

**OVERSIGHT OF THE SEC'S DIVISION  
OF CORPORATION FINANCE**

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**HEARING**

BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENT  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED FIFTEENTH CONGRESS  
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## OVERSIGHT OF THE SEC'S DIVISION OF CORPORATION FINANCE

Thursday, April 26, 2018

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENT,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Present: Representatives Huizenga, Hultgren, Wagner, Poliquin, Hill, Emmer, MacArthur, Davidson, Budd, Hollingsworth, Maloney, Sherman, Lynch, Scott, Ellison, Foster, Meeks, Sinema, Vargas, and Gottheimer.

Also present: Representatives Hensarling and Royce.

Chairman HUIZENGA. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

This hearing is entitled, "Oversight of the SEC's Division of Corporation Finance." We are very pleased to have Mr. Bill Hinman here.

I do want to take a personal point of privilege, though, here a moment. I know it is take your child to work day.

We have one special guest. One Mr. Donald, young master Donald, over here. Donald McGahn is joining us, and he is going to be heading over to the White House. So, if you have a judicial appointment, this isn't the right Don McGahn you want to get to. The one is—he will be—he will be with the other one a little later.

I know from my own children over the years, it has always been a great opportunity. So, we are glad that we can have this day.

So, I am going to recognize myself now for 3 minutes to give a quick opening statement. As we all know, the Securities and Exchange Commission (SEC) has a three-part mission. Protect investors, maintain fair, orderly and efficient markets, and to facilitate capital formation.

Today's hearing will focus on the policies and procedures of the SEC's Division of Corporation Finance. CorpFin, as the office is better known, is responsible for ensuring that investors are provided with materially complete and accurate information in order to make informed voting and investment decisions. This includes disclosure requirements when the company initially offers its securities to the public and on a continuing and periodic basis.

CorpFin also provides interpretive guidance to companies regarding SEC rules and forms and makes recommendations to the Commission on new rules and revisions to existing rules.

The Division of CorpFin's activities and responsibilities include regularly monitoring and reviewing filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to ensure compliance with disclosure and accounting requirements, conducting a comprehensive review of the SEC's rules governing public company disclosure, completing rulemakings to implement disclosure-related provisions of the Dodd-Frank Act, and conducting oversight of the proxy process, including the activities of proxy advisory firms.

One of my biggest concerns is the declining number of public companies which has led to fewer investment opportunities for main street investors. IPOs have historically been one of the most meaningful steps in the life cycle of a company.

Going public not only affords companies many benefits, including access to the public capital markets, but IPOs are important to the investment public as well.

Already, the recently enacted Tax Cuts and Jobs Act has strengthened our economy at the local, regional, and national level. By making our tax code more competitive, we have signaled to the world that America is, again, open for business, investment, and job creation.

To build on this success, we must continue with the pro-growth reforms that ensure the United States has the strongest, deepest, and most liquid markets in the world.

Unfortunately, from a regulatory standpoint, it has become increasingly apparent that our capital markets are becoming less and less attractive to growing businesses, due to the, quote, unquote, "one-size-fits-all securities regulations" currently in place.

Let us work together to reverse this negative trend of declining IPOs and focus on capital formation. Hard-working families in West Michigan and across the nation rely on capital markets to save for everything from college to retirement.

By making capital formation the priority, we can maximize Mr. and Mrs. 401K's return on their investment, expand opportunity, and increase job creation and grow our economy.

The Chair now recognizes the Ranking Member, the gentlelady from New York, Mrs. Maloney, for 5 minutes for an opening statement.

Mrs. MALONEY. Thank you. Thank you so much and thank you for holding this important hearing, Mr. Chairman.

The SEC's Division of Corporation Finance is hard to believe the most important division in the SEC, because it is responsible for ensuring that investors have access to all the information they need to make informed investment decisions.

They review the financial statements and disclosures that companies file and ensure that they are both complete and accurate. This is critically important because investors simply will not invest in a company unless they have confidence in the company's financial statements, understand the business model, and are aware of all the risks that the company faces.



The fact that investors all around the world are so eager to invest in the public companies is a testament to the confidence investors have in the disclosure framework that Congress and the SEC have developed over the years.

In my personal view, we shouldn't make significant changes to that disclosure framework lightly. When in doubt, we should err on the side of more disclosure, not less.

But the Division of Corporation Finance has another role, too. It also reviews the filings that companies make for their IPOs, when they are offering securities to the public for the very first time.

In these reviews, the SEC staff reviews the company's IPO filings to ensure that the company is complying with the Federal securities law.

One very important provision that public companies have to comply with is the so-called, quote, "anti-waiver provision" which prohibits companies from waiving compliance with the Federal securities law.

For example, a company can't require all its investors to agree not to sue them for securities fraud, or to allow the company to file their financial statements only once every 2 years, rather than every quarter.

The anti-waiver provision ensures that the basic investor protections in the securities law, including the right to sue companies for securities fraud, are guaranteed for all investors.

So, I was troubled when I read an article in "Bloomberg" in January, that said the SEC staff was laying the groundwork for a change that would allow public companies to strip investors of their right to sue for securities fraud in court, and instead force all of those claims into secret arbitration proceedings.

Last month, I led a letter to SEC Chairman Clayton which was signed by every single Democrat on the Financial Services Committee.

The Senate has also sent over a letter strongly opposing any effort to allow public companies to insert these forced arbitration clauses into their corporate governing documents.

I ask unanimous consent to place in the record my letter, Mr. Chairman.

Chairman HUIZENGA. Without objection.

Mrs. MALONEY. Let us be clear about the stakes here. If the SEC allows companies to use these forced arbitration clauses, that would essentially be the end of any securities fraud cases in public courts. It would definitely be the end of class action lawsuits for securities fraud.

So, when the next Enron or WorldCom comes around, shareholders who have been defrauded wouldn't be able to hold these companies accountable in court at all.

The reason this issue is so important for this hearing is simple. If a company that is preparing for an IPO tries to insert the forced arbitration clause into its corporate governing documents, it would be the staff in the Division of Corporation Finance that would have to decide whether that forced arbitration clause violates Federal securities laws.

For decades, the SEC's position has been that forced arbitration clauses violate the anti-waiver provision of the Exchange Act.

So, allowing companies to use these clauses would be an enormous change in policy that would affect every single investor in our markets.

So, I will be very interested to hear Mr. Hinman's thoughts on this, and will expect to hear whether he supports any efforts to reverse the SEC's long-standing position on the use of forced arbitration clauses in the bylaws of public companies.

I thank you, Mr. Chairman.

I yield my remaining seconds to my dear friend and colleague. I just had to get that into the record, because I feel it is important. But he deserves a lot more time than what I am yielding on.

Mr. SHERMAN. Bitcoin is a security and it is an investment. Investment protection is your business. Obviously, initial coin offerings.

The tax bill, that the Chairman refers to, says you could have a zero percent tax on the profit of your factory, but only if you move that factory to a foreign country.

I yield back.

Chairman HUIZENGA. The gentlelady's time has expired.

If you would, actually, give me a copy of the letter. I have not seen the letter. All right, that will be inserted in.

So, with that, Mr. Hinman, we welcome you here. I appreciate your time and attention.

I am sorry I was being delinquent. I have 2 minutes remaining in which I am going to be recognizing the Vice Chair of the Capital Markets Committee, Mr. Hultgren, from Illinois for 5 minutes.

Mr. HULTGREN. Thanks, Chairman Huizenga.

Thank you for convening this hearing today. I have been very pleased with the new leadership that we have seen at the SEC under Chairman Clayton.

But I do value these opportunities to have the chance to discuss the Commission's work to promote capital formation and investor protection.

My constituents have been extremely happy with the strong economic growth we have seen over the last year. I believe much of the growth is attributable to tax reform. But the common sense regulatory relief and reform across governments has also been extremely important.

I am especially pleased that Chairman Clayton has acknowledged the importance of reducing burdens on public companies, in order to increase opportunities for all investors.

One of the challenges I hear about most frequently, from public companies or companies interested in going public, is challenges with the shareholder proposal process.

This committee has spent a significant amount of time exploring the damaging effects of activist investors using the shareholder proposal process to achieve social change. But this is at the detriment of investors who are simply seeking to build wealth. These are many of my constituents who are seeking to save for retirement.

According to proxy monitor in 2017, proposals related to social or policy concerns, that did not relate to long-term shareholder value, represented over half of the proposals.

This committee has advanced a number of legislative proposals to address such issues, including a number of provisions of the Financial Choice Act.

I am interested in hearing about how the Commission can use its existing authority to revisit the shareholder resubmission thresholds under Rule 14a-8.

Last March, under the leadership of acting Chairman Piwowar, the Commission proposed a new rule to adopt inline XBRL to merge traditional unstructured filing submitted by public companies and mutual funds with standardized machine readable XBRL formats into a single filing.

At the time, Ranking Member Maloney and I wrote the Commission to encourage them to pursue this work to modernize these filings. I believe this is important to both investors and market surveillance by the Commission.

I hope we will be able to discuss this and that maybe you can give us an update on this work.

Thank you, again, Chairman, for holding this hearing.

I yield back the balance of my time.

Chairman HUIZENGA. The gentleman's time has expired.

With that, today, we welcome the testimony of Mr. William, Bill, Hinman, Director of the SEC's Division of Corporation Finance.

Mr. Hinman, you will be recognized for 5 minutes to give an oral presentation of your testimony, and, without objection, your written statement will be added into the record.

So, with that, Mr. Hinman, you are recognized.

#### **STATEMENT OF MR. WILLIAM HINMAN**

Mr. HINMAN. Thank you very much, Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee.

Thank you for inviting me to testify on behalf of the SEC's Division of Corporation Finance.

Since arriving at the SEC in May 2017, I have felt very privileged to work alongside the division's dedicated and talented staff.

As you mentioned, Chairman, the mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Our division oversees the review of the disclosures of companies, and we seek to ensure that investors have access to the important information they need to make informed voting and investment decisions.

In addition, the division provides interpretative advice about securities laws and makes recommendations to the Commission for rulemaking in areas of disclosure and securities offerings. The division stands ready to collaborate with companies in discussing how to comply with Federal securities laws.

Our reviews of reporting companies monitor and enhance compliance of the disclosure and accounting requirements we enforce. The Sarbanes-Oxley Act requires us to review the financial statements of reporting companies at least once every 3 years. In addition to these mandated reviews, the division selectively reviews filings made for other offerings, business combination transactions, and proxy solicitations.

Due to the declining number of U.S. public reporting companies, the division has been considering ways to make the public company alternative more attractive.

To the extent we are able to attract more companies to join our reporting system and to do so at an earlier stage, it will ultimately benefit those companies, our markets, and investors.

Companies that go through the evolution from a private company to a public company emerge as stronger companies with better disclosure.

Investors also benefit when there are more public companies in which to invest. This is a high priority. We are taking policy and rulemaking steps in this effort. For example, in July 2017, the division expanded its non-public review process for draft registration statements.

This expanded policy now applies to all IPOs for all issuers, not just emerging growth companies (EGCs). It allows follow-on offerings during that first year of being a public company to be submitted on a draft basis.

Companies are taking advantage of that process. It saves them money. It allows them to better access market windows.

Under this expanded process, we received draft submissions for more than 20 IPOs, and from more than 50 follow-on offerings from registrants that would not have qualified for that review process under the old rules. We are hearing that this is very helpful.

Through this process, companies can avoid preparing and filing interim financial information for draft filings if that information will be superseded by the time it is made public.

We still perform complete filing reviews. Investors still continue to receive the full financial information and other required disclosure at the time companies publicly file. We have also been working to assist companies in their efforts to comply with our rules in other areas.

Over the past months, the Commission or the division has issued interpretations of the pay-ratio disclosure requirements, the new tax reform law, and cyber security disclosures.

The division has also been focusing attention on digital assets and on initial coin offerings.

As this area continues to evolve, we are striving for a balanced approach, one that encourages capital formation while maintaining a strong focus on investor protection. We also are keenly focused on the importance of capital formation by small and emerging companies.

Congress and the Commission have taken steps, in recent years, to provide additional capital-raising avenues through Regulation A, securities-based crowdfunding, and Regulation D.

While at the same time we are doing this, we are maintaining robust investor protections under those new exemptions.

We continue to monitor the use of these exemptions, and we engage with a wide range of interested parties at meetings and at conferences around the United States to see how they are being used.

We recognize that small companies and investors can also benefit from reduced regulatory complexity. We are considering ways to harmonize and streamline our exempt offering rules.

Further, the division continues to work on reforms to make our disclosure regime more effective. Staff is working to finalize a recommendation for the Commission to raise the financial thresholds, under which more companies would qualify for scaled disclosures as smaller reporting companies.

We are reviewing our disclosure requirements and Regulations S-K and S-X, considering other ways to improve the disclosure regime for both investors and companies.

In addition to our disclosure reform efforts, we are looking to fulfill other rulemaking responsibilities, including disclosure rules related to resource extraction, conflict minerals, and executive compensation.

The division is also exploring where there are rules that could encourage more companies to go through the IPO process. We are thinking about extending the test the waters provision that was enacted in the Jobs Act for emerging growth companies to a wider range of participants.

Thank you very much for inviting me to discuss the division's activities and responsibilities. I look forward to answering your questions.

[The prepared statement of Mr. Hinman can be found on page 36 of the appendix.]

Chairman HUIZENGA. Thank you.

With that, I will recognize myself for 5 minutes of questioning.

So, as you have talked about in this, and I can't stress enough my concern about the number of IPOs that are happening or, frankly, not happening. We have about half as many public companies in the U.S. as we did 20 years ago.

I think that is detrimental to investors. The common investors, not institutional investors. I am very pleased to hear you say that the division is looking at ways to make the IPO market more vibrant.

Can you elaborate a little more on the division's capital formation agenda and discuss your priorities for enacting and encouraging more companies to go and stay public?

Mr. HINMAN. Sure. Thank you for that question.

We are doing a number of things. Some things require rule-making and that is a longer process, which is one of the reasons we first did this broadening of the confidential review process.

We have heard that companies find it much more useful to be able to time the public announcement of their offering closer to the time they actually expect to go to market. That gives the company less exposure to market vagaries.

That also works in their first year as a public company where prior to being S-3 eligible, companies would have to file and wait, perhaps as much as a month before they could go to market.

Now, with the confidential review process, that window is much shorter and they have much less exposure to market fluctuations during that period. That is helping people achieve more liquidity sooner which is good for investors. That is one area.

We have been trying to streamline our guidance and make it more transparent to users. We have done things as simple as putting more of our direct phone numbers in our manuals that the public sees so that they can reach people more quickly on issues.

Chairman HUIZENGA. Actual live people?

Mr. HINMAN. Actual—

Chairman HUIZENGA. Not voice mail—

Mr. HINMAN. It still may go to voice mail, but it goes at least to the right office mailbox.

Chairman HUIZENGA. Right.

Mr. HINMAN. Sometimes people pick up their line.

Chairman HUIZENGA. Yes.

Mr. HINMAN. But we have, now, identified the people and the phone numbers and the areas you might be interested in and made that quite public.

There is an area in which we have had authority for a long time, under Rule 3-13 of Regulation S-X, to provide waivers of financial statement requirements, when those statements would not serve investors but may be very burdensome to prepare. We have reduced the amount of time it takes a company to go through that process.

We have encouraged companies to come to us earlier in the process and not wait and develop an expensive 30-page letter explaining why they should receive a waiver, but to talk to us earlier and find out where our head is on that, and see if we can accommodate the request or not, but to save money in the process.

Of course, on the rulemaking side, we are doing a number of things which I can elaborate on if time permits.

Chairman HUIZENGA. Great. Well, in 2011, there was an IPO task force that asked public company CEOs. It was 92 percent of them said that the, quote, “administrative burden of public reporting was a significant challenge to completing an IPO.”

I appreciate that accumulative effect of those being looked at.

My colleague brought up ICOs. I want to touch on those as well.

Do you believe that ICOs could be a potential solution to the declining number of IPOs? I want to have you touch on that. You can hit on this if you would like, the differences between an ICO and an IPO.

But do you believe that there are any circumstances, instances where an initial coin offering should not be regulated as an offering of securities?

Some have discussed the concept of a utility token. If you could maybe take the next minute and a half and touch base.

Mr. HINMAN. Sure. I think the Chairman has made a number of statements around the use of this new technology. We very much want to see our efforts not stifle innovation in that area.

We have developed working groups that cross the divisions, my division and Trading and Markets, and Investment Management, to work with issuers who are interested in complying with our securities offering rules as they explore these new technologies.

The issues around whether a particular coin offering may involve an offering of a security are somewhat complex. But the drafters of the 1933 Act were quite wise and added very flexible provisions there.

An instrument that may be called a coin may still have the hallmarks of a security and need to be regulated as such or be offered on a registered basis or an exempt basis. We work with issuers that are exploring those options.

Chairman HUIZENGA. Can you come up with an instance when they wouldn't or shouldn't be viewed as securities?

Mr. HINMAN. In theory, there is a time when a coin may achieve a decentralized utility in the marketplace. There are some coins where you wouldn't have an issuer to regulate. They operate on their own.

Our rules, which look to protect investors by providing disclosure, generally require some centralized authority to make those disclosures.

In theory, there may be coins where that lack of central actor would make it difficult to regulate at least the offering as a securities offering.

Chairman HUIZENGA. OK.

Mr. HINMAN. That said, if someone is raising money and they have a stake in that, and they are promoting that, that is usually the central authority we are looking to for disclosing it.

Chairman HUIZENGA. My time has expired.

With that, I recognize the gentlelady from New York for 5 minutes.

Mrs. MALONEY. Thank you.

Mr. Hinman, as I mentioned in my opening statement, I led a letter to Chairman Clayton that every single Democrat signed, in strongly opposing any effort to allow public companies to use forced arbitration clauses on their own shareholders.

If the SEC allowed this, it would, essentially, be the end of securities fraud cases in Federal court. It would deprive shareholders of their ability to hold companies accountable for fraud. I think we can all agree that this would be an absurd and wrong result.

Chairman Clayton sent us a response on Tuesday which included an analysis by your division at the SEC.

While I appreciate Chairman Clayton's and your detailed response and how seriously both of you looked at our letter, I do have a question for you.

If it was actually reported earlier this year by Bloomberg that the SEC staff was, quote, "laying the groundwork to start allowing these forced arbitration provisions."

I want to ask you, are you or any of the staff in the department of the division at the SEC actively encouraging companies to submit registration statements with forced arbitration provisions in them?

Mr. HINMAN. So, I think that the letter that you referenced, in response to your inquiry and the other committee members' inquiry, covers that point. This is something that we are not actively looking at, in terms of trying to bring something in and address this issue.

It is a complex issue. It involves our laws and regulations. It involves other Federal laws, such as the Federal Arbitration Act and State laws.

As the Chairman's correspondence noted, if this issue were to come over to my division in the context you mentioned, of an IPO of a U.S. company, we would not be declaring that registration statement effective at the division level.

We recognize that this is an important issue, that is in the correspondence. We would defer to the entire Commission.

Mrs. MALONEY. Then, where did this report in Bloomberg come from, that the SEC was actively pursuing this course?

Mr. HINMAN. I hate to speculate where the press gets some ideas. I do know that it correlated to a conference that was held in California. The SEC was not in attendance because the Government was shut down.

I think panel members there were speculating and I think it got translated into the article you read.

Mrs. MALONEY. OK, thank you.

Last year, this committee marked up the Republicans Choice Act which made sweeping changes to the securities law. One provision of the act that got a lot of attention would have raised the threshold for shareholders who were allowed to put proposals on the public company's ballot.

Currently, a shareholder can submit a proposal, as long as he or she has held either \$2,000 or 1 percent of the company's stock for at least 1 year.

The Choice Act would have eliminated the \$2,000 threshold and would also have lengthened the holding period from 1 year to 3 years. Which means that in order to submit a proposal, shareholders would need to own at least 1 percent of the company's stock for 3 years.

This would make it virtually impossible for ordinary shareholders to submit proposals at the largest companies. For example, under the Choice Act, for a shareholder to submit a proposal at Wells Fargo, he or she would have to own \$2.7 billion worth of Wells Fargo stock and hold it for 3 years.

So, my question is, do you believe that only shareholders who own more than 1 percent of very large companies, like Wells Fargo, should be able to submit shareholder proposals to get voted on at annual meetings? Or do you believe that would unfairly restrict the ability of small shareholders to participate and try to influence the companies that they own?

Mr. HINMAN. In the shareholder proposal area, in general, we don't have a rule proposal moving forward, at this time.

The proposal thresholds that you had mentioned are the current rules that we are operating under. Those are somewhat aged. They haven't been looked at in, I think, over 20 years, in terms of either adjusting those for inflation or otherwise.

There have, from time to time, been discussions around what would the right threshold be? If we were to engage in rulemaking there, we would receive comments from a wide range of people and consider all of them.

We do see the value of the shareholder proposal process and giving shareholders access to the proxy to express their opinions.

So, we would be mindful of that as we develop whatever new or updated rule in this area we would come up with.

Mrs. MALONEY. Thank you.

My time has expired. Thank you.

Chairman HUIZENGA. The gentlelady's time has expired.

The gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Chairman. Thank you, Director. Appreciate you being here.



As a proponent of seeing all aspects of our Government innovate with technology, I have been closely following the way the Division of Corporation Finance has been trying to implement the use of machine readable, searchable, structured data formats in its operations.

To that end, what efficiencies and productivity gains has the division been able to realize in analyzing filings as it has continued to innovate with standardized data?

Mr. HINMAN. The XBRL tagging of information does assist us, as we try to review companies. We now have more modern tools to use some of those items to screen for certain characteristics of a financial statement.

So, we have found them to be of value.

Mr. HULTGREN. Great.

On March 1st of last year, 2017, Commissioners Piwowar and Stein proposed a new rule to adopt inline XBRL to merge the traditional unstructured filings with the standardized machine readable XBRL formats into a single filing.

I authored a letter to the Commission, with Ranking Member Maloney and Representative Issa, with whom I had championed the Financial Transparency Act to encourage the Commission to continue this work.

I wonder if you could give us an update on where this proposed inline XBRL reform stands?

Mr. HINMAN. It is something we are actively working on. I do expect to get something out in the next 12 months, in that area.

Mr. HULTGREN. Great, thank you.

Chairman Clayton has indicated that on the Commission's longer-term agenda is reviewing shareholder engagement in the proxy process. This is something that we have touched on a little bit already, but I want to go into a little bit different direction.

The House has passed legislation sponsored by Chairman Duffy, that brings long-overdue transparency, supervision, and accountability to proxy advisory firms.

In November, Chairman Clayton stated that the Commission should be, and I quote, "lifting the hood and taking a hard look at whether the needs of shareholders and companies are being met," end quote.

I have heard from a number of companies and shareholders that feel their current needs are certainly not being met. There is particular concern regarding proxy advisory firms in the outsized influence they seem to have in the market, yet they are subject to a little oversight and are susceptible to conflicts of interest.

I was particularly concerned, when I was advised of a filing earlier this month from one pharmaceutical company, Abbott Labs. That proxy advisory firm they engaged with was, and I quote, "aware of the flaws and inaccuracies of its report and has disregarded our attempts to correct them and proceeded to publish a flawed and inaccurate report," end quote.

I wonder if you have any updates for the committee regarding when the Commission will be addressing issues like this? Will the Commission reopen the comment file of the 2010 proxy plumbing concept release?

Mr. HINMAN. As you mentioned, this is an area of interest for the Chairman. He and I meet periodically with investor groups, the funds and the advisory firms themselves, to talk this through.

We are still gathering information. The Chairman has indicated in some of the speeches informally that proxy plumbing is a topic of interest for developing some ideas, in terms of what comments to ask for in that area. This is certainly on the list of things that we are considering.

In the meantime, we are applying our 2014 guidance which does apply more rigor to the process in watching for compliance in that area.

Mr. HULTGREN. Great, thanks.

SEC's Rule 14a-8 provides an opportunity for a shareholder owning a small a relatively amount of the company's securities to have his or her proposal placed alongside management's proposals in that company's proxy material for presentation to a vote at an annual or special meeting of shareholders.

The rule generally requires the company to include the proposal, unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the Rule's 13 substantive bases for exclusion.

On September 22, 2016, the Capital Markets Subcommittee held a hearing entitled, "Corporate Governance, Fostering a System That Promotes Capital Formation and Maximizes Shareholder Value." Where witnesses from the Society of Corporate Secretaries and the Business Roundtable provided compelling testimony for making updates in order to reduce unnecessary regulatory burdens.

The Financial Choice Act that has been discussed, proposed a number of changes to Rule 14a-8, that I think would be valuable for public companies, investors, and our markets.

I wonder, does the Commission plan to revisit Rule 14a-8? Specifically, what are your views on increasing the resubmission threshold under 14a-8?

Mr. HINMAN. To the extent that we would open 14a-8, which I mentioned, that would probably happen in the context of this request for more comment on the wide range of proxy issues.

In terms of the thresholds, we would look at where they are. Both the initial submission threshold and the recent submission thresholds, where once a proposal has been voted down, can it be submitted again? Those two have not been looked at for some time.

So, we would be very interested in public comment on those provisions.

In the meantime, one of the things that we are doing is trying to get more input from the companies' boards on these topics.

So, we put out a staff legal bulletin this past year, asking for the board's more in-depth analysis. That has created more engagement between boards and shareholders.

Some of these proposals go away after that engagement happens. But it allows us to make rulings on whether it is something that can be excluded or not, more effectively.

Mr. HULTGREN. Thanks, Director. I know my time has expired. Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from California is recognized for 5 minutes.

Mr. SHERMAN. I would like to talk about parity between disclosing long positions versus short positions.

Securities law requires investors or certain investors to disclose their long positions 45 days after the end of each quarter. It would require institutions to make disclosures within 10 days after their position reaches 5 percent of a company's outstanding shares.

But there is nothing corresponding for those taking short positions. I am not criticizing short positions, however there is an asymmetry of information.

It is my understanding that several European countries require the disclosure of short positions.

Here, in the United States, the principles that underlie Section 13 disclosure requirements, applicable investors with long positions, transparency, fairness and efficiency apply equally to investors with significant short positions.

Moreover, investors with short positions can pursue strategies designed to invisibly drive down share prices or rely on regulatory processes to challenge the intellectual company—property of a company intending to profit from the uncertainty created.

To provide transparency to other investors in affected companies, would you support extending the existing disclosure requirements for long investors, such as those on forms 13-F, Schedule 13-D, and Schedule 13-G, to persons with short positions, including any agreements or understandings that allow an investor to profit from a loss in the value of a security?

Mr. HINMAN. Thank you for the question.

There has been some experimentation in the disclosures around short positions post-financial crisis. Certain institutions were required to disclose, in real time, their short positions. DERA, our economic analysis division, had an opportunity to look at the cost benefits there.

Mr. SHERMAN. I know you have looked at it. Where do you stand?

Mr. HINMAN. In that provision, I think they concluded that there was not a good return cost benefit for real time reporting of all transactions.

Mr. SHERMAN. This—well, long positions aren't, for the most part, real time. Why not throw away the disclosure of long position? Why require one without a cost-benefit analysis and then say to the other, oh, we have decided it isn't worth doing?

Mr. HINMAN. I—again, I think this is something that DERA would need to look at before we did it, because it would have market effects. I haven't done that work myself.

Mr. SHERMAN. Let me shift to another issue.

The Chairman says that the decline in IPOs might be replaced by an increase in ICOs initial coin offerings. I think we missed the mark in this meeting because we think that the reason for security markets is to let people issue and trade and be securities lawyers and be government bureau executives, et cetera.

The reason for security markets is to provide jobs in the real economy. An IPO does that.

An ICO does the opposite. It takes money out of the real economy. It takes people willing to invest in risk and says, don't use that ability to risk. Don't use those animal spirits to help create a

job for a person who needs one, let alone build a factory for thousands. Sit there and trade back and forth in the ICO.

Now, it is—these are investments. They are—I think it was you that said a balanced approach.

The balance we have in the real economy is, on the one hand, we want people to invest in new companies and factories and provide jobs. But on the other hand, we want to protect the investors. So, we have a lot of burdens on somebody who wants to build a new factory.

But with the coins, there is no factory. There are no jobs. We have no burden on the invest—no investor protection.

It is—when you strike a balance between those who are trying to create a new currency to facilitate drugs, tax evasion, to deprive the fed of its ability to market our securities and return a hundred billion dollars or so to the U.S. Treasury, all the balances are for total investor protection which could be achieved by totally banning.

Why aren't you stopping all the ICOs which are clearly unregulated investments?

Mr. HINMAN. So, when I talked about taking a balanced approach, what we are trying to do is recognize that this new technology, specifically the blockchain technology that underlies it, may have some promise.

Mr. SHERMAN. Oh, I am not saying ban blockchain. Just ban the ICOs.

Mr. HINMAN. OK. Some folks are finding that the ICO instrument allows for a different type of enterprise. One that is more decentralized in which they think has some value. We are—

Mr. SHERMAN. Charlatans and scammers have always favored decentralized new enterprises.

Chairman HUIZENGA. The gentleman's time has expired.

Mr. SHERMAN. I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes the gentlelady from Missouri, Mrs. Wagner, for 5 minutes.

Mrs. WAGNER. Thank you, Chairman Huizenga.

Director Hinman, as you noted in your written testimony, your role is to support the SEC's mission to protect investors as well as to maintain fair, orderly, and efficient markets.

To follow up on my colleague, Representative Hultgren's, questioning, there are some red flags when it come to the—in particular, to the two largest proxy advisor firms who, together, seem to control at least 97 percent of the proxy advisory industry.

Director Hinman, what are the main factors hindering greater competition in the proxy advisory industry, do you think?

Mr. HINMAN. I am not an economist, so it is hard for me to know exactly what would hinder more competition there.

I do know that the service they provide is basically collecting all of the proxies that are out there, looking through, and thinking about how a particular matter should be voted on. Once someone does all that work and there are one or two people supplying that, it is hard for a new entrant to come in.

Mrs. WAGNER. What steps is the division taking to ensure that all proxy advisory firm conflicts of interest are properly disclosed?

Mr. HINMAN. That was something that we emphasized strongly in our legal bulletin that came out in 2014. We, through our Office of Inspections, continue to look at how that is being complied with.

We are seeing better disclosure than what predated that guidance.

Mrs. WAGNER. What steps is the division taking to ensure that public companies have sufficient time to respond to errors or flaws that are made in proxy advisory firm recommendations?

Mr. HINMAN. As I mentioned earlier, we do meet with these firms. We have provided feedback around the kinds of concerns you are raising. We have seen an increase in the level of some responsiveness.

We are still monitoring it, but we do think encouraging the firms that are providing these services to listen more actively is something we can do and are doing.

Mrs. WAGNER. Switching topics. I wanted to spend some time talking about cyber-security attacks.

On February 21, 2018, the SEC voted unanimously to approve updated interpretive guidance to assist public companies in preparing disclosures about cyber-security risks and incidents.

How does this guidance expand upon the guidance issued in 2011?

Mr. HINMAN. One of the basic differences is where it was issued. The original guidance was issued in my division. The updated guidance was approved by the full Commission and, therefore, has more weight.

But, in terms of the substance, there were maybe three or four areas that we concentrated on and brought attention to.

One was disclosure controls. We reminded companies it is very important for them to take cyber risk into account when they are looking at their disclosure controls, so that if an attack happens and when someone in the front line sees that, they raise it to the company's disclosure experts and more consideration is given to timely disclosure.

But we also reminded companies that as that happens, to enforce their insider trading policies. So, now that they have a better sense of what is going on at the higher level, they are more apt to apply their insider trading policies.

Mrs. WAGNER. Given the increasing number of cyber security breaches, such as the Equifax breach, how does this guidance help to ensure that companies have the appropriate procedures in place to both prevent and respond to cyber-security incidents?

Mr. HINMAN. What we were trying to do was to emphasize this disclosure point.

We also—one of the other items that is a little different than the old guidance was that we said, when a company has cyber risk as a material risk that they face, we expect to see disclosures of how their board is overseeing that risk.

So, board oversight, better controls, and more compliance on the insider trader policies.

Mrs. WAGNER. To that point, can you walk me through more of the steps you believe that companies should take after they have discovered material cyber-security event has occurred?

Mr. HINMAN. Sure. After it has been discovered and you have determined it is material, and that may take a little time because these companies are attacked daily. One of the reasons we wanted this to be elevated was to make that materiality decision that you are referencing.

Once that decision has been made, insiders with knowledge of that should not trade. The company, we would expect, would be moving to formulating appropriate disclosures.

Mrs. WAGNER. What disclosure forms do you think they should be using, in the event that they have an event related to the cyber security breach?

Mr. HINMAN. Sure. There are a number of ways. The most common we see is Form 8-K. That is something that is not just done quarterly or annually, but can be done at the time an event is occurring.

Mrs. WAGNER. My time has expired.

Chairman HUIZENGA. The gentlelady's time has expired.

The gentleman from Massachusetts is recognized for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

If we could, I would like to stay right on the same topic that the gentlelady from Missouri was talking about.

So, last year, we had an increase of about 80 percent in the number of cyber-attacks.

As the gentlelady pointed out, we haven't updated this guidance on cyber-security protocol since 2011. So, exponentially increased on the number of attacks.

But last year, if you sort out the significant cyber-attacks on publicly traded companies, it was about 82 of those companies that publicly traded that had major cyber-attacks on their systems. Only 3 percent, only 3 percent, filed an 8-K to inform the shareholders that their systems have been hacked.

So, you have 97 percent of the companies that have been hacked failed to file an 8-K to let their shareholders know that there had been a significant event.

The problem seems to be on the definition of materiality. The legal counsel within the company is nervous about disclosing the hack, because share price will drop and there is vulnerability. That is an issue.

But on the other hand, shareholders have a right to know. Also, if we don't do anything about that, I think this trend will continue.

The companies will not improve their—there is no price to pay. There is no accountability. The companies will not improve their cyber protections, and we will just keep seeing the volume of these hacks continue.

How do we get at that decisionmaking being made at the corporate level to encourage—you don't want to punish a company that is a victim of a cyber-attack. I understand that.

But you do want to encourage them to disclose. That is basically the mission of the SEC.

How do we get these companies to come forward so that we will know about the attacks in a timely fashion and protect the shareholders and also the entire system because everything is so interconnected?

Mr. HINMAN. Thank you for the question.

We agree that this is an important disclosure issue and that the materiality judgment can be a difficult one. But we do expect more.

As you mentioned, the 2011 guidance has actually been updated at the beginning of this year by the full Commission. It highlights some of the items I had mentioned.

Beyond that, we conduct our reviews of companies. This is an item of review priority for us. We look at those each year. This is one that clearly we are looking at.

Then, moreover, when we see a hack occur, we will often pick up the phone—our review teams that are familiar with that particular company may pick up the phone, talk to counsel, and ask to be walked through. Is this something that is material?

You will see things, sometimes, reported in the press. The company has decided it is not material. We sometimes will ask them to walk us through that analysis.

Mr. LYNCH. Yes, it is still—it is still fairly discretionary, however. Timing is important.

Where—what we are seeing right now is, like I have said before, 97 percent not filing an 8-K. Not telling people.

There needs to be some consequences. I was hopeful that the new guidance would get at that issue. I am not sure if a legislative solution is the best way to go here. I would rather have the SEC do it themselves. It is not happening fast enough, in my opinion.

But I appreciate your willingness to come here before the committee and help us with our work. I yield back the balance of my time.

Thank you.

Chairman HUIZENGA. The gentleman yields back.

With that, the gentleman from Minnesota is recognized for 5 minutes.

Mr. EMMER. Thank you, Mr. Chair.

Director Hinman, welcome to the committee and congratulations on your new position.

You touched on it briefly during your testimony, however can you give more detail as to why it is so important for the SEC to encourage more small companies to go public and not just the big ones?

Mr. HINMAN. We think capital formation at all levels, and the small levels, is important for job creation, number one. We think it obviously is good for the economy.

We are very interested in looking at our rules. Over the years there has been more and more added to the disclosure requirements. We do want to look at the scaling of those requirements for smaller companies.

We do have a rule actively being considered right now. It has been proposed and we will try to finalize it for lifting the limits for who qualifies for that scaled reporting.

Mr. EMMER. When Chairman Clayton came before this committee in the fall, I asked him about the concept of venture exchanges and whether or not the creation of a lower-tier equity market to facilitate the secondary trading of shares of smaller companies, where liquidity challenged securities would entice more early stage IPOs.

Do you have any thoughts on this matter?

Mr. HINMAN. Sure. I am not the trading and markets expert. Our colleagues in the Division of Trading and Markets actually are focused on the issue. In fact, they had a roundtable earlier this week, I believe, to discuss some of the issues smaller companies face in terms of developing liquidity in their shares and in smaller company trading.

Venture exchanges, ideas like that where liquidity is enhanced and an exchange is used to do that certainly would provide more liquidity.

I think, again, the Trading and Markets folks are very interested in exploring those ideas and that is why they are holding these roundtables.

Mr. EMMER. Wonderful.

I want to change gears just a little bit. I find that people tend to fear what they don't know. If people who started sailing the oceans at the time of Columbus would have believed that the world was flat, we never would have had the great discoveries of the new world.

The typical attitude, too, that I get from so many elected officials who have no idea what they are talking about—they are ignorant on a topic—is that everyone who is involved in the area that they maintain their greatest ignorance. That everyone who is participating in that area is either bad or dishonest. Therefore, the elected official must rush in and help people from these.

I find this a lot when we talk about initial coin offerings. We are talking about blockchain technology. There is a lot of ignorance about how special this area is.

Given your division's jurisdiction, as it relates to crypto currencies and initial coin offerings, do you have any circumstances that come to mind that might render a token sale as something other than a securities offering?

Mr. HINMAN. The initial sale—it is quite hard to have an initial sale without having a securities offering which is why the Chairman has noted that the initial sale of these may require compliance or exemptions.

Mr. EMMER. Let me ask you a question about that. Is it possible that a utility token would not be a security, because it is not done for capital formation?

Mr. HINMAN. It is certainly possible that there are tokens that would not have the hallmarks of a security.

Over time, many of these fundraisings are intended to develop networks where a token may be used to buy a good or service.

That is its only use. It doesn't have much utility—

Mr. EMMER. No, I understand. But there is a difference.

Mr. HINMAN. There are other senses.

Mr. EMMER. If you can just—this is the difference. I get this all the time. People are suggesting that everything that is done in this area involves a currency or something like a currency or security.

But, in fact, a security—or a utility token is nothing more than a card, if you would, that would allow you access to a certain platform so that you can participate.

Is it possible, in your jurisdiction, that that may not qualify as something that is a security offering?



Mr. HINMAN. We certainly can imagine a token where the holder is buying it for its utility and not as an investment. In those cases, especially if it is a decentralized network in which it is used and there are not central actors that would have information asymmetries where they know more than the investors in those tokens.

Mr. EMMER. Can I—I have to get this in before my time runs out.

You have stated that, quote, “sponsors of offerings conducted through the use of a distributed ledger or blockchain technology must comply with the securities law,” close quote. You also stated, quote, “Investors need the essential facts behind any investment opportunity, so they can make fully informed decisions.”

How can we improve the regulatory clarity for entrepreneurs here in the United States so that their contribution to something that may not be a security will not see enforcement actions by the SEC?

Chairman HUIZENGA. I will allow a quick reply.

Mr. HINMAN. One of the things we are doing is meeting with the participants who have these ideas, that think that they may have a token that shouldn't be regulated as a security, to work through with them how that may be structured.

Mr. EMMER. Wonderful. I will follow up in writing. I have a bunch of other questions.

Thank you for your patience, Mr. Chair.

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

With that, the gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Thank you, Chairman Huizenga.

I am very, very pleased to have Mr. Hinman here, because you are in the crucible of what we really refer to as wealth building in this country. You are the SEC Director of the Division of Corporation Finance and capital formation and public offerings.

There are basically three ways we build wealth, meaning financial security, and stability, and that is either through a job, your business, but most acutely through investments.

I want to talk to you about the fact that we have some alarming news. My excellent staff has done some research that I want to bring to your attention. Important research. One, they have informed me that during the past 20 years, the number of new companies deciding not to go public has increased dramatically.

As a matter of fact, they inform me that in 1997, we had 474 companies that went public, while only 108 went public in 2017. That is astounding. So, with this in mind, I wanted to ask you about this expanded use of nonregistered offering exemptions.

Because I truly believe that it makes sense to expand our security laws to make it easier for our businesses, especially our startups, that we rely on. Small business startups are still the driving force.

From that comes the necessary resources to make those investments through the public and private offering. One other thing I want to tell you is that I agree with you, when you said this in your testimony. You said, it is far more efficient for retail investors to invest in companies through our public markets rather than our private markets.

Now, that, to me, is very profound. As a matter of fact, I think it gives us a nobility of purpose why you are here.

You went further. You said, the SEC is conducting a look-back review of the impact Regulation Crowdfunding and Regulation A on capital formation and investment protection.

So, my question is this. I am very interested to know, first of all, what you think about the points I have made. Also, how this look-back is going with you.

I am curious to know if the SEC is including in its look-back a measure of whether our capital markets are operating efficiently, from the standpoint of retail investors.

Mr. HINMAN. Thank you for the question and the comment on your observations around the decline in numbers of public companies or companies deciding to do IPOs. We share that concern.

We do think, as you mentioned I said in my testimony, that public companies are terrific vehicles for the smaller investor to invest in. There is more liquidity because of our regulations. There is more transparency.

So, we do share a concern that those numbers are declining, in terms of the number of investment options retail investors, in particular, may have.

In terms of the various ways that our rules are working together to, hopefully, encourage people to join the public reporting system, you mentioned crowdfunding and Regulation A.

I think Regulation A, at the time it was expanded by Congress, the thought was, this is perhaps, a bit of a roadmap to becoming public. It's still very early days, in terms of experience of Regulation A.

We have seen some Regulation A issuers get used to the idea of providing disclosure and having it reviewed by the SEC. Some of those issuers have matured to the point where they have been listed.

Not all those are great successes in the same way. Not all IPOs are great successes. We are monitoring the developments under Regulation A carefully. Same with crowdfunding. With crowdfunding, we see a lot of activity on the coasts. We see less in the middle of the country. We think it would be terrific to have more activity there.

We are looking at ways to stimulate portals interest in folks across the country, not just on the coast.

Mr. SCOTT. Thank you very much, Mr. Chairman and Mr. Hinman.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from New Jersey, Mr. MacArthur, is recognized for 5 minutes.

Mr. MACARTHUR. Thank you, Chairman.

Director, thank you for being here.

Forgive me if I work on fields that have already been plowed. But I had to step out for a few minutes, so I don't know what you have been talking about.

In the Chairman's opening remarks, he mentioned that primary goals are protecting investors, facilitating orderly markets, encouraging capital formation.

One of the concerns I have is we have a lot fewer initial public offerings than we used to. We have to consider, why is there less interest in the public markets?

One of the things I have observed is that companies engaged in interstate commerce, that are traded on public exchanges, have a very difficult situation in both State and Federal actions that target them for civil fraud. Not criminal fraud but civil fraud.

So, for example, an overzealous State attorney general might not have a case that rises to the burden of proof to prove civil fraud. They will accuse a company anyway and that company can get raked over the coals for something that doesn't even have any intent.

This is not unique to one State alone. It is not even unique just to the States.

For example, CFPB raked their company, in my district, over the coals and ended up losing their actions. But the company lost a billion dollars in market value which hurt all of their main street investors.

States like New York, California, Connecticut have gone after companies and decimated share-holder value.

That hurts main street investors. It is hard for those companies to recover. The moment there is an accusation of anything, they have to disclose it because they are publicly traded companies.

So, I just wanted to ask you if you could comment on the problem. How you see it. The fact that these publicly traded companies engaged in interstate commerce all across the country are subjected to 50 different standards on civil fraud.

Could you talk about the problem from your perspective? Do you see any solutions? I would be happy to hear those, too.

Mr. HINMAN. Sure. So, to go to the broader point of fewer public companies, one of the reasons—this is one of them. I think there are a number of reasons why fewer companies are choosing to go public.

There is the Federal regulatory burden. There are the State regulatory burdens. There is simply more money available in the private sector right now as well. So, the need to seek public funding is lower than it would have been in the past.

So, there are all these different factors going on all at the same time. So, to pick one out and to try and weigh it in the equation is difficult.

The point you are raising is not something I have a view on as a Federal regulator. The ability to change that landscape would be one of Federal statute. That is a Federal preemption question, really, that you are getting to, if you were trying to make a more uniform anti-fraud landscape for public companies.

Mr. MACARTHUR. Do you see it as a problem?

Mr. HINMAN. I certainly—

Mr. MACARTHUR. As part of the—as part of the issue.

Mr. HINMAN. I certainly see that some companies bear that in mind as they decide to go public. It is not a positive factor.

Mr. MACARTHUR. I agree with you that it is not the only issue. I didn't mean to imply that it was.

But I know, as a former businessman, it certainly weighed into my mind. Just the difficulty of the environment.

You mentioned there is more capital available in other mechanisms, like private equity and such.

But there is a reason more capital is being attracted into that space, too. It is because the public markets are less attractive.

Mr. Chairman, I am happy to yield my remaining time to you, if you have any other comments or questions.

Chairman HUIZENGA. Thank you. Yes, I will take that.

We are going to go on a slightly different direction from what you were having.

I want to touch base on something that Chair Clayton and CFTC Chairman Giancarlo stated. That they, along with their counterparts at the Department of Treasury and Federal Reserve, may come to Congress in the coming months, regarding ICOs.

I am curious what you believe the role for Congress might be in that? Is there concern that the Congressional regulatory intervention will chill the ICO market?

Mr. HINMAN. In terms of what is going on in the landscape right now, I think Treasury, through the FSOC committee, is trying to gather views from the various regulators, CFTC and us principally. But also the banking regulators, everyone that participates in FSOC.

People that have your customer concerns, anti-money laundering concerns, our securities law concerns, commodities concerns, to look at the overall regulatory touch here. To see if there are gaps and to see if there are ways to improve the environment.

One thing we are trying to do is provide as much guidance as we can to the marketplace, so we don't have a chilling effect.

But it is still something that is being worked on by all the agencies, and we are trying to coordinate to make sure we don't stifle innovation.

Chairman HUIZENGA. All right. Thank you. Time has expired.

With that, the gentleman from North Carolina, Mr. Budd, is recognized for 5 minutes.

Mr. BUDD. Thank you, Mr. Chairman. Thank you, Director Hinman, for your service. The first time out, you are doing a good job.

Chairman HUIZENGA. Thank you.

Mr. BUDD. So, thank you.

I want to talk this morning about SEC efforts to facilitate capital formation and efforts to increase investment opportunities here at home.

Obviously, this is an issue of importance to me. I have led H.R. 3903, the Encouraging Public Offerings Act, along with my friend, Representative Meeks from New York. That would expand testing the waters.

So, a lot of us on the committee were pleased to see the SEC expand the use submitting of confidential draft filings of last year, just from emerging growth companies to all companies.

In that vein, do you plan on extending the use of testing the waters from these emerging growth companies to all companies as well? What steps are the division taking to help facilitate pre-IPO communications between businesses and investors?

Mr. HINMAN. Thank you for that question.

As you point out, the test the waters exemptions from Section 5 have been available for the emerging growth companies. We have put on our agenda expanding that. It seems to be working well.

There are parameters in which those test the waters activities take place. We think investors are protected by those. As I said in my opening remarks, this is something that we think could make a difference, and we will explore it very carefully.

Mr. BUDD. So, just to clarify, you said it is on your agenda. Is there any timeline for expanding that?

Mr. HINMAN. I don't think we have it on a specific timeline right now. But it is something that we would like to move forward.

I don't think it will take an inordinate amount of time to duplicate what we have done for the EGCs for a broader group of folks.

Mr. BUDD. Very good.

So, in a speech earlier this year, you stated that your intent is to put emerging growth companies and non-EGCs on as level a playing as possible. Can you please elaborate on this and how the division aims to ensure that this is a level-playing field?

Mr. HINMAN. One of the primary things would be looking at the EGC opportunity to test the waters and broadening that.

There had been, prior to the revisions we made in the policies, certain advantages the EGCs had, in terms of confidential filings, which we have spoken about, that has been extended to all.

Then, as we expanded confidential filings, beyond what the EGCs had available, we made sure that both the EGC group and others were allowed to file confidentially for their first year. So, we kept them on the same level playing field.

Mr. BUDD. Very good. I appreciate your time. Chairman, I yield back.

Chairman HUIZENGA. The gentleman from North Carolina yields back.

The gentleman from New York, Mr. Meeks, is recognized for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman.

Let me ask you a question, Mr. Hinman. Over the years, we have seen an increase in the amount of public companies with dual-class share structures, including many of the largest tech companies in Silicon Valley, like Google, Facebook, Snapchat.

These structures can create benefits for a company by allowing founders to guide a company's success after going public. But sub-structures also pose a risk for shareholders who are less able to hold boards and CEOs accountable for their failures.

The SEC's Investor Advisory Committee recently proposed ways of improving disclosures related to dual-class shares.

So, my question to you is, what is your personal opinion of those recommendations and the risk associated with dual-class share structures?

Mr. HINMAN. Thanks for the question.

You are right, the Advisory Committee did ask us to look at those disclosures. I had independently talked with our disclosure teams about the disclosures that we are able to receive, when a company has a dual-class or a unique structure.

We are looking for robust disclosure there, so investors understand not just the voting ratios, but things like the life of the ar-

rangement, whether it has a sunset. We are looking for disclosure of those provisions.

The Advisory Committee did not ask us to ban those, in part because the SEC really doesn't have jurisdiction on this topic, to ban or allow. We are a disclosure agency.

State law generally governs whether a dual class is allowed or not or how it may be limited. We look to the State law to see whether these are allowed.

But if they are allowed, we are then focused on disclosure. Our jurisdiction in this area has been limited by case law and by the statutory structure.

Mr. MEEKS. So, you don't believe that the SEC has any plans for considering and/or adopting the recommendations?

Mr. HINMAN. Again, what we can do is focus on the disclosure. Because it is case law, that has limited our ability to legislate one share one vote. That was done many years ago in a business round-table case which the SEC did not prevail on.

We see our focus now as one of disclosure.

Mr. MEEKS. Let me jump to the other issue in my last 2 minutes.

Earlier this year, New York's controller announced that the State's pension fund would oppose reelection of all directors of boards that lacked women representation.

New York was unable to make a similar action with respect to boards that lacked racial or ethnic diversity, because the SEC's board diversity rule has not yielded robust disclosures. This has been a constant problem and complaint of my office and investors that we have talked to nationwide.

In October, when Chairman Clayton was here, we asked whether or not the agency would adopt the proposal from the SEC's Advisory Committee on small and emerging companies that requires companies to specifically list their race, gender, and ethnicity of their board members.

Chairman Clayton made no commitments to adopt these recommendations. Merely stated that the Division of Corporation Finance, your division, will monitor compliance with the current rules.

So, what has been your division's assessment of compliance with the agency's board diversity rule? Have diversity disclosures been adequate, considering shareholder demands for more information? Will the Division of Corporation Finance eventually provide a public recommendation to the SEC on whether it should adopt proposals to improve the rule?

Mr. HINMAN. To start with your last question, the answer would be, yes, we will. It is on the Chairman's rulemaking agenda. This is a topic that both he and I view as highly important.

The old policy in this space has been subject to some criticism that it doesn't get enough useful disclosure. Our division has been looking at how that policy has been complied with.

Some companies, notwithstanding the fact that the disclosure doesn't require specific items, such as gender, race, or ethnicity, to be disclosed, had been providing that disclosure. Sometimes in graphic forms, tables.

We have been looking at how people are approaching the issue. We have talked to some of those issuers to find out what has their experience been in preparing those kinds of disclosures?

One thing that we have discovered is that there is some sensitivity to their board members' privacy issues, in terms of self-identifying on some of these topics. So, we would want to take that into account as we develop any new rules here.

But we are gathering information on this. It is on the rule-making agenda. It is important to both myself and the Chairman.

Mr. MEEKS. Thank you very much.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentleman from Maine, Mr. Poliquin, is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman, very much. Thank you very much, Mr. Hinman, for being here.

I represent rural Maine. We have a huge Congressional district geographically with lots of hard-working folks and small savers with 401Ks and IRAs and 529 plans for their kids to go to school and to plan for their own retirement.

So, I am very concerned about small savers and small investors in Maine and throughout America, Mr. Hinman.

Now, there is a bill that I originated called—well it is 1312, H.R. 1312, which deals with the annual government business forum that you folks host every year.

You get together and you get all these great ideas from folks on the public side and the private side, to see if there are ways that we can improve the enhancement of capital formation in our economy.

The bill, sir, which is included in Mr. Crapo's bill over in the Senate, simply requires the SEC to make sure they take a look at every recommendation, evaluate them and act upon them.

Are you familiar with that bill, sir?

Mr. HINMAN. I have heard of it, yes.

Mr. POLIQUIN. OK. Do you, right now, go through the process of making sure the recommendations from that annual business forum are evaluated by the SEC?

Mr. HINMAN. Certainly. I personally participated in that forum in Texas this year. We see the reports, my staff in the small business office receives that and helps compile it and helps to get it out. We take all the recommendations under consideration. We are always looking for good ideas.

Mr. POLIQUIN. That is great.

Since you have personal knowledge of this, Mr. Hinman, I appreciate that very much.

We just want to make sure that folks that go through the effort, like you in your former life, do not let these recommendations which could help our economy grow and thrive and companies raise more capital.

They just don't sit on the shelf somewhere, but they are actually evaluated and looked at. Make sure that that information is useful to everybody.

OK. I would like to move on a little bit to data security here, sir.

On Tuesday, the former Yahoo company paid about \$35 million in a penalty because you folks determined they misled investors,

when it comes to a hacking that took place that disclosed the personal data of hundreds of millions of accounts around the world.

Are you comfortable that the SEC has the metrics in place such that public companies know, in fact, when they should disclose material events like this?

Mr. HINMAN. We do think we have given very good guidance in this space. We don't use bright line metrics, in part because those bright lines sometimes will result in over-inclusive disclosures or under-inclusive.

If someone is on one side, it still might be material to an investor. But they would say, oh, we didn't have to disclose because we didn't meet the metric. We don't want to flood the market with things that are just noise.

So, the bright line tests don't seem to work that well in this space. We have used, basically, principle based guidance and have elaborated on that in a 30-page Commission-level guidance document most recently.

Mr. POLIQUIN. I just want to make sure that you folks are giving every due consideration for investors, small investors, who have taken a position in a company.

Then, at the same time, making sure that you don't overly burden companies with this. So, it seems like you are moving down that path.

On a third issue, quickly, sir, if I may, is that there seems to be, over the years, the threshold for small groups of political activists to take \$2,000 positions in companies in order to push a specific agenda at a shareholder annual meeting, is something that is a concern to companies that are thinking about going public.

I wonder if you have any input on that. I know the number of companies that have gone public over the years has dropped precipitously.

Also, I notice that Mr. Clayton, in his speech last November, said he had a concern about this threshold.

Do you have any feelings at the SEC where those thresholds may or may not be adjusted to make sure folks do have a voice, if they own part of a public company? But, at the same time, is not so disruptive and costly for the company, that they hurt small investors who actually bought shares in the company also.

Mr. HINMAN. We are certainly looking at the right balance there. You point out the issues in terms of that you want to make sure that shareholders still are able to have a voice, and you don't want to overburden a company with trivia.

Those thresholds haven't been looked at in quite some time. I mentioned earlier today that we do have an interest in looking at that.

The Chairman is going to be seeking more comment in the space. He has, as he mentioned in the speech, expressed interest here. I expect that will continue.

Mr. POLIQUIN. Great, thank you.

With indulgence, Mr. Chairman, please.

The State of Maine, Mr. Hinman, has a 2.6 percent unemployment rate. I think it is the lowest in the country. Clearly, lower taxes for our families and small businesses. It is having a dramatic effect.



I know you folks are responsible for making sure public companies disclose this good news of more growth and more hiring and for their companies.

Are you comfortable where there is a right balance between making sure they report this great news to their shareholders, but, at the same time, not overburdening them with the more costly regulations that would be hurtful?

Mr. HINMAN. We are very focused on that.

Mr. POLIQUIN. Thank you, sir. Thank you, Mr. Chairman.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from Minnesota, Mr. Ellison, is recognized for 5 minutes.

Mr. ELLISON. Thank you, sir.

Director Hinman, when do you expect to finalize the Executive Compensation Rule, Section 953(a), which requires companies to detail the relationship between CEO pay and profits?

Mr. HINMAN. That rule is on the Chairman's agenda. We don't have a date certain. There isn't in the statute, unlike some of the other Dodd-Frank provisions, a mandated date.

He has indicated he wants to go through all the executive compensation rules of Dodd-Frank in order. That is one we will get to. But he hasn't set a date for us, yet.

Mr. ELLISON. When do you expect to finalize the clawback rule so that CEOs who jack up their incentive pay to increase profits only to have those profits paying, have their incentive pay clawback?

Mr. HINMAN. That is part of that package, so it would be the same approach.

Mr. ELLISON. Any date on that? You can give us a range, like next year, like next month? I understand you may not know the exact date. But if you can give us some sense because the public would like to know, my constituents want to know.

Mr. HINMAN. Right. I would say it would not be in this fiscal year. The short-term agenda is pretty packed. We are trying to achieve everything that is on there.

I would think it would be some time after this fiscal year.

Mr. ELLISON. When do you think you will finalize the incentive-based compensation guidelines for our large financial institutions?

Mr. HINMAN. That is part of that package of three compensation-related initiatives. It fits into that same category. I think the Chairman wants to look at those together and take them in order.

Mr. ELLISON. OK. Do you think they will come all out together at the same time or you don't know?

Mr. HINMAN. I think he will likely ask us to do these in sequential order.

Mr. ELLISON. OK.

Mr. HINMAN. That is up to the Chairman. I haven't heard what the order would be or whether there would be a possibility of soliciting comment collectively.

Mr. ELLISON. All right.

I just want to give you a little context for my question. One of the lessons that I think we have learned from the great recession just 10 years ago, which I still remember very well, is that CEO

pay incentives were actually encouraging—CEOs to encourage, engage in activity, I think put a premium on risk-taking.

If we had a better incentive structure, more risk assessment, create an oversight at the corporate level, we may not have engaged in some of the things that really hit our economy hard.

So, when pay is tied to short-term profits, CEOs will take risks that prioritize quick returns. When Congress rolled Dodd-Frank, Congress included a number of provisions to ensure CEO pay was no longer promoting excessive risk-taking.

The SEC is charged with propagating the rules here. It has been 8 years since Dodd-Frank, and we still have the final rules.

I am not blaming you, personally. But I think that it has been plenty enough time. I am disappointed to hear that we are not going to be having those rules in this fiscal year. I think that there has been more than ample time.

By the way, the delay has been costly. We have seen some serious banking crises that could have been avoided, in part with better CEO pay regulations.

Look at Wells Fargo, for example. They were trying to pump up profits every quarter by creating fake accounts. I know a lot of workers got fired by the people who directed and designed the program. I think the CEO got away with a \$173 million severance package or something like that.

Anyway, New York State controller, Thomas DiNapoli, sent a letter to Wells Fargo shareholders last week, in advance of their annual meeting, asking for Wells to disclose their payments in the policies.

I will tell you what he said in that letter. He said, incentive pay practices have been identified as contributing to the multiple crises at Wells Fargo.

Investors need to know whether the company is taking steps to identify employees' incentive-based compensation. It could spur conduct. It puts the bank, its customers, and investors at risk.

I will say, the economy, if widespread enough. I don't believe in beating up our witnesses unless they have it coming. I don't think you do.

But I will say, I hope you take back to the people you work with that 8 years is plenty enough. This is a serious thing. It is the law. It has to get handled quickly.

I don't think the American people can afford to wait much longer. I think, until these rules are finalized, CEOs are still getting pay packages that misalign their shareholders with their own compensation. I don't think that is right.

So, thank you.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from Indiana, Mr. Hollingsworth, is recognized for 5 minutes.

Mr. HOLLINGSWORTH. Good morning. I really appreciate you being here.

I will be brief. I want to focus on a very narrow topic that is really important to me, and important to constituents back home, and, frankly, important to America as a whole.

It really has to do with some of our emerging growth companies, and specifically those involved in biotech. The economists can

tongue in cheek remark that all is required for one to get a drug approved in this country is superhuman persistence over 10 years and \$2 billion.

Many of these companies are very early stage. Many of these companies are very small, in terms of the number of employees, even if their market cap is relatively large. Just waiting on approval of drugs, waiting on approvals to be able to get through the process.

One of the things I continue to hear from them is concern about 404(b) compliance and the cost of 404(b) compliance.

We have heard testimony in this very room about companies that are on the cutting edge of new technology. Cutting edge of new biology and be able to finally cure diseases that ail millions of Americans. But are spending more and more of those dollars that they have raised on compliance instead of the search for cures.

I know that a 2011 SEC study noted that those companies with a public float between 75 million and 250 million, spend on average, \$840,000 a year on compliance with 404.

Really, what I wanted to ask you was if there is any look at the cost of 404(b) on very, very small companies that are public, and the benefits of 404(b) for those very small companies that are public. Whether we can better align those two to ensure that we are enabling and empowering them to do more of what they do best, serve their customers research technology development products instead of more and more compliance.

Mr. HINMAN. Thank you for the question.

We are looking at that very carefully. As I think you probably know, today, we draw the line at \$75 million market cap, right below that 404(b) attestation is not required.

We are doing some things, scaling disclosures up to the \$250 million market cap. That is something where the SEC, in a proposed rule, decided we would not move the 404(b). We suggested we would not move the 404(b) threshold along with the rest of those requirements.

We are taking a fresh look at that. The life science industry, as you mentioned, makes a fair point that this is costly for them. They have lots of terrific ways to spend money.

At the same time, we want to protect investors. We want to have, perhaps, a more sophisticated test in this area. So, we want to adjust that market cap.

We also might look at revenues. If you are a low-revenue company but a higher-market cap, you probably have some promising product in the pipeline. You don't have the revenues, but people value you highly.

You probably also have a simpler set of financial statements. Where the requirement is to do a full attestation, maybe that is not money well spent.

We haven't analyzed that yet. In terms of looking—having DERA look at it. Is there a better way to draw the lines here? That is something we are quite interested in doing. Your life science industry colleagues have suggested that we do that, and I think that is a good idea.

Mr. HOLLINGSWORTH. Mr. Hinman, you have stolen all of my thunder because that is exactly where I was going, in the hope that we would have a more sophisticated test.

Some of these biotech companies have a billion dollars in float, but they have seven employees and they are outsourcing their drug trial process. This is expensive to go through.

We heard some testimony from individuals that were in that same camp. We earn \$10 million a year from licensing a few things. But we have a billion-dollar float while we wait to go through this process.

We certainly don't believe that we should be held to the same levels as a larger, more operating entity with many more employees, many more moving parts, many more subsidiaries, et cetera.

So, I really appreciate the fact that you brought that up and want to look at a more sophisticated and thorough test to better understand what companies can benefit.

Just one last point, since you stole most of my thunder in the middle here, is nothing that you would do, I imagine, would say you are absolutely barred and restricted from getting any 404(b) to any of these companies.

If they elected to say, look, it lowers our equity cost of capital, if we underwent a 404(b) audit attestation. They could still pursue that if they wanted to at any level.

Mr. HINMAN. You are absolutely right and some companies do that.

Mr. HOLLINGSWORTH. The reality is they can make that as a business decision.

As you well said, and have said on many occasions, disclosure can benefit companies as well and ensuring investors feel more comfortable with the asset that they own and lowering their equity cost of capital.

I don't think anything I propose, anything that this committee has voted on, anything that I have heard from other testimonies says, we should bar companies from doing this at any size.

But, instead, let us make it up to those companies to determine whether it is in their best interest, their investors' best interest, their products best interest to do this or whether it is not at a certain level or not.

So, thank you for being here. Thank you for your testimony today.

Mr. HINMAN. Thank you.

Chairman HUIZENGA. The gentleman yields back.

With that, the Chair recognizes the gentleman from Ohio, Mr. Davidson, for 5 minutes.

Mr. DAVIDSON. Thank you, Chairman. Mr. Hinman, Director Hinman, thank you for your testimony today.

I want to return to the topic of initial coin offerings. I want to focus particularly on the Howey Test.

The Howey Test is used to determine whether an asset is classified as a security and, therefore, subject to Federal securities laws. The test was developed by the 1946 Supreme Court case SEC versus W.J. Howey Company.

Do you believe the Howey Test should be—is it adequate for application for crypto currencies?

Mr. HINMAN. I think the principles annunciated there are still solid principles, in terms of the factors one would weigh to see if an investment contract could be viewed as a security.

Mr. DAVIDSON. Do you believe that it should be updated or changed to better incorporate what is, in fact, a security?

Mr. HINMAN. Again, I do think the basic principles there are the investor giving money or some consideration to a third party to have an enterprise take that money and generate a return? That feels, to me, like those are pretty flexible and sound hallmarks of how to judge whether an instrument is a security.

Mr. DAVIDSON. As you were speaking with Chairman Huizenga earlier, you know, a little concerned by the idea that the SEC would inherently be involved in an ICO. But you left some latitude to say that, perhaps, it wouldn't meet.

When you look at the criteria. There is an investment of money. There is an expectation of profits. The investment of money is in a common enterprise and any profits come from the efforts of a promoter or third party.

Some of those offerings of coins, as disclosed currently in white papers, are, really, almost like prepaid cards. They are not really securities.

In some cases, they are assets for sure. But is it a security? Is it a commodity? As some migrate, is it, really, even a currency?

I am encouraged by the work of FSOC to try to bridge that understanding. Our office is working to help provide clarity as to where those lines should be drawn. Because there isn't clarity in law or it has certainly been tested.

In one of the ways it has been tested is with SAFTs which is—let me get the correct piece of this acronym. Are you familiar with this acronym?

Mr. HINMAN. I am, a Simple Agreement for a Future Token.

Mr. DAVIDSON. Right, there you go. So, this is a—because there is no guarantee that there are future profits to the holder of the token. The token would simply be able to be traded at some point.

Currently, the investment wouldn't necessarily have a lot of value. But at some point it may and then, therefore the token, even in the early stages, would be able to be exchanged.

What is your assessment of the path on SAFT?

Mr. HINMAN. The number of folks who have tried to raise funds through the SAFT technique have an interesting idea. They say that they will eventually have a network on which this token may be used. If that network is developed, the token may have more value than it does on day 1.

People who are buying into those agreements are hoping that that happens, that those developers and other parties are actually able to do that.

So, you have all the hallmarks there. You have, I am getting money to the person who is getting me the SAFT. I hope that they will develop this network and that it will have more value and give me a return.

So, in early days, before that network exists and before that token has real utility, it probably is a security.

In theory, there may be a time when the people, the developers go away. What you have is a token that can be used. To use your Howey analogy.

In the Howey case, you had a developer putting together this orange grove, tending to it and making it work and selling interest in it.

The court viewed that as an investment contract, because this developer knew how this was going to progress. He had more information about it than the people he was selling the contract to.

Someday, in theory, he could have gone away. People could have come in and tended to their groves themselves or parties that participate in these decentralized networks, their equivalent could have tended to the grove and those oranges probably wouldn't be securities.

I think that analogy somewhat works to say, at some point, you may have a token that doesn't represent investment in the efforts of others. In this case, the Howey Hill Service—

Mr. DAVIDSON. Thank you.

As my time winds down, I would just say there is a clear distinction there between jurisdiction in the SEC and the commodities future trading Commission, I am glad FSOC is paying attention to it as is our office. As you can tell, as is our committee.

So, I look forward to future collaboration.

My time has expired and I yield.

Chairman HUIZENGA. The gentleman's time has expired.

Seeing now there are members on the other side, we will go to Mr. Hill of Arkansas for 5 minutes.

Mr. HILL. Thank you, Chairman. I appreciate you testifying today. Glad to have you before the panel and also glad that you bring your years of private-sector experience and transactions to the division. That is an important skillset. So, I appreciate your public service.

In my nonpublic service, a lot of that time was spent raising money for startup businesses and growth enterprises. Frequently, that used the Reg D exemption for raising those dollars.

A couple of things. On the issue of the definition of accredited investor, I see in your testimony, the division is considering recommending to the Commission proposed amendments to expand the definition of accredited investor. So, I commend you for that.

One of the most frequent frustrations, I think, in normal 506 Reg D-type offerings was that you could offer it to the accredited investors and no more than 30, or whatever the number was, nonaccredited investors.

But in point of fact, due to potential liability, very few lawyers would allow their client to offer to so many nonaccredited investors.

What I found time and time again, it is the inventor. It is the scientist. It is the person with the PhD. It is a CPA. It is somebody with a CFA. It is somebody who is a registered broker dealer. Who wants to participate in the Reg D offering. They certainly have the knowledge to do that, but they are excluded due to the net worth test or income test.

So, is one of the things you are considering expanding the definition for professional qualifications or expertise in a particular area?

Mr. HINMAN. It is. That expansion of the accredited investor definition, updating it to include folks who may be sophisticated but not meet financial tests. It is certainly under consideration as one of the items that the Small Business Forum observed as well.

As I mentioned earlier, we take those comments seriously.

Mr. HILL. Right.

Mr. HINMAN. That is something we will be considering.

Mr. HILL. We have a lot of bipartisan support for that. I appreciate Mr. Schweikert of Arizona being one of the leaders in the House on that topic.

My colleague from Indiana was talking about 404, and I really encourage you to—after the decade or so post-Sarbanes-Oxley.

But, really, the Commission thinks differently about it. We impose this internal control or regime that only maybe a financial institution would have on every public enterprise, regardless of business model and regardless of size with the small cap exemption that you noted.

Really, I would love to see an economic cost benefit analysis of who has benefited from that.

The purpose of it was that Arthur Andersen and Enron were running a black box. The transparent internal control process was bypassed and the shareholders couldn't determine what was happening.

And, yet, 404 was fully present during AIG, I am sure. Some would argue AIG was a black box.

So, I really think we ought to step back and see what is the real benefit of this and how can it be customized by industry or by size of business. Because I think it has probably far exceeded its benefits and burdened, particularly, our small-cap companies.

So, I do support expanding of the size exempt from 404.

I think another one of our industries that has perpetually come to the Commission for an exemption is the small broker dealer industry under 404 for a separate audit.

I wonder your views on if you would be supportive? That is more of a regulatory issue for the Commission, but are you supportive of some industries that are heavily regulated, like a small B.D., small broker dealer, overseen by—of the Commission from being exempt from 404? Permanently, although it has been waived many times over the last decade.

Mr. HINMAN. The application of some of these rules to the broker dealer community is something that the Division of Trading and Markets would be better suited to address.

So, I wouldn't want to jump into their space and I hope they don't jump into mine.

Mr. HILL. Thank you for that.

You have also talked in your testimony about materiality. It seems like there has been real mission creep out in public reporting, and that we are getting beyond a materiality standard.

Do you, as a—having practiced law for all these years and helped many, many companies navigate the public process, do you support a materiality standard for our public disclosures and not going beyond that, unless a company wants to go beyond that?

Mr. HINMAN. If I understand your question correctly, I think you are saying companies just need to disclose what is material and that is it.

We do think that a number of the specific requirements that are qualified by materiality, but which remind registrants to describe parts of their business, to do certain disclosures with respect to their results of operations, the MD&A, all, again, qualified by materiality are helpful.

We think the issuers find that helpful to have the guidance that gives them the sense of what are we, as the securities laws experts, saying might be material.

But we do, in general, think that a materiality standard should be applied to disclosures generally. We have a rule that says even if we haven't hit something in our overall requirements, please tell us what is material. In practice, I always focus—

Mr. HILL. Thank you.

I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

I see no further questions. I would like to thank our witness today for your time and your expertise and your attention to this.

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.

I ask our witness to please respond as promptly as able. I know I will be sending in a question regarding—plus. I will just put you on notice on that one.

Again, thank you for your time, Mr. Hinman. We appreciate it. The hearing is adjourned.

[Whereupon, at 11:46 a.m., the subcommittee was adjourned.]



# **A P P E N D I X**

April 26, 2018

**Testimony on “Oversight of the SEC’s Division of Corporation Finance”**

**By William H. Hinman, Director  
Division of Corporation Finance  
U.S. Securities and Exchange Commission**

**Before the  
United States House of Representatives Committee on Financial Services  
Subcommittee on Capital Markets, Securities, and Investment  
April 26, 2018**

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

Thank you for inviting me to testify today on behalf of the U.S. Securities and Exchange Commission (SEC or Commission) about the Division of Corporation Finance’s (Division) activities and responsibilities. Since arriving at the SEC in May 2017, I have felt privileged to serve alongside such dedicated and talented individuals. Every day I am more impressed by the depth and breadth of the staff’s work and experience.

The mission of the Commission is to protect investors, and maintain fair, orderly, and efficient markets, and facilitate capital formation. The Division promotes the agency’s mission by overseeing the review of disclosures by companies to the investing public and seeking to ensure that investors have access to materially complete and accurate information upon which to make voting and investment decisions.

The Division’s authority is derived primarily from the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act). The Securities Act regulates offers and sales of securities in the United States. Unless an offering qualifies for an exemption from registration, the Securities Act requires the company offering securities to file a registration statement containing information about itself, the securities it is offering, and the offering. The Exchange Act requires companies that have an effective registration statement or that meet certain thresholds to report information regularly about their business operations, financial condition, and management. These companies must file periodic reports and other information with the SEC.

As part of its work, the Division engages in selective reviews of companies’ Securities Act and Exchange Act filings. We also administer the regulations under which registered and exempt offerings are conducted by providing interpretive advice about the securities laws and corresponding regulations and making rulemaking recommendations to the Commission on matters within the Division’s expertise. Further, Division staff stands ready to assist companies in complying with the federal securities laws, and we want to make sure that message is reaching everyone. The Division staff has engaged in outreach efforts to make sure that companies know we are open for business and that we want to be as transparent and collaborative as possible.

This testimony provides a summary overview of those activities, with a focus on current Division initiatives and priorities.

**Overview of Disclosure Review**

The Division regularly and systematically reviews the disclosures and financial statements of reporting companies to monitor and enhance compliance with disclosure and accounting requirements. The Sarbanes-Oxley Act of 2002 requires the Commission to review the financial statements of companies reporting under the Exchange Act at least once every three years and more frequently where circumstances warrant. In addition to these mandated reviews, the Division selectively reviews registration statements and other filings made for public offerings, business combination transactions, and proxy solicitations. The Division's staff has broad discretion to select filings for review, and we continuously work to allocate our resources effectively.

Division staff members conducting filing reviews are assigned to one of eleven offices that have specialized industry, accounting, and disclosure expertise. In the course of a filing review, the staff will conduct an evaluation of company disclosure and will, as appropriate, issue comments to elicit better compliance with applicable disclosure requirements. We concentrate our resources on critical disclosures that appear to conflict with Commission rules or applicable accounting standards and on disclosures that appear to be materially deficient in explanation or clarity.

In response to staff comments, a company may amend its financial statements or other disclosures to provide additional or enhanced information in the filing that is subject to the review or, in some instances, may provide improved disclosure in future filings. A company may also provide supplemental information so the staff can better understand the company's disclosure decisions. The comment process also provides a mechanism to respond to evolving trends in the marketplace. The Division coordinates with other offices and divisions within the Commission on complex or interconnected issues that arise within these reviews. Where appropriate, the Division refers matters to the Commission's Division of Enforcement.

To increase the transparency of the filing review process, after the Division completes a filing review, the comment letters and company responses to those letters are made public on the SEC website. Each comment letter is designed to elicit more effective disclosure based on the specific facts and circumstances of the company and should not be interpreted as generally applicable to all companies.

**Facilitating Capital Formation and Investment Opportunities**

Against the backdrop of a declining number of U.S. public reporting companies, the Division has been looking at ways to make the public company alternative more attractive. While there are many reasons why companies may choose not to go public, to go public at a later stage, or to exit the public markets, to the extent we are able to attract more companies to join our public company reporting system and do so at an earlier stage, it will ultimately benefit companies, our markets and investors. Companies that go through the evolution from a private company to a public reporting company emerge as better companies with better disclosure. Markets as a whole benefit from the increased transparency and the better-informed price discovery that occurs when more companies participate in the public markets. Investors benefit

when there are more companies in which to invest. Although initial public offerings (IPOs) and developing public companies may not be suitable for all investors, more IPOs occurring at an earlier stage means a wider range of investors are able to more fully participate in the growth of companies. It is far more efficient for retail investors to invest in companies through our public markets than our private markets. Increasing the number of public companies is becoming more and more important as Americans are increasingly relying upon their own investments for retirement.

With this in mind, the Division is examining our interpretive advice, our processes, and how we interact with registrants, investors, and others, to see where we can make enhancements while maintaining important investor protections.

#### *Recent Initiatives*

In July 2017, the Division expanded the non-public review process for draft registration statement submissions to all companies conducting certain securities offerings, including an IPO and follow-on offerings within one year of an IPO. This expands on the confidential submission process established for emerging growth companies (EGCs) in response to the Jumpstart Our Business Startups (JOBS) Act of 2012.

Companies are taking advantage of this process. We have received draft submissions for more than 20 IPOs of companies that exceed one billion dollars in revenue or otherwise do not qualify to submit as EGCs, and from over 50 companies engaged in follow-on offerings. These options simplify the capital-raising process for first-time registrants and newly-public companies by allowing them to submit their proprietary information on a non-public basis while the staff reviews their draft offering documents. This can reduce uncertainty for these companies and allow them to raise capital with less exposure to market volatility, which benefits companies and their investors.

The Division also recently provided greater clarity about what financial information is required when submitting draft registration statements or filing publicly. As a result, companies can avoid the time and expense of preparing and filing interim financial information if that information will be superseded by the time the filing is first made publicly available.

While these accommodations are making a positive difference to issuers, the Division is still able to perform fulsome filing reviews, and investors continue to receive the full array of financial information and other required disclosure when the company files publicly.

The Commission's interpretive guidance on pay ratio disclosure was another constructive initiative. In September 2017, the Commission issued interpretive guidance to assist companies in their efforts to comply with the pay ratio disclosure requirement in a cost efficient manner consistent with the statutory requirement. The Division also updated its interpretations and closely collaborated with staff in the Division of Economic and Risk Analysis (DERA) to provide assistance on calculating the pay ratio and using statistical sampling. The Commission and staff actions reflect feedback the SEC received as companies worked to implement the requirement and underscore the flexibility incorporated into the rule.

The Division also worked closely with the Commission's Office of the Chief Accountant to issue interpretations related to the new tax reform law when it was enacted in late December 2017. These interpretations reflect a practical approach to working with companies as they integrate new laws into their financial accounting and reporting.

#### ***Cybersecurity***

In February 2018, the Commission issued a statement and interpretive guidance to assist public companies in preparing their disclosures about cybersecurity. This guidance reinforces and expands upon guidance the Division issued in 2011. The new guidance provides the Commission's views about public companies' obligations under our laws and regulations with respect to matters involving cybersecurity risk and incidents and describes the importance of comprehensive policies and procedures related to cybersecurity events, including appropriate disclosure controls. The guidance reminds companies that these disclosure controls are important in their own right and that they play a role in ensuring that their insider trading policies and procedures guard against corporate insiders trading during the period between a company's discovery of a cybersecurity incident and public disclosure. It also addresses the importance of selective disclosure prohibitions in the cybersecurity context.

#### ***Cryptocurrencies and ICOs***

Cryptocurrency and initial coin offering (ICO) markets are additional areas where the Division has been focusing a significant amount of attention and resources. These markets have grown rapidly and the technology on which cryptocurrencies and ICOs are based has the potential to be transformative. If done consistent with the federal securities laws, ICOs have the potential to facilitate capital formation. At the same time, we are aware of the potential for fraud and abusive market practices and we are mindful of our need to see that investors are protected and are receiving the information they need to make informed investment decisions.

The Division is taking a balanced regulatory approach that both fosters innovation and protects investors. For example, in the area of ICOs, we assisted in the development of the SEC's July 2017 Report of Investigation regarding the application of the federal securities laws to those products. Our staff meets regularly with entrepreneurs and market professionals interested in developing new and innovative investment products in compliance with the federal securities laws. We also participate in the SEC's Distributed Ledger Technology Working Group, which focuses on emerging applications of distributed ledger technology in the financial industry. As this area continues to evolve, we will encourage new developments that facilitate capital formation while maintaining a focus on investor protection.

#### **Small Business Initiatives**

A significant and growing amount of capital is being raised pursuant to non-registered offering exemptions. Congress and the Commission have taken notable steps in recent years to further develop a capital formation ecosystem that includes a scaled disclosure regime and

provides small and medium-sized businesses additional capital raising avenues while maintaining robust investor protections.

Since the Commission adopted amendments to Regulation A in 2015, the number of qualified offerings and the aggregate amount sought in Regulation A offerings has substantially increased relative to the pre-amendment numbers. Seventy-eight issuers in 185 qualified offerings disclosed raising a total of approximately \$670 million through the end of 2017.

In addition to Regulation A, the use of other JOBS Act exemptions is also increasing. Rule 506(c) permits the use of general solicitation if sales are limited to accredited investors and the issuer takes reasonable steps to verify that the purchasers are indeed accredited investors. In 2017, \$147 billion was raised using Rule 506(c). We are also seeing small growth businesses begin to use crowdfunding as a securities offering method. Between May 2016, when Regulation Crowdfunding went into effect, and December 2017, there were 643 offerings initiated under the regulation's exemption, with a reported total amount raised of \$53 million.

As the exempt offering market continues to grow and evolve, the Commission and staff from Corporation Finance and other divisions continue to monitor developments, gather and examine data, and assess the effectiveness of these new exemptions in terms both of their ability to raise capital for smaller companies as well as providing appropriate protections for investors in these markets. Staff will be conducting look-back reviews of the impact of Regulation Crowdfunding and Regulation A on capital formation and investor protection. The Division also is considering recommending that the Commission propose amendments to expand the definition of accredited investor under Regulation D of the Securities Act.

Further, we recognize that as new and enhanced exemptions provide additional avenues for capital formation, small companies and their investors also could benefit from reduced regulatory complexity. The Division is considering ways to harmonize and streamline the Commission's exempt offering rules in order to enhance their clarity and ease of use.

As part of the Division's efforts to improve capital formation opportunities, we seek to engage with a wide range of interested parties at meetings and conferences around the United States. In October, Chairman Clayton and I attended a high tech jobs summit in Montana. The summit brought together lawmakers, regulators, and businesses – both large and small – to discuss job creation and capital formation, among other things. In November 2017, the Commission held its annual Government-Business Forum on Small Business Capital Formation in Austin, Texas. In addition to this forum, Division staff continues to participate in a number of outreach events that provide opportunities to hear from smaller companies seeking to grow their businesses. Each of these opportunities proves useful to hear views from issuers, investors, and other market participants about what is working and what could be enhanced under our regulatory regime. As you know, Congress recently created a new Office of the Advocate for Small Business Capital Formation at the SEC. Some of the responsibilities that traditionally have been staffed in the Division – such as organizing the Government-Business Forum on Small Business Capital Formation and facilitating the work of the Small Business Capital Formation Advisory Committee – will be handled by that new office. I look forward to working collaboratively with that new office.

Title VII of the JOBS Act required the Commission to provide online information and conduct outreach to inform small and medium-sized businesses, as well as businesses owned by women, veterans, and minorities, of the changes made by the JOBS Act. Division staff engage in outreach events throughout the year that are tailored to these business communities, informing them of different capital raising options and listening to feedback on what is working in their communities and what could be enhanced under our regulatory regime. Division staff also continue to modernize and streamline the Division's website and online resources. As part of this effort, in 2017, the Division reorganized its small business website, which provides easily accessible and user-friendly resources on the various capital raising options available to small businesses, including the exemptions from registration.

#### **Upcoming Priorities**

In addition to the capital formation and small business initiatives discussed above, the Division continues to work on a full rulemaking agenda, with a focus on reforms to make our disclosure regime more effective.

##### ***Smaller Reporting Company Definition***

The staff is working to complete a recommendation for the Commission's consideration to raise the financial thresholds below which companies would qualify for "smaller reporting company" eligibility. As proposed, the amendments would enable a company with less than \$250 million of public float to provide scaled disclosures as a smaller reporting company, as compared to the \$75 million threshold under the current definition. In addition, if a company does not have a public float, it would be permitted to provide scaled disclosures if its annual revenues are less than \$100 million, as compared to the current threshold of less than \$50 million in annual revenues.

##### ***Disclosure Effectiveness***

In recent years, the Division has undertaken an initiative to improve public company disclosure, working to identify disclosure requirements that the Commission can simplify and make more effective. The Division is reviewing the disclosure requirements in Regulation S-K, which provides requirements for public company disclosure, and Regulation S-X, which provides requirements for financial statements, and is considering ways to improve the disclosure regime for the benefit of both companies and investors. The goal is to comprehensively review the requirements and make recommendations on how to update them to facilitate timely, material disclosures by companies and shareholders' access to that information. Initially, the review is focusing on the business and financial disclosures required by periodic and current reports, Forms 10-K, 10-Q, and 8-K.

In October 2017, the Commission voted to propose amendments to modernize and simplify Regulation S-K as mandated by the Fix America's Surface Transportation (FAST) Act. As proposed, the amendments would change exhibit filing requirements and the related process for confidential treatment requests and would make changes to Management's Discussion and

Analysis that would allow for flexibility in discussing historical periods. The Division is preparing recommendations for the Commission to finalize these amendments.

The Division also is developing recommendations for final rules to update and simplify disclosure requirements that may have become outdated, overlapping, or duplicative with other Commission rules or U.S. GAAP. The Division is developing recommendations for proposals to amend the rules that affect the disclosure of financial information required in Regulation S-X and for updating certain of our Industry Guides to modernize industry-specific disclosure requirements.

#### ***Dodd-Frank Act Requirements***

In addition to disclosure simplification, the Division is also working to fulfill other rulemaking responsibilities. Last year Congress disapproved the Commission's rules that implemented the Dodd-Frank Act requirement that resource extraction issuers disclose payments made to governments for the commercial development of oil, natural gas, or minerals. The Division is reviewing all aspects of those rules in order to identify appropriate changes consistent with the Congressional Review Act and is preparing recommendations for a proposal for the Commission's consideration. The Division also is looking at possible revisions to the Commission's Conflict Minerals Rule in light of portions of that rule being set aside as a result of litigation. The Division also continues to work on finalizing the executive compensation rulemakings required by the Dodd-Frank Act – hedging, clawbacks, and pay versus performance. The Commission has issued proposals and received public comment on all of these provisions.

#### ***Capital Formation***

The Division is also examining our rules to explore whether there are changes that could be made to encourage more companies to go through the U.S. IPO process. The JOBS Act provided an exemption for EGCs and persons authorized to act on their behalf to communicate with potential investors that are qualified institutional buyers or institutional accredited investors prior to or following the filing of a registration statement to “test the waters” for an offering. The Division is considering recommending that the Commission propose amendments to extend the “test the waters” provision to non-EGCs.

All of our rulemakings have benefitted from public comments and we will continue to encourage comments on any new proposals that the Commission issues.

#### **Conclusion**

Thank you again for inviting me to discuss the Division's activities and responsibilities. I also would like to emphasize that the overview that I have shared with you today does not fully capture the tremendous commitment of the staff of the Division to our mission of capital formation and investor protection. I am happy to answer your questions.



Congress of the United States  
Washington, DC 20515

March 12, 2018

The Honorable Jay Clayton  
Chair  
The Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

Dear Chairman Clayton:

We are writing regarding a recent report that the Securities and Exchange Commission (SEC) is “laying the groundwork” for allowing public companies to include forced arbitration provisions in their corporate governance documents.<sup>1</sup> We strongly oppose any effort to reverse the Commission’s longstanding position that such forced arbitration provisions violate Federal securities law.

The Commission should continue to prohibit public companies from requiring shareholders to individually arbitrate their claims against the company, including Federal securities law claims, both as a matter of public policy and as a matter of law.

First, as a matter of public policy, there is a strong public interest in ensuring that shareholders have access to the courts to resolve their claims. This includes the ability to participate in securities class action lawsuits.<sup>2</sup> In 1995, Congress explicitly recognized the importance of private enforcement of the securities laws through litigation, stating that “[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action.”<sup>3</sup> In addition, the Supreme Court “has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC).”<sup>4</sup> Forcing shareholders to individually arbitrate their Federal securities claims, however, would effectively eliminate private securities litigation as a meaningful supplement to Commission enforcement of the securities laws, thereby undermining the comprehensive scheme of enforcement that Congress envisioned.

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<sup>1</sup> Benjamin Bain, “SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits,” *Bloomberg* (January 26, 2018), available at <https://www.bloomber.com/news/articles/2018-01-26/trump-s-sec-mulls-big-gift-to-companies-blocking-investor-suits>.

<sup>2</sup> Securities class action lawsuits have time and again proven effective in compensating shareholders for corporate frauds. See e.g., *In re Tyco International, Ltd.*, Securities Litigation, U.S. District Court, District of New Hampshire, No. 02-266 (\$3.2 billion settlement); *In re Enron Corporation*, Securities Litigation, U.S. District Court, Southern District of Texas, No. 01-3624 (\$7.2 billion settlement); *In re WorldCom, Inc.*, Securities Litigation, U.S. District Court, Southern District of New York, No. 02-3288 (\$6.1 billion settlement).

<sup>3</sup> H.R. Conf. Rep. No. 104-369, p. 31 (1995).

<sup>4</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 308 (2007).

Forced arbitration of Federal securities claims would also devastate investor confidence in the U.S. capital markets. Investors' ability to hold companies that commit securities fraud accountable through private litigation is critical to their confidence that their rights will be respected when they invest in U.S. companies. The ability to participate in class action lawsuits is particularly important in claims for securities fraud, where the victims are dispersed throughout the country, the factual and legal issues are extremely complex, and there is a substantial information asymmetry between the shareholders and the company.

Moreover, the Commission's position has long been that forced arbitration of Federal securities claims should not be allowed as a matter of public policy. In 1990, the Commission's then-Assistant General Counsel, Thomas L. Riesenberg, wrote that "it would be contrary to the public interest to require investors who want to participate in the nation's equity markets to waive access to a judicial forum for vindication of federal or state law rights, where such a waiver is made through a corporate charter rather than through an individual investor's decision."<sup>5</sup>

Second, allowing public companies to include forced arbitration provisions in their corporate governance documents violates the anti-waiver provisions of the Federal securities laws. It is well settled that shareholders may bring private lawsuits for securities fraud under section 10(b) of the Securities Exchange Act of 1934.<sup>6</sup> Section 29(a) of the Exchange Act provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter ... shall be void."<sup>7</sup>

The Supreme Court has stated that a provision will run afoul of the anti-waiver language of section 29(a) where the agreement "weakens [investors'] ability to recover under the Exchange Act."<sup>8</sup> A provision waiving an investor's right to sue in court will violate section 29(a) "where arbitration is inadequate to protect the substantive rights at issue."<sup>9</sup>

The Commission has long taken the view that including forced arbitration provisions in the corporate governance provisions of public companies violates section 29(a) of the Exchange Act because arbitration is inadequate to protect investors' rights. In an amicus brief urging the Supreme Court to uphold an arbitration agreement only where the arbitration procedure was subject to the Commission's strict Section 19 oversight for self-regulatory organizations, the Commission stated that its argument "would not apply" where the arbitration procedure was not subject to the Commission's Section 19 oversight — and for public companies generally, such arbitration procedures would not be subject to the Commission's Section 19 oversight.<sup>10</sup>

Mr. Riesenberg, the Commission's then-Assistant General Counsel, later stated the Commission's position that there were four separate grounds for finding forced arbitration

<sup>5</sup> Thomas L. Riesenberg, *Arbitration and Corporate Governance: A Reply to Carl Schneider*, 4 Insights 8 (1990).

<sup>6</sup> 15 U.S.C. § 78j(b); see also *Tellabs, Inc.*, 551 U.S. at 318; *Central Bank of Denver v. First Nat'l. Bank of Denver*, 511 U.S. 164, 171 (1994).

<sup>7</sup> 15 U.S.C. § 78cc(a); see also 15 U.S.C. § 77n (identical anti-waiver provision in the Securities Act of 1933).

<sup>8</sup> *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 230 (1987) (internal alterations omitted).

<sup>9</sup> *Id.* at 229.

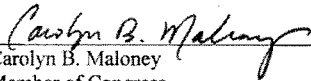
<sup>10</sup> Brief for the Securities and Exchange Commission at 20, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (No. 86-44).

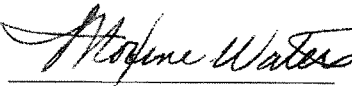
provisions in corporate governance documents violated Federal securities laws.<sup>11</sup> Mr. Riesenberg reasoned that such forced arbitration provisions violate section 29(a)'s anti-waiver language because the Commission oversight over the arbitration procedures was wholly inadequate to protect investors' substantive rights.<sup>12</sup> More recently, the Commission staff affirmed the view that a shareholder proposal to amend a company's bylaws to require arbitration of securities claims "would cause the company to violate the federal securities laws."<sup>13</sup>


Further, because of the long-standing public position of the SEC, and the significant impact such a monumental shift in policy would have on American investors, any examination of this issue should be done in a transparent manner — one in which the public is fully informed and able to participate. Investors, shareholders, and other stakeholders should have their voices heard through a formal and public process. Anything less will be seen as a stealth attempt by the Commission to circumvent U.S. securities laws and the fundamental rights of shareholders. As such, we would expect a swift and negative response from Congress and the public.


Accordingly, we respectfully request that the Commission reaffirm its longstanding position that forced arbitration provisions in the corporate governance documents of public companies harms the public interest and violates the anti-waiver provisions of the Federal securities laws.

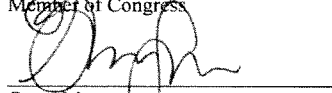
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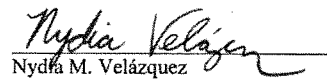
  
 Carolyn B. Maloney  
 Member of Congress

  
 Maxine Waters  
 Member of Congress

  
 Michael E. Capuano  
 Member of Congress

  
 John K. Delaney  
 Member of Congress

  
 Gwen Moore  
 Member of Congress

  
 Nydia M. Velázquez  
 Member of Congress

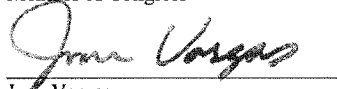
<sup>11</sup> See Riesenberg, *supra* note 5.

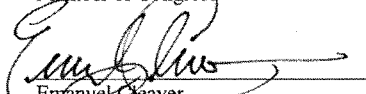
<sup>12</sup> *Id.* at 30.

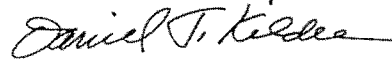
<sup>13</sup> Gannett Co., Inc., SEC No-Action Letter (February 22, 2012).


  
Joyce Beatty  
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Member of Congress


  
Juan Vargas  
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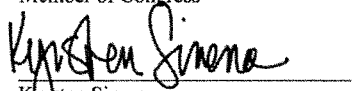
  
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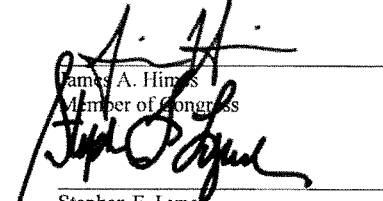
  
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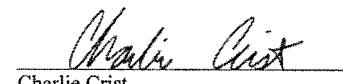
  
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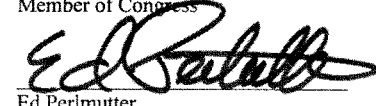
  
Brad Sherman  
Member of Congress

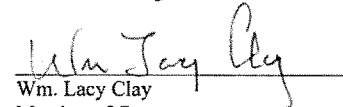
  
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James A. Himes  
Member of Congress

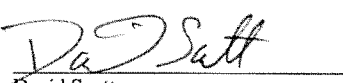
  
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Ed Perlmutter  
Member of Congress

  
Wm. Lacy Clay  
Member of Congress

  
Denny Heck  
Member of Congress

  
Vicente Gonzalez  
Member of Congress

  
David Scott  
Member of Congress



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Al Green  
Member of Congress



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Josh Gottheimer  
Member of Congress



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

April 24, 2018

The Honorable Carolyn B. Maloney  
U.S. House of Representatives  
2308 Rayburn House Office Building  
Washington, DC 20515

Dear Representative Maloney:

Thank you for your March 12, 2018 letter regarding the ability of companies to require shareholders to arbitrate claims against them under the federal securities laws.

This matter is complex. It involves our securities laws, matters of other federal and state law, an array of market participants and activities, as well as matters of U.S. jurisdiction. It also involves many public policy considerations. Further, this issue has come before the Commission in a variety of ways and contexts and may do so in the future. Views of market participants on this issue, particularly in the case of an initial public offering (IPO) of a U.S. company, are deeply held and, in many cases, divergent. In response to the recent heightened interest from Congress and others relating to the inclusion of mandatory arbitration provisions in the charters or bylaws of U.S. companies contemplating an IPO, I have (1) made several statements<sup>1</sup> and (2) more recently, asked the Division of Corporation Finance (the Division) to review how this issue has arisen in the past, and may arise in the future, in connection with filings made by companies with the Division.

A summary provided by the Division of its prior approach to this issue, as well as how the Division would expect to proceed if the issue were presented in the context of an IPO of a U.S. company, is below. The summary reflects the Division's view that should a U.S. company pursue a registered IPO with a mandatory arbitration clause in its governing documents, the decision about whether to declare the filing effective should be made by the Commission, not the Division by delegated authority. I agree with the Division's view on process and, in particular, that this would be a decision for the Commission. Although I have made several prior statements on this issue, for reasons of clarity and completeness, I summarize my perspective on the issue below.

As a threshold matter, and recognizing the complexity and importance of this issue, I reiterate my personal view that any analysis of this issue or decision making by the Commission in the context of a registered IPO by a U.S. public company should be conducted in a measured and deliberative manner.

<sup>1</sup> See, e.g., Remarks before the SEC Investor Advisory Committee (March 8, 2018), available at <https://www.sec.gov/news/public-statement/statement-clayton-2018-3-8>.

The Honorable Carolyn B. Maloney  
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The federal securities laws provide a basis for private rights of action by investors in the event of material misstatements as part of securities offerings. There is a long history of claims of this type being brought against U.S. publicly traded companies in our federal and state courts, including as class actions. The Division's summary notes that, in the case of foreign private issuers that have conducted registered offerings in the United States and U.S. companies that are not listed, direct and indirect limitations on such actions have been prevalent for many years. In addition, and beginning several years prior to my arrival at the Commission, certain U.S. companies conducting exempt Regulation A offerings have included mandatory arbitration clauses in their governing documents or subscription agreements. The Division's summary discusses these and other matters in more detail.

It is my view that if we are presented with this issue in the context of a registered IPO of a U.S. company, I would expect that any decision would involve Commission action (and not be made through delegated authority) and that the Commission would give the issue full consideration in a measured and deliberative manner. Such a review would take into account various considerations, including developments in applicable law and any other relevant considerations. I have reiterated these views and sought to appropriately frame this issue and my preference for such a process in my public statements.

These statements have not only addressed my perspective on the appropriate procedure for analyzing this matter but also its relative priority. With respect to priority, generally speaking, my view is that the Commission should allocate its limited rulemaking and other related resources to a portfolio of matters that (1) present currently pressing and significant issues for investors and our markets, (2) are central to our mission, (3) are ripe for consideration, and/or (4) are addressable through a reasonable share of Commission and staff time. To me, such matters currently include, among others and in no particular order, (1) standards of conduct for investment professionals, (2) Congressionally-mandated rulemaking, (3) the regulation of investment products, including ETFs, (4) the impact of distributed ledger technology (including cryptocurrencies and ICOs), (5) FinTech developments, (6) the elimination of burdensome regulations that do not enhance investor protection or market integrity with an eye toward facilitating capital formation, (7) an examination of equity and fixed income market structure, and (8) of course, inevitable issues that we have not yet identified but will emerge as pressing.

These statements have made it clear that I have not formed a definitive view on whether or not mandatory arbitration for shareholder disputes is appropriate in the context of an IPO for a U.S. company. I believe any decision would be facts and circumstances dependent and could inevitably divert a disproportionate share of the Commission's resources from the priorities I noted above. In short, this issue is not a priority for me. Although the issue is not a priority for me, it does not mean that it is not worthwhile to analyze, and I have encouraged those with strong views to support their position with robust, legal and data driven analysis. If this matter does come before the Commission, such analysis will assist the Commission in its deliberative process.

The Honorable Carolyn B. Maloney  
Page 3

**Summary Provided by the Division of Corporation of Finance:**

The Division of Corporation Finance (the Division) oversees periodic filings by reporting companies and filings of issuers seeking to raise money in the capital markets through, for example, initial public offerings. The federal securities laws generally focus on requiring companies to provide full and fair disclosure of material information to investors and the Division's oversight of filings is intended to facilitate compliance with those laws.

State laws generally provide the parameters for companies to establish their corporate governance through their organizational documents, such as their charter or bylaws. The Commission does not have rules permitting or prohibiting companies from using arbitration provisions.

The Commission's processes with respect to arbitration provisions have been and may in the future be implicated through the Division's role in overseeing and processing filings by companies. The most often identified channel for this issue to arise is if a U.S. company sought to include a mandatory arbitration provision in its governing documents when it filed an initial registration statement to offer and sell securities publicly. Following is an overview of circumstances in which mandatory arbitration provisions have been and could be present in the governance documents of companies that make filings with the Commission.

*Registered Offerings by U.S. Companies*

A company may not sell securities in the United States unless (1) it has an effective registration statement on file with the SEC or (2) an exemption from registration is available. Section 8(a) of the Securities Act of 1933 (Securities Act) provides that a registration statement will become effective 20 days after it is filed and authorizes the Commission to accelerate the effective date of a registration statement after taking into account the adequacy of the disclosure and certain other considerations.<sup>2</sup> This authority to accelerate the effective date has been delegated to the Division by the Commission. By statute, registration statements become effective with the passage of time. As a matter of practice, a company will nearly always include in any pre-effective registration statement a legend, referred to as a "delaying amendment," in order to prevent the registration statement from becoming effective automatically following the passage of time and to better control the timing of its offering. During this time, the Division staff may review the filing. In the course of a filing review, Division staff will evaluate the company's disclosure and may issue comments to elicit better compliance with disclosure requirements, and the company will amend its registration statement to address the

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<sup>2</sup> In its entirety, Section 8(a) states that "The effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine, having due regard to the adequacy of the information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors [emphasis added]."



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comments as appropriate. Following this review and comment process, the company submits a request to accelerate the effective date of the registration statement.

When this issue last arose in the context of an initial public offering (IPO) of a U.S. company in 2012, the Division took the position, based on a consideration of relevant federal laws and case law, that it would not use its delegated authority to accelerate the effective date of a U.S. company's registration statement when the company's governing documents contained a mandatory arbitration provision covering disputes arising under federal securities laws. In that context, the Division was unable to conclude that such provisions are consistent with "the public interest and protection of investors" as required by Securities Act Section 8(a) in light of, among other things, the anti-waiver provision in Section 14 of that Act.<sup>3</sup> More specifically, at that time, the Division advised a company that it did not anticipate exercising its delegated authority to accelerate the effective date of the registration statement if such a provision was included in the company's governing documents and that the Commission would need to make any decision on a request for acceleration. In that situation, the company decided not to include the mandatory arbitration provisions in its governing documents in connection with its IPO.

If this issue were to come before the Division in a U.S. company's registration statement for an IPO today, as discussed in more detail below, the Division would not use its delegated authority to accelerate the effective date of the registration statement. Instead, the Division would refer a request for acceleration to the full Commission.

The historical treatment of this issue in other circumstances, such as in the qualification of Regulation A offerings and in the processing of registration statements filed by foreign private issuers, is described below.

#### *Other Circumstances*

For many years, U.S. and non-U.S. companies have made other types of filings with the Commission that have included mandatory arbitration provisions for shareholder disputes in their governing or offering documents. These circumstances and the relevant considerations are described further below. In these circumstances, the relevant statutes and rules generally require appropriate disclosure regarding material risks to the issuer or of the offering, which would include risks relating to mandatory arbitration provisions and any impact on holders of the offered securities.

- Regulation A: Some companies utilizing the exemption from registration available under Regulation A have included mandatory arbitration clauses in their governing documents or subscription agreements. Under Regulation A, a company may not sell its securities until the Division has qualified its offering statement. In these exempt offerings, neither the federal securities laws nor the Commission's rules require the Division to make the same public interest determination as is required when accelerating the effective date of a registration statement in the context of an IPO.

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<sup>3</sup> Section 14 states that "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void."

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In 2015, after reviewing the relevant law and regulations, the Commission staff concluded that there would not be grounds to withhold qualification of a Regulation A offering on the basis that the issuer had included a mandatory arbitration provision in its governing documents. Since then, in light of the Commission staff's 2015 determination, certain offerings that have included a mandatory arbitration clause have been qualified under Regulation A, provided that the material risks of such a dispute resolution approach had been disclosed and the issuer otherwise qualified for the exemption.

- Foreign Private Issuers: For many years, a number of foreign companies with securities listed or traded in the United States have included mandatory arbitration and other analogous provisions in their filings. Registration statements of foreign private issuers offering and selling securities in the United States also generally include disclosures regarding limitations investors may face as a result of the issuer's foreign status and home country laws and regulations. These disclosures have typically included a risk factor informing investors that due to jurisdictional issues it may be difficult for them to obtain or enforce judgments or bring original actions, including actions styled as class actions, against the company. In these instances and in situations where mandatory arbitration has been required, either due to local law requirements or otherwise, the Division staff has focused on the disclosure of the material risks related to these limitations and has declared these filings effective.
- Exchange Act Reporting Companies: There are several other ways a company could be in the Securities Exchange Act of 1934 (Exchange Act) reporting regime and have a mandatory arbitration provision in its governing documents. For example, a registration statement for a class of securities pursuant to Exchange Act Section 12(g) becomes effective automatically 60 days after filing. As another example, a public reporting company could amend its bylaws or seek shareholder approval of a charter amendment or to include an arbitration provision (assuming that the applicable state law allows for the enforceability of such a provision)<sup>4</sup>. In any of these situations, the Commission's rules would require appropriate disclosures to investors.

#### *Considerations*

Mandatory arbitration clauses involve complexities beyond the Commission and its rules. For example, they raise issues under the state corporate laws under which the issuers are organized. In addition, federal case law regarding mandatory arbitration continues to evolve. Since 2012, when this issue was last presented to the Division in the context of an IPO of a U.S. company, the Supreme Court has affirmed the strong federal interest in promoting the arbitration of claims under federal laws.<sup>5</sup> Over the last several years, commentators have observed that there is uncertainty as to whether the Commission

<sup>4</sup> See Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes*, 39 Del. J. of Corp. Law 751, 779-782 (2015) (discusses circumstances where arbitration clauses included in public issuers' filings) ("Allen").

<sup>5</sup> See, e.g., *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013) (holding that, under the Federal Arbitration Act (FAA), courts must "rigorously enforce" arbitration agreements according to their terms unless the FAA's mandate has been "overridden by a contrary congressional command").

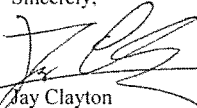
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would have a basis to deny an acceleration request in these circumstances.<sup>6</sup> If a U.S. company were to file for an IPO with governing documents that included a mandatory arbitration provision, the Commission would need to evaluate the specific facts and circumstances in the context of not just the federal securities laws but also state corporate and other federal law. This is a complex legal and policy issue that requires careful consideration. As such, and as discussed above, if the issue were presented to the Division in the context of an IPO for a U.S. company, the Division would decline to exercise its delegated authority to accelerate the effective date of a registration statement and instead refer the matter to the Commission for its consideration.

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Thank you again for your letter. Please do not hesitate to contact me at (202) 551-2100 or Bryan Wood, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010 if you have any questions or comments.

Sincerely,



Jay Clayton  
Chairman

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<sup>6</sup> See, e.g., Allen at 778 (fn 141).



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April 16, 2018

Roxanne S. Austin  
Chair of the Compensation Committee  
Abbott Laboratories Board of Directors  
c/o Abbott Corporate Secretary  
Abbott Laboratories, Dept. 364, Bldg. AP6D  
100 Abbott Park Road  
Abbott Park, IL 60064-6400

Dear Ms. Austin,

I am writing in connection with your letter (the "Abbott Letter") to the shareholders of Abbott Laboratories ("Abbott"), contained in Abbott's Schedule 14A filed with the SEC on April 5, 2018. The Abbott Letter relates to the Proxy Analysis report (the "ISS Report") issued by Institutional Shareholder Services Inc. ("ISS") to its clients, in connection with Abbott's upcoming annual meeting of shareholders on April 27, 2018.

The Abbott Letter claims to "highlight and correct substantial errors in analysis and fact" purportedly made by ISS in the ISS Report. Given the severity of the accusations in the Abbott Letter and ISS' fundamental disagreement with the assertions, we felt it was important to communicate with you directly on these matters. I will address each of the main complaints from the Abbott Letter below in more detail, but let me start by saying in summary that all the main assertions made in the Abbott Letter about the ISS Report are either misinformed or plain incorrect, and we are surprised that such a mischaracterization was sent by Abbott to its shareholders. The Abbott Letter itself contains a number of serious factual errors and misrepresentations about both the ISS Report and the process undertaken by ISS in the preparation of the ISS Report, including its engagement efforts with Abbott.

Below I've taken the liberty of extracting from the Abbott Letter the key accusations and assertions made, and following each of those extracts I've provided ISS' substantive response. I have numbered them for easier reference, but would note that they are not so-numbered in the Abbott Letter.

1. ***Abbott Letter: "ISS is aware of the flaws and inaccuracies in its Report and has disregarded our attempts to correct them. Attached as Annex A is the detailed letter sent to ISS correcting their errors, omissions and misrepresentations."***

ISS Response: ISS is not aware of any flaws or inaccuracies in the published ISS Report, and certainly has not disregarded any attempts to correct any errors. To the contrary, in response to Abbott's April 3 letter to ISS (the letter referenced above as Annex A), ISS corrected the two factual inaccuracies Abbott identified in the draft report which was provided to Abbott as part of our "draft review" process for companies in the S&P 500 index. Those two factual inaccuracies were identified in Abbott's April 3 letter to ISS and we of course corrected them before publishing the final version of the ISS Report to our clients. This is precisely the goal of our draft review process, namely to help ensure the accuracy and quality of our reports for the benefit of our institutional investor clients for whom the reports are prepared. While Abbott's April 3 letter did identify a number of other areas that we understand Abbott considers to be flaws and inaccuracies, in fact those other areas reflected differences of opinion or disagreements by Abbott with the methodologies



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that ISS applies. These methodologies are made available publicly, are consistently applied in the ISS models and research, and have been correctly and fairly applied within the ISS Report.

While Abbott is obviously free to disagree with the philosophical approach of ISS (or of any research provider or shareholder for that matter), and ISS acknowledges that there is room for open-minded debate on various corporate governance policies and assessment methodologies, a disagreement in philosophy or approach does not constitute an error, omission or misrepresentation.

**2. Abbott Letter: “Additionally, we made multiple requests to ISS for a meeting to discuss the Report. Contrary to their stated policies, however, ISS refused to engage and proceeded to publish a flawed and inaccurate Report”.**

ISS Response: ISS is always happy to consider engagement requests, as you should be aware from our in-depth engagement with Abbott in advance of the company’s 2017 shareholders meeting. However, Abbott did not make multiple requests for engagement this year. In fact there was only one request for a meeting to discuss the ISS Report, and ISS responded to this request on the same day in a manner fully consistent with our policies.

As part of our draft review process, Abbott submitted its written comments on the draft ISS Report on April 3<sup>rd</sup>. Once received, our analysts considered the company’s extensive commentary, identified that most of the alleged errors were based on disagreements about our stated methodology rather than being errors of fact or omission, and identified two items that were factual inaccuracies (the date Abbott entered into the agreement to acquire Alere was incorrectly noted in the draft, and the start year of the company’s audit firm was confirmed by Abbott to be 2014 rather than 2013). In addition to some other adjustments to our analysis which were made based on Abbott’s feedback, these two factual corrections were made before the ISS Report was finalized and sent to our clients.

The “multiple requests” for engagement mentioned in the Abbott Letter were in reality one request for an engagement meeting following the company’s provision to ISS of its April 3 written comments on the draft Report. This request was received from Jessica Paik of Abbott on April 4<sup>th</sup>, and ISS responded on the same day to let Abbott know that the company’s comments were being reviewed, that we would reach out to the company if we had any questions, and asking the company to let us know if it had any additional comments. Subsequently, our analysts determined that Abbott had provided fulsome comments and feedback and that they had no further questions which would necessitate further engagement at that point.

I should also point out that our decision that no further engagement was necessary at that point was not in any way a violation of our stated engagement policies. To the contrary, in the March 30, 2018 email cover letter ISS sent to John Berry of Abbott when delivering our draft report for review, we noted the following on our policies for full clarity:

**Requests for further engagement/follow-up:** [i.e. after the submission of the draft Report for fact-checking purposes]

We do need to receive your written comments before we can determine whether further engagement is necessary, and that determination is at ISS’ sole discretion. During proxy season, companies should expect that only truly exceptional situations will warrant engagement immediately prior to, or following, publication of ISS’ reports

Our records show no other requests for engagement were received from Abbott in 2018 prior to the delivery of the draft ISS Report to Abbott for review.



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3. **Abbott Letter:** *“In 2017 the Company performed at the top of its peer group with Total Shareholder Return (TSR) growth of 52% and completed all of its financial and strategic objectives. The CEO was granted LTI in 2017 at the 23rd percentile of our peer group. Abbott improved over 35 points on ISS’ Key Relative Degree of Alignment test and achieved an overall “low concern” outcome on ISS’ quantitative tests. It is absurd that in the face of these facts that ISS has not recommended support for Say-On-Pay. ISS’s recommendations should be objective and based on facts.”*

ISS Response: The basis of the ISS vote recommendation on the “Say-on-Pay” item is clearly stated in the ISS Report, and is neither an issue with Abbott’s performance nor with the amount of the CEO’s pay and equity grants. The “against” recommendation was driven by concerns (1) regarding the design and structure of the incentive plan and a lack of transparency of metrics and goals, and (2) that the long-term program awards are too heavily influenced by short-term TSR performance. We also note that ISS’ quantitative assessment of the compensation program resulted in an overall “medium concern”, not an overall “low concern” as you state in the Abbott Letter (see page 14 of the ISS Report).

In any event, ISS’ analysis of, and vote recommendations on, Say-on-Pay agenda items are based on both qualitative and quantitative factors. ISS conducts an analysis of the pay programs and practices for all companies, and an enhanced review is conducted for all companies that exhibit an elevated overall concern (Medium or High) on the quantitative screen, and for a selection of companies that exhibit a Low overall concern level from the model.

With respect to the company’s specific comment that, “Our CEO was awarded LTI at the 23rd percentile of our peer group in 2017, while our Company performed at the top of our peer group with a TSR of 52%”, ISS does not dispute this statement. It does not, however, mitigate the structural and transparency concerns identified in our qualitative review.

4. **Abbott Letter:** *“Instead, ISS’s recommendation on executive pay is driven by:*
- *Manipulation of our peer group—ISS altered the Company’s peer group and selected inappropriate peers which do not reflect the impact of Abbott’s significant increase in size following two significant acquisitions, St. Jude and Alere, during 2017. ISS added peers which do not even meet their own criteria and omitted Company selected peers if they paid relatively high while performing relatively low, thus purposely manipulating the outcome. “*

ISS Response: These assertions are wholly without basis. ISS-selected peers are not a “manipulation” of the company’s peer group, and there has absolutely been no “manipulation” of the ISS-selected peer group to Abbott’s detriment. In fact, the only alterations to the initially-selected ISS peer group have been to take account of the acquisitions made by Abbott in 2017, which adjustments were made after considering the information Abbott provided to ISS.

As a starting point and to confirm what I believe Abbott already knows, ISS’ policy approach provides for the creation of an ISS-selected peer group for every company, and this is based on an algorithmic-driven approach. ISS’ methodology for its peer group determinations is made available publicly and is used consistently without prejudice. Our peer selection methodology considers the market capitalization, revenue, and industry of a company and its peers, and does not take into account relative shareholder returns or CEO pay at any point in the process, as the Abbott Letter alleges. The purpose of using ISS-selected peer groups is to provide objectivity in peer selection and consistency amongst companies for the purpose of our quantitative analysis of pay for performance. ISS’ peer selection for Abbott adhered to our methodology, and also appropriately took into account the acquisitions made in 2017 based on information provided by Abbott.



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The ISS peer group for the ISS Report was first generated based entirely on our peer selection algorithm, which fully considered Abbott's 2017 peer group as submitted by the company to ISS during the "peer feedback" process. This algorithm-selected peer group already had significant overlap with the company's self-selected peer group. Abbott then reached out to ISS in early March 2018 asking that we consider the acquisitions that the company had made during 2017, and the impact of those acquisitions on Abbott's market cap and revenue as it relates to our peer group selection. After considering the points raised in Abbott's March 1, 2018 letter, ISS determined that it was appropriate to remove one of the peers that ISS' algorithm had selected (Boston Scientific Corporation), and to add an additional company suggested by Abbott and which met ISS' requirements for an appropriate peer (Thermo Fisher Scientific).

Contrary to the assertion that ISS manipulated the peer group to the detriment of Abbott, these updates were made taking into account the information Abbott provided, and resulted in an even greater overlap between the company's selection and the ISS-selected peers. The final peer group used by ISS in the ISS Report had significant overlap with Abbott's self-selected peers (12 out of 16).

5. **Abbott Letter:** *"Manipulation of GAAP and non-GAAP measures—ISS selectively uses GAAP and non-GAAP measures during its analysis. When GAAP measures are employed, ISS ignores the one-time impact of U.S. Tax Reform and thereby understates all of Abbott's financial metrics. Although they state EBITDA is the most important measure for our GICS code, they exclude its use. Abbott outperformed all of its Company and ISS peers in EBITDA growth. Inclusion of EBITDA in the analysis would have positively impacted Abbott's scoring. After excluding EBITDA, ISS then claims ROA, ROIC and ROE results are low based on the one-time GAAP-effect of U.S. Tax Reform. With such arbitrary methods, ISS artificially inflates pay and falsely asserts operating performance is lower. Moreover, ISS makes little attempt to explain the composition of, or rationale for use of, those measures."*

ISS Response: There was no manipulation of GAAP and non-GAAP measures in the ISS Report. The measures used in our models and analyses are consistent and transparent, and they were certainly not selectively used "against" Abbott as is implied here. Equally important and as explained above, our vote recommendation on the Say-on-Pay agenda item did not rely upon either the quantitative model results or the operating performance measures quoted by Abbott.

A number of other assertions here are simply incorrect statements of fact - we do not state that EBITDA is the most important measure for Abbott's GICS code nor does "ISS then claim[s] ROA, ROIC and ROE results are low..." In fact, the references to ROE, ROA, and ROIC performance in the draft report were removed before the ISS Report was finalized, after taking into consideration the comments provided by Abbott in the April 3 draft review response letter.

6. **Abbott Letter:** *"Inflation of CEO compensation—ISS uses a non-GAAP approach to the valuation of option grants which leads to an inflated and incorrect calculation of 3-year average CEO pay. For example, the combination of a 10-year option life (Abbott's average option life is actually 6) with a 3-year volatility assumption purposely overstates the value of the grant the Compensation Committee made, the value of the award the CEO received, the actual expense to the Company and the actual impact on shareholders."*

ISS Response: There was no inflation of CEO compensation in the way that Abbott describes. ISS' Black-Scholes option valuation methodology is clearly explained in our publicly available policy documents and I refer you to FAQ #4 in our U.S. Compensation Policies—Frequently Asked Questions document which is available on our public website at <https://www.issgovernance.com/file/policy/active/americas/US-Compensation-Policies-FAQ.pdf>.



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The valuations of the option grants to Abbott's CEO were made fully in line with that methodology, in line with our normal process, and we consider them correct and fair.

Regarding option life, ISS is aware and acknowledges that Abbott is using valid, permissible and accepted accounting practices to estimate the life of the options for all employees, and uses the same assumptions for calculating the option term for the CEO for valuation purposes – which we understand is completely consistent with what is allowable under applicable accounting rules. ISS' methodology, however, is based on the different assumption that most executives tend to hold onto their options until close to expiration and there is empirical evidence to suggest this pattern. In looking at the specifics for Mr. White, we see that this holds true – Mr. White tends to hold options for longer than six years. Per Abbott's most recent proxy, for example, he has a tranche of options that was issued over 9 years ago and with less than a year left to expiration.

Regarding volatility, according to a "Radford Review" published by Radford Consulting, which can be found at [https://www.radford.com/home/ccg/valuation\\_services/Whitepaper\\_ASC\\_Topic718\\_Assumptions\\_Best\\_Practices.pdf](https://www.radford.com/home/ccg/valuation_services/Whitepaper_ASC_Topic718_Assumptions_Best_Practices.pdf), about 20% of companies use a similar method to calculate volatility as ISS does– that is, basing volatility assumptions on a single historical volatility measurement period (in our case, three years). In the study, Radford states: "In practice, the most frequent categories for determining expected volatility are historical volatility, implied volatility, and peer volatility. Further, many companies elect to use a combination of the above volatility types, also referred to as a blended volatility."

According to the same study, 95% of companies use historical volatility as an input to their volatility assumptions. 70% of companies do use historical volatility in concert with implied or peer volatility; for the strong majority of companies, historical volatility is an important input into their final volatility assumptions.

We believe ISS' methodology is robust and transparent – and is also accepted as a standard, or as a primary component, by many companies.

ISS' treatment of Abbott's options is consistent with our published methodology, has been in place for a number of years (providing year on year consistency), and there are no deviations from our standard valuation methodology in the ISS Report. For full transparency, ISS displays in our research reports both ISS' and the company's assumptions used for CEO option award valuation, as well as the resulting difference (if any) between the two valuations. This information was included in the ISS Report as follows:

**Abbott Laboratories (ABT)**  
POLICY: United States

OPTION VALUATION ASSUMPTIONS

For CEO's last FY Grant	Company	ISS
Volatility (%)*	18.00	20.74
Dividend Yield (%)*	2.40	2.28
Term (yrs)*	6.00	10.00
Risk-free Rate (%)*	2.10	2.42
Grant date fair value per option*	6.54	9.27
Grant Date Fair Value (\$ in 000)**	4,100	5,920

\*Source: Standard & Poor's Xpressfeed; \*\*Source: DEF14A (company value); ISS (ISS value); Difference between ISS and company grant date fair value is 44.39%





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7. **Abbott Letter:** *“A false claim that our Proxy Filing lacked adequate disclosure—ISS incorrectly claims that our disclosure in our Proxy Filing lacks rigor and specifics. To the contrary our disclosure clearly states the reasons for compensation decisions as well as specific targets and achievement levels, the design of our compensation programs, and provides disclosure on 2018 grants which is not required or provided by most companies. Although we do not publish competitively sensitive strategic goals, the goals themselves are direct, measurable, time-bound and individually assigned to the appropriate executives. They are neither subjective or without rigor as ISS suggests.”*

ISS Response: While we understand that Abbott disagrees with our conclusions, ISS believes that its Say-On-Pay analysis in the ISS Report correctly identifies concerns around disclosure. In ISS' view, and as explained in the ISS Report, several incentive metrics and goals are described in overly broad terms, without specific results or weightings on a per-goal basis being disclosed. In other cases, performance results are entirely undisclosed. These concerns are exacerbated by the fact that the strategic and leadership goals accounted for half of the annual incentive award opportunity, and that the award was paid out above target without the company providing its shareholders with adequate information to assess this. We believe our analysis of the incentive programs is correct and reasonable, and it is in line with our established policy and practice.

8. **Abbott Letter:** *“ISS then reaches a conclusion regarding separation of Chairman and CEO based entirely on “concerns” about control of executive compensation that ISS created through its distorted analysis.”*

ISS response: Putting aside the efficacy of our analysis on the Say-on-Pay item as discussed in detail above, ISS' recommendation to vote “for” the shareholder proposal for the company to adopt a policy to have an independent chair was not based only on the compensation concerns. When analyzing shareholder proposals seeking an independent chair, ISS' policy approach for U.S. companies is generally to recommend “for” the proposal, while considering on a case-by-case basis the scope of the proposal, company-specific factors, and any other factors that may be applicable (such as compensation concerns).

In addition to referencing the executive compensation concerns, the ISS Report is clear that the scope of this particular proposal is not considered overly prescriptive on the company. This is also a strong supporting factor to our “for” recommendation on the proposal. You will be aware that there was a similar proposal at Abbott's 2017 meeting, and that we also recommended a vote in favor of that proposal last year.

9. **Abbott Letter:** *“As explained in our March 1, 2018 and December 11, 2017 letters to Mr. Bimal Patel, your Vice President, U.S. Research, Abbott completed two large strategic acquisitions during 2017 which greatly increased our size and had a substantial impact on our financial metrics. As these letters appear not to have been adequately considered, we have reiterated their contents below.”*

ISS Response: The letters referenced were reviewed and considered in full. As noted above, the issues and information Abbott articulated in its March 1, 2018 letter did result in changes to the ISS peer group selection for Abbott to reflect the acquisitions made. In hindsight perhaps we could have communicated to Abbott directly at that point that we had, in fact, considered and acted upon the March 1, 2018 letter. However we considered that those changes would be fully apparent in the draft report sent to Abbott on March 30, 2018 as part of the draft review process.

10. **Abbott Letter:** *“Substantive reliance on our CEO's 2018 equity award as a basis for concern which is irrelevant to 2017's Say on Pay recommendation, and is provided only as information in advance of next year.”*

ISS Response: As described by Abbott itself in its 2018 proxy statement, the 2018 equity award for Mr. White was determined based on performance in 2017, and based on relative TSR for the one-, three-, and five-year periods ending in



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2017. Given this disclosure, while the grant was made in 2018, it was an appropriate consideration in the analysis of the CEO's total pay for 2017. The practice of considering grants made subsequent to the corresponding performance year is routinely applied by ISS for companies that have such a timing lag issue. This point is also explained in the ISS Report.

We would also note that during Abbott's review of ISS' report for the 2017 shareholders meeting, Abbott made the case to ISS at that time that pay decisions made with respect to 2016 performance were reflected in the magnitude of the CEO's 2017 equity grant, and that ISS' evaluation should take this into account. Having accepted Abbott's argument for our 2017 analysis, this approach was also used in the 2018 ISS Report to provide fair and correct consistency.

I hope that the foregoing will be helpful in addressing the concerns and allegations you raised to your shareholders, and in understanding that the alleged "substantial errors in analysis and fact" perceived by Abbott are nothing of the kind. It is also my hope that you will now understand that ISS did not refuse to engage with Abbott in the way that is mischaracterized in the Abbott Letter or contrary to our policies.

While you may not necessarily agree with aspects of our methodologies or our conclusions, I hope you are now more fully informed as to the facts of the disagreements, and of ISS's methodologies and approaches which are applied as consistently and transparently as possible, and without prejudice. If you and other members of the Abbott Board or Compensation Committee would like to discuss further, we would be happy to do so, whether now or in advance of Abbott's 2019 proxy and annual meeting.

If you think it would be appropriate and/or useful, you have our permission to make this letter available to your shareholders.

Yours sincerely,

Georgina Marshall,  
 Global Head of Research  
 Institutional Shareholder Services Inc.

cc: Gary Retelny, ISS President and CEO



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May 7, 2018

The Honorable Bill Huizenga  
Chairman  
Subcommittee on Capital Markets, Securities and Investment  
Committee on Financial Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Carolyn B. Maloney  
Ranking Member  
Subcommittee on Capital Markets, Securities and Investment  
Committee on Financial Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Huizenga and Ranking Member Maloney:

Institutional Shareholder Services Inc. (ISS) is pleased to submit this statement, as well as the enclosed document, for the record of the April 26 hearing entitled, "Oversight of the SEC's Division of Corporation Finance," held by the House Financial Services Subcommittee on Capital Markets, Securities, and Investment. ISS respectfully submits these documents to clarify common misconceptions about the proxy advisory industry and to reiterate its opposition to H.R.4015, "The Corporate Governance Reform and Transparency Act."

**Misconception: Proxy Advisory Firms Have "Outsized Influence"**

Proponents of H.R.4015 argue that ISS and other proxy advisory firms have "outsized influence," a misconception which apparently drives their support for the legislation. In reality, ISS clients control both their voting policies and their vote decisions. ISS is generally not a discretionary proxy voting manager, except in rare situations where a client has an actual conflict of interest (for example, a financial institution that holds and must vote the shares of its parent company), and asks ISS to make a proxy voting decision on the client's behalf.

In fact, ISS is charged by its clients to assist them in fulfilling their own fiduciary responsibilities regarding proxy voting and these clients understand their duty to vote proxies in their clients' or beneficiaries' best interests. Many proxy advisors' research and vote recommendations are just one source of information used in arriving at an institutions' voting decisions. Many investors have internal research teams that conduct proprietary research and use proxy advisory research to supplement their own work. Some investors use third-party proxy research as a screening tool to identify non-routine meetings or proposals. A number of institutional investors use the services of two or more proxy advisory services. These views are consistent with the results of a 2012 survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with investors.<sup>1</sup>

<sup>1</sup> Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: <http://ssrn.com/abstract=2084231>. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").



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Moreover, in their paper, *The Power of Proxy Advisors: Myth or Reality?*,<sup>2</sup> University of Pennsylvania Law School Professor Jill Fisch, along with colleagues from New York University, analyzed the effect of proxy advisor recommendations on voting outcomes in uncontested director elections. The authors estimate that, after controlling for underlying company-specific factors that influence voting outcomes, an ISS recommendation appears to shift only 6 to 10 percent of shareholder votes, but that this influence may stem from ISS' role as information agent:

*[W]e find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms. Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences (emphasis added).<sup>3</sup>*

Many large institutional investors have their own customized voting and corporate governance principles that proxy advisory firms use as the basis for making custom vote recommendations for that particular investor. As of January 1, 2018, approximately 85% of ISS' top 100 clients used a custom proxy voting policy. Moreover, in addition to its "benchmark" proxy voting guidelines, ISS also offers multiple specialty policy options for investors with a particular philosophical approach to proxy voting and corporate governance, including one emphasizing social responsibility and another set for faith-based investors. In other words, ISS does not have a monolithic view on these issues nor does it dictate how investors themselves think about these issues. Indeed, ISS analysts could very well present opposing recommendations on the same issue to different clients based on the differing policies/approaches of those clients. In short, ISS provides investors with research, data and vote recommendations to enable them to implement their own proxy voting and corporate governance philosophies.

As noted by the Council of Institutional Investors (CII), a leading nonpartisan and nonprofit association of public, corporate and union employee benefit funds and state and local entities with combined assets exceeding \$3.5 trillion: "Proxy advisory firm influence is exaggerated by analyses that confuse correlation with causation. ISS and Glass Lewis tend to follow investors on governance policy, not lead them. In setting their policy frameworks, the two firms have a business interest to ensure they reflect investor (client) perspectives, in part through extensive consultative processes, and to consider empirical evidence. Their franchises are built on credibility with investors. As a result, advisors' views reflect those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisors punished in the marketplace."<sup>4</sup>

At the end of the day, institutional investors are not required to hire proxy advisors, nor obligated to hire only one proxy advisory company, nor are they required to follow our vote recommendations. The ultimate voting decision for each resolution at a company meeting remains the responsibility of our clients, the owners of the corporation, as we believe it should.

#### **Misconception: Proxy Advisory Firms are Subject to "Little Oversight"**

Proponents of H.R.4015 suggest that legislation is required because proxy advisors are unregulated. This is simply not true. Indeed, ISS is a Registered Investment Adviser ("RIA") and, as such, is subject to the Investment Advisers Act of 1940 ("Advisers Act") and the rules and regulations that the U.S. Securities and Exchange Commission (SEC) has

<sup>2</sup> Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, *The Power of Proxy Advisors: Myth or Reality?* 59 Emory L. J. 869 (2010); University of Pennsylvania, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: <http://ssrn.com/abstract=1694535>.

<sup>3</sup> *Id.* at 906.

<sup>4</sup> June 13, 2016 letter from the Council of Institutional Investors to Rep. Hensarling, Chair of House Committee on Financial Services.



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promulgated thereunder, including SEC oversight and review authority. The Advisers Act and related SEC rules provide a mature and comprehensive regulatory regime that covers virtually every aspect of an investment adviser's business. As an RIA, ISS is required to implement and maintain a comprehensive compliance program, including a mandatory requirement for a Code of Ethics. ISS' Regulatory Code of Ethics is available on our public website at <https://www.issgovernance.com/file/duediligence/iss-regulatory-code-and-exhibits-june-2017.pdf>. The RIA regime also dictates that we provide clients with transparency about our internal operations, including how potential conflicts of interest are addressed. Indeed, ISS is already subject to and complying with rigorous federal legal requirements.

**Misconception: Proxy Advisory Firms Have Unchecked Conflicts of Interest**

ISS places primary importance on conducting our business in a transparent and responsible manner, and discloses all real and perceived conflicts of interest to our clients per our compliance policies and per the requirements of the Advisers Act. We provide our clients with an extensive array of information to ensure that they are fully informed of potential conflicts and the steps ISS has taken to address them. Among other things, ISS supplies a comprehensive due diligence compliance package, also publicly available on our website, so that our clients can confidently and fully assess the reliability and objectivity of our voting recommendations.

One measure that ISS has historically taken to ensure transparency is the disclosure of instances where a relationship between ISS and a party exists that may present a conflict of interest. This includes potential conflicts with ISS Corporate Solutions, Inc. ("ICS"), which is a subsidiary of ISS that provides governance tools and services to corporate issuer clients. ISS' standard institutional client contract contains specific disclosure regarding the work of ICS, ensuring our clients have full visibility into any significant relationships that may exist between ISS and the subjects of our proxy research reports.

ISS clients can readily identify any potential conflict of interest through ISS' primary client delivery platform, ProxyExchange (PX), which provides information about the identity of ICS clients, as well as the types of services provided to those issuers and the revenue received from them. Similarly, each proxy analysis and research report issued by ISS contains a legend indicating that the subject of the analysis or report may be a client of ICS. This legend also advises institutional clients about the way in which they can receive additional, specific details about any issuer's use of products and services from ICS, which can be as simple as emailing our Legal/Compliance department.

One of the most important components of the ISS compliance program is the firewall maintained between the core institutional business and the ICS business. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning even the identity of ICS' clients, thereby ensuring the objectivity and independence of ISS' research process and vote recommendations. The firewall mitigates potential conflicts via several layers of separation:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- The ISS Global Research team works independently from ICS.
- ICS and ISS staff are forbidden to discuss the identity of ICS clients.
- ISS' institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.

Yet another element of the conflict mitigation procedures is the "blackout period," pursuant to which ICS staff may only have limited interactions with issuers or their representatives when a "live" voting issue is pending for review by ISS. The "blackout period" runs from immediately after definitive proxy materials are filed with the appropriate regulatory body through the date of the issuer's shareholders' meeting. During this period, interactions between ICS and its corporate clients are limited. During the blackout period, ICS is precluded from providing advisory services to, or otherwise interacting with,



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issuers with respect to matters that are “live” or pending on the issuer’s proxy statement. In addition, during the blackout period, ICS does not engage in marketing or selling efforts to issuers (whether they are existing ICS clients or prospects).

Moreover, ICS explicitly tells its corporate clients, and also indicates in their contracts, that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. ICS further informs its clients that ISS’ Global Research team prepares its analyses and vote recommendations independently of, and with no involvement from, ICS.

In short, we have taken the necessary steps to identify, mitigate and disclose any alleged conflicts.

**Misconception: Proxy Advisory Reports Are Prone to Errors and Flaws**

ISS is committed to having the most complete and accurate information upon which to base our research and recommendations to our clients. To this end, ISS regularly undertakes dialogue and interacts with company representatives, institutional shareholders, shareholder proponents and other relevant stakeholders to (1) gain the greatest possible insight for our clients and (2) improve the overall quality of the research by ensuring full information and deeper insight into key issues.

Because S&P500 companies are the most widely held by our clients and generally have the most complex disclosures, ISS voluntarily provides companies in this index the opportunity to review the factual accuracy of the data included in ISS’ pending proxy analyses. ISS believes that this review process helps improve the transparency, accuracy and quality of its analyses, an outcome that is in the best interests of both the institutional investors for whom the analyses are prepared, as well as for the companies that are the subject of these reports. Some have suggested, and H.R.4015 requires, making this review mandatory for reports on all issuers, and requiring an ombudsman process to resolve disputes. This would add significant costs to our clients, as well as to individuals whose assets are under management, and would severely hamper the timely delivery of proxy advisors’ report to our clients, as well as interfere with the independent responsibility that proxy advisors have to the clients who hire them.

In addition, ISS provides an open mechanism for comment and input through its Feedback Review Board, which is accessible on the ISS website ([www.issgovernance.com](http://www.issgovernance.com)) and serves as an additional channel for any market participant to communicate with ISS regarding accuracy of research, accuracy of data, policy application and general fairness of ISS’ policies, research, and vote recommendations.

ISS’ dialogue with issuers is transparent to clients. ISS’ research reports include a section that details relevant dialogue with the company, shareholder proponents or other stakeholders, including the date(s) of dialogue, the topic(s) covered, the initiator of the dialogue, and the outcome.

ISS has robust systems and controls designed to ensure that research reports and vote recommendations include high-quality relevant information, are accurate, correctly based on the relevant ISS policy and are reviewed by appropriate personnel prior to publication. With respect to factual errors, ISS tracks such occurrences, which are extremely rare. For example, in 2017, ISS covered over 6,400 meetings in the United States and the error rate was approximately 0.76%.

**Industry Competition**

ISS is indeed an industry leader and has earned its market share by virtue of the quality of its work and the level of service it has provided for more than a quarter century.

While H.R.4015 ostensibly aspires to promote market competition, the proposed regulatory regime is unnecessary, burdensome and does nothing to enhance market competition or create market conditions conducive to new market entrants. CII wrote in its most recent opposition letter that H.R.4015, if enacted, would “increase barriers [emphasis supplied] to new entrants and potentially lead some current proxy advisory firms to exit the industry altogether.”



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Further, supporters of the legislation should heed the warning posed by the National Conference on Public Employee Retirement Systems (NCPERS), the largest national, nonprofit public pension advocate whose members manage more than \$3 trillion in pension assets, that H.R.4015 proposes to “bypass free-market principles by authorizing the SEC to pre-qualify industry entrants based on a set of vague and highly subjective standards.” Such authority would likely provide the SEC with only tools to further restrict, not enhance, competition.

**Allegations Made by Abbott Laboratories**

During the hearing, a Committee member referenced a letter that Abbott Laboratories (“Abbott”) sent to its shareholders and which it filed with the SEC on April 5, 2018. We are enclosing with this submission a letter which ISS sent to Abbott in response to that filing. In the context of this hearing, however, we would like to underscore that (1) as noted above, ISS is committed to ensuring the accuracy and quality of our reports; and that (2) there is a fundamental and important difference between factual errors versus disagreements over interpretive judgment and methodology, which does not constitute an error, omission or misrepresentation.


As our response letter to Abbott explains, after sharing the draft report with Abbott, receiving Abbott’s written comments and prior to publishing our final report, ISS corrected two factual inaccuracies (the date Abbott entered into an agreement to acquire Alere and the start year of Abbott’s audit firm). It is simply inaccurate and misleading for Abbott to assert that ISS was “aware of the flaws and inaccuracies in its Report...disregarded [Abbott’s] attempts to correct them...and proceeded to publish a flawed and inaccurate Report.”

Even before Abbott published its proxy statement, ISS considered arguments made by Abbott that ISS should change its choices of “comparable corporations” (or peers) for purposes of evaluating Abbott’s executive compensation program. After consideration of the merits of Abbott’s comments and consistent with ISS’ policy approach, ISS subsequently removed an ISS selected peer to instead include a company suggested by Abbott. This resulted in even greater overlap – 12 out of 16 - between the final peer group used by ISS and Abbott’s self-selected peers. This process and the change made based on Abbott’s feedback clearly demonstrates the extent to which ISS does engage with, and take into account, the input of the companies that it covers. While differences in approach and opinion may still exist, that is a far cry from the suggestion that the underlying analysis or vote recommendation results from a mistake or error.

In conclusion, we want to reiterate our strong view that H.R.4015, “The Corporate Governance Reform and Transparency Act of 2017,” is a misguided attempt to improve corporate governance. If enacted the legislation will set a dangerous precedent that will harm all shareholders who rely on independent research to make informed investment decisions. H.R. 4015 would establish a costly, duplicative and unnecessary new regulatory regime for proxy advisory firms and institutional investors, destroy the fiduciary responsibility that proxy advisory firms have to the institutional investors who hire them, and make it more difficult for shareholders to cast informed proxy votes, thereby decreasing the transparency of corporate boardroom decisions.

Shareholders should have the right to choose the tools, services and information they need to make informed proxy voting decisions– without it being filtered through the management of the corporation in question. This is a fundamental tenet of corporate governance and it is why this bill is opposed by a number of large public sector pension fund managers, as well as many other institutional investors.

Thank you for considering our views, and for this opportunity to have our views included in the hearing record. If there is any additional information I can provide, please do not hesitate to contact me.

Sincerely,  
  
 Steven Friedman, General Counsel  
 Institutional Shareholder Services Inc.

House Committee on Financial Services Subcommittee on Capital Markets, Securities, and  
Investment: "Oversight of the SEC's Division of Corporation Finance"  
4.26.18

*Questions for the Record from Congressman Randy Hultgren (R-IL)*

**Question One**

Page 7 of your written testimony mentions that the Division of Corporate Finance is reviewing all aspects of certain Dodd-Frank rules to "identify appropriate changes consistent with the Congressional Review Act" given that the CRA was used to overturn the SEC's so-called "Resource Extraction Rule." The CRA prevents the SEC from promulgating a rule that is "substantially similar" to the rule that was overturned by Congress. However, as you know, section 803 of the CRA establishes a "special rule" for a regulation originally promulgated pursuant to a deadline set by Congress, the courts, or by another regulation.

1. How do you interpret the definition of "substantially similar"? In my opinion, Congress made it abundantly clear that this additional disclosure requirement is unnecessary and overly burdensome. Furthermore, Chairman Clayton has stated the importance of simplifying disclosures as a means of encouraging more companies to go public.
2. Is there any case law you can use for guidance?

**Response:**

Because the Congressional Review Act (CRA) requires that the "new rule" cannot be "substantially the same" or in "substantially the same form" as the disapproved rule, I believe that the CRA requires the substance of the "new rule" to be substantially different from the 2016 rule. While the Commission's statutory obligation to promulgate a rule was not overturned by the joint resolution disapproving the rule, I think the Commission can adopt a version of the rule that satisfies the statutory mandate while being substantially different from the 2016 rule.

I am not aware of case law construing the phrases "substantially the same" or in "substantially the same form" that involve circumstances where an agency has a statutory mandate to promulgate a rule, as is the case with the resource extraction rule. In the absence of dispositive case law or further general guidance on the CRA, the Division staff will confer with our colleagues in the Office of the General Counsel and also will look to the concerns raised by members of Congress during the floor debates on the joint resolution to help guide the Division's development of a new rule that is not in "substantially the same form" as the 2016 rule. It is my understanding that many concerns expressed by members of Congress focused on the potential adverse economic effects of the rule, specifically, that the 2016 rule would impose undue compliance costs on companies, undermine job growth, and place U.S. companies at a competitive disadvantage.



**Question Two**

I want to ask you today about the relationships between quarterly targets and companies deciding to not go public. We are seeing more and more companies decide to forgo the public markets in exchange for finding private capital to help finance their businesses. One advantage of private funding is that it allows companies to make big investments in their long-term growth that public companies can't necessarily afford to make because it hurts their quarterly targets. According to a McKinsey study from 2015 80% of public company CFOs admit they are would forgo long-term value creation initiatives to avoid missing quarterly targets.

1. What can the SEC do to encourage companies to prioritize long-term growth over quarterly targets?

**Response:**

Our role at the SEC is not to dictate companies' operations or strategic decisions, but instead, it is to focus on whether companies are complying with the disclosure and other requirements of the federal securities laws. Companies must provide investors with information they need to make informed investment and voting decisions.

Some of the debate about what could be driving short-termism relates to quarterly reporting. Quarterly reporting is useful to inform the market, but companies also make other disclosures to investors and the market. For example, many companies make earnings releases before they file their Form 10-Q because the market wants the information, and this information may affect the stock price more than the filing of the quarterly report. Our rules do not require earnings releases, but this is something that companies choose to do. It is worth noting that some who express concerns about short-termism are advocating that companies move away from quarterly earnings forecasts while also continuing to affirm the importance of quarterly reporting to the market.

Overall, as our Division continues to assess our regulatory regime and its impacts on investors, issuers, and our overall markets, I believe the issues you raise are worthy of consideration by the staff.

**Question Three**

Following-up on my questions about the benefits of XBRL and structured data, I would appreciate your insight on whether data standardization has benefits to filing companies and investors.

1. If the SEC provides data in an XBRL format, would there be a corresponding decrease in the cost of research and analysis on reporting companies? For these reasons, isn't XBRL reporting especially beneficial to smaller companies, including emerging growth companies?

**2. Would an increase in analyst coverage of these companies, brought about through XBRL reporting, improve the ability of these companies to raise capital?**

**Response:**

All companies, including emerging growth companies and smaller reporting companies, are required currently to tag their financial statements and accompanying footnotes in SEC filings using XBRL. In June 2018, the Commission adopted amendments to require the use of XBRL on a phased basis. In doing so, the Commission noted that the use of Inline XBRL has the potential to benefit investors and other market participants while decreasing, over time, the cost of preparing information for submission to the SEC. There is a wide range of users of XBRL data, including investors, financial analysts, economic research firms, data aggregators, academic researchers, filers, and Commission staff. With respect to smaller companies, recently published research shows that during 2012 to 2015, EDGAR filings for small companies were more frequently accessed in the XBRL format (61%) compared to conventional html format (39%). This was based on more than 12 million requests for small company 10-K and 10-Q filings.<sup>[1]</sup>

A company's ability to raise capital depends on a variety of factors. In my opinion, an increase in analyst coverage can help companies raise their visibility and could potentially attract new capital.

***Questions for the Record from Congressman Trey Hollingsworth (IN-09)***

**Question:**

I appreciated the comments from your testimony during the hearing; I found our exchange related to potential updates to regulatory compliance with Sarbanes-Oxley 404(b) to be promising. As you mentioned, under current SEC rules, companies qualify as both an SRC and a non-accelerated filer if their public float falls below \$75 million. I think we both can agree that the threshold for compliance with 404(b) at \$75 million is outdated. As you know, the Treasury Capital Markets Report included a recommendation to exempt companies with up to \$250 million in public float from Section 404 (b) compliance. While I know the idea of aligning the definition of non-accelerated filer with the SRC definition has been brought up, I am curious what your thoughts are on the proper threshold for a 404(b) exemption.

1. Should the definition of non-accelerated filer be updated?
2. If so, what do you think is the appropriate threshold for this updated definition?

Further, I am encouraged by your comments that you plan to look very carefully at raising the threshold for non-accelerated filers as it pertains to the attestation requirement. I believe tailoring these compliance burdens will help better facilitate capital formation while maintaining important investor protections (and in no way prohibiting small companies from pursuing an external audit). You mentioned in your testimony the need for a more sophisticated test for determining the necessary compliance with SOX 404b rather than simply relying on market capitalization as the sole determining factor.

1. Other than revenues, what other factors need to be taken in to account?
2. Do you plan to update the 2011 study on the cost and benefits of 404(b) on smaller public companies?

**Response:**

As you know, requirements related to internal control over financial reporting were put in place by the Sarbanes-Oxley Act to help strengthen our financial reporting system. Since that time, concerns have been raised about the costs associated with the requirements, including the auditor attestation requirement in Section 404(b). While changes have been made to reduce the compliance burdens, concerns remain.

On June 28, 2018, the Commission adopted amendments to the definition of “smaller reporting company” to expand the number of registrants that qualify to provide scaled disclosures. These amendments take into account the views expressed by commenters on the Commission’s June 2016 proposed amendments to the definition, as well as recommendations made by the Commission’s Advisory Committee on Small and Emerging Companies and the SEC Government-Business Forum on Small Business Capital Formation. Under the amended definition, a registrant qualifies as a smaller reporting company if it has a public float of less than \$250 million or annual revenues of less than \$100 million for the previous year and either no public float or a public float of less than \$700 million.

While the amendments unanimously adopted by the Commission did not adjust the application of the thresholds contained in the definitions of “accelerated filer” and “large accelerated filer,” Chairman Clayton noted:

The proposal on the smaller reporting company definition, which was issued before I arrived at the Commission, discussed but did not squarely raise the important issue of adjusting the thresholds at which a small public company becomes an “accelerated filer.” Accelerated filers are subject to, among other things, the auditor attestation requirement contained in Section 404(b) of the Sarbanes-Oxley Act. In light of the comments received on this topic in connection with the proposal, I have directed the staff, and the staff has begun, to formulate recommendations to the Commission for possible additional changes to the “accelerated filer” definition. I have directed them to consider ways in which reducing the number of companies that qualify as accelerated filers may promote capital formation by reducing compliance costs for those companies, while maintaining important investor protections. It might have been attractive to tackle the thresholds for mandatory application of 404(b) today, but it is important to me that we approach this issue in a thoughtful manner, including further opportunity for staff analysis.

Consistent with my testimony and the Chairman’s statement, I am eager to look at these requirements in a thoughtful way, with the benefit of a robust economic analysis. The staff has begun work to prepare these recommendations.

As the staff considers recommendations for possible changes to the accelerated filer definition, we are focused on achieving the right balance for disclosure and auditor involvement, keeping in mind that all registrants are required to maintain an adequate system of internal accounting controls, and management of the registrant must annually assess and report on the effectiveness of the registrant's internal control over financial reporting. While the amendments adopted by the Commission in June 2018 change the historical relationship between the "smaller reporting company" and "accelerated filer" definitions by allowing a registrant to qualify as both a smaller reporting company and an accelerated filer, as part of the staff's consideration of possible recommended amendments, the Chairman also has directed the staff to consider, among other things, the historical and current relationship between the "smaller reporting company" and "accelerated filer" definitions. In addition, the staff is considering whether the accelerated filer definition should be based on a public float threshold, a revenue threshold, a combination of these thresholds, or a different type of threshold. Any potential changes to the accelerated filer definition and the Section 404(b) requirements would require notice and comment rulemaking and an updated analysis of the costs and benefits of Section 404(b) compliance.

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<sup>i3</sup> <http://aaajournals.org/doi/10.2308/isvs-51885>