



## Statement of the U.S. Chamber of Commerce

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**ON: Legislative Proposals to Examine Corporate Governance**

**TO: United States Senate Committee on Banking, Housing, and Urban Affairs**

**BY: Thomas Quadman, Executive Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce**

**DATE: June 28, 2018**

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The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Chairman Crapo, Ranking Member Brown, and members of the Committee on Banking, Housing and Urban Affairs: my name is Tom Quaadman, executive vice president of the Center for Capital Markets Competitiveness (“CCMC”) at the U.S. Chamber of Commerce (“Chamber”). Thank you for the opportunity to testify today regarding the important topic of corporate governance and to discuss the Chamber’s views regarding a number of legislative proposals.

The Chamber has long been concerned that the public company regulatory model in the United States has failed to keep up with the times, as evidenced by the significant drop in the number of public companies over the last two decades. The United States is now home to roughly half the number of public companies than those that existed in the mid-1990s, and the overall number of public listings has little changed from 1983.<sup>1</sup> While there is no single reason behind this decline, what is clear is that the overall regulatory burden – coupled with a steady rise in special interest activism – has made an initial public offering (“IPO”) increasingly unattractive. In short, we need new policies that will make it more attractive for businesses to go and stay public.

The public company model has been a key source of strength and growth, which has made the American economy the strongest and most prosperous in world history. When businesses go public, jobs are created and new centers of wealth are formed. During the 1980s and 1990s, stories of the Microsoft executive assistant or the UPS driver becoming a millionaire were not uncommon after a company went through the IPO process. A 2012 study done by the Kaufmann Foundation found that for the 2,766 companies that went through the IPO process between 1996 and 2010, employment cumulatively increased by 2.2 million jobs.<sup>2</sup> Other benefits also accrue to companies when they go public, such as revenue growth.

The public capital markets are also not static and help to support innovation. Only about 12% of the Fortune 500 companies in 1955 were still on the list in 2014, while the other 88% have either gone bankrupt, merged, or fallen out of the Fortune 500.<sup>3</sup> This system of creative destruction has forced businesses to change with the times, or be replaced by new entrants with innovative ideas and products to meet the needs of consumers and an ever changing market place.

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<sup>1</sup> “America’s Roster of Public Companies is Shrinking Before our Eyes.” Wall Street Journal, January 6, 2017. <https://www.wsj.com/articles/americas-roster-of-public-companies-is-shrinking-before-our-eyes-1483545879>

<sup>2</sup> Post-IPO Employment and Revenue Growth for U.S. IPOs June 1996-2010 <http://innovation.ucdavis.edu/people/publications/kenney-m.-patton-d.-ritter-j.-2012.-post-ipo-employment-and-revenue-growth>

<sup>3</sup> Mark Perry, AEIdeas, August 18, 2014

From 1996-2016, the number of public companies dropped in 19 of 20 years. The one year where there was an increase is attributable to the passage of the Jumpstart our Business Startups Act of 2012 (“JOBS Act”). Title I of the JOBS Act included provisions known as the IPO “on-ramp,” consisting of scaled disclosure and other requirements for emerging growth companies (EGCs). These provisions had an immediate effect on the IPO market: in 2013 – the first full calendar year after the JOBS Act was passed – 226 IPOs were listed in the United States (the highest number since 2004), followed by 291 in 2014.<sup>4</sup> Importantly, the JOBS Act has demonstrated that the rules that apply to public companies can be scaled appropriately without compromising important investor protections.

However, the JOBS Act was just a start. In recent years, the Chamber has issued a number of reports and recommendations calling upon the Securities and Exchange Commission (SEC) and Congress to do more to help companies go public. Many of these reports and recommendations involve fundamental issues of corporate governance including disclosure, proxy voting, and shareholder proposals. The Chamber’s reports include:

- 2013: [\*Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice\*](#), a report that helped kick-start an important debate over the broken proxy advisory system in the United States;
- 2014: [\*Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation\*](#), a report that included two dozen specific recommendations to modernize the SEC’s disclosure regime;
- 2017: [\*Essential Information: Modernizing Our Corporate Disclosure System\*](#), which emphasized the importance of the longstanding “materiality” standard for corporate disclosure;
- 2017: [\*Shareholder Proposal Reform: The Need to Protect Investors and Promote the Long-Term Value of Public Companies\*](#), which outlined seven recommendations on how to fix the outdated shareholder proposal system under Rule 14a-8 of the Securities Exchange Act.

And most recently, the Chamber – along with seven other organizations – issued a report entitled [\*Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public\*](#), which included 22 recommendations that would expand upon the success of the JOBS Act. While the Chamber is pleased that many of our

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<sup>4</sup> <https://www.sec.gov/info/smallbus/acsec/giovanetti-presentation-acsec-021517.pdf>

recommendations have been acted upon either by Congress or the SEC, there is still much room for progress.

### **Sarbanes-Oxley, Dodd-Frank, and the “Federalization” of Corporate Governance**

Traditionally, corporate governance was structured under the state laws where a business is incorporated, as well as the by-laws of the corporation. This system allowed directors and shareholders to create governance structures that fit the needs of individual businesses and its investors.

From the time of the New Deal up until the passage of the 2002 Sarbanes-Oxley Act, with some exception in the area of compensation, the role of securities laws was a disclosure-based regime intended for investors to have the material information needed to make informed investment decisions.

Sarbanes-Oxley started a trend towards “federalizing” corporate governance by placing the federal government in a more predominant role. For example, Sarbanes-Oxley created specific requirements for the composition of a company’s audit committee as well as its operation. It also created a quasi-regulatory body in the Public Company Accounting Oversight Board (“PCAOB”), an entity with expansive authority and tremendous influence over the manner in which public companies are operated.

This trend was exacerbated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which mandated new rules on compensation committee independence, pay versus performance, compensation disclosures, claw-back policies, incentive compensation rules for financial firms, “say on pay” votes, new disclosure regarding the Chairman and CEO structures, conflict minerals disclosures, resource extraction disclosures, and mine safety report disclosures. Furthermore, the Investor Advisory Committee at the SEC – created by Dodd-Frank – has produced recommendations that would further expand the use of federal mandates, such as the mandated use of universal proxy ballots in contested director elections.

In a post-Dodd-Frank world, some groups have sought to exploit federal securities laws to advance social or political objectives. Bills have been introduced – though not passed – to require human trafficking disclosures, political and lobbying spending disclosures, and other issues that are best left addressed outside the securities laws. Policymakers should take steps to ensure that disclosure requirements always meet the test of the Supreme Court-articulated materiality standard, otherwise

investors risk becoming inundated with information that does not inform their voting and investment decisions.

### **The Challenges of Being Public Today**

The legislative mandates of Sarbanes-Oxley and the Dodd-Frank Act have been coupled with the exponential growth of the proxy statement and corporate disclosures. Furthermore, the SEC has largely failed or been unable to provide oversight over proxy advisory firms, modernize corporate disclosures, and update information delivery systems, or reform proxy plumbing systems. The SEC has also gradually receded from its duty as a gate keeper of shareholder proposals under Rule 14a-8, which has allowed agenda-driven items to work their way into board rooms and shareholder meetings. This condition has allowed a small group of special interests to dominate the shareholder proposal process and frustrate the views of a majority of shareholders. Concurrently, businesses are facing increasing pressure to disclose and engage shareholders on environmental, social, and governance issues, many of which investors have deemed immaterial.

It is little wonder why companies that are deciding to go public are increasingly doing so in nontraditional ways. For example, many companies have recently decided to go public under a dual-share class structure that limits voting rights to only certain investors. While such corporate structures have generated criticisms, many of these companies have completed successful IPOs with heavy investor interest, and some offerings have been oversubscribed. Instead of requiring businesses to submit to a myopic view of how a corporation should be structured, companies should be free to choose their own structure, and investors should be free to choose where they want to place their money. If you don't like the corporate structure, don't buy the stock. The markets will help determine if the business got it right or not.

Under the more federalized system, rather than a company's board determining the long-term strategy of success, boards are increasingly bogged down with mandated regulatory compliance issues. Corporations are being forced into a "one size fits all" model that is more expensive, provides less opportunity to grow, and makes it more difficult to run a business.

There have been beneficial developments that have occurred over the past several decades. Shareholders are more empowered and communications between businesses and investors have increased. Businesses are understanding that they must increase board diversity on their own rather than have a mandate imposed upon them.

Nevertheless, the U.S. public company system—which is still the global gold standard by far, has been increasingly turning into a net negative. As a result, businesses and investors are walking away from an ever shrinking public company pie. America’s entrepreneurs are just as comfortable staying private, or being acquired as they are going through the IPO process.

We appreciate that the Committee has called today’s hearing to gather thoughts on a number of bills related to corporate governance. Our comments on these legislative proposals are included below.

### **H.R. 4015, the Corporate Governance Reform and Transparency Act**

Effective and transparent corporate governance systems that encourage shareholder communication and participation are a key ingredient for public companies to grow, and for their investors and workers to prosper. Institutional investors may invest in large numbers of public companies. Therefore, the due diligence associated with proxy voting – learning and understanding the issues around director elections or shareholder proposals – is costly, complex, and burdensome. The proxy advisory industry emerged to help institutional investors fulfill these obligations by researching proxy matters and providing voting recommendations to clients.

The proxy advisory industry has been dominated for some time by only two firms: Institutional Shareholder Services (“ISS”) and Glass-Lewis. These two firms control roughly 97% of the proxy advice market and by some estimates can “control” up to 38% of the shareholder vote,<sup>5</sup> because some clients of ISS and Glass-Lewis automatically follow their recommendations. As a result, ISS and Glass-Lewis are in many ways the *de facto* standard setters for corporate governance in the United States.

Notwithstanding their influence and market power, both ISS and Glass-Lewis operate with a startling lack of transparency, rampant conflicts of interest, and have been prone to make significant errors when developing vote recommendations. The Chamber’s 2013 report, *Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice*, was intended to address many of these fundamental flaws of the two firms. The Chamber developed these best practices and core principles to improve corporate governance by ensuring that proxy advisory firms:

- Are free of conflicts of interest that could influence vote recommendations;

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<sup>5</sup> ISS 24.7% Glass Lewis 12.9% Source: Ertimur, Yonca, Ferri, Fabrizio and Oesch, David *Shareholder Votes and Proxy Advisors: Estimates from Say on Pay* (February 25, 2013).

- Ensure that reports are factually correct and establish a fair and reasonable process for correcting errors;
- Produce vote recommendations and policy standards that are supported by data driven procedures and methodologies that tie recommendations to shareholder value;
- Allow for a robust dialogue between proxy advisory firms and stakeholders when developing policy standards and vote recommendations;
- Provide vote recommendations to reflect the individual condition, status, and structure for each company and not employ “one size fits all” voting advice; and
- Provide for communication with public companies to prevent factual errors and better understand the facts surrounding the financial condition and governance of a company.

Following the release of this report, Congressional hearings were held and the SEC held a roundtable on proxy advisory firms on December 5, 2013. In June 2014, the SEC’s staff issued Staff Legal Bulletin 20<sup>6</sup> which marked the first time that the SEC exerted oversight over proxy advisory firms while providing institutional investors with valuable guidance on how to use proxy advice.

However, the Chamber has found that many of the longstanding issues with these two firms remain. For example, ISS continues to operate a consulting division to provide advice to companies as to how they can achieve better ISS corporate governance ratings. ISS’s ownership of both a research division and a consulting arm – accepting fees from both the institutional investors who receive their proxy voting advice as well as from the public companies that are the subject of their voting advice – has been a focal point for criticism that conflicts of interest inherent in this business model.

While Glass-Lewis does not operate a consulting division, its ownership structure presents a unique conflict of interest. Glass Lewis is owned by an activist institutional investor – the Ontario Teachers’ Pension Plan and the Alberta Investment Management Corporation. The Chamber brought to the attention of the SEC

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<sup>6</sup> <https://www.sec.gov/interp/leg/cfslb20.htm>



examples of where this ownership structure has presented conflicts related to Glass Lewis voting recommendations.<sup>7</sup>

Additionally, proxy advisory firms have not taken steps to ensure that their recommendations are developed based on clear, objective, and empirically-based analysis. With ISS companies often times may only be given a few hours to respond to an ISS recommendation and, for example, point out if ISS has made an error in developing the recommendation. Even more troubling, Glass Lewis appears to have no clear process or procedures for providing companies with ample time to respond to recommendations.

H.R. 4015 would address many of these problems by building upon the 2014 SEC staff guidance by requiring proxy advisory firms to register with the SEC and to become more transparent with the public about their methodologies and conflicts of interest.

Under the legislation, proxy advisory firms would need to develop clear procedures and methodologies for the development of voting recommendations, which would allow for fair due process in the system. Firms would also have to both disclose and manage any conflicts of interest they have, including whether they engage in any ancillary services (such as a consulting arm) that present a direct conflict to their research work.

Proxy advisors would also have to demonstrate that they have the capability and expertise to provide empirically-based and objective vote recommendations. ISS, for example, currently has only about 1,000 total employees covering 40,000 shareholder meetings in more than 100 countries. Glass Lewis has roughly 360 employees issuing approximately 20,000 research reports annually. Both firms have been prone to making flaws in assumptions or outright factual errors in many of their recommendations. H.R. 4015 would help promote a system of fact-based proxy advice and improve the quality of information that investors receive.

Additionally, H.R. 4015 directs the SEC to withdraw two no-action letters issued in 2004 to Egan-Jones and ISS. As a practical matter, these no-action letters had the effect of allowing a registered investment adviser to rely on a proxy advisory firm's general policies and procedures regarding conflicts of interest – as opposed to any specific conflict that a proxy advisory firm may have in relation to a voting recommendation. The Egan-Jones and ISS no-action letters have therefore helped to

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<sup>7</sup> See e.g. Letter of May 30, 2012 to SEC Chair Mary Schapiro <http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-5.30-Glass-Lewis-letter-release.pdf>

further entrench the position of proxy advisory firms, while doing little to mitigate actual conflicts of interest as they relate to particular proxy recommendations.

H.R. 4015 is a logical next step in the wake of the 2014 SEC staff guidance. The Chamber strongly supports this legislation and urges the Committee to advance a companion Senate bill as swiftly as possible.

### **S. 536, the Cybersecurity Disclosure Act.**

There is no question that cybersecurity has become a critical issue for both businesses and government. Illicit activity on the part of cybercriminals and other threat actors represents a grave danger to the economy and capital markets. While we are generally supportive of efforts to enhance cybersecurity, we believe that the Cybersecurity Disclosure Act misses the mark.

Regulators have worked aggressively to deal with cyber threats. The SEC has become very aggressive in its regulatory efforts, and we generally support these activities intended to keep our capital markets safe. The SEC's Division of Enforcement recently formed a dedicated Cyber Unit, and has been actively pursuing cases involving cybersecurity and data security. Even before the formation of the Cyber Unit, the SEC began to bring a series of cases against broker-dealers, investment advisers, and other market intermediaries for violations of SEC rules regarding safeguarding of customer data involving hacks and other cybersecurity shortcomings.<sup>8</sup> To its credit, FINRA (the Financial Industry Regulatory Authority), which also regulates the conduct of securities broker-dealers, has likewise been highly engaged on the issue.<sup>9</sup>

The SEC also recently issued Commission-level guidance (the "Guidance") that clearly lays out the disclosure expectations for public companies on this important topic.<sup>10</sup> Central to the Guidance is the concept that material cybersecurity risks must be disclosed to investors. The Guidance also encourages public companies to adopt comprehensive policies and procedures related to cybersecurity and to assess their compliance regularly, including the sufficiency of their disclosure controls and

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<sup>8</sup> A lengthy list of SEC cybersecurity enforcement cases appears at <https://www.sec.gov/spotlight/cybersecurity-enforcement-actions>.

<sup>9</sup> See Finra's web page describing these efforts at <http://www.finra.org/industry/cybersecurity>.

<sup>10</sup> The complete text of the *Commission Statement and Guidance on Public Company Cybersecurity Disclosures* is available at <https://www.federalregister.gov/documents/2018/02/26/2018-03858/commission-statement-and-guidance-on-public-company-cybersecurity-disclosures>.

procedures as they relate to cybersecurity disclosure. To that end, the SEC urges companies to assess whether they have sufficient disclosure controls and procedures in place to ensure that relevant information about cybersecurity risks and incidents is processed and reported to the appropriate personnel, including up the corporate ladder, to enable senior management to make disclosure decisions and certifications. Additionally, the Guidance recommends that public companies adopt policies and procedures designed to prohibit directors, officers, and other corporate insiders from trading on the basis of material nonpublic information about cybersecurity risks and incidents.

Of particular relevance to today's hearing, existing SEC regulations already require a public company to disclose the extent of its board's role in the risk oversight of the company.<sup>11</sup> To the extent cybersecurity risks are material to a company's business, the Guidance makes clear that this disclosure should include the nature of the board's role in overseeing the management of that risk. Additionally, the Guidance reiterates the SEC's view that disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues will allow investors to assess how a board of directors is discharging its risk oversight responsibility.

Investors have also begun to express concerns to public company boards and management over cybersecurity risks and disclosures. According to PricewaterhouseCooper's most recent Global Investor Survey,<sup>12</sup> cyber threats were the most common concern of investors when asked to rank potential business, economic, policy, social, and environmental threats to a company's growth prospects. Not surprisingly, cybersecurity preparedness has become a common topic of discussion among public companies and their investors during shareholder engagement sessions.

We believe existing SEC regulations and market practices already provide the kinds of disclosure that the Cybersecurity Disclosure Act seeks to address. We believe that policymakers must focus on strengthening public-private cooperation to proactively protect against cyberattacks as opposed to taking a "blame the victim" approach.

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<sup>11</sup> For example, see Item 407(h) of Regulation S-K and Item 7 of Schedule 14A.

<sup>12</sup> <https://www.pwc.com/gx/en/ceo-survey/2018/deep-dives/pwc-global-investor-survey-2018.pdf>

Moreover, companies are sometimes subjected to competing directives from different government agencies regarding cyberattacks. For example, a company may be advised by a law enforcement or national security body to *not* disclose an ongoing cyber breach so that the source of the attack may be discovered. Such guidance could find itself in conflict with a company's obligation to inform its investors that it has been hacked. Agencies should coordinate with one another to ensure that a company complying with one agency's directive does not find itself out of compliance with another agency.

Companies take cybersecurity very seriously and are generally proactive in taking steps to mitigate or respond to threats. Effectively requiring companies to have a board member with cyber expertise will not make companies any more or less responsive to cyber threats.

### **S. 1744, the Brokaw Act**

We do not believe it is wise for Congress to consider S. 1744 at this point.

In its current form, the Brokaw Act would direct the SEC to amend the Section 13(d) reporting rules in a number of notable ways. First, the Brokaw Act would reduce the 10-day filing deadline for an initial Schedule 13D filing to four business days. Second, it would require the disclosure of short positions over 5 percent on Schedule 13D. Third, it would expand the definition of beneficial ownership to include a direct or indirect pecuniary interest, in addition to voting or dispositive power. As a practical matter, in making this determination, investors would therefore have to include shares held in swaps and other cash-settled derivatives, not merely equity securities or securities convertible into equity securities. Finally, the Brokaw Act would specifically require the disclosure of activity by hedge funds and groups of hedge funds under Section 13(d). The explicit inclusion of "hedge fund" in the definition of "persons" is a clear signal that the SEC is directed to pay close attention to activist investors and to concerted activity among them.

There remains a vigorous debate among market participants about the propriety of the Brokaw Act. On one side of the issue, its supporters contend that the Act would bring an additional layer of transparency to capital markets, particularly as it concerns public disclosure of short positions.

On the other hand, we have heard from many institutional investors that the Brokaw Act's accelerated Schedule 13D reporting requirements and new short position disclosures would have a chilling effect on proprietary investment strategies.

Many investors contend that they would change their market behavior as a result, which over the longer term could impede liquidity and price discovery.

The Chamber has long called on the SEC to address abusive practices related to short sales, including our call to put an end to “naked short selling.” We also have very serious concerns regarding “short and distort” schemes, which involve spreading false or misleading information about a company in order to drive its stock price down and return a profit for the short seller. However, we are sympathetic to concerns that adoption of a broad short sale disclosure regime could hamper a legitimate market activity that increases liquidity and price discovery.

Even if the SEC were to determine that a new short-sale disclosure regime is in the public interest, the Chamber has doubts as to whether modeling such a regime on Schedule 13D reporting would prove optimal. The current legislation makes no distinction between a short seller who has taken a net short position in a company because they believe the stock will decline in value, and a short seller who may short the company as a hedge against an existing long position. Making such a distinction would require Congress or the SEC to determine the motivation and investment strategy of market participants – a difficult, if not impossible, task that speaks to the complexities of adopting a short sale disclosure regime.

We support continued study of issues related to short selling, and urge the SEC to take the lead in assessing whether future modifications to its rules on these issues are necessary or prudent.

### **S. \_\_\_\_, the 8-K Trading Gap Act of 2018**

The Chamber believes it is important to root out bad actors from capital markets. However, we do not believe the 8-K Trading Gap Act will prevent future insider trading activity.

First, it is already unlawful to trade on the basis of material, non-public information (MNPI) in violation of a fiduciary duty. Corporate insiders may not trade or make tips on the basis of MNPI learned during the course of employment. A bad actor who has determined to violate the federal securities laws by engaging in conduct as serious as insider trading is not likely to be deterred by a second, redundant prohibition against the same misconduct that is found in an employer’s internal policies, procedures, and controls.

Second, the Act assumes that all Form 8-K events are certain on Day 1 of what is often a four-business-day reporting cycle, but decisions may take several days and

consultations with counsel. In many cases, a public company will not determine to file until closer to the reporting deadline of Day 4.

If this timing problem raises several questions and the company is unsure of the reporting status on Days 1, 2, and 3, how is it going to develop policies and procedures to bar insiders from trading? And how would insiders even know they are blacked out if their employer has not provided notice to them? What if the company unintentionally misses a filing deadline and the company makes a late filing months later? What are the consequences then? How do policies, procedures, and controls address these kinds of hypotheticals in any realistic, enforceable way?

### **S. 2756, the Fair Investment Opportunities for Professional Experts Act**

The Chamber supports the Fair Investment Opportunities for Professional Experts Act, which is an innovative way to expand accredited investor definitions in a limited manner to bring more sophisticated investors into the marketplace.

It is appropriate to put in place requirements and tests that correctly define persons who have the sophistication to invest in complex vehicles and have the ability to withstand loss. Asset and income tests are objective standards that have served well in determining who should be allowed the designation of accredited investors.

Still, one may not meet these objective tests but could still fit the criteria of a sophisticated investor. Such a person, in limited circumstances, could be considered an accredited investor. If that issue is addressed appropriately, more investors can access markets and the potential for capital formation for businesses can be expanded.

However, other factors should be allowed to be considered.

Presumably an individual who has met the educational and licensing requirements to sell securities and investments could be deemed to be of such a level of sophistication that they should be considered to be an accredited investor. This is also an objective test that could be easily codified. Accordingly, we support the Act's provisions that would lead to this result.

We also support the idea that SEC should, through notice and comment rulemaking, consider other ways to expand the accredited investor definition.

## S. 2499, Compensation for Cheated Investors Act

Arbitration is an important means for customers to resolve disputes, and it provides significant benefits to consumers, investors, and businesses. Arbitration forums can provide investors or other injured parties with accessible and fair procedures for obtaining redress for claims that cannot be vindicated in court. Current FINRA rules do not mandate that arbitration be the sole forum for investors to resolve disputes with brokerages, however FINRA does require that arbitration be used if it has been requested by an investor.

According to FINRA statistics, in 2016, 2,457 arbitration cases involved customer disputes, but only 16% of these cases resulted in the customer being awarded compensation. Seventy-one percent settled prior to the award, while another 9% were withdrawn.<sup>13</sup> This distribution of arbitration outcomes has remained fairly consistent over the years, and a relatively low number of cases each year end up as unpaid customer arbitration awards. For example, there were 44 such cases in 2016.<sup>14</sup> Furthermore, 13 of the 44 unpaid arbitration award cases in 2016 involved a pre-award settlement between the customer and a brokerage firm.<sup>15</sup> Other cases of unpaid arbitration awards may include situations involving brokerage firms that are inactive or no longer active or registered with FINRA, meaning that FINRA no longer has jurisdiction over the firm.

FINRA's Customer Code states that unless a brokerage firm has a bona fide reason for non-payment of an arbitration award, the firm must pay the award within 30 days. Firms that do not pay within 30 days risk being penalized or suspended by FINRA. The Chamber fully supports such regulatory mechanisms that ensure customers or investors receive the full amount of arbitration awards granted to them.

However, we are concerned that S. 2499, the Compensation for Cheated Investors Act would do more harm than good for investors. The legislation creates an open-ended "FINRA Relief Fund" that is to be funded in part by "sources determined by FINRA." The Relief Fund would ostensibly be created in order to compensate customers that have not received arbitration awards they are entitled to.

The legislation could effectively allow FINRA to assess firms that have done nothing wrong in order to pay out arbitration awards that have been awarded due to

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<sup>13</sup> Discussion Paper – FINRA Perspectives on Customer Recovery available at [http://www.finra.org/sites/default/files/finra\\_perspectives\\_on\\_customer\\_recovery.pdf](http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf)

<sup>14</sup> *Id.* at 6

<sup>15</sup> *Id.* at 9

the activities of bad actors. It would also establish what amounts to an insurance fund that has no actuarial basis whatsoever for the amounts that should be assessed on FINRA members in order to properly fund it, which will likely lead to the fund becoming insolvent in the future.

More troubling, the legislation would empower bad actors by ensuring them there is a backstop in place – paid for by somebody else – to compensate investors they have cheated. S. 2499 also does not contemplate or take into account the existing Securities Investor Protection Corporation (SIPC) regime that was created to compensate investors in the event of a broker liquidation. We believe that these issues make S. 2499 inherently flawed, and would urge the Committee to reject the legislation.

### **S. 2953, the Expanding Access to Capital for Rural Job Creators Act**

The Chamber supports this legislation, which would expand the focus of the Office of the Advocate for Small Business Capital Formation at the SEC to include ways to increase capital access for rural-area small businesses.

A 2016 report from the Economic Innovation group found that half of all post-recession business creation in the United States occurred across only twenty counties, and that many rural areas missed out on economic growth following the financial crisis.<sup>16</sup> S. 2953 is an incremental but important step that will help focus the SEC on the needs of businesses in rural communities.

### **Conclusion**

The Chamber appreciates the opportunity to provide perspective on these important issues on behalf of our member companies, and we commend the Senate Banking Committee for holding this important hearing. I would be happy to answer any questions you may have.

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<sup>16</sup> <https://eig.org/wp-content/uploads/2016/05/recoverygrowthreport.pdf>