WRITTEN TESTIMONY OF
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BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
AND GOVERNMENT SPONSORED ENTERPRISES

"LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION,
TRANSPARENCY,
AND REGULATORY ACCOUNTABILITY"

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WITNESS BACKGROUND STATEMENT

Jennifer Taub is a Professor at Vermont Law School where she teaches courses in contracts, corporations, securities regulation, and white-collar crime. She earned a J.D. *cum laude* from Harvard Law School, and a B.A. *cum laude* from Yale College. Prior to joining academia, she was an associate general counsel at Fidelity Investments.

Professor Taub has published on topics relevant to today's hearing, including proxy voting, private funds, and shadow banking. She has written extensively about the 2008 financial crisis and on the Dodd-Frank Wall Street Reform and Consumer Protection Act. This includes the book, *Other People's Houses*, published in 2014 by Yale University Press.

She remains current on asset management industry issues including by participating on a non-profit board that holds an annual investment fund roundtable. This gathering draws together market participants, practicing attorneys, regulators, and academics to discuss legal developments relevant to the mutual fund and private fund industries.

Professor Taub has not received any compensation in connection with her testimony, nor has she received federal grants or contracts. The views expressed in her testimony are her own and do not represent the positions of her law school or any other organization with which she is affiliated.

EXECUTIVE SUMMARY

Chairman Garrett, Ranking Member Maloney, and distinguished members of this Subcommittee, thank you for this opportunity to testify today. My name is Jennifer Taub. I am a Professor at Vermont Law School where I teach business law courses including Corporations and Securities Regulation. Before joining academia, I served as an associate general counsel at Fidelity Investments. I offer my testimony today solely as an academic and not on behalf of my law school or any other association.

First, the Investment Advisers Modernization Act allows private funds to retreat into the shadows once again. The word "private" is somewhat misleading these days. Consider that one-quarter of the equity in private equity funds comes from public pension retirement funds. And, please recall that private funds -- including hedge funds -- can now be marketed through general solicitations to the public.

It's odd. Just when private equity funds are in the sunlight thanks to Dodd-Frank and many have been exposed in SEC examinations as in violation of the law, you are now proposing that they be able to hide their tracks. Instead of encouraging a culture of compliance, this bill would provide a loophole for investment adviser recordkeeping requirements. Subjecting communications to confidentiality agreements or keeping them in-house would allow advisers to destroy critical investment records.

This bill would also exempt all private equity fund advisers and many hedge fund advisers from submitting a completed form PF. This information is important to monitor for systemic risk and to protect investors. It would block the SEC from broadly banning materially misleading statements in private fund sales literature, including concerning fund performance.

This is backwards. The SEC should be encouraged to, not discouraged from making rules against fraud.

With rule 506(c) pursuant to the JOBS Act, private funds can now be advertised through general solicitations to the public. Public offerings were supposed to come with commensurate broad protections against fraud.

It would also weaken the SEC's ability to stop false advertising by advisers generally, including to certain retail investors. And, it would shockingly eliminate the annual independent audits of certain fund advisers to ensure they actually have the assets and securities they claim to hold.

Next, the SEC Regulatory Accountability Act would limit the agency's ability to protect the investing public. Prior to issuing most regulations, the SEC would have to engage in a new cost-benefit process. Yet, the SEC already conducts economic analysis. And the securities laws already require the consideration of the promotion of efficiency, competition and capital formation. The SEC is also already subject to the Paperwork Reduction Act, the Regulatory Flexibility Act, and the Congressional Review Act.

The existing requirements set out several speed bumps. The proposed requirements are tire shredders designed to bring progress to a crashing halt. Notably, this bill would require the SEC to consider endless alternative approaches, and only select the one that "maximizes net benefits." How could this be measured with any precision? It can't.

As Harvard Professor John Coates notes, it is not possible to specify and quantify "all benefits and all costs in a single, uniform bottom-line metric (usually dollars) representing the net welfare effects of a proposed rule." Thus results are not precise, but instead what he calls "guestimations." What this bill mostly creates is opportunities for litigation and legal fees to be generated.

Finally, the Proxy Advisory Firm Reform Act represents paternalistic overreaching that is unnecessary and would entrench existing firms. These firms help institutional investors to cast votes on important corporate governance matters at the portfolio companies they own. The SEC already has the authority to examine and discipline any institutional investors who mindlessly follow advice without considering their fiduciary duty to underlying investors. And, the SEC has authority under the Exchange Act and the Advisers Act to address conflicts of interest at advisory firms.

In short, the status quo is far better than the changes on offer here.

I. THE INVESTMENT ADVISERS MODERNIZATION ACT

The Investment Advisers Modernization Act of 2016 is misnamed. Instead of ushering in modernity, it would send the SEC and investors back to the Dark Ages. Like the other bills today, it is misaligned with the hearing's title, "Legislative Proposals to

Enhance Capital Formation, Transparency, and Regulatory Accountability." This bill would not enhance capital formation. Instead it would undermine investor protection and trust, which could inhibit or drive up the cost of capital. It would not promote transparency, but allow certain private equity advisers and other private fund advisers that have been exposed as lacking in recent SEC examinations to hide their tracks. It would not encourage regulatory accountability. Instead it would punish regulatory success, depriving the SEC of the information and tools it has been using to monitor system-wide risks, identify firm-specific risk, investigate fraud, and enforce the law.

A. Don't Punish Regulatory Success

Progress is very recent in this area. With the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), there were two major changes that began to bring private fund advisers out of the shadows. Before identifying those changes, it should be noted that the word "private" is somewhat misleading these days. [1] Consider that according to economists Eileen Appelbaum and Rosemary Batt, 25 percent of the equity in private equity funds comes from public pension retirement funds.[2] A total of 35 percent comes from public and private pension funds. Also, please recall that private funds -- including private equity and hedge funds -- can now be marketed through general solicitations to the public.[3]

First, Dodd-Frank closed a loophole that previously permitted private fund advisers to avoid registering with and providing reports to the SEC.[4] Whereas advisers to mutual funds and the funds themselves had to register with the SEC since the 1940s, these other "private" fund advisers and their funds did not. Yet both the "public" mutual funds and the private funds have significant assets. Mutual funds have about $16 trillion

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[1] It is a label used to refer to investment companies that would be generally considered mutual funds, but for the fact that they fall into an exemption under the Investment Company Act of 1940. Before 1996, under §3(c)(1) such "private" funds could have only 100 persons as investors, but with §3(c)(7), that cap was lifted, but given the 1934, the practical limit was 499. Now, it is 1,999. However, a person is a direct investor, and could be another fund, without the need to look through to the investors in that intermediary fund.

[2] https://www.russellsage.org/publications/private-equity-work

[3] https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782; http://www.sidley.com/news/us-congress-enacts-jobs-act-increasing-499-investor-limit-for-private-funds-to-1999-and-eliminating-prohibition-against-general-solicitation-in-connection-with-certain-private-offerings-03-28-2012

[4] https://www.sec.gov/news/press/2011/2011-133.htm; https://www.sec.gov/rules/final/2011/ia-3308.pdf

in assets under management ("AUM") and (as the SEC has now learned), private funds have about $10 trillion in AUM.

Dodd-Frank amended the Advisers Act, and the SEC issued final rules. Effective March 30, 2012, advisers with $150 million in assets under management in private funds must now register.[5] Prior to Dodd-Frank, as SEC Chair Mary Jo White noted in a 2013 speech entitled "Hedge Funds, A New Era of Transparency and Openness,"[6] the agency only saw "a small portion of the financial landscape" of private funds. They only had information on those 2,500 advisers to private funds that voluntarily registered or who had to because the also managed a mutual fund. With the new legal requirement, another 1,500 private fund advisers registered.

And, second, Dodd-Frank permitted the SEC to mandate that advisers file reports concerning the private funds they managed "as necessary and appropriate in the public interest and for investor protection, or for the assessment of systemic risk by the Financial Stability Oversight Council" ("FSOC").[7] As a result, private fund advisers are now required to report information concerning themselves and the funds they manage on Form PF to the SEC.[8] This Form PF information is shared with the FSOC, but not with investors or the public.

In a 2015 speech before the Managed Fund Association, Chair White said that "[r]equired registration and reporting have been critical to increasing transparency and protecting investors in private funds." She noted that "[e]xcessive leverage, lack of liquidity, and asset concentrations have in the past been at the root of financial crises, and we now have the regulatory tools to help better identify and appropriately mitigate potential problems." She also stated that "Before 2010, the Commission had relatively limited insight into private funds and the business of private fund advisers. We did not know for example, even how many existed, and we had limited tools to learn more." Chair White also made clear that Form PF has helped the SEC "monitor trends in the

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[5] Generally speaking, private fund advisers with assets under management greater than $100 million may have to register, and those with greater than $150 million must register with the SEC. Those with between $25 million and $100 million are subject to state registration. https://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf

[6] https://www.sec.gov/News/Speech/Detail/Speech/1370539892574

[7] https://www.treasury.gov/initiatives/fsoc/Pages/home.aspx

[8] https://www.sec.gov/rules/final/2011/ia-3308.pdf

industry" and that addressing risk that could have systemic impact "is fundamental to our long-standing mission to protect investors, maintain market integrity, and promote capital formation. Simply put, investors are not protected if broad and interconnected segments of the financial system are at risk." (emphasis added).

The benefits of these two Dodd-Frank changes to bring private fund advisers out of the shadows have been considerable and costs minimal. Filing form PF is not expensive. University of St. Thomas School of Law Professor Wulf Kaal gathered data through a survey of private funds. He found that the majority of respondents spent just $10,000 in their first year of filing and half that the following year.[9] Altogether, compliance costs associated with Dodd-Frank filing and reporting requirements for private funds ranged from $50,000 to $200,000 per year (with 48% of firms spending between $50,000 - $100,000).[10] This is minimal relative to management fees and to the investor protection and systemic risk benefits. These costs do not appear to have negatively impacted fund returns. After studying the returns of more than 3,400 private funds, Professor Kaal and colleagues determined that private fund registration and disclosure required under Dodd-Frank had no impact on fund returns.[11]

B. Let the Sunshine In

With the new requirement to register as an investment adviser with the SEC came 1,500 new private adviser registrants and a spate of examinations. Beginning in October 2012, the SEC Office of Compliance Inspections and Examinations ("OCIE") began examinations of the multi-trillion dollar[12] private equity industry. Immediately, they found problems.

According to a May 2014 speech entitled, "Spreading the Sunshine in Private Equity,"[13] OCIE Director Andrew Bowden shared the agency's alarming findings with his audience at the PEI Private Fund Compliance Forum. After conducting more than 150

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[9] SSRN-id2447306.pdf
[10] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2389423
[11] SSRN-id2629347.pdf
[12] According to aggregate data provided by the SEC, as of the 4th quarter of 2014, gross asset value of PE was $1.887 trillion, and net asset value totals $1.744 trillion.
[13] https://www.sec.gov/News/Speech/Detail/Speech/1370541735361

exams of private equity advisers, many deficiencies were found. Director Bowden explained:

> When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.

He deemed this to be a "remarkable statistic." In addition to hidden fees and misallocated expenses, he also identified serious problems in how these advisers were valuing the funds and how valuations were being improperly represented in fund marketing. The OCIE found many inconsistencies and misrepresentations. He also identified various conflicts of interests and "temptations" endemic to the industry. [14]

Director Bowden included in his speech an emphasis on the need for strong compliance programs. He said that when facing risks of "outright fraud, reckless behavior, and conflicts of interests" within private equity advisory firms, a "culture of compliance" would be the "most effective defense." He concluded his remarks with "the hope that our observations are helpful to the private equity industry."

This speech was an eye-opener. Half of the examined firms were doing the right thing. It was time then to get the other half to play by the same rules. But instead of holding the line and encouraging everyone to build that culture of compliance, and abide by the law, it appears that some lawmakers wish to help them hide their tracks, and remove those regulations with which the bad actors do not wish to comply.

C. Specific Concerns

The following highlights particular concerns with the bill's provision. This is not an exhaustive list, however.

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[14] Concerns about many private equity firms continues to draw the attention of economists and general public. A recent report by economists Eileen Appelbaum and Rosemary Batt entitled, "Fees, Fees and More Fees: How Private Equity Abuses Its Limited Partners and U.S. Taxpayers," describe various abuses designed to line the pockets of private equity fund managers at the expense, without the knowledge or consent of their investors. They detail what they deem "lack of transparency, misallocation, and fraud" in private equity fee practices. http://cepr.net/images/stories/reports/private-equity-fees-2016-05.pdf

Custody Rule Exemption. Under the existing custody rule, an investment adviser that has custody of client assets or securities is required to undergo an annual surprise exam by an independent auditor to ensure they actually have what they claim to. Shockingly this bill would require the SEC to eliminate the surprise audit of certain fund advisers. For example, advisers to funds owned including by people with a "personal relationships" with the investment adviser or its employees would not be checked up on. This should be called the Madoff Loophole.

Record Destruction. In addition, this bill would require the SEC to make a rule permitting all investment advisers to destroy important records that the SEC staff uses during examinations. This would include records that the examiners could use to determine whether the advisers are cheating their clients. Under existing regulations, advisers must keep standard business records. This includes for example, trade confirmations, cash disbursements, and investment advice, and the like.

This bill would permit all investment advisers, presumably including those to mutual funds, private equity funds, hedge funds, and even retail investors, to destroy any communications or materials used while looking into a prospective investment "if the communications or materials are subject to a confidentiality agreement." This is far too broad. It would cover even those investments choices that are made. It could facilitate hiding of front running and hiding of insider trading among other violations. By subjecting a range of communications to confidentiality agreements, advisers could destroy records critical for internal compliance goals as well as SEC examinations. Communications with a client about a prospective investment, communications between an adviser and a potential portfolio company could be destroyed.

There is also another broad loophole for internal communications. Under existing regulations, advisers must keep originals and copies of records relating to recommendations, advice, cash disbursements, and securities purchases for clients, for example. Under this proposal, any such written communication could be destroyed if "sent and received only by supervised persons of the investment adviser." These are the types of emails of great importance. For example, this could permit an adviser to destroy emails between employees where they discuss whether they plan to recommend an investment to a client. If the emails suggest it is a bad choice but the employee makes the recommendation nevertheless that would relevant to examiners. Or put differently, knowing such information would need to be kept would encourage building a compliance culture including the training of employees on fiduciary duty and conflicts of interest.

Not Completing Form PF. This bill would promote opacity by allowing private equity funds to retreat into the shadows, gaining exceptions from completing form PF just a few years after they began doing so. This information is important to monitor for systemic risk and to protect investors. If enacted, private equity fund advisers could stop completely section 4 of the form. This section provides important information related to leverage and counterparty risk. It also includes information concerning geographic and industry breakdown of portfolio companies.

In addition, if enacted, section 1c of Form PF would apparently no long have to be completed by hedge fund advisers with between $150 million and $1.5 billion in AUM. The information is very important as it provides insight into trading and clearing of derivatives as well as short-term wholesale funding including bilateral and triparty repo. Given that derivatives and the short-term wholesale funding markets accelerated the financial crisis and still remain a source of risk, it is critical for the SEC and FSOC to gather this information.

False Advertising. In addition, the bill would weaken the SEC's ability to stop false advertising by advisers generally, including to retail investors. It would require the SEC to create a rule exempting all investment advisers from complying with existing advertising rules for certain advertisements. For example, under existing rules it is considered fraud for an adviser to directly or indirectly, publish, circulate or distribute any advertisement which "contains any untrue statement of material fact, or which is otherwise false or misleading." Under the proposal, this would not be fraud if the adviser "publishes, circulates, or distributes" such an ad to four types of investors including certain employees and anyone who is "an accredited investor." Note that an "accredited investor" is just an ordinary person without income of at least $200,000 per year.[15] No special knowledge or skill is needed for this designation.

This bill also would block the SEC from broadly banning materially misleading statements in private fund sales literature, including concerning fund performance. This is

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[15] https://www.sec.gov/investor/alerts/ib_accreditedinvestors.pdf

backwards. The SEC should be encouraged to, not discouraged from making rules against fraud. With rule 506(c) pursuant to the JOBS Act, private funds can now be advertised through general solicitations to the public. Public offerings were supposed to come with commensurate broad protections against fraud.

II. THE SEC REGULATORY ACCOUNTABILITY ACT

The SEC Regulatory Accountability Act would undermine the SEC's ability to act effectively. Prior to issuing any regulation, the SEC would need to undergo a new, extensive cost-benefit analysis process. This bill would require the SEC to consider endless alternative approaches, and only select the one that "maximizes net benefits." Yet this cannot be measured with precision.

As Harvard Law School Professor John Coates noted in his article "Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications,"[16] it is not possible to specify and quantify "all benefits and all costs in a single, uniform bottom-line metric (typically dollars) representing the net welfare effects of a proposed rule." Thus results are not precise, but instead "guestimations." The bill would apply this new requirement not just to rulemakings, but also more broadly to interpretive guidance. Also, the bill would require review of each regulation one year later and then every five years.

Better Markets, the non-profit organization led by Dennis Kelleher, has produced a detailed report entitled "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC."[17] The organization has also opined that what sounds like a benign "cost-benefit analysis" is actually an "industry-only analysis."[18] Such a calculation "fails to properly and fully capture the costs and benefits to the public of financial stability and preventing another crash and economic catastrophe." Better Markets notes that, "Indeed, many of those benefits (like stability, risk reduction, etc.) and costs (like human suffering from losing a job or home, etc.) are inherently difficult if not impossible

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[16] http://www.yalelawjournal.org/article/cost-benefit-analysis-of-financial-regulation; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2375396

[17] http://bettermarkets.com/sites/default/files/documents/Setting%20The%20Record%20Straight.pdf

[18] http://bettermarkets.com/blog/courts-agree-innocent-sounding-cost-benefit-analysis-really-biased-industry-cost-only-analysis

to quantify." In that way, a cost-benefit analysis "over-weights and prioritizes the more readily identifiable quantitative costs of individual rulemaking on the industry."

Evidence of this bias can be seen in the bill's text itself. It would require the SEC to explain in a final rule the comments it received from industry or consumer groups. However, the SEC would only be required to provide "the reasons that the Commission did not incorporate those industry group concerns related to the potential costs or benefits in the final rule."

The SEC is already required under the securities laws to consider in addition to investor protection efficiency, competition, and capital formation whenever it is "engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest." The SEC also complies with analysis required the Regulatory Flexibility Act of 1980,[19] the Paperwork Reduction Act of 1995,[20] and the Congressional Review Act of 1996.

In addition, the SEC voluntarily engages in rigorous economic analysis. In 2012 the Division of Risk, Strategy, and Financial Innovation ("RSFI") and the Office of the General Counsel ("OGC") issued internal guidance regarding economic analysis as part of the rulemaking process.[21] That guidance asserted that "the Commission considers potential costs and benefits as a matter of good regulatory practice whenever it adopts rules." The guidance made clear that:

> It is widely recognized that the basic elements of a good regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis. As a general matter, every economic analysis in SEC rulemakings should include these elements.

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[19] https://www.sba.gov/advocacy/regulatory-flexibility-act
[20] https://www.epa.gov/laws-regulations/summary-paperwork-reduction-act
[21] https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf

This bill would raise costs for the agency. The CBO estimated that a previous iteration of this bill would cost about $23 million over a five-year period.[22] In addition, it would create opportunities for litigation and generate legal fees. The existing requirements set out several speed bumps for agency. The proposed requirements are tire shredders designed to bring progress to a crashing halt.

III. THE PROXY ADVISORY FIRM REFORM ACT

Finally, the Proxy Advisory Firm Reform Act would be a heavy-handed upheaval of a successful industry. Proxy advisors serve an important function for institutional investors. They provide independent advice and technological services to help institutional shareholders vote at annual meetings. Most of these institutional shareholders are mutual funds[23] and investment advisers[24] who are required to maintain proxy voting policies and procedures in relation to voting their shares. Investors voluntarily pay for these services and do not appear to be clambering for this legislation.

In his 2014 article *A Defense of Proxy Advisors*,[25] Case Western Reserve University School of Law Professor George Dent examines the "charges leveled against proxy advisors and the new regulations proposed by their critics." His article concludes that complaints are "mostly unwarranted" as "market forces minimize any problems with proxy advisors." In addition Professor Dent cites a 2010 article by NYU School of Law Professor Stephen Choi, University of Pennsylvania Law School Professor Jill Fisch, and NYU School of Law Professor Marcel Kahan entitled "The Power of Proxy Advisors: Myth or Reality?" This research found "a substantial degree of divergence [in voting mutual funds] from ISS recommendations, refuting the claim that most funds follow ISS blindly." While leading firms ISS and Glass Lewis have the vast majority of the proxy advisory market, a onerous new regulatory regime could likely entrench these players by creating barriers to entry.

The SEC already has the authority to examine and discipline any institutional investors who mindlessly follow advice without considering their fiduciary duty to

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22 https://www.cbo.gov/publication/44174
23 https://www.sec.gov/rules/final/33-8188.htm
24 https://www.sec.gov/rules/final/ia-2106.htm
25 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2451240

underlying investors. And, the SEC has authority under the Exchange Act[26] and the Advisers Act to address conflicts of interest. The staff has provided helpful guidance in this area in a 2014 legal bulletin entitled "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms."[27]

CONCLUSION

The title of this hearing, "Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability" sounds quite promising on the surface. However, dig into the text of the bills, and disappointing results emerge. We find that these proposals are greatly misaligned with this hearing's purported goals.

Taken together, these legislative proposals would substantially weaken one of the central pillars of the U.S. capital markets, the protection of investors.[28] It is a curious endeavor to take away authority and information that the SEC and investors need and want, while simultaneously foisting upon the market a costly and bureaucratic processes that investors have not asked for.

Thank you again. I look forward to your questions.

[26] https://www.sec.gov/interps/legal/cfslb20.htm
[27] https://www.sec.gov/interps/legal/cfslb20.htm
[28] https://www.sec.gov/News/Speech/Detail/Speech/1370540451723 (SEC Commissioner Aguilar: "Unfortunately. . .when many say capital formation, what they mean is simply capital-raising. That's the wrong goal. The singular act of raising capital does not necessarily result in capital formation—for example, whatever makes it easier and cheaper for issuers to raise money does not necessarily increase the rate of capital formation—and, in fact, can be detrimental to capital formation. In my five years as a Commissioner, I have considered countless enforcement recommendations that involve some very good capital raisers who raised millions of dollars through fraudulent means. Unfortunately, these fraudsters ended up destroying the capital they raised, rather than putting it to work toward economic growth. ")