



HOUSE FINANCIAL SERVICES SUBCOMMITTEE HEARING ENTITLED “LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION, TRANSPARENCY, AND REGULATORY ACCOUNTABILITY”

OVERVIEW

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

On May 17, the House Financial Services Subcommittees on Capital Markets and Government Sponsored Enterprises held a hearing entitled “Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability.” The hearing focused on [H.R. the “SEC Regulatory Accountability Act,”](#) [H.R. the “Investment Advisers Modernization Act of 2016,”](#) and [H.R. the “Proxy Advisory Firm Reform Act.”](#)

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

Key Takeaways

- Former SEC Commissioner Dan Gallagher advocated for the SEC Regulatory Accountability Act (RAA), noting that it merely clarifies and codifies the cost benefit analysis to which the SEC has already committed. Jennifer Taub, Professor of Vermont Law School, said RAA will slow down the rulemaking process – Gallagher disagreed.
- Taub stressed that the Investment Advisers Modernization Act’s (IAMA) “relationship” definition is too broad and that this legislation is an open invitation for fraud to flourish in the shadows (“Madoff” loophole).
- Three witnesses stated that the Proxy Advisory Firm Reform Act (PAFR) will address the conflict of interest that exists in proxy advisory firms (two firms cover 97% of market share). They indicated that it was the right time for the Federal government to step in.

SUMMARY

Opening Statements and Testimony

Subcommittee Chairman Garrett (R-NJ)

- RAA will make the SEC determine whether the benefits actually outweigh the cost of proposed regulations.
- IAMA will play a critical role in our economy and capital formation, and reduce unnecessary and outdated bureaucratic regulatory requirements.
- PAFR will provide sunlight into how firms develop and distribute proxy advice.

Subcommittee Ranking Member Maloney (D-NY)

- PAFR raises several concerns: giving companies the private right of action to sue proxy advisers, and companies having a right to a comment period on draft recommendations of proxy advisers - there is no statutory right for private companies to provide notice and comment.

- Concerned IAMA makes sweeping changes to core aspects of a regulatory regime that has been very successful.

Hurt (R-VA)

- IAMA will reduce unnecessary regulatory burdens by updating the Investment Advisers Act to reflect current business models of private equity firms, while still facilitating capital formation and maintaining investor protection.

Duffy (R-WI)

- Two proxy advisory firms control 97% of the market and market participants have continuously raised concerns – PAFR addresses these concerns.

[Daniel Gallagher, President, Patomak Global Partners](#)

- PAFR helps resolve many issues through a comprehensive registration and examination regime for proxy advisory firms.
- RAA will improve the SEC's economic analysis and make them more accountable to the public, especially in mandated rulemakings. RAA will ensure that economic analysis conducted by economists are fully entrenched in every rulemaking.
- IAMA will preserve the current registration regime, but works to remove or modernize unnecessary and overly burdensome requirements in the Investment Advisers Act. The SEC should focus on making capital formation more efficient and competitive.

[Timothy Bartl, CEO, Center on Executive Compensation](#)

- The lack of oversight and the check the box mentality of proxy advisory firms need to be addressed. These firms also present conflict of interest concerns at the consulting, research, operations, and ownership levels. A more formal and appropriate regulatory regime will address conflict of interest concerns.

[Jennifer Taub, Professor, Vermont Law School](#)

- IAMA allows private funds to retreat into the shadows once again. This bill provides for a loophole on recordkeeping requirements, and exempts many advisers and hedge funds from Form PF.
- RAA limits the SEC's ability to protect the investing public and creates opportunities for litigation.
- PAFR is unwarranted – the SEC already has the authority to examine proxy firms and to address conflict of interest concerns.

[Thomas Quadman, Senior VP, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce](#)

- RAA will allow the SEC to conduct a post-implementation economic analysis to measure the exact costs and benefits, and to recommend changes if necessary. The lookback provision allows the SEC to either amend or eliminate obsolete rulemakings.
- PAFR is needed to provide more oversight and to increase transparency in proxy advisory firms, as only two firms cover 97% of market share. This bill requires further disclosure and management of

conflicts, and requires firms to demonstrate that they have the resources needed to meet its due diligence requirements.

- IAMA is an important step forward and allows the SEC to tailor regulations for public and private companies.

[Joshua Cherry-Seto, CFO, Blue Wolf Capital Partners, LLC](#)

- IAMA will make it more efficient for private equity advisers to comply with SEC rules and will improve the efficacy of regulatory oversight by clarifying and focusing resources on reporting information that is relevant to investor protections.

Discussion

SEC Regulatory Accountability Act

Garrett: What is the impact of RAA on joint rulemakings? *Gallagher:* Today, the Volcker Rule does not require the SEC to conduct cost benefit analysis because it stems from the Bank Holding Company Act. Under RAA, the SEC would have to conduct some form of cost benefit analysis.

Scott (D-GA): Will RAA hamper the SEC's rulemaking process? *Gallagher:* No, economic analysis has never slowed down the process, but rather speeds it up. Good analysis tends to provide alternatives and evidence in guiding Commission votes. RAA merely clarifies and codifies what the SEC has already committed to do.

Royce (R-NY): Should the SEC require FASB and the PCAOB to conduct similar cost benefit analysis?

Quaddman: Yes, any quasi-governmental agency that has rulemaking authority should be subject to economic analysis.

Investment Advisers Modernization Act

Maloney: What is the impact of IAMA and the SEC's authority to inspect firms? Are the exemptions too broad? *Taub:* Internal communications with employees, confidential external communications, fee disclosure and incentive information may now be destroyed. The "relationship" definition is too broad and is an open invitation for fraud to flourish in the shadows ("Madoff" loophole).

Hurt (R-VA): Do IAMA's changes jeopardize investor protection, and if not, how do they help your firm?

Cherry-Seto: The books and records provision applies to internal communications that are recommendations to the advisory committee within the firm that do not get disseminated to investors.

Neugebauer (R-TX): Do private equity funds pose systemic risk? *Cherry-Seto and Gallagher:* No.

Himes (D-CT) and Poliquin (R-ME): Is everything in this bill a bad idea? How does this bill help private equity funds make good investments and create jobs? *Taub:* I only highlighted problematic provisions in my remarks; *Gallagher:* Form PF does not make any sense for private equity firms; *Cherry-Seto:* IAMA allows private equity firms to focus on their core business, rather than governance and other issues.

Sherman (D-CA): Do prudential regulators need all the information on Form PF? *Cherry-Seto*: Form PF's primary purpose is to look at systemic risk. IAMA does not exempt anyone subject to Form PF reporting today from these reporting requirements.

Scott (D-GA): What evidence suggests now is the right time to loosen the SEC's grip? *Taub*: Not now. Form PF is provided to the SEC confidentially, with access to FSOC. Information on the behavior, leverage, and counterparty risk of these firms is important.

Proxy Advisory Firm Reform Act

Maloney: Studies show proxy advisers are not influential anymore - agree? *Quaadman*: Other studies show that they are still influential.

Garrett, Royce (R-NY), and Duffy (R-WI): What more can the Congress or the SEC do to address conflict concerns? Has the 2013 SEC guidance been sufficient in changing a proxy advisory firm's operations?

Gallagher: The SEC should rescind the no-action letter allowing the two firms to dominate market share; *Bartl*: Proxy advisory firms are providing consulting on shareholder proposals while also providing recommendations to investment firms on the same proposals. No changes have resulted from the 2013 guidance.

Wagner (R-MO): Explain why there are fewer companies going public? Is there a disincentive for small businesses looking to go public, and how should we improve this corporate governance climate? How has the proxy system contributed to this anomaly? *Quaddman*: Public companies face many costs and burdens such as annual shareholder fights. Executives have less time to focus on their core business. Creating a small business advocate office is important to maintain a voice for capital formation and competition within the SEC. Proxy advisory issues are one of the distractions that companies do not want to deal with; *Gallagher*: As Commissioner, I heard many failures of proxy advisory firms. It is time for Congress to look at how the Federal government can step in.

Regulation NMS

Sherman (D-CA): Does it make sense for the NMS plan to include folks other than the exchanges?

Gallagher: Congress should look at this issue.