



HOUSE FINANCIAL SERVICES SUBCOMMITTEE HEARING

OVERVIEW

For questions on the note below, please contact [Kwon Park](#) at (202) 547-3035.

Today, the House Financial Services Subcommittees on Capital Markets and Government Sponsored Enterprises held a hearing entitled “Continued Oversight of the SEC’s Offices and Divisions.”

Please click [here](#) for the Committee Memorandum.

Key Takeaways

- Congressmen from both parties expressed concerns on the conflict of interest that exists within credit rating agencies (CRAs) and the companies that pay for favorable ratings. Specifically, members were worried about the lack of provisions that allow a CRA to refuse rating a bond (i.e. Peruvian bonds) and prohibit rating analysts from receiving benefits based on a CRA’s financial performance.
- Mark Flannery, SEC Chief Economist and Director of DERA, said the fiduciary duty rulemaking is a major priority for Chair White and that staff is working on a recommendation for the Commission. Many Congressmen conveyed dissatisfaction over the absence of coordination between the Department of Labor (DOL) and the SEC.
- Marc Wyatt, OCIE, indicated that his office is allowing FINRA to conduct more broker-dealer (BD) examinations to inspect more investment advisers (IAs) due to limited resources.

SUMMARY

Opening Statements and Testimony

[Subcommittee Chairman Garrett \(R-NJ\)](#)

- The SEC’s budget has quadrupled in the last 15 years and the SEC still missed some of the greatest frauds in history, was ill-prepared for the financial crisis of 2008, failed to properly incorporate economic analysis into rulemakings, and has often times been complicit in advancing the priorities of special interests.
- Dodd-Frank created more offices and divisions within the agency, yet, the SEC has struggled to implement rulemakings effectively. I am concerned over the pay-ratio and credit rating rulemakings.

[Subcommittee Ranking Member Maloney \(D-NY\)](#)

- Office of Credit Ratings has increased oversight of CRAs and the Office of the Whistleblower has allowed whistleblowers to come forward with specific and timely information on corporate wrongdoings.

- Office of Compliance, Inspections, and Examinations remains underfunded - only 10% of IAs are examined each year, and about 40% are never examined. In 2015, 77% of examinations identified deficiencies with IAs.

Vice Chairman Hurt (R-VA)

- Concerned because the SEC often deviates from its three-part mission - access to capital has been problematic for small businesses in my district.

Thomas Butler, Director of the Office of Credit Ratings (OCR), Securities and Exchange Commission (SEC)

- The Credit Rating Agency Reform Act of 2006 provided the SEC with express authority to implement a registration and oversight program for CRAs that elect to be treated as nationally recognized statistical rating organizations (NRSROs).
- OCR has three groups with the following responsibilities:
 - Examinations: examines NRSROs at least annually for compliance with Federal securities laws and prepares an annual public examination report summarizing those findings.
 - NRSRO Monitoring and Constituent Monitoring: gathers, analyzes, and assess data and identifies trends across the industry to provide useful input for examination scoping, determining and communicating best practices, and guiding the direction for any future rulemaking related to NRSROs.
 - Policy and rulemaking: develops rule recommendations for the Commission's consideration and reviews registrations and applications for NRSROs.

Mark Flannery, Director of the Division of Economic and Risk Analysis (DERA), SEC

- DERA supports the SEC's mission through data-driven, high-quality economic analysis:
 - Rulemaking and Policy Support: examines the need for regulatory action, analyzes potential economic impacts of rules, evaluates public comments, and also prepares white papers and other documents for specific policy issues or rulemakings.
 - Risk Assessment: provides financial and risk modeling expertise to support supervisory, surveillance, and investigative programs.
 - Litigation Economics: supports the enforcement division by applying economic theory and statistical methods to answer key questions that arise during investigations, settlement negotiations, and litigation.
 - Data Oversight: acts as a central hub for the intake, processing, and use of data.
 - Research: regularly publishes papers to cover SEC topics.

Sean McKessy, Chief of the Office of the Whistleblower (OWB), SEC

- OWB continues to receive a significant amount of award claims and the number of claims has increased each year.
- OWB is actively involved with investigative staff to ensure that employees feel secure in reporting wrongdoings without fear of retaliation from their employers.

Marc Wyatt, Director of the Office of Compliance, Inspections, and Examinations (OCIE), SEC

- Through its National Examination Program, OCIE protects investors, ensures market integrity, and supports responsible capital formation through risk-focused strategies that: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy.
- The results of OCIE's examinations are used by the Commission to inform rule-making initiatives, identify and monitor risks, improve industry practices, and identify misconduct.
- To meet the challenges posed by a registrant population that far exceeds resources, OCIE has adopted a risk-based approach to examinations, utilized data analytics, and promoted compliance through transparency.
- OCIE's priorities include the reTIRE initiative, cybersecurity, and liquidity controls. Amidst the changes in fixed income markets over the past several years, OCIE is examining advisers to mutual funds, ETFs, and private funds that have exposure to potentially illiquid fixed income securities.
- OCIE will also examine registered BDs that have become new or expanding liquidity providers in the marketplace. These examinations include a review of various controls in these firms' expanded business areas, such as controls over market risk management, valuation, liquidity management, trading activity, and regulatory capital.

Discussion

Credit Rating Agencies (CRAs)

Garrett: Some pension funds are still including Federal references - has 939A, the provision to remove Federal references been effective? *Butler:* Removals have been effected and authorities are comfortable with the information provided.

Lynch (D-MA) and Fitzpatrick (R-PA): Since the crisis, the SEC has not implemented any fundamental changes to CRAs and record profits have returned. No fines, penalties, or suspensions have been issued when annual reviews reveal many inefficiencies. How can we eliminate the conflict of interest that exists with CRAs and companies that pay for favorable ratings? *Butler:* In August 2014, the SEC adopted a new set of rules that require the complete separation of the sales and marketing functions from the credit rating analyst functions.

Sherman (D-CA) and Fitzpatrick (R-PA): Any prohibition exist so rating analysts cannot receive benefits from the company - to eliminate conflicts? Any rule exist that allows CRAs to refuse rating a bond (i.e. Peruvian bonds)? *Butler:* No.

Neugebauer (R-TX): Any way to improve NRSRO reviews? *Butler:* Current rules are effective but it can always be better. An increased budget will allow the SEC to hire specialized examiners.

Data

Maloney: Is structured data like XBRL useful for investors? How can the SEC better enforce the accuracy of XBRL data? *Flannery:* The Office of Structured Disclosure within DERA advises where, what, and how data should be structured. XBRL data is publicly published quarterly, allowing investors to better grasp information most relevant to firms having the hardest time raising capital. The Commission relies on the information provided by the industry and various mechanisms ensure internal consistency in the data. For stock sales, we have direct feeds from exchanges, and the consolidated audit trail (CAT)

will eventually make audit trails more accurate and detailed. The SEC shares this information with the Office of Financial Research (OFR) and have coordinated information regarding Form PF and money market funds.

Retroactive Review

Hurt: Has the SEC performed any retroactive review of its rules, and if so, repealed any rules that are outdated or burdensome? *Flannery:* We conduct reviews under the Regulatory Flexibility Act for existing rulemakings, and other rules are reviewed ten years out. The Office of the General Council and DERA examine older rules together. There have been no repeals to date.

Wagner (R-MO): Are you committed to analyzing impacts of reporting requirements on smaller companies? *Flannery:* Reducing reporting requirements for smaller companies might actually harm them because evidence shows companies providing less information are less traded.

Insider Trading

Himes (D-CT): The Newman decision overturned two high profile insider trading convictions – Is a statutory definition of insider trading warranted to provide more clarity to the industry? *McKessy:* The Newman decision raises extraordinarily nuanced issues.

Cost Benefit Analysis

Hurt: Cost benefit analysis is not required in joint rulemakings – have you received pushback in joint rulemakings based on the SEC's cost benefit analysis? *Flannery:* Our economic analysis is used to assess impacts to our registrants. Banking regulators are not required to put economic analysis out for public comment. Unaware of any problems.

Hinojosa (D-TX): Cost benefit favors industry and introduces litigation risks – How does the SEC conduct cost benefit analysis? *Flannery:* A 15 - 20 page guidance document lays out the content to our analysis. First, we determine the baseline which analyzes the state of the market if we do not introduce a rule. Then, we identify impacted parties to assess the costs and benefits. In many cases, we simply cannot quantify a benefit.

OCIE

Hultgren (R-IL): OCIE's institutional changes sufficient to detect fraud like Madoff? Would a standardized institutional code (i.e. LEI) help prevent future failures? *Wyatt:* OCIE detects and streamlines connectivity amongst regions to ensure we act accordingly utilizing a risk-based program. We have adopted strategies to capture data analytics and centralized all the information with regard to examinations.

Poliquin (R-ME): How many examinations per inspector do you conduct for registered IAs? Are examiners spending a disproportionate amount of time to inspect accredited investors versus mainstreet investors? *Wyatt:* On average, 6 - 8 inspections (in teams) per investigator. We noticed a 23% increase per examiner every year for the past three years. The large institutional investors comprise of endowments and pension funds that are investing for the average American.

Hinojosa (D-TX): Do you have sufficient resources to keep pace with the increasing number of examinations that need to be done? *Wyatt:* We are using our resources most effectively and trying to increase examinations in the IA space by allowing FINRA to examine more BDs. OCIE could use additional resources to conduct more examinations.

Contingent Capital Requirements

Foster (D-IL): Is there potential for adopting contingent capital requirements in the U.S.? *Flannery:* I am unaware of any considerations to adopt contingent capital requirements.

Fiduciary Duty Rulemaking

Hinojosa (D-TX): Has the SEC studied the DOL rule to see whether the conflicts of interest provisions hurt investors? *Flannery:* Fiduciary duty rulemaking is a major priority for Chair White and staff is collaborating on a recommendation.

Royce (R-NY): The U.K. retail distribution review, identical to the DOL rule, revealed that this rulemaking locks out middle to low income investors from investment advice – did the SEC and DOL review this study? *Flannery:* We undertook conference calls with U.K. regulators and conveyed our concerns to DOL economists.

Hill (R-AR): Concerned with the DOL rule? *Flannery:* DERA is studying how financial individuals versus average investors are processing information. The DOL rules were promulgated under different standards than the securities laws.

Hultgren (R-IL), Wagner (R-MO), and Duffy (R-WI): How did DERA assist DOL in its rulemaking? Did DOL disregard advice from the SEC? Did DERA analyze DOL's rule? *Flannery:* We provided technical comments. DOL implemented some suggestions and did not adopt others. DERA will analyze DOL's rules if and when we start the rulemaking process.

Pay-Ratio Rule

Garrett: Can you quantify a benefit for the pay-ratio rule, if not, was it completed only because it was a Dodd-Frank mandate? *Flannery:* The benefits tied to informing investors on pay-ratio are not easily quantifiable.

Whistleblower

Royce (R-NY): Is the new structure working, and what can be done to improve it? Are there gaps in coordinating information with other agencies? *McKessy:* OWB has created a market intelligence group to deal with information gaps.

Neugebauer (R-TX): Are there internal controls with respect to the whistleblower fund? *McKessy:* Yes. OWB can only make payments with Commission approval and GAO audits the fund.

JOBS Act

Himes (D-CT): The gross spread for IPOs are about 7% - does that clustering strike you as odd and worthy of investigation? *Flannery:* I can find economic arguments on both sides of whether the percentages are nefarious or not.