flannery, last summer, Chair White stated in a speech that she was directing the staff to develop recommendations regarding universal proxy. This is obviously a controversial topic, where many feel that the costs associated do not outweigh the proposed benefits. At what point in time are you or your staff brought in to assist in the development of recommendations to assess costs and benefits?**

[7] Exec. Order No. 13579, "Regulation and Independent Regulatory Agencies," 76 Federal Register 41587 (July 14, 2011).

a. Have you started such an analysis regarding universal proxy?

Response:

Economic analysis is a fully-integrated part of the SEC's regulatory process. Per the 2012 *Current Guidance on Economic Analysis in SEC Rulemakings*, DERA economists are involved at the earliest stages of a rulemaking process, before the specific preferred regulatory course is determined, and throughout the course of writing proposed and final rules.

On October 26, 2016, the Commission voted to propose two amendments to the proxy rules.[8] The proposal issued by the Commission included a robust economic analysis, including consideration of the costs and benefits of the proposed rule changes.

3. **Dr. Flannery, the Committee is very concerned with the increasing influence by international groups and organizations on the SEC's rulemaking. It comes as no surprise to us anymore, that once the FSB issues a report, the FSOC shortly follows suit thereafter.**

    a. **In particular, we are concerned about the FSOC's review of asset managers as systemically important in light of the Office of Financial Research's 2013 extremely flawed and inaccurate report. According to Secretary Lew, the FSOC has coordinated with the SEC staff in the course of its review of "potential risks from asset management products and activities." Has DERA been involved or provided comment to the FSOC?**

        i. **Do you think it is appropriate that the FSOC has decided to review activities and products in the asset management industry for systemic risk? In your opinion, why do you believe FSOC has shifted its focus from asset manager firms to products and activities?**

        ii. **As you are aware, Chair White has set forth an agenda to enhance the oversight of asset managers, and a number of these rules have been proposed. Are you concerned that the separate review of the FSOC on the asset management industry could influence what should be a data driven rulemaking at the SEC?**

Response:

Chair White is a member of FSOC, and DERA's primary role with respect to FSOC is to support the Chair in that capacity. DERA staff also participates in FSOC committees and working groups, and we provide FSOC with technical assistance and data if requested by FSOC.

The oversight of registered funds and the investment advisers that manage them is an important function of the Commission. The FSOC is charged with identifying risks to the

[8] *See* Release No. 34-79164, *Universal Proxy* (October 26, 2016), *available at* https://www.sec.gov/rules/proposed/2016/34-79164.pdf

financial system of the United States. In its most recent update on the status of its review of asset management products and activities, the FSOC focused on potential risks that the asset management industry could pose — liquidity risks (liquidity transformation and the first-mover advantage), leverage risks, operational risk, securities lending risk, and resolvability and transition planning. The SEC's asset management initiatives, announced by Chair White in December 2014, are designed to modernize the SEC's regulation of the asset management industry, and these projects address many of the potential risks in the registered fund space cited in the FSOC's most recent report.

SEC staff is working to complete the rulemaking projects that are part of the asset management initiatives. As illustrated by the Commission's final rule on money market funds, the Commission, as an independent regulatory agency, is committed to bringing its own expertise to bear in crafting rules through a robust notice and comment rulemaking process, pursuant to its statutory mandate to protect investors and to promote efficiency, competition, and capital formation.

Questions for Sean McKessy – Office of the Whistleblower

1. **How do you believe you, and the SEC, can balance the conflicting policy interests of wanting whistleblowers to come forward to the SEC, but also encourage employees to raise the issue internally to hopefully have the company address it as soon as possible?**

Response[9]:

In adopting its whistleblower rules, the Commission recognized that whistleblower reporting through internal compliance procedures can complement or otherwise appreciably enhance the Commission's enforcement efforts in appropriate circumstances.[10] For this reason, the Commission adopted strong incentives and protections for employees who choose to work within their company's own compliance structure because they believe that the employer's internal compliance function is an effective mechanism to address any potential wrongdoing.

For example, under the Commission's whistleblower rules, if an employee reports wrongdoing through his or her company's internal whistleblower, legal, or compliance procedures, and within 120 days, submits the same information to the Commission, then the Commission will consider that the employee provided the information as of the date of his or her original report through the company's internal reporting system.[11] This mechanism gives the

[9] Mr. Sean McKessy prepared the below responses before his departure from the Commission on or about July 29, 2016.

[10] *See* Release No. 34-64545 at 229, n.450 (May 25, 2011), *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, ("Whistleblower Adopting Release"), *available at* https://www.sec.gov/rules/final/2011/34-64545.pdf

[11] 17 C.F.R. § 240.21F-4(b)(7)(2015).

company the opportunity to address misconduct first, while protecting the whistleblower's "place in line" in award consideration in the event that other whistleblowers also report to the Commission. Further, the employee's internal report may itself become award-eligible if the company later provides the Commission with the information that the employee reported internally, or with the results of an internal investigation that was prompted by the employee's report, and the Commission brings a successful enforcement action based on that information. [12]

The Commission's whistleblower rules also support internal reporting through consideration of the amount of an award. Section 21F of the Exchange Act permits the Commission discretion to set awards between 10 percent and 30 percent of the amounts collected in an enforcement action or related action.[13] The whistleblower rules set forth several factors that the Commission will consider in determining a whistleblower's award percentage, two of which relate to the individual's conduct with respect to his or her company's internal reporting or compliance system. If the individual reported the violation internally through the company's internal reporting channels or mechanisms, then the award percentage may be increased. On the other hand, if the individual did anything to interfere with or undermine the company's internal reporting process, then his or her award percentage may be decreased.[14]

Employees are more likely to report wrongdoing internally when they believe they will not suffer negative consequences for doing so. Thus, along with financial awards, anti-retaliation protection is a principle component of the whistleblower incentive structure that Congress enacted in Section 21F of the Exchange Act.[15] The Commission's whistleblower rules ensure that employees who choose to report concerns internally receive the same anti-retaliation protections under Section 21F as whistleblowers who report to the Commission, irrespective of whether they satisfy the criteria to qualify for a whistleblower award.[16] The Commission has appeared as *amicus* in federal courts throughout the country in support of its position that internal whistleblowers are entitled to the protection against retaliation under section 21F of the Exchange Act.[17]

a. Do you believe there is a potential conflict of interest for some employees to hold off on reporting a tip – either internally or to the SEC – to allow the

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[12] 17 C.F.R § 240.21F-4(c) (3) (the employee must submit the information they reported internally to the Commission within 120 days of providing it to the entity in order to be entitled to this incentive).

[13] 15 U.S.C. § 78U-6 (b) (1).

[14] 17 C.F.R. § 240.21F-6(a) (4); 21F-6 (3).

[15] 15 U.S.C. § 78u-6 (h) (1).

[16] 17 C.F.R. § 240.21F-2 (b).

[17] *See e.g., Berman v. Neo@Ogilvy LLC,* 801 F.3d 145 (2d. Cir. 2015).

misconduct to occur longer and potentially increase an SEC settlement, and therefore receive a higher award?

Response:

The SEC's whistleblower rules were designed to incentivize individuals with knowledge of potential securities law violations to report their information promptly. One of the factors the Commission considers in determining whether to decrease the award percentage is whether the individual unreasonably delayed in reporting the violation.[18] The Commission recently rejected a whistleblower's request for a higher award because, although the whistleblower's delay was limited in duration, the violations continued and the respondents in the underlying action obtained additional ill-gotten gains, with a resulting increase in the monetary sanctions upon which the whistleblower's award was based.[19] The Commission reasoned that "it would undermine our objective of leveraging whistleblower tips to help detect fraud early and thereby protect investor harm if whistleblowers could unreasonably delay reporting and receive greater awards due to the continued accrual of wrongful profits."[20] Because the Commission considers unreasonable reporting delay in determining award percentage, we believe that whistleblowers are incented to report promptly without delay.

Additionally, a whistleblower could run the risk of losing out on any award if he or she delays reporting. For example, under the Commission's rules, an individual who sits on knowledge of a fraud until being contacted by investigators generally will not qualify for an award.[21] This approach to the statute's requirement that a whistleblower act "voluntarily" was intended to create a strong incentive for whistleblowers to come forward early with information about possible securities violations.[22] Our rules generally require that, in order to qualify for an award, a whistleblower's tip must cause the Commission staff to open an investigation or must significantly contribute to the successful action. A whistleblower who waits to report an ongoing violation runs the risk that a co-worker or other source might report the wrongdoing first, making it so that he or she would have the higher hurdle of providing information that significantly contributed to an ongoing investigation. A potential whistleblower who delays in reporting also faces the possibility that his or her information will not be "original," and thus not eligible for an award, if the agency already learned of the information from another source or through its own investigative processes. Accordingly, we believe our rules provide the right checks and balances to encourage whistleblowers to come forward as promptly as possible to both preserve their

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[18] 17 C.F.R. § 240.21F-6(b)(2)(2015).

[19] *See In the Matter of the Claim Award*, Securities Exchange Act, Rel. No. 76338, File No. 2016-1 (Nov. 4, 2015).

[20] *Id.* at 3.

[21] 17 C.F.R. § 240.21F-4(a).

[22] Whistleblower Adopting Release at 25.

eligibility for an award and avoid a potentially significant downward adjustment to their award percentage.

Questions for Mark Wyatt – Office of Compliance, Inspections, and Examinations:

1. **The Dodd-Frank Act subjected thousands of advisers to private funds to SEC registration and reporting requirements and therefore examination by OCIE. How has this mandate affected the percentage of investment advisers that OCIE is able to examine annually?**

Response:

In general, when OCIE receives mandates to examine new or expanded registrant populations, without receiving additional resources, OCIE fulfills its new or expanded obligations by drawing resources from other programs.

In the case of private fund advisers, to enhance industry and product expertise, OCIE has formed a small Private Funds Unit. The percentage of staff resources dedicated to the Private Funds Unit is disproportionately less than the percentage of advisers registered with the SEC that manage private funds (approximately 37 percent of all SEC-registered advisers).

Since OCIE began examining private fund advisers following the implementation of the Dodd-Frank Act, OCIE's exams of private fund advisers have yielded tens of millions of dollars in recoveries for investors, primarily relating to hidden fees and expense issues. The staff's work related to private funds has been a catalyst for the investors in such funds to demand greater transparency from the funds' advisers, which, in turn, could benefit retail pensioners whose pension plans have invested in private equity funds.

   a. **As you know, many of these private funds only allow investments from accredited investors and qualified institutional buyers. Do these investors need the same type of protection as retail investors? How is OCIE's examination program tailored to those distinctions?**

Response:

OCIE's Private Funds Unit executes private fund adviser exams, builds private fund expertise among examiners, and develops new private fund exam approaches. In addition, the Private Funds Unit members provide guidance and assistance to other examination teams as needed when they encounter issues related to private funds.

The types of issues identified during exams of private fund advisers may be difficult to detect by even the most sophisticated investors. For example, one of the primary issues OCIE has observed in examinations of private fund advisers is potential misallocation of fees and expenses. These include instances in which examiners have observed private fund advisers shifting expenses away from the adviser and to the funds' investors or portfolio companies. They also include instances in which examiners have observed private fund advisers charging

fees to the portfolio companies or the funds they manage. These expense allocations and fees may not be disclosed to investors in a clear or meaningful manner. Accordingly, these types of issues are likely to be a focus during OCIE examinations.

Moreover, OCIE's private fund exams have enabled Commission staff to better understand and take into account private fund business models and the needs of private fund investors. The information obtained in OCIE's private fund examinations has assisted Commission staff in providing to private fund advisers guidance regarding the application of the Investment Advisers Act of 1940 (Advisers Act) and its rules over the past few years. This review of the application of the Advisers Act to private fund advisers is ongoing and Commission staff may, where appropriate, issue additional guidance.

b. Do you believe OCIE should focus its resources on examining investment advisers serving retail customers? If not, how is this practice consistent with OCIE's Examination Priorities for 2016 which lists as its top priority "Protecting Retail Investors and Investors Saving for Retirement?"

Response:

As stated in OCIE's 2016 Examination Priorities, protecting retail investors and retirement savers is an exam priority, and it will likely continue to be a focus for the foreseeable future. The 2016 Examination Priorities also stated that OCIE staff will continue examining private fund advisers, maintaining a focus on fees and expenses. [23]

Pension plans (private and public), which are large investors in private funds, have been harmed by the issues involving private fund advisers' expense allocation and fees discussed above. While pension plans are accredited investors, harm to pension plans impact retail investors like retired teachers, firefighters, etc. who often rely on the funds as a primary source of retirement income.

2. Mr. Wyatt, the SEC must be a responsible steward of sensitive and proprietary information it collects from registered entities, particularly since the Dodd-Frank Act has required for the first time registration of advisers to certain private funds.

a. Please outline the top-level framework that the SEC uses to safeguard proprietary information collected through Form PF or other means from registrants.

Response:

The Commission is committed to protecting proprietary information collected through Form PF and other means from registrants. The Dodd-Frank Act provides specific confidentiality protections for proprietary information of private fund investment advisers collected by the Commission on Form PF. Consistent with the enhanced confidentiality

[23] As noted in OCIE's 2016 Examination Priorities, the priorities mentioned therein do not constitute an exhaustive list of OCIE's initiatives and priorities may change.

provisions established under the Dodd-Frank Act, Commission staff has designed and implemented controls and systems for the handling of Form PF data across the agency. Senior staff members from various Divisions and Offices within the Commission are members of a Steering Committee that is tasked with developing and overseeing a consistent and agency-wide approach to accessing, sharing, and securing Form PF data. Internal requests to access Form PF data are managed by a centralized access management capability.

Concerning other information that is collected to support our regulatory mission, the SEC adheres to the risk management framework developed by the National Institute of Standards and Technology (NIST) that focuses on implementing management, operational and technical security controls to protect information stored, transmitted, and processed by agency information systems. Identified security requirements are independently validated as part of the SEC's Security Assessment and Authorization program and tested periodically to ensure controls are in place and operating as intended. Specific controls that are implemented that directly support security in field or exam settings include data encryption of information both in transit and at rest, secure email protocols, multi-factor authentication, and security awareness and training conducted on a regular basis to teach and reinforce all employees and contractors how to protect sensitive information.

Chairman Scott Garrett
Additional Question for the Record
Capital Markets Subcommittee Hearing Entitled "Continued Oversight of the SEC's Offices and Divisions"
April 21, 2016

Additional Question for Thomas Butler, Office of Credit Ratings:

Mr. Butler, your written testimony noted that the "NRSROs have been generally responsive to the Commission staff's findings and recommendations." How has regulatory oversight of the NRSROs changed since the creation of your office?

a. Alternative: Mr. Butler, over the course of your tenure as Director of this office, can you please tell us what changes you have noticed related to the regulatory oversight of the NRSROs? For example, since you first submitted the Annual report to Congress in 2012 and your most recent report submitted to us?

Response:

The Office of Credit Ratings ("OCR") was established in June 2012, pursuant to the Dodd-Frank Act. To date, there have been five public reports issued on the essential findings of the annual NRSRO examinations pursuant to the Dodd-Frank Act, four of which were completed after the formation of OCR.[24] OCR continues to observe that the examinations are driving

[24] https://www.sec.gov/ocr/reportspubs/special-studies/nrsro-summary-report-2015.pdf; https://www.sec.gov/ocr/reportspubs/special-studies/nrsro-summary-report-2014.pdf; https://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf;

compliance and serving as an effective catalyst for change. In OCR staff's view, the NRSROs have enhanced their understanding of their obligations as regulated entities and they are better managed organizations today due to the regulatory requirements and the examinations together with their associated recommendations. Many of the NRSROs have hired key personnel, restructured their organizations and invested in technology to enhance governance and controls. There is also increased disclosure and transparency for the benefit of investors. At several of the firms, operational improvements made in prior years are being further integrated and strengthened, including investments in compliance systems and infrastructure, and more robust procedures and controls for certain ratings processes.

While there have been significant improvements in the overall compliance cultures at the firms, there is always more work to be done. OCR continues to observe examination findings in part because the staff conducts disciplined, individualized risk assessments to identify different risks for each NRSRO as a component to the examination preparation. For example, during a particular examination, OCR may focus on risk-targeted areas such as quantitative analysis and information technology, including cybersecurity. As a result, the examination of each NRSRO covers all of the eight review areas required by the Dodd-Frank Act while being tailored to the NRSRO's specific risk profile to determine areas of emphasis and issues of focus. This bespoke approach serves to prevent the examinations from becoming stale and predictable, and assures that the examination results represent meaningful improvements to mitigate identified risk areas.

During recent examinations, OCR has found limited instances where certain NRSROs failed to adhere to their policies and procedures related to methodologies, criteria, quantitative models and rating publications. OCR has also found limited instances where certain NRSROs did not adhere to their IT policies and procedures concerning access, updates and use of third-party vendors. The annual examinations include a review of whether the NRSROs appropriately addressed the staff's recommendations regarding these findings. Notably, past NRSRO examinations have led to referrals to the Division of Enforcement resulting in settled administrative proceedings and accompanied by admissions and agreed undertakings together with the imposition of fines, disgorgement penalties, prohibitions and industry bars.

The rules that were adopted by the Commission in August 2014 became effective by June 2015 and added substantial new requirements on NRSROs to, among other things, address internal controls, manage conflicts of interest and enhance the integrity of the ratings process. The annual examinations include an assessment of compliance with these rules. The NRSRO must have standards of training, experience and competence for its analysts, which must be reasonably designed to ensure that the NRSRO produces accurate credit ratings.

Global oversight of credit rating agencies has also been strengthened, as jurisdictions around the world are adding new and amending existing regulatory requirements. OCR engages in bilateral and multilateral dialogue with international credit rating agency regulators to discuss examination findings and recommendations and consider risk areas to inform potential future examinations.

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https://www.sec.gov/news/studies/2012/nrsro-summary-report-2012.pdf; and
https://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.

In addition to the annual report on NRSRO examinations that is made available to the public pursuant to the Dodd-Frank Act, OCR prepares an annual report to Congress on NRSROs as required by the Credit Rating Agency Reform Act of 2006. The most recent annual report, which was issued in December 2015, discusses the significant competitive inroads that some of the smaller NRSROs have made in rating certain asset classes, including commercial mortgage-backed securities.[25]

[25] https://www.sec.gov/ocr/reportspubs/annual-reports/2015-annual-report-on-nrsros.pdf.

The Honorable Luke Messer
Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing
Entitled "Continued Oversight of the SEC's Offices and Divisions"
April 21, 2016

Questions for the Record for Mr. Mark Flannery:

Mr. Flannery, as I'm sure you're all aware, the Department of Labor recently finalized a new and complicated rule imposing fiduciary obligations on certain persons selling retirement assets. Despite claims from Secretary Perez that DOL "worked extensively" with the SEC throughout the rulemaking process, actual comments from SEC officials and staff suggest otherwise. In fact, former SEC Commissioner Gallagher criticized the DOL rule comment period, calling it "merely perfunctory." However, Commissioner Gallagher made these comments well before the DOL issued its final rule.

Mr. Flannery, did the Department of Labor change their approach in their collaboration with the SEC before issuing their final rule—were these collaborations more than "merely perfunctory"?

As a result of these collaborations, did the DOL amend the rule to account for concerns raised by SEC officials and staff?

Has DERA undertaken an analysis of the impact of the DOL rule?

If not, how would DERA analyze the potential adverse effects of adviser conflict of interest?

Is it even possible to analyze the cost of this kind of conflict of interest with a reasonable level of statistical certainty?

Mr. Flannery, in an email uncovered in a report issued by the Senate Homeland Security and Governmental Affairs Committee, an SEC economist responded to an email from a DOL economist stating "I am now utterly confused as to what the purpose of the proposed DOL rule is then, if not to limit advisor conflicts when providing retirement advice?"

Mr. Flannery, do you believe the final DOL fiduciary rule will reduce advisor conflict of interest? What types of individuals are likely to lose access to their financial advisers as a result of the rule?

Response:

As separate agencies, with distinct regulatory mandates, the Commission and the DOL may each proceed independently to consider changes to the standards that apply to advice given by each of our regulated entities. However, in light of potential impacts that rulemaking may have on regulated entities, investors, and the markets, consultation between the DOL and the SEC has been, and will continue to be, important.

SEC staff, including DERA staff, provided DOL staff technical assistance and expertise on the Commission's regulatory regime as DOL considered its rule. SEC staff also shared experiences with how services are provided in this area of the market. Given DOL's independent statutory authority in this area, however, we gave our comments with the understanding that the DOL may accept or challenge our views as it saw fit.

We will of course perform a thorough economic analysis, compliant with the Current Guidance on Economic Analysis in SEC Rulemaking, of any uniform fiduciary rule that the Commission issues, and will issue that economic analysis for comment in conjunction with the proposed rules. I expect that the DOL's rule, including the DOL's regulatory impact analysis that accompanied the rule, will be important for DERA to review and analyze as part of the regulatory baseline — our explanation of the existing state of the world — that is an integral part of each of our economic analyses.

Given the current status of that project, which is a challenging one — it is a complicated issue with potentially direct impacts on millions of investors — and given the independent jurisdiction of the DOL, I have not had the opportunity to study or form an opinion on the likely effects of the DOL rule on broker or adviser conflicts of interest or access to brokers or advisers, or whether any such effects have already begun to manifest themselves in the marketplace.

Questions for the Record for Mr. Marc Wyatt:

Mr. Wyatt, as you're well aware, Dodd-Frank gave the SEC new authorities to pursue certain cases through administrative proceedings, rather than filing in a Federal Court. This broke long standing precedent that dates back to the inception of the agency. According to the Wall Street Journal, the SEC has a distinct advantage when pursuing cases through administrative proceedings—when they are "operating on their own turf"—winning over 90% of cases, while only winning 69% of cases in Federal court. Stanley Sporkin, a former SEC enforcement chief, said it might appropriate to address the "perception problem" the SEC in-house court has by amending the law.

Do you agree with Mr. Sporkin? Do you support legislation, like Chair Garrett's bill[1], that would protect the right to due process?

Response:

Given that OCIE is responsible for administering the SEC's nationwide examination and inspection program. OCIE does not bring enforcement actions or initiate any administrative proceedings. As such, I am not in a position to express a view regarding Mr. Sporkin's statement or any related legislation.

Mr. Wyatt, according to the SEC FY 2017 Congressional Budget Justification, approximately 31% of examinations conducted by OCIE in 2015 resulted in a "significant

[1] Due Process Act of 2015, H.R. 3789, 114th Cong. (1st Sess., 2016)

finding," which by your definition means deficiencies in firm operations having a high potential to cause harm to clients of a firm, or reflect recidivist misconduct.

Mr. Wyatt, given this high number of "significant findings" as a result of these examinations, why have SEC exam rates remained constant, as a percentage of the industry, when the SEC receives regular increases in its annual appropriations and has a Reserve Fund outside of the appropriations process from which the SEC can spend up to $50 million each year without limitation?

Response:

Over the past several years, OCIE has improved efficiencies by refining its risk-based approach to selecting and examining firms and conducting more narrowly-focused examinations that concentrate on specific issues and areas of industry risk. These efforts have contributed to recent increases in the number of examinations completed, as OCIE completed more exams in FY2016 than in any of the prior seven years. During the same time, OCIE has continued a number of critical staff activities that are not reflected in our examination (and corresponding coverage) numbers, including conducting hundreds of outreach and education programs and thousands of internal desk reviews.

It is also important to note that the number of registrants examined and overall examination rates are dependent on many factors, including the types and scope of examinations conducted in each year, the size and complexity of firms examined, program priorities, legislative changes, changes in registrant populations, and, of course, staffing levels. For example, the number of registered advisers, their complexity, and their assets under management has increased substantially over the last decade, making it increasingly difficult to materially improve coverage levels with existing resources. Given this growth, effective October 1, 2016, OCIE has transitioned some staff from our broker-dealer examination program to the investment adviser/investment company examination program, with the goal of increasing our coverage of investment advisers. We will keep examining broker-dealers and maintain a significant presence nationwide, including in market centers such as New York and Chicago. We will also bolster our oversight of FINRA and are exploring ways to leverage FINRA's resources and its regulatory reach into the broker-dealer industry. We believe that this pro-active approach will likely improve coverage even further in the areas of greatest risk to investors. Finally, OCIE has made significant improvements in productivity and capability through technology advancements over the past several years, benefitting from a portion of the resources provided by the SEC's technology reserve fund.

Could you please explain how the employee's union collective bargaining agreement with the SEC impacts the Office's ability to increase its annual examinations rates?

Response:

We have a strong working relationship with the National Treasury Employees Union. While there is naturally some compromise through negotiation in any labor-management forum, particularly in the work-life areas included in the collective bargaining unit, we believe it to be

offset by improvements in staff morale, job satisfaction, productivity, and attracting new talent, as supported by OCIE's 2015 Federal Employee Viewpoint Survey and examination results, among other things. For example, 94.9% of OCIE staff responded that they would put in the extra effort to get a job done when needed. Moreover, 88.7% of OCIE staff felt that the work they did was important, and 83.6% of the staff responded that they felt that their supervisor supported their need to balance work and other life issues. At the same time, OCIE's total number of completed examinations has increased progressively each of the past five years. Also, as you noted, the significant findings resulting from examinations is approximately 31%, which we believe is one indicator that our examinations are effective. Overall, we believe we successfully manage an effective and efficient examination program in the given environment.

What steps would need to be taken to increase the amount of examinations each examiner conducts per year?

Response:

The number and type of entities over which OCIE has examination authority has expanded considerably over the past several years and placed a greater demand on OCIE's resources. With this increased responsibility, OCIE has recognized the importance of maximizing the efficiency and effectiveness with which it utilizes those resources in carrying out its work. OCIE has made it a priority to channel its limited resources toward their highest and best use by implementing a risk-based strategy across the entire examination program. OCIE has taken, and will continue to pursue, several steps to maximize its limited resources for overseeing regulated entities. These include continuing to refine the program's risk assessment process and use of focused initiatives, leveraging technology and data analytics in examination planning and execution, recruiting industry experts, and strengthening examiner training.

Finally, it is important to emphasize that the quality of exams we are conducting is our main priority. Increases or decreases in exam numbers do not tell the entire story of our program as exam numbers alone do not speak to quality or the breadth of our work.

4/21/2016 Hearing

Subcommittee on Capital Markets & Government Sponsored Enterprises
"Continued Oversight of the SEC's Offices and Divisions"

Questions for Mr. Flannery from Rep. Neugebauer:

Are you concerned that the proposed rule 18f-4, use of derivatives by Registered Investment Companies, will limit the average investor's ability to access diversifying assets? Are you concerned that this rule could harm rather than protect investors as it limits diversity and makes for a higher concentration of riskier investments like equities?

Response:

Currently, registered funds can create significant leverage through derivatives, which could expose investors to the risk of considerable losses. Further, certain derivatives that achieve similar economic exposures are, under the current regulatory framework, treated differently, which can create economic inefficiencies. The Commission's proposed rule regarding derivatives would limit certain leveraged exposures, require that funds operate with an adequate buffer to meet their derivatives obligations, and focus the attention of fund managers and boards on ensuring that derivatives risks are properly managed.

The economic analysis included in the release sets out the proposed rule's potential economic impacts, including both the benefits and costs. The proposed rule could benefit investors by limiting the possibility that they would suffer outsized losses caused by using derivatives to achieve leverage, and it could benefit funds through a consistent and comprehensive yet flexible treatment of derivatives. Our economic analysis also acknowledged potential costs. While many funds do not use derivatives in substantial amounts and would not be significantly affected by the rule, other funds could react in a number of ways, including by shifting their portfolio composition or investment strategy, or operating in a legal structure that is not subject to the limitations on leverage that the proposed rule would apply. The release acknowledges that there is significant uncertainty as to which of these various options funds are likely to pursue, but that they could have impacts on investors. The Commission staff is actively considering comments received on the proposed rule.

Proposed rule 18f-4, use of derivatives by Registered Investment Companies, attempts to regulate the use of derivatives but will ultimately alter the commodities futures market by setting arbitrary portfolio limitations for derivatives. The rule incentivizes funds to overweight portfolios with stocks and bonds and move away from trading commodities. What is your view on the regulation of simple, diversifying derivatives? Can you tell me how the SEC intends to fix this problem with the rule?

Response:

One of the difficulties the release acknowledges is that derivatives used for diversifying or hedging purposes may sometimes fail to have their anticipated effect. If they fail to perform as intended, they may instead result in additional, speculative exposure. Similarly, the release noted in conjunction with its proposed exemption for netting purposes, that some seemingly-offsetting transactions may not have the effect of eliminating or reducing market exposure. For example, using a pair of derivatives contracts to produce a "collar" or "spread" return might introduce potential risks associated with strategies that seek to capture small changes in the value of such paired instruments.

The DERA staff white paper on the use of derivatives in mutual funds released in conjunction with the proposed rule last December finds that certain funds that invest in commodity derivatives are among the more intensive users of derivatives. However, the Commission observed in the proposing release that the Commission staff's analysis indicated that it should be possible for funds to pursue, in some form, almost all existing types of investment strategies in compliance with the proposed rule. The economic analysis included in the release discusses the economic effects that could result if funds were to respond to the proposed rule by shifting their portfolio composition, including through purchasing substitute instruments, or by offering the investment strategy through some other form of investment vehicle, such a hedge fund, that would not be subject to the limitations on derivatives discussed in the proposed rule.

The proposed rule was put forth for public comment in December 2015, and the comment period closed March 28, 2016. The Commission staff is actively considering comments received on the proposed rule. Chair White has indicated that moving forward with this rule is one of her rulemaking priorities.