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# OVERSIGHT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE WORK AND AGENDA OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

DECEMBER 11, 2018

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# C O N T E N T S

## TUESDAY, DECEMBER 11, 2018



## WITNESS

# OVERSIGHT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

**TUESDAY, DECEMBER 11, 2018**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

## OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. This hearing will come to order.

Today we will receive testimony from Securities and Exchange Commission Chairman Jay Clayton regarding the work and agenda of the SEC.

Your appearance before the Committee, Mr. Chairman, is appreciated, and it is essential to the oversight of the SEC. I thank you for your willingness to testify today.

The SEC has a critical mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

The SEC plays an important role in public confidence and trust in our Nation's capital markets. It provides information to investors to ensure that as Americans prepare for their futures, they have the information necessary to make informed investment decisions. I commend the SEC for its work to advance these missions.

Last week, this Committee held a hearing to discuss the appropriate role of proxy advisory firms, the shareholder proposal process, and the level of retail shareholder participation.

Many Members expressed interest in continuing the discussion on the appropriate relationship between proxy advisory firms and market participants as it relates to shareholder proposals and corporate governance.

I am concerned about the misuse of the proxy voting process and other aspects of the corporate governance system to prioritize environmental, social, or political agendas over the economic interests of end investors.

Last week, you stated your intent to address aspects of our proxy system, including proxy "plumbing," ownership and resubmission thresholds for shareholder proposals, and proxy advisory firms.

Many of the rules governing our proxy system have not been examined for decades, and I encourage the SEC to take an aggressive approach assessing the scope and appropriateness of previous regulatory actions.

Capital markets are also vital to facilitating job growth and expanding American investment opportunities. This Committee worked hard in the 115th Congress to pass a number of bipartisan securities and capital formation bills.

I will continue to work with Members to identify additional legislative proposals that encourage capital formation and reduce burdens for small businesses and communities.

The SEC has also taken a number of steps this year to make it easier for emerging companies to go public while not discouraging the availability of capital in the private market.

Additionally, this year the SEC proposed Regulation Best Interest and a related interpretation to establish standards of conduct for broker-dealers and investment advisers. This is a significant step forward, and I look forward to seeing a final rule in the near term.

Finally, the SEC has been proactive in addressing cryptocurrencies and coin offerings. For example, the Enforcement Division created a new Cyber Unit this year, which led efforts to counter fraud against retail investors involved in initial coin offerings and brought charges against a bitcoin-denominated platform operating as an unregistered securities exchange.

I look forward to receiving updates on these and other SEC initiatives, including your views on when we can expect final rules in these areas.

Senator Brown.

**OPENING STATEMENT OF SENATOR SHERROD BROWN**

Senator BROWN. Thank you, Chairman Crapo. Welcome, Chair Clayton. Nice to see you again. Thank you for your service.

Since I assume this will be the last Banking Committee hearing for this Congress, I would like to express my thanks and appreciation for the work of Senators Donnelly and Heitkamp and Corker and Heller over the years. So thanks to all of them.

We have discussed the SEC's enforcement program in previous hearings and our recent meeting, Chairman Clayton. As you have highlighted, the SEC has worked hard to return money to harmed investors. I agree that is an important goal, but enforcement can begin and end with protecting wealthy investors.

Ten years ago today, Bernie Madoff was arrested. His giant Ponzi scheme was exposed. There is no doubt that Ponzi schemes still exist. Your enforcement report shows that SEC is focused on finding them and punishing the wrongdoers, as you should.

We also know a decade ago Bernie Madoff was far from the biggest threat to most families. It was Wall Street firms that had just wrecked our economy. And just as the SEC will continue to pursue Ponzi schemes, it must also continue to pursue in many ways the harder, the complex cases against the big banks when they break the rules and threaten families' homes and savings. I have said to this Committee a number of times that my Zip code, 44105, where Connie and I live in Cleveland, had more foreclosures in the first half of 2007 than any Zip code in the United States, so I still see the remnants of inaction and wrong actions by regulators and by Wall Street.

The big banks have not turned into angels over the last 10 years. Last month, German authorities conducted a 2-day raid of Deutsche Bank's headquarters in a money-laundering and tax evasion investigation. Last year, both the Fed and New York State regulators imposed fines totaling more than $500 million on Deutsche Bank's U.S. entity for anti–money-laundering violations. And Deutsche Bank is not alone. Similar problems persist at other banks.

Looking at your Strategic Plan, I see a lot missing. There is nothing about stock buybacks. There is nothing about excessive corporate debt. Take a look at what has happened since the Republican tax overhaul.

Since last year, corporations have announced more than $1 trillion in stock buybacks, $1,000 billion, $1 trillion in stock buybacks. Take one example. GM has spent more than $10 billion on stock buybacks since 2015. Last month, on the same day it announced—last month, it announced it is laying off 14,000 workers and closing five plants, including the Chevy Cruze plant in Lordstown, Ohio. Close to 5,000 lost jobs, 5,000 more jobs in the supply chain at least, and probably another 10,000 jobs in Mahoning Valley. The same day they laid off shift two several months ago, they announced they were expanding production in Mexico. Yet the stock buybacks continue, and executive compensation continues to go up.

The priority of these corporations are clear. Buying back shares boosts companies' stock prices, which means even bigger bonuses for corporate executives. Investing in a company's workers supports the long-term health of the company, but that is not what Wall Street rewards.

Our economy functioned fine without massive stock buybacks. The SEC rule facilitating buybacks was adopted 36 years ago, but since then, the size, the use, the frequency of stock buybacks has increased dramatically. My colleagues and I have asked you to take a look at that rule and ask probing questions as you do it. It is time to question whether it is too easy for companies to buy back their shares. The GM case shows us the risks to workers and communities when companies think only about short-term profits. We should be looking at the record levels of risky corporate debt and leveraged loans, how that debt is packaged in collateralized loan obligations, the complex securities that allow investors to trade pools of loans. The Fed and the OCC are looking at banks' exposure to leveraged loans, but they say the risks are manageable and they are not worried.

We have heard that one before. It was a little over 10 years ago before the economy came crashing down. Leveraged lending CLO investors include hedge funds, mutual funds, other market participants under SEC oversight. As the shadow banking market plays a larger role in leveraged lending, watchdogs cannot just focus on the big banks. It is your job to worry when it seems like there is nothing to worry about. And I will say that again. It is your job to worry when the public seems to think there is nothing to worry about. That is what consumers and investors expect so that risks do not buildup across the financial system.

A decade ago, the regulators in the Bush administration failed the country, and the price was enormous. The SEC needs to be closely watching this market not just to make sure disclosures and credit ratings are adequate, but to complement the work of the banking regulators. We know the financial system is more interconnected than ever and the systemic risks are more likely. Main Street cannot afford for you to stand by watching Wall Street greed again, every decade perhaps, grow out of control. Any Strategic Plan for any agency guiding our economy needs to focus on the American workers who drive growth, not just wealthy investors.

Thank you.

Chairman CRAPO. Thank you, Senator Brown.

And, again, Chairman Clayton, we appreciate you being with us. You may proceed.

**STATEMENT OF JAY CLAYTON, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION**

Mr. CLAYTON. Chairman Crapo, Ranking Member Brown, Members of the Committee, thank you for the opportunity to testify before you today about the work of the Securities and Exchange Commission. On behalf of my fellow Commissioners and the 4,500 women and men of the SEC, I would like to thank this Committee for its support.

Congress' funding of the agency enables us to improve our tools and expertise relating to our markets, capital formation, and protecting Main Street investors. Further, your interest in and engagement on our rulemaking and other initiatives have helped us refine and improve these initiatives, often to the benefit of our long-term Main Street investors. Thank you for your input.

From a day-to-day management perspective, I see our job as having four principal areas of focus: One, protecting investors through forward-looking policies and rulemakings and through inspections and strong enforcement of our securities laws; two, monitoring our disclosure-based capital markets and the numerous market participants, including through oversight of issuers, gatekeepers, and intermediaries; three, ensuring that our trading markets function effectively and fairly, including during times of volatility and price discovery; and, four, identifying, evaluating, and addressing emerging market risks.

With regard to the fourth category, I want to note several key risks that are front of my mind.

First, cybersecurity continues to be a pressing threat to our capital markets and many market participants. The SEC deals with cybersecurity risk through a number of perspectives, both within and outside the agency. Combating these challenges will continue to require significant resources and attention as well as an understanding that this is both an entity-specific and a systemic risk.

Second, the potential effects of Brexit on U.S. investors and securities markets and on global financial markets more broadly is a matter of increased focus for me and my colleagues at the SEC. In short, I believe that the potential adverse effects of a poorly executed Brexit are not well understood and, in some areas where they are understood, are underestimated. The SEC's responsibility is primarily related to the effects of Brexit on our capital markets, and I have directed the staff to focus on the disclosures companies make about Brexit and the functioning of our market utilities and infrastructures.

Third, managing the transition from LIBOR to a new rate such as SOFR is a significant issue for many market participants, including Main Street investors, as borrowers, for example, have consumer credit tied to LIBOR. We and our colleagues at the Federal Reserve, Treasury Department, and other financial regulators are monitoring this issue and working to facilitate a reasonable transition. However, an effective transition requires participants to take actions well ahead of year-end 2021 when the bank's itment to submitting the information used to set LIBOR ends.

Finally, the process for developing and implementing the Consolidated Audit Trail, or CAT, remains slow and cumbersome and significantly behind deadlines. According to the SROs, substantial delivery of the first phase of CAT is now not expected until 16 months after the initial deadline. While I believe the CAT should be completed with deliberate speed, protection of CAT data, particularly any form of PII, remains a threshold issue for me.

As the SROs continue to make progress in the development and implementation and operation of the CAT, I believe that the Commission, the SROs, and the plan processor must continuously evaluate their approach to the collection, retention, and protection of PII and other sensitive data. More generally, I have stated before that the SEC will not retrieve sensitive information from the CAT unless we need it and believe appropriate protections are in place to safeguard it.

In closing, I would like to again thank the Committee for its continued support of the SEC, its mission, and its people. I would also like to note that my colleague Commissioner Kara Stein will be leaving us at the end of this year, and I thank her for her contributions to the Commission and to investors.

I look forward to answering your questions. Thank you.

Chairman CRAPO. Thank you, Chairman Clayton.

I will start out on the proxy voting process. That has been a focus of both the SEC and this Committee recently. In your testimony, you note that there is consensus on the need for major overhaul of certain aspects of the proxy voting process, including proxy plumbing and proxy advisory firms. As staff recommends comprehensive overhaul proposals, what reforms can you enact in the short term, if any?

Mr. CLAYTON. So with respect to proxy, I put this into three categories, Chair Crapo. First is proxy plumbing. Our proxy plumbing, the voting from end investor back to the company, is very complex, and the verification of that process, the facilitation of that process, does not work as well as it should. We are looking for short-term fixes. We are looking to the industry to propose them, so in that area I am looking for short-term fixes. We do need a long-term overhaul.

In the area of shareholder voting, I believe there are things that we can do to that process that will not in any way diminish engagement, but will, what I would say, eliminate unnecessary processes.

And then in the area of proxy advisers, I think that there is broad agreement that there are elements of the proxy advisory, what I will call, ecosystem that can be improved fairly quickly. And I would be happy to discuss more detailed views.

Chairman CRAPO. All right. I appreciate that. And one last question from me. The SEC has devoted significant time and resources to issues surrounding digital assets and cryptocurrencies. Do you feel that the regulatory framework is sufficiently in place to provide certainty and predictability for market participants?

Mr. CLAYTON. So I want to thank this Committee for holding a hearing, I think it may have been 9 months ago, on this very issue as the emergence of ICOs and cryptocurrencies became, I would say, of broad interest to our investment community. At the time, Chairman Giancarlo and I noted that we thought the securities laws functioned well for securities, the commodities laws functioned well for commodities, and that to the extent there were cryptoassets that fell outside either of those—for example, we talked about bitcoin at that hearing—we should continue to monitor whether other laws such as anti–money-laundering laws needed to be supplemented. We are continuing to monitor that, but I very much appreciate this Committee's attention to it and vigilance.

Chairman CRAPO. All right. Thank you very much.

I am going to yield back my time. We do have a vote coming up sometime after 11, maybe 11:15 or 11:30, so I am going to yield back 2 minutes to help us meet that deadline. Senator Brown.

Senator BROWN. Not that that is going to spread.

Chairman CRAPO. Yeah.

[Laughter.]

Chairman CRAPO. No, actually, I am setting a new standard, 3 minutes.

Mr. CLAYTON. I can hope.

Senator BROWN. Thank you, Chairman Crapo.

Recently, banking regulators have noted the risks in the leveraged lending market, but only well after the market has reached record highs. We have seen lending move outside the banking system and fuel the significant increase in collateralized loan obligations. What is the SEC doing to monitor the growth of risky loans outside the traditional banking system?

Mr. CLAYTON. So what I could say is many months ago—and I do not want to say too many, but 4 or 5—we started looking at this issue in detail, and you touched on a number of things that we should be looking at in your opening remarks, so kind of from beginning to end, you have got issuers on the one hand, which, you know, do we have too much leverage at the issuer end of the spectrum, companies borrowing too much money, too much increased leverage, all the way through to the end investors, whether it is mutual funds, pension funds, and the like. And there are entities in between, including rating agencies, banks which originate loans, and then what I will call the CLO packagers who buy the loans from the banks, form the CLOs, and send them to the end investors.

We are looking at each component of that, and we are looking at it with two ideas in mind. One is systemic risk. Are there elements of this market that are going to cause the kind of systemic issues that you discussed, you know, knock-on effects?

One thing that we are looking at in particular is will the change in ratings for these types of securities trigger substantial selling that would not be picked up by ordinarily expected demand. If you go from investment grade to below investment grade, do things like investment restrictions cause selling where the credit really has not changed that much but there is nobody there to pick it up? That is one of the many issues we are looking at.

I can go on for a long time. I do not want to take more of your time.

Senator BROWN. Let me shift. FSOC does not seem as engaged as many of us would like it to be. They have moved in the wrong direction by de-designating the insurance companies that were deemed systemically important, as you know. As a member of FSOC, what are you doing to push a greater focus on leveraged lending and the interconnectedness of banks and shadow banks?

Mr. CLAYTON. Well, the discussion that I was going through, I would say the components of the CLO—I will call it the CLO ecosystem—the leveraged lending that is outside of—the traditional high-yield debt market, bringing our knowledge and, what I would say, continued analysis of that market to the other members of the FSOC is one of the things that we are doing.

Senator BROWN. Well, and I am hopeful that—I guess I will ask you on the record: Will you commit to pursue these interests with the rest of FSOC? Is that something you will absolutely plan to do?

Mr. CLAYTON. I think it is—I generally try not to commit, but it is easy to commit for that because I am already doing it.

Senator BROWN. OK. I cannot underemphasize the importance of that. Yesterday former Federal Reserve Chair Janet Yellen said that corporate debt is at high levels and would prolong the damage of an economic downturn if it were to come or whenever it comes, leading to more corporate bankruptcies. I am inclined to believe her. I hope you and other regulators take the appropriate action as corporate debt seems to continue to mount and continues to play the role that it has in this economy.

Mr. CLAYTON. Thank you.

Senator BROWN. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

Mr. Chairman, thanks for coming back. Good to see you again. You know, we have discussed in the past, including at a public hearing, that we have had this amazing decline in the number of public companies in America, the number of IPOs that we launch in the United States. I for one think it is a terrible thing if people are choosing to finance their business through private capital because of the costs and regulatory implications of going public. Obviously, a public company creates an investment opportunity for a Main Street investor. It creates another vehicle for capital raising. The competition between the public markets and the private markets has the effect of lowering the cost of capital. So in any way I can think about it, very robust public equity markets is a very good thing for our economy.

I think in the past you have acknowledged that the regulatory costs of being a public company are probably a contributing factor to the relative decline and the absolute decline in public companies. Is that still your view that that is a contributing factor?

Mr. CLAYTON. Yes, it is.

Senator TOOMEY. One of my concerns is that, as we all know, there is a subset of activist shareholders who engage in forcing votes, shareholder votes, sometimes repeatedly on issues that they have no chance of succeeding on. Other times it is an effort to impose an ESG agenda on a company. Does this activity contribute, do you think, in any way to companies' reluctance to go public?

Mr. CLAYTON. So, look, I think the answer to that question is do the decision makers who decide whether a company should go public or not, when they look at that kind of activity, is it a check mark in the negative box? Yes.

Senator TOOMEY. OK. That is what I was getting at. Vanguard is headquartered in Pennsylvania. It is a great, great American success story, great innovative institution that has made investing affordable for millions of Main Street investors. But Jack Bogle, the founder, recently made an interesting observation. He warned, and I quote, "If historical trends continue, a handful of giant institutional investors will one day hold voting control of virtually every large U.S. corporation."

Now, if the trend continues, which is Bogle's caveat, wouldn't that be a bad thing if a handful of institutional investors had voting control of virtually every large company in America?

Mr. CLAYTON. The short answer to your question is yes. The broader answer is a continued reduction in the number of public companies has, I would say, negative effects—I believe has negative effects that go beyond just opportunities for Main Street investors to invest. A vibrant public capital market has a number of other benefits to our society.

Senator TOOMEY. Yes, I mentioned some of them. I totally agree. But I do have this concern that we have this regime that is discouraging companies from going public, and when they do go public, we have got processes that may result in votes being cast that are not really well aligned with the interests of the investors.

One thing just by point of clarification. Former SEC Commissioner Dan Gallagher was here just last week, and he reminded us that it is perfectly permissible under existing law and regulation for a fund manager to come to the conclusion that it is not in the best interest of their investor clients to be voting on every proxy matter. That is factually correct, right? It is not required to have those votes.

Mr. CLAYTON. I saw former Commissioner Gallagher's testimony, and I think he described the staff position appropriately, yes.

Senator TOOMEY. So one idea that has been floated as a way to increase the likelihood that when votes are cast they actually reflect the wishes of the investor who is the ultimate shareholder is client-directed voting. Do you have an opinion on the merits of that? And is it your view, are there any regulatory changes the SEC would need to make in order to facilitate client-directed voting?

Mr. CLAYTON. So I do not have a specific opinion today on client-directed voting. On the core question of are the intermediaries, fund managers or others, voting shares in the interests of their clients, that is something that was the subject of our roundtables. It goes to the question of regulation of proxy advisers, and it is something that I intend for the Commission to continue to look at. And I think we can improve it.

Senator TOOMEY. So you do not have an opinion on client-directed voting? Is that what I hear you saying?

Mr. CLAYTON. I do not have one here today, Senator.

Senator TOOMEY. That is something I would like to pursue with you.

Mr. CLAYTON. Thank you.

Chairman CRAPO. Thank you, Senator Toomey. And before I move to Senator Reed, I would like to notify the Committee the vote has now been moved up to 11. I would like to finish by then. I want to congratulate Senator Brown for giving back a minute and a half and encourage everybody to really stay tight on your questions.

Senator Reed.

Senator REED. So you want me to be short.

Chairman CRAPO. Yeah. See if you can beat my record. I gave 2 minutes back.

Senator REED. I will try. Thank you, Mr. Chairman. Thank you, Chairman Clayton.

Following up on some of the comments that Senator Brown made about share buybacks, not only is it difficult to look at GM buy back significant stock and then lay off thousands of workers, but your whole approach has been for the long-term Main Street investor. And one of the options that GM had was investing in innovation, investing in more sophisticated products, and effectively they chose not to do that. They gave the money back. So this issue of stock buybacks has several dimensions, one of which is not investing in the long-term future of the company. Is that something that concerns you? And is that something that the SEC can take steps to try to correct?

Mr. CLAYTON. Senator Reed, I want to be clear about the SEC's authority. We do not have authority over capital allocation, over whether a company chooses to allocate its capital by distributing it to its shareholders or investing. But I agree with a number of observers that, in terms of how companies should communicate what they intend to do with their capital, we can do a better job around disclosure. So you have—what are your capital allocation decisions? Our disclosure rules are based on, I think, historic facts, plant, property, equipment, how am I going to spend my money on plant, property, and equipment? In today's economy, I think we should be driving disclosure more toward human capital, intellectual property, and the types of advantages we have from things like supply chain management, distribution management, and our relationships with other vendors. Those are the things that drive companies' value today, and I would like to see our disclosures evolve toward that.

Senator REED. But in terms of the SEC's role, as I understand it—and please correct me—36 years ago you could not have these stock buybacks under SEC rules. Is that——

Mr. CLAYTON. I do not think that is correct. What happened 36 years ago was the SEC said if you are going to buy back stock in the market, here is a way you can do it where, if your intent is not to manipulate—there is no safe harbor if you are trying to manipulate. But if your intent is not to manipulate and you do it this way, you can feel comfortable that the buyback is being done without subjecting you to a claim of manipulation.

Senator REED. Essentially what you did is provide a pathway to buyback which previously was considered somewhat risky because of the implications of inside information, of timing, of the self-aggrandizement by the CEOs. So you do have the authority to look at that rule again.

Mr. CLAYTON. We do, but I just want to be clear what authority we have, which is the authority over whether to provide a pathway where you will not be—you will be presumed not to be manipulating the stock.

Senator REED. Well, again——

Mr. CLAYTON. It is not prohibiting or allowing buybacks.

Senator REED. Again, I think given what we have seen, you have to go back and sort of reroute that pathway, not only for modernization and innovation, but also because the choice for many individuals, I presume—and if I was in that position, I would certainly be thinking of this—is if I do a stock buyback, my stock options suddenly are hugely beneficial to me, oh, and by the way, my pay based each year is on the value of the stock, so this could be nothing to do with the shareholders, nothing to do with the workers, nothing to do with the future of the company, but it is a very good payday for me. And that I think goes against, you know, the notion 36 years ago of manipulation.

Mr. CLAYTON. Let me say I agree that if the purpose of the buyback is to drive the price up for the benefit of an individual, that is a problematic situation. And I just want to say I would encourage compensation committees who set compensation and structure compensation to look at that issue.

Senator REED. Well, I have to give at least 20 seconds back, so I would encourage the SEC, not deferring to the compensation committees, which are not that rigorous in many cases, to take strong and appropriate action. Thank you.

Mr. CLAYTON. Thank you.

Senator BROWN [presiding]. Good question. Good assertion.

Senator Rounds.

Senator ROUNDS. Thank you, and in the interest of following the Chairman's lead, I will ask just one question, and I will submit several for the record.

In your written testimony, you discuss the impact of Brexit on the American markets. From a securities standpoint, I have been following how Brexit could complicate the ability of American clearinghouses to compete in the EU and the U.K. markets. For U.S. clearinghouses to operate in the EU, EU authorities must determine that U.S. regulatory regimes are equivalent to the EU's; otherwise, market participants would face higher capital charges for accessing American markets.

Although the U.S. and the EU agreed that the CFTC's regime was equivalent in 2016, there has yet to be any determination for the SEC's regime. Progress in these areas is under threat thanks to Brexit and legislation pending in the European Parliament. If that legislation passes, large American clearing firms would only be allowed to continue operating in the EU if the EU regulators could jointly supervise them. Such legislation would violate the 2016 agreement, hurt American companies and taxpayers by making the market for U.S. Treasury bonds less liquid and increase the cost of trading derivatives for farmers and ranchers.

My question is: Can you share your thoughts on the U.S.–EU clearinghouse issue? And do you foresee any other regulatory challenges associated with Brexit and clearing securities? And if so, how would we work to resolve them?

Mr. CLAYTON. So, Senator, I think your premise described the issue very well. It is complicated. It requires international cooperation and recognition, and if we fail to identify what I will call a smooth path forward, there will be costs. I have made that clear, Chairman Giancarlo has made that clear to our European counterparts. I know that they recognize it. This is part of a broader issue. It is one of the reasons I am worried about Brexit—there are a number of issues just like the issue that you describe that seem to get kicked down the road as the broader issue unfolds.

Senator ROUNDS. Do you see a format for resolving the issues?

Mr. CLAYTON. Pursuing several. Pursuing several.

Senator ROUNDS. Can you share any thoughts?

Mr. CLAYTON. I think I should leave it at that out of respect for the international nature of the negotiations, but this is very much front of mind.

Senator ROUNDS. Very good. Thank you. And I will yield back my 2 minutes and 8 seconds.

Senator BROWN. Thank you, Senator.

Senator Menendez.

Senator MENENDEZ. Thank you. Can I take Senator Rounds' 2 minutes and 8 seconds?

[Laughter.]

Senator MENENDEZ. No. Mr. Chairman, thank you for being here. In your testimony, you state that you have made protecting Main Street investors a key guiding principle of your tenure at the SEC. So let me ask you, do you agree that Main Street investors were harmed by excessive risk taking on Wall Street in the years leading up to the financial crisis?

Mr. CLAYTON. I do. I think that excessive risk taking in our markets—let me just say this: Excessive risk taking in our markets from my perspective is more likely to have an adverse effect on Main Street investors than just about any other class of people.

Senator MENENDEZ. I agree with you. Do you agree that pay practices at big banks and financial institutions have at times ignored long-term consequences in favor of rewarding risky behavior to make short-term gains?

Mr. CLAYTON. I do not want to make a general statement about this, but what I will agree with you on this: I think that your concept is when you take someone's activity and you bring forward the benefits—so let us say I am working somewhere and I do something that is going to last for 5 years, and then I say to you, hey, over the 5 years this is going to make 100, so pay me based on 100 today—that type of incentive drives short-term behavior.

Senator MENENDEZ. Do you think Main Street investors might object to the fact that Wells Fargo CEO Tim Sloan was paid $17.4 million last year, the same year other regulators investigated and took actions on scandals relating to the bank's auto lending, mortgage lending, and investment management practices?

Mr. CLAYTON. Senator, I am not going to comment about a specific institution here in this forum.

Senator MENENDEZ. Well, OK. So do you think Main Street investors might object to the fact that any CEO would be paid, you know, tens of millions of dollars after they faced all of those investigations and all of those consequences for fraudulent behavior at their institution?

Mr. CLAYTON. I do think that investors in companies should have clear disclosure of what the senior executives of those companies are making, and they should have input through various engagement processes, including some of the processes that we have discussed here today.

Senator MENENDEZ. So with that in mind——

Mr. CLAYTON. Senator, in a word—I am sorry. In a word, there should be accountability.

Senator MENENDEZ. Good. Why is it then that the Commission has not made it a priority to finish congressionally mandated rules to rein in pay practices that put Main Street investors at risk?

Mr. CLAYTON. You are speaking about the Dodd–Frank mandates around pay practices, I believe.

Senator MENENDEZ. Yes.

Mr. CLAYTON. Yes, I am aware of those. I keep track of the Dodd–Frank mandates. I am pursuing them, working with my fellow Commissioners. We proposed rules around some of those. We are reviewing the comments. We received a number of comments. Some of them raised very significant issues.

Senator MENENDEZ. Can you give me a timeframe in which you would expect the Commission actually to be able to promulgate rules in this regard?

Mr. CLAYTON. I have the hedging rule on our near-term agenda. I expect that in the near term. The others I cannot be as precise.

Senator MENENDEZ. Well, let me just say that if we agree in principle that runaway executive pay which rewards risk taking can be harmful to investors and you have a mandate from Congress to do something about it, it just seems to me that this should be a priority. It falls right in line with your Main Street investor priorities, so I hope you will make it such at the end of the day, and I hope the next time you come before the Committee, we will have rules promulgated.

Let me ask you one other question. I read your statement issued on Friday regarding the SEC's difficulties assessing information about Chinese companies that are listed on U.S. exchanges. There are 224 companies listed on U.S. exchanges with a combined market capitalization of $1.8 trillion that are located in countries, primarily China, that make it difficult for U.S. regulators to review their financial reporting. This presents a major risk to U.S. investors who may assume that the financial reporting of these companies is in line with U.S. requirements. Moreover, it is fundamentally unfair for Chinese companies to take advantage of the strength and liquidity of U.S. capital markets but do not have to play by the rules.

The U.S.–China Economic and Security Review Commission recommended that Congress consider legislation providing authority to ban and de-list companies that have refused to sign reciprocity agreements with the Public Company Accounting Oversight Board. Despite the SEC and the Board's best efforts to reach an agreement, it appears unlikely that Beijing will cooperate.

Would such authority strengthen your hand in negotiations with your Chinese counterparts?

Mr. CLAYTON. Let me say this, Senator: I think your characterization of where we are, where there are information barriers to us receiving what I would say is the same information and the PCAOB receiving the same information that we would expect to receive in other jurisdictions that exist today, yes. Are we working through those? Yes. I am not prepared to support a specific remedial action in this forum, but we need to make progress.

Senator MENENDEZ. I will just close with this. We cannot continue this process, $1.8 trillion, investors under your own previous statement about our other line of questions about transparency, should have transparency to know that these companies are living up to the standards for which investors rely upon to make investment decisions.

Mr. CLAYTON. And that transparency is why we put the statement out. People should know where we sit today and know that we need to improve.

Senator MENENDEZ. Yeah, but all I will say is that we do not know exactly what their accountability is. We just know that there is an accountability. So at the end of the day, you should—I would hope the Commission would embrace us giving you the tools to get the Chinese and other companies similarly situated to disclose.

Thank you, Mr. Chairman.

Senator BROWN. Senator Kennedy.

Senator KENNEDY. Mr. Chairman, thanks for being here. I think you are doing a great job.

Mr. Chairman, would you buy a bond issued by a State if you did not know whether they were broke or not?

Mr. CLAYTON. No, I would not.

Senator KENNEDY. OK. I read you gave a speech recently. I was reading it the other night. It was very good. One of your statistics says the issuers in States, municipalities, et cetera, who file either annual financial information or audited financial statements within 12 months of their fiscal year do so on an average of 188 and 200 days after the end of the fiscal year. So their financial statements are between 188 and 200 days left. Why is MSRB allowing that to happen? Are they doing anything over there other than standing around and sucking on their teeth?

Mr. CLAYTON. What I will say is this—the reason I gave that speech is I think this is an area that needs to improve. The first step in improving it is to make sure that investors understand that the financial statements they are looking at in some cases are 18 months old.

Senator KENNEDY. Yeah, well, let me——

Mr. CLAYTON. That is pretty old.

Senator KENNEDY. Let us suppose that you are an individual investor and you want to research the bonds. Aside from the fact MSRB, which is supposed to regulate themselves, you want some information about the bond issue or about the State. Are you aware MSRB charges 60,000 bucks to download bulk data?

Mr. CLAYTON. Actually, I was not aware of that, Senator.

Senator KENNEDY. Would you look into that for me?

Mr. CLAYTON. I would be happy to.

Senator KENNEDY. OK. Do you need disgorgement of ill-gotten gains to do your job?

Mr. CLAYTON. I think you are referring to the effects of the Kokesh Supreme Court decision.

Senator KENNEDY. Yes.

Mr. CLAYTON. I believe that the Kokesh Supreme Court decision—we need some help. We need some help, because what it did was it said basically Ponzi schemes and other types of frauds like that that go on beyond 5 years, we are not able to reach back and get the money back for people who were a victim of those schemes, because disgorgement was viewed in that case as a penalty subject to the 5-year statute of limitations.

Senator KENNEDY. And you do not have that authority now?

Mr. CLAYTON. We do not have the authority in those——

Senator KENNEDY. Only Congress can give you that authority.

Mr. CLAYTON. I am not going be a lawyer here, but yes.

Senator KENNEDY. OK. Let me ask you one final question. Are you familiar with the Stanford case where Allen Stanford stole $7.2 billion in a Ponzi scheme from about 21,000 people?

Mr. CLAYTON. Yes.

Senator KENNEDY. OK. Well, we are doing great getting the money back from Bernie Madoff and his people. We have collected over 75 cents on the dollar. We are not doing as well with Stanford. We have clawed back $431 million, and the lawyers took $226 million.

SEC took a position to oppose a motion to eliminate the restriction to file involuntary bankruptcy which will help the people get their money back. Why did the SEC do that? And would you reconsider? I know I am catching you cold. Just trust me. It would be a good idea.

[Laughter.]

Mr. CLAYTON. How about I say I trust you?

Senator KENNEDY. OK. I am going to yield back 1 minute and 17 seconds, Mr. Chairman.

Chairman CRAPO [presiding]. Thank you, Senator Kennedy.

Before I go on, for some of those who have just arrived, we have a vote at 11 o'clock, and I am encouraging all Members to shrink down their questioning. Three of them have given back a minute or two—counting me, four of them have given back a minute or two. So you do not have to, but please help us get there.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. It is good to see you again, Chairman Clayton.

As you know, right now investment advisers are subject to what is called a fiduciary standard. That means they are legally required to put the financial interests of their clients ahead of their own interests.

Brokers who get a commission for every trade that they make follow different rules, and, in fact, they can recommend a product that boosts their own commission even if it is not the best deal for the customer. And we also know that brokerage firms artificially create all sorts of perverse incentives to encourage brokers to make certain recommendations that are very profitable for the firm or for the broker, even if they are not real good for the customers. So that is a problem, and in April, the SEC proposed some new rules for brokers.

Now, Mr. Clayton, as you have told me before, the idea behind these new rules is to help regular retail investors—you like to call them "Mr. and Mrs. 401(k)"—to make informed choices, right?

Mr. CLAYTON. That is one component of it. There are several components of the rules.

Senator WARREN. OK, but it is trying to help investors make informed choices, right? That is what this is about.

Mr. CLAYTON. Absolutely.

Senator WARREN. OK. So one option would simply be to make brokers subject to the same fiduciary standard that investment advisers are subject to, but you did not do that. Instead, the SEC's proposal says that brokers have to act in the best interests of the client, but then you never define what "best interest" actually means.

So here is where I am stuck. For the proposal to help customers make good decisions, they need first to understand the difference between a broker and an investment adviser; and, second, how the fiduciary standard for investment advisers is different from the best interest standard for brokers, which is something you do not define. Do I have that right so far?

Mr. CLAYTON. I do not think so. I think we are pretty clear on what the best interest standards—and we are going to be clear on——

Senator WARREN. You are saying you do define it in the rules?

Mr. CLAYTON. The best interest standard as we have proposed means that you as a——

Senator WARREN. I am sorry. Is it defined in the rules?

Mr. CLAYTON. Is there a specific definition that says this is what it means? No. But there is no specific definition that says this is what the investment adviser standard means.

Senator WARREN. So I just want to be clear then. Anybody who is trying to figure this out first has to figure out do you have a broker or an investment adviser, and then, second, they have to figure out, depending on which one you have, what the difference is between the fiduciary rule and the best interest test. Is that right? Otherwise, you cannot——

Mr. CLAYTON. Almost, because you also have to understand the relationship. You have got it right, but there are three components to it. The adviser relationship, the reason it is important to understand who you are dealing with, whether it is a broker or an adviser, is the adviser relationship is a portfolio relationship.

Senator WARREN. OK. You have got two, and you are just telling me it is even more complex than that. All I want to get to——

Mr. CLAYTON. That is where we sit today.

Senator WARREN. ——you cannot start—I know. And we could have fixed that by just giving everybody the same rule, but we did not. So here is the question: You have got to start with the difference between an investment adviser and a broker. The SEC has done a study on this, and your own data show that a lot of investors have no idea what the difference between brokers and investment advisers is and the legal standards that are different for each of them. Your Office of the Investor Advocate commissioned a study of whether investors could figure out these differences based on the standard disclosures that you gave them, and the bottom line was they cannot.

I do not have time to go through every example in the study, but I picked one out. One participant told an interviewer, after reading side-by-side descriptions of the best interests and the fiduciary standards, "I do not know. It is basically the same language, but the same, they just kind of word it differently. Yeah, so it is pretty much the same."

But, of course, the standards are not the same, which is the whole point here. When your own study shows that disclosures do not work to help regular investors make informed decisions, will you move away from a disclosure-based approach in your final rule and just adopt a uniform fiduciary standard for both advisers and brokers as Congress instructed in Section 913 of Dodd–Frank?

Mr. CLAYTON. That is a good summary of where we are.

Senator WARREN. Good. Thank you.

Mr. CLAYTON. Let me tell you what we are doing. It is very good. Let me tell you what we are doing. The adviser standard—and I am going to call it the baseline adviser standard because advisers are allowed to contract around this standard. It is not well known. This is something that we want people to understand. The baseline adviser standard is the adviser cannot put their interests ahead of the client's interests. Now, they are able to say, you know, but I am going to do these things, and within informed consent they can cut back on that standard. That is not well understood. We want that to be understood. But on the broker side, the fundamental duty is going to be that the broker cannot put her or his interests ahead of the client's. So it is the same, but it is a different——

Senator WARREN. Well, if it is the same——

Mr. CLAYTON. ——type of relationship.

Senator WARREN. Let me suggest, Mr. Chairman, if it is the same, just use the same words.

Mr. CLAYTON. We may do that.

Senator WARREN. Because when you are not using the same words and, in fact, trying to give a description so that people have to sort out which of the two kinds of people they are dealing with and how the standards differ from each other, it means the disclosure is not working.

Look, we have had study after study after study that shows that pages of disclosures do not work. And even if people read the disclosures, they cannot make heads nor tails from it. Now your own study reaches exactly the same conclusion. You know, the inference I draw from this is that we need a clear, uniform fiduciary standard for advisers and brokers. It is the only way to make sure that people who are trying to save for their kids' college education or their retirement are getting the advice that is best for them, instead of what is most profitable for the person giving the advice.

Mr. CLAYTON. I believe—oh, sorry.

Senator WARREN. OK.

Chairman CRAPO. We need to shut it down.

Senator WARREN. Thank you, Mr. Chairman.

Mr. CLAYTON. OK. Thank you.

Chairman CRAPO. Senator Corker.

Senator BROWN. I just want to thank Senators Donnelly and Corker for their service on this Committee, so thank you, Joe, very much.

Chairman CRAPO. And I join in that.

Senator CORKER. Thank you. It has been a great privilege. It really has.

I am going to be very brief and defer to Senator Cotton because I know the Chairman and Ranking Member want to have this end at an appropriate time, and we have got a lot of other things happening. I have had the opportunity to get to know our Chairman, both prior to him being confirmed and throughout the process. I just want to say I am really proud of what he is trying to do at the SEC. I am proud of his leadership. I know that he is acting in an independent manner, which I appreciate very much, and I wish him well as he continues, and all those on the Committee as you continue to wrestle with issues relative to our financial system.

And with that, thank you, and I will defer to Cotton.

Chairman CRAPO. Thank you.

Senator Cotton.

Senator COTTON. Did not know we get to work that way. Thank you, Senator Corker.

Chairman Clayton, I want to discuss with you the SEC gag rule on settlements. It was addressed in a *Wall Street Journal* opinion piece on November 14th. Here is how Judge Jed Rakoff from the Southern District referred to them in 2011: "The result is a stew of confusion and hypocrisy unworthy of such a proud agency as the SEC. The defendant is free to proclaim that he has never remotely admitted the terrible wrongs alleged by the SEC, but by gosh, he had better be careful not to deny them either. Here an agency of the United States is saying, in effect, although we claim that these defendants have done terrible things, they refuse to admit it, and we do not propose to prove it, but will simply resort to gagging their right to deny it. The disservice to the public inherent in such a practice is palpable."

Would you explain to the Committee what public interest the gag order on discussing settlements with the Commission serves?

Mr. CLAYTON. It has been an effective means to reach a settlement that is in the interests of the public. Let me just say that if we can settle matters quickly, we can move on to look at other matters. And the no-admit/no-deny approach has enabled us to get to settlements, to get people their money back, get bad actors out of the marketplace, and draw a line under that matter. So it has been an effective means of pursuing remedies.

Senator COTTON. One might also say it allows a company and an agency who have both failed in a particular matter to conceal that failure from the public as well.

Mr. CLAYTON. It is not the right approach in every matter.

Senator COTTON. So there is a wrinkle in the roll that says if a defendant who has reached a settlement and is under one of these orders testifies in a court of law that he is no longer bound by that gag order, which implies that the gag order might require him to say something untruthful, what are your thoughts on that wrinkle?

Mr. CLAYTON. I think that is a—how would I say this? It is a result of the unique nature of testifying in those types of situations.

Senator COTTON. So it is OK to have defendants who have reached a settlement with the SEC to say things to the public that might be untruthful but not to say them in court? We are talking about a prior restraint on speech that is also content-based, the most disfavored kind of regulations under Supreme Court First Amendment precedent. They require a compelling Government interest in the most narrowly tailored means.

Mr. CLAYTON. Look, we all know that the First Amendment, you know, does not permit all speech without sanction. You cannot commit fraud, you know, using words. I think this was developed in part to restrict somebody who had done prior wrong or we think had done prior wrong from telling people, "Pay no attention to that." And when you are dealing with somebody in the securities industry, their history is something that is of relevance.

Senator COTTON. Well, they can say that they did not commit what was alleged against them. They just cannot deny the allegations that were made. I know this is not a Jay Clayton initiative. It goes back since before I was born, but it has come under criticism for a very long time. I mean, do you think that this gag order has First Amendment problems? You personally.

Mr. CLAYTON. Me personally? I think that we have a long history of people agreeing to restrict certain things that they can say in the commercial arena.

Senator COTTON. OK. My time has almost expired. Thanks for the exchange. I think the SEC probably——

Mr. CLAYTON. I did not know this was going to be a con law class. I am struggling.

Senator COTTON. I think the SEC should probably reconsider it. I mean, it was passed at a time in 1972 when First Amendment precedent was much different and, frankly, more favorable to the Government than it probably should have been. I understand the points that you are making about public interest, but I do think it is quite overbroad. It is not at all narrowly tailored anymore, and it can undermine other legitimate public interest.

Mr. CLAYTON. I understand.

Senator COTTON. Thank you, Mr. Clayton.

Mr. CLAYTON. Thank you.

Chairman CRAPO. Senator Van Hollen.

Senator VAN HOLLEN. Thank you, Mr. Chairman. Welcome, Mr. Chairman.

I want to pursue some of the questions Senator Reed had on stock buybacks because the claim that many made at the time that the big tax cut was passed was that companies were going to use all this extra money that they got from their tax cuts to invest in more plant and equipment and wages increasing for their workers. And the evidence is overwhelming that, in fact, they are using that money for stock buybacks. We are up to $800 billion in stock buybacks today since the passage of the bill.

Now, we can all debate the merits of a stock buyback, but as I understand your testimony, you agree that if executives are using stock buybacks to elevate the price of their stock and then quickly cash out their own compensation, that would be a problem from your perspective. Am I understanding you correctly?

Mr. CLAYTON. Let me be clear on what I said. Senator Reed and also others said, you know, if the motivation is driven by a compensation scheme, I think that is something——

Senator VAN HOLLEN. So let me ask you this——

Mr. CLAYTON. I think that is something compensation committees ought to——

Senator VAN HOLLEN. Well, let me ask you this: So there is mounting evidence that executives are cashing out more frequently after a stock buyback than before. Well, I mean, there has been evidence that, in fact, twice as many companies have insider selling in the 8 days after a buyback announcement as sell on an ordinary day. Would that trouble you if that was a pattern?

Mr. CLAYTON. I saw that stat, and it is kind of interesting. The question there is: Are the announcements coincident for the window where they are actually permitted to sell their stock? So, you know, I think a little more work needs to be done on that. So if the only time you can sell as an executive is right after earnings are announced, which is most—then if you needed to sell as part of your planning, it is going to be coincident——

Senator VAN HOLLEN. I just—it is possible the data is wrong, but if the data is correct——

Mr. CLAYTON. No, I think the data are correct.

Senator VAN HOLLEN. ——you are finding though—but those—in other words, if it is happening a lot more frequently in this period in the 8 days after stock buybacks, I think that would be a problem. But let me just ask you this: Would you be willing to host a roundtable discussion to look into this issue?

Mr. CLAYTON. Let me say this: I am happy to continue to discuss this issue. I do not want to commit to a roundtable, but the SEC's role in this is clearly something that people are focused on. I want to be as clear as I can about what our role is, so I am happy to continue the conversation to bring clarity——

Senator VAN HOLLEN. But I understood—and a number of us wrote you a letter on this. I understand your position with respect to decisions that have to be made by corporations for the benefit of their shareholders. But what we appear to be seeing is a pattern where more executives are cashing out when they have had stock buybacks, which boosts the price. And that would be decisions made for their own benefit as opposed to the stockholders. So I would like to pursue this——

Mr. CLAYTON. I would be happy to.

Senator VAN HOLLEN. ——because you have, as you know, hosted a roundtable on something which I think is a lot less of a priority, which is proxy shareholding. And, you know, where you have chosen to focus your efforts I think is a little bit troublesome. But let me just ask you this on shareholder voting, proxy shareholder voting, because we had an earlier hearing on this, and I mentioned a statement from T. Rowe Price, which is a Maryland-based company, that is on both sides of the shareholder proxy issue. They are an institutional client to proxy advisory firms, but they are also an issuer where others use proxies to decide whether to purchase—how to cast their votes with respect to T. Rowe Price. And what they say very clearly in this letter is that they think that the requirements that proxy firms run their advice or proposals or concerns through the corporations first would actually significantly diminish the value of that advice to T. Rowe Price.

Do you agree that we should not be dictating to the market that these proxy advisers have to somehow show the executives or the corporations their information before they give it to the clients who are paying for it?

Mr. CLAYTON. So I am certainly not wedded to that method of improving the process. There is an issue in the process, which is the proxy advisory firm comes out with their analysis, and the company wants to respond, and you have to look all over the place. It would be nice if you could see the responses side by side, or something else like that. But I am not wedded to running it through the company before it is published.

Senator VAN HOLLEN. OK. I just find it curious. We have had people advocating here that a firm like T. Rowe Price just does not know what it is doing and it needs this extra step in order to make good decisions.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you. We have 10 minutes left in the vote. I will be glad to recess and come back for those that want 5 minutes, but I understand that a number of you are willing to avoid that by just going a couple of minutes.

Senator MORAN. Mr. Chairman, I will ask just one question.

Chairman CRAPO. OK. Go ahead.

Senator MORAN. Chairman Clayton, thank you for being here. The Consolidated Audit Trail will be the second largest database in the world, and it will be a repository for both personally identifiable information and sensitive trade data. As such, the CAT will be a major target for cybercriminals and other bad actors. Broker-dealers will be required to report consumers' personally identifiable information to the CAT and then rely upon the security measures set up by CAT operators.

What is the SEC doing to require that CAT operators will provide prompt and accurate notification of a data breach? And how will the SEC assure that broker-dealers are not held liable by their customers for data breaches caused by the CAT?

Mr. CLAYTON. What I can tell you, Senator, is I think all three significant issues in your question are things we are focusing on, including whether retail customer PII is actually going to go into the CAT or whether we are going to do something, a "hashing" is the technical term, and that is about as much as I know about hashing, to ensure that the data that goes into the CAT is not PII for those retail investors. And in terms of issues around liability, I am not going to speak about who owes what to whom and what the law applies, but we are sensitive to those issues.

Senator MORAN. With the time constraints, perhaps we can have this conversation in my office or your office as well.

Mr. CLAYTON. Happy to.

Senator MORAN. Thank you, Mr. Chairman.

Mr. CLAYTON. Thank you.

Chairman CRAPO. Thanks, Senator Moran.

Senator Schatz.

Senator SCHATZ. Thank you, Mr. Chairman. Thank you, Chairman, for being here.

I want to follow up on a conversation we had just about a year ago. The SEC issued guidance in 2010 on climate risk. Many in the investment community like BlackRock and Bloomberg have called these disclosures inadequate. Currently, less than half of America's largest companies even make these disclosures. In October, a group of investors representing $5 trillion in assets, 15 leading securities law professors sent a petition to the SEC arguing that improved disclosure rules would increase market efficiency and that the SEC has the authority to issue such rules.

Yesterday a group of 415 investors that represent $32 trillion in assets wrote that Governments need to act on climate change, and they specifically say it is vital that Governments commit to improve climate-related financial reporting standards.

I thought we had a good conversation about this. I thought you expressed a willingness to work on this. I have seen no evidence that you are working on this, and what little evidence I have seen goes to the contrary in terms of the shareholder proposals which are putatively not about climate; it is just that every example given in raising thresholds for shareholder action is about climate.

So what are you going to do to make sure that publicly traded companies disclose climate risk?

Mr. CLAYTON. So our Division of Corporation Finance, which reviews public company filings, this is one of the issues that they are reviewing filings for. They make company-specific comments, ask company-specific questions. We are doing that. I have been in discussions with our head of Corp. Fin., Bill Hinman, about whether we should do more, what that would be.

Senator SCHATZ. They are sandbagging, and I will leave it there. We will follow up for the record, and I would like a meeting in person. I understand that they are working in good faith, but they view this as an ideological question, and 8 years later, this is very clearly an issue of economics. And there was a point at which you could say, well, you know, we cannot measure this, we cannot know this, this is not short term. None of that is true anymore. All of this is proveably an economic question, and in the interest of time—I do not mean to cut you off—I will yield back.

Chairman CRAPO. Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you. Chairman, it is good to see you again. I want to jump back to the best interest standard that you were talking with Senator Elizabeth Warren about. First of all, I supported the Department of Labor's fiduciary standard, and if you do not know, Nevada is the first, I think, State in the country that passed a State statute for a fiduciary requirement for broker-dealers. I am curious with respect to the proposed regulation that was just introduced by the SEC. Under that proposed regulation, can brokers create sales incentives for recommending certain products to its customers, to their customers?

Mr. CLAYTON. The short answer to your question is some sales incentives, like growing assets under management or total assets, you would think you would compensate somebody for bringing in new customers and growing assets just like happens in the investment advisory space. But there are some activities like that that I believe—and I am speaking for myself, not for the Commission— That I believe are inconsistent with—not putting your interests ahead of the client's. High-pressure products, specific sales contests, I have been clear, they do not work for me. Get this out the door.

Senator CORTEZ MASTO. And I agree with you because—in the interest of time, I agree with you, but isn't it true that just any incentive works against the best interest of the client?

Mr. CLAYTON. Well, I do not think so because if what you are doing is saying to a broker, "Hey, if you now have $100 million, for example, and you grow it to $200 million, you should make more money." I think that is OK. That is the way the investment advisory firm works. If you are managing a pension plan for someone and you get another pension plan to manage, you may get paid more. I think that is OK.

Senator CORTEZ MASTO. OK. Let me ask you this: Does the proposal—can brokers create bonuses for recommending certain products to customers under this proposal?

Mr. CLAYTON. I think it depends on the structure.

Senator CORTEZ MASTO. Again, there is another opportunity for somebody to make money that really, in reality, they are supposed to be looking at the best interest of the client, but there is now an incentive for them to make money. And I have always found—and I was a former Attorney General—that when you put those incentives there, it really erodes looking out for the best interest of the client, and that is my concern.

So let me jump to one final thing because in the conversation with Senator Warren, you talked about the potential—did I hear you correctly that when she talked about defining the best interest standard and looking out for that fiduciary relationship, you said that this proposal may use the same words for defining a fiduciary? Is that correct? What did you mean by that?

Mr. CLAYTON. What I mean is what I just said to you, that the bedrock principle is that I cannot put my interests ahead of my client's interests.

Senator CORTEZ MASTO. But that to me is pretty clear, and so that means no bonus, no incentive, nothing should be looking out for your own interests over somebody else's. That is my concern.

Mr. CLAYTON. They have to get paid.

Senator CORTEZ MASTO. Well, that is different. That is different.

Mr. CLAYTON. And I have engaged a lot with investors around this just to hear what they think, and they recognize that people should get paid. What they do not want are hidden incentives or incentives that are clearly inconsistent with making a recommendation that is in the interest of the client.

Senator CORTEZ MASTO. OK. In the interest of time, I appreciate you coming here today. Thank you.

Mr. CLAYTON. Thank you.

Chairman CRAPO. Senator Jones.

Senator JONES. Thank you, Mr. Chairman. Chairman Clayton, thank you for coming today.

Real quickly, you have been outspoken about the need for disclosures for companies that face unpredictable risk, such as Brexit, which seems to be becoming more unpredictable by the hour. Cybersecurity is also another one. Recently, the SEC issued guidance on cybersecurity disclosures, and I am hoping that the SEC does not lose focus.

What I want to ask you, there were a couple of your colleagues that thought that the guidance did not quite go far enough, and I am just wondering if you could talk briefly about what you are seeing from companies after the guidance was issued and if there are other improvements for these disclosures that you think might be prudent going forward.

Mr. CLAYTON. I have discussed those issues with my colleagues and understand—I think that they understand how difficult it would be to be more precise. For a long time, I thought that disclosure was not where it should be in terms of what the real risk was. I think we have seen improvement. We have seen improvement in, OK, here is the general risk, and we have seen some improvement in reporting when you have an issue. And when I say the general risk, how that general risk applies to your company. I would like to see more disclosure around what companies are doing to minimize that risk. Are we collecting less data? Are we looking at how we operate our business so that, you know, you are less susceptible and are now not just looking inside the company, but looking at your vendors and suppliers and data that comes in from the outside that, if corrupted, creates a risk for you. It is increasing in terms of sophistication, but we have a ways to go.

Senator JONES. This can be just yes or no. I am assuming it is a work in progress for the SEC.

Mr. CLAYTON. This is a work in progress for our economy.

Senator JONES. OK. That is all. Thank you, Mr. Chairman. Thank you, Chairman Clayton.

Mr. CLAYTON. Thank you.

Chairman CRAPO. Thank you, Senator Jones.

That does wrap up the questioning. Thank you for being here today, Mr. Chairman. We appreciate the work that you are doing.

For Senators who wish to submit questions for the record, those questions are due on Tuesday, December 18th, and I encourage you, Mr. Chairman, to respond to them promptly.

This is our last hearing for this Congress. We have had a lot of productive hearings, and I thank all of our Senators for making that happen. I especially want to, as has already been done, thank Senators Corker, Heller, Heitkamp, and Donnelly for all the work they have done on this Committee. We will miss them.

With that, this hearing is adjourned.

[Whereupon, at 11:16 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

## PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today we will receive testimony from Securities and Exchange Commission Chairman Jay Clayton regarding the work and agenda of the SEC.

Your appearance before the Committee is essential to our oversight of the SEC. I thank you for your willingness to testify today.

The SEC has a critical mission to protect investors; maintain fair, orderly, and efficient markets; facilitate capital formation; and enforce securities laws.

The SEC plays an important role in public confidence and trust in our Nation's capital markets.

It provides information to investors to ensure that as Americans prepare for their futures, they have the information necessary to make informed investment decisions.

I commend the SEC for its continued work to advance these missions.

Last week, this Committee held a hearing to discuss the appropriate role of proxy advisory firms, the shareholder proposal process and the level of retail shareholder participation.

Many Members expressed interest in continuing the discussion on the appropriate relationship between proxy advisory firms and market participants as it relates to shareholder proposals and corporate governance.

I am concerned about the misuse of the proxy voting process and other aspects of corporate governance to prioritize environmental, social, or political agendas over the economic interests of end-investors.

Last week, you stated your intent to address aspects of our proxy system, including proxy "plumbing," ownership, and resubmission thresholds for shareholder proposals and proxy advisory firms.

Many of the rules governing our proxy system have not been examined for decades, and I encourage the SEC to take an aggressive approach assessing the scope and appropriateness of previous regulatory actions.

Capital markets are vital to facilitating job growth and expanding American investment opportunities.

This Committee worked hard in the 115th Congress to pass a number of bipartisan securities and capital formation bills.

I will continue to work with Members to identify additional legislative proposals that encourage capital formation, and reduce burdens for small businesses and communities.

The SEC has also taken a number of steps this year to make it easier for emerging companies to go public while not discouraging the availability of capital in the private market.

Additionally, this year the SEC proposed Regulation Best Interest and a related interpretation to establish standards of conduct for broker-dealers and investment advisers. This is a significant step forward, and I look forward to seeing a final rule in the near term.

Finally, the SEC has been proactive in addressing cryptocurrencies and coin offerings.

For example, the Enforcement Division created a new Cyber Unit this year, which led efforts to counter fraud against retail investors involved in initial coin offerings and brought charges against a bitcoin-denominated platform operating as an unregistered securities exchange.

I look forward to receiving updates on these and other SEC initiatives, including your views on when we can expect final rules in these areas.

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## PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you Chairman Crapo, and welcome to Chair Clayton.

As I believe this will be the last Banking Committee hearing for this Congress, I would like to express my thanks and appreciation for the work of Senators Heitkamp, Donnelly, Corker, and Heller over the years.

Chair Clayton, we've discussed the SEC's enforcement program in previous hearings and in our recent meeting. As you've highlighted, the SEC has worked hard to return money to harmed investors. I agree that is an important goal, but enforcement can't begin and end with protecting wealthy investors.

Ten years ago today, Bernie Madoff was arrested and his giant Ponzi scheme was exposed. There's no doubt that Ponzi schemes still exist, and your enforcement report shows the SEC is focused on finding them and punishing the wrongdoers.

But, we also know that a decade ago, Bernie Madoff was far from the biggest threat to most families. It was Wall Street firms that had just wrecked our economy. And just as the SEC will continue to pursue Ponzi schemes, it must also continue to pursue complex cases against the big banks when they break the rules and threaten families' homes and savings.

The big banks have not turned into angels over the past 10 years. Last month, German authorities conducted a 2-day raid of Deutsche Bank's headquarters in a money laundering and tax evasion investigation.

Last year, both the Federal Reserve and New York State regulators imposed fines totaling more than five hundred million dollars on Deutsche Bank's U.S. entity, for anti–money-laundering violations. And Deutsche Bank is not alone—similar problems persist at other banks.

Looking at your strategic plan, I frankly see a lot missing—there's nothing about stock buybacks, and nothing about excessive corporate debt.

Take a look at what has happened since the Republican tax overhaul. Since last year, corporations have announced more than one trillion dollars in stock buybacks.

To take one example, GM has spent more than 10 billion dollars on stock buybacks since 2015, and last month it announced it's laying off 14,000 workers and closing five plants, including the Chevy Cruze plant in Lordstown, Ohio. At the same time, it's expanding production in Mexico.

The priorities of these corporations are clear—buying back shares can boost a company's stock price, which can mean even bigger bonuses for corporate executives. Investing in a company's workers supports the long-term health of the company—but that's not what Wall Street rewards.

But there's nothing intrinsic to our economy about stock buybacks. The SEC rule facilitating buybacks was adopted 36 years ago, and since then, the use, size, and frequency of stock buybacks has increased dramatically.

My colleagues and I have asked you to take a hard look at that rule.

It is time to question whether it is too easy for companies to buy back their shares. The GM case shows us the risks to workers and communities when companies think only about short-term profits.

We should also be looking at the record levels of risky corporate debt and leveraged loans, and how that debt is packaged into collateralized loan obligations—the complex securities that allow investors to trade pools of loans.

The Federal Reserve and the OCC are looking at banks' exposure to leveraged loans, but they say the risks are manageable and they are not worried.

We've heard that one before—it was a little over 10 years ago, before the economy came crashing down.

Leveraged lending and CLO investors include hedge funds, mutual funds, and other market participants under SEC oversight. As the shadow banking market plays a larger role in leveraged lending, watchdogs can't just focus on the big banks.

It's your job to worry when it seems like there is nothing to worry about. That's what consumers and investors expect, so that risks don't build up across the financial system.

The SEC needs to be closely watching this market—not just to make sure disclosures and credit ratings are adequate, but to complement the work of the banking regulators. We know the financial system has become more interconnected and that systemic risks are more likely.

Main Street cannot afford for you to stand by watching Wall Street greed grow out of control. And any "strategic plan" for any agency guiding our economy needs to focus on the American workers who drive growth—not just wealthy investors.

Thank you Mr. Chairman.

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## PREPARED STATEMENT OF JAY CLAYTON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

DECEMBER 11, 2018

Chairman Crapo, Ranking Member Brown, and Senators of the Committee, thank you for the opportunity to testify before you today about the work of the U.S. Securities and Exchange Commission (SEC or Commission or Agency). Chairing the Commission is a great privilege, and I am fortunate to be able to observe firsthand the incredible work done by the agency's almost 4,500 dedicated staff, approximately 41 percent of whom are outside of Washington, DC, in our 11 regional offices.[1]

Our people are our greatest assets, and they are our direct connection to the investors we serve. None of the important work described in this testimony would

[1] The views expressed in this testimony are those of the Chairman of the U.S. Securities and Exchange Commission and do not necessarily represent the views of the President, the full Commission, or any Commissioner.

have been achieved without the solutions-oriented attorneys, accountants, examiners and economists at the SEC, whose work, in turn, is made possible thanks to the important, often behind-the-scenes work of the agency's administrative and operations personnel. The agency's supervisors and program managers also play a critical role in ensuring effective and efficient operations and activities.

Across the SEC, we recognize the importance of our capital markets to the U.S. economy and millions of diverse American households. Our people are skilled and committed. They accomplish a great deal with the resources at their disposal, and they are proud to serve. This testimony embodies the record of their work over the past year in pursuit of the SEC's tripartite mission of protecting investors, maintaining fair, orderly, and efficient markets and facilitating capital formation.

**New Strategic Plan**

We recently released our Strategic Plan for 2018–2022, which outlines three goals that will guide the work of the SEC moving forward.[2] I hope you will agree that we have made meaningful progress over the past year toward satisfying these goals.

Our first goal, which has been a priority of mine since I became Chairman, is focusing on the interests of our long-term Main Street investors. The past year has presented many opportunities for me, my fellow Commissioners and SEC staff to interact directly with investors from across the country. Those discussions allowed us to better answer the question we ask ourselves every day: how does our work benefit the Main Street investor? Each proposal or action we take is guided by that principle.

Our second goal—to be innovative and responsive—reflects the changing nature of our markets. As technological advancements and commercial developments have changed how our securities markets operate, the SEC's ability to remain an effective regulator requires that we continually monitor the market environment and adapt our rules, regulations and oversight. This maxim applies to nearly every facet of what we do at the SEC. For example, it drove the establishment of a Cyber Unit in the Division of Enforcement (Enforcement or Division) in September 2017, a Fixed Income Market Structure Advisory Committee in November 2017, and more recently, our new Strategic Hub for Innovation and Financial Technology (FinHub).

Our third goal—elevating the agency's performance through technology, data analytics and human capital—embodies our commitment to maintaining an effective and efficient operation. We are using technology, analyzing data and promoting information-sharing and collaboration across the agency, while also maintaining the work environment that has resulted in consistent high levels of employee satisfaction. Maintaining a high level of staff engagement, performance and morale is critical to our ability to execute the SEC's mission. We are committed to continued investment in both new technology and human capital.

**The Commission's Fiscal Year 2018 Initiatives and Upcoming Agenda**

I am proud of what our people have accomplished in Fiscal Year (FY) 2018 and look forward to building on this work as we continually review and recalibrate our approach to accomplishing the SEC's mission. Overall, America's historic approach to our capital markets has produced a remarkably deep pool of capital with unprecedented participation. It is our Main Street investors and their willingness to commit their hard-earned money to our capital markets for the long term that have ensured that the U.S. capital markets have long been the deepest, most dynamic and most liquid in the world. Their capital provides businesses with the opportunity to grow and create jobs, and supplies the capital markets with the funds that give the U.S. economy a competitive advantage. In turn, our markets have provided American Main Street investors with better investment opportunities than comparable investors in other jurisdictions.

To place this historic achievement in perspective, I note that the United States has approximately 4.4 percent of the world's population, yet the U.S. markets are the primary home to 56 of the world's 100 largest publicly traded companies, and U.S. households have over $22.4 trillion invested in the world's equity markets.[3]

More significantly, at least 52 percent of U.S. households are invested directly or indirectly in our capital markets.[4] This level of retail investor participation stands

[2] See U.S. Sec. and Exch. Comm'n Strategic Plan: Fiscal Years 2018–2022 (Oct. 2018), available at *https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY22_FINAL.pdf*.

[3] Board of Governors of the Federal Reserve System, 2016 Survey of Consumer Finances (2016).

[4] See Jesse Bricker et al., "Changes in U.S. Family Finances From 2013 to 2016: Evidence From the Survey of Consumer Finances", Federal Reserve Bulletin, vol. 103 (September 2017), available at *https://www.federalreserve.gov/publications/files/scf17.pdf*; see also Rel. No. 34-83063, Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in

out against other large industrialized countries and is especially important to keep in mind as our Main Street investors—whether they participate in our markets directly or through an intermediary such as an investment adviser or broker-dealer—now, more than ever, have a substantial responsibility to fund their own retirement and other financial needs. As a result of increased life expectancy and a shift from defined benefit plans (e.g., pensions) to defined contribution plans (e.g., 401(k)s and IRAs), the interests and needs of our Main Street investors have changed.

We are responding to that change. It is our obligation to preserve, foster, and build on the successful history of our capital markets, and history and experience demonstrate our work is never complete. Markets change, and new risks to our markets and investors will emerge. We know we must continuously assess whether we are focused on the right areas and doing the right things, keeping the interests of our long-term Main Street investors top of mind.

My testimony summarizes our important FY2018 initiatives, grouping them in five areas: (1) the regulatory and policy agenda; (2) enforcement and compliance; (3) enterprise risk and cybersecurity; (4) increasing our engagement with investors and other market participants; and (5) emerging market risks and trends. It also discusses a number of forward-looking initiatives that we are pursuing as our 2019 near-term agenda is now publicly available.[5] Continuing with the themes of transparency, accountability, and clarity of mission, the 2019 near-term agenda focuses on the initiatives we reasonably expect to complete over the next 12 months. I welcome feedback from all interested parties on areas in need of focus and how we can best allocate our resources.

**Regulatory and Policy Agenda**

During my September 2017 testimony, I noted that the near-term Regulatory Flexibility Act agenda would be streamlined to increase transparency and accountability to the public and Congress, as well as to provide greater clarity to our staff. The 2017 agenda embodied a collective effort, benefiting from the input of my fellow Commissioners, our division and office heads and many members of our staff on key questions, including: (1) what initiatives the agency could reasonably expect to complete over the next 12 months, and (2) of those initiatives, which ones would have the most positive impact on our Main Street investors.

During the last year, the Commission advanced 23 of the 26 rules in the near-term agenda, a good result on both a percentage basis (88 percent) and an absolute basis.[6]

In addition, the Commission responded to major events and changes in the broader regulatory landscape by advancing several other initiatives not in the original agenda. For example, we issued guidance to public companies about disclosures of cybersecurity risks and incidents.[7] During FY2018, the Commission also responded to a new congressional mandate from the Economic Growth, Regulatory Relief, and Consumer Protect Act by expanding a key registration exemption used by nonreporting companies to issue securities pursuant to compensatory arrangements,[8] and provided relief for those affected by Hurricane Florence.[9] In addition, to facilitate more accurate, clear, and timely communications between issuers and shareholders, the staff released guidance on how to approach near-term financial reporting uncertainties resulting from tax law changes on the same day the bill was signed by the President.[10]

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Retail Communications and Restrictions on the use of Certain Names or Titles (Apr. 18, 2018) (for statistics except the mutual fund data); 2018 Investment Company Fact Book (mutual fund statistics), available at *https://www.ici.org/pdf/2018_factbook.pdf*.

[5] The agenda for 2019 rulemaking was published in the *Federal Register* on August 7, 2018, available at *https://www.reginfo.gov/public/do/eAgendaMain?operation=Operation-Get-Agency-Rule-List&currentPub=true&agencyCode=&showStage=active&agencyCd=3235.*; see also Appendix B.

[6] See Appendix A. Over the past 10 years, the Commission completed, on average, approximately one-third of the rules listed on the near-term agenda.

[7] See Press Release 2018-22, "SEC Adopts Statement and Interpretive Guidance on Public Company Cybersecurity Disclosures" (Feb. 21, 2018), available at *https://www.sec.gov/news/press-release/2018-22*.

[8] Rule 701—"Exempt Offerings Pursuant to Compensatory Arrangements", 83 *Federal Register* 34,940 (July 24, 2018); see also, "Concept Release on Compensatory Securities Offerings and Sales", 83 *Federal Register* 34,958 (July 24, 2018).

[9] See Press Release 2018-202, "SEC Provides Regulatory Relief and Assistance for Hurricane Victims" (Sept. 19, 2018), available at *https://www.sec.gov/news/press-release/2018-202*.

[10] See Press Release, "Commission Staff Provides Regulatory Guidance for Accounting Impacts of the Tax Cuts and Jobs Act" (Dec. 22, 2017), available at *https://www.sec.gov/news/press-release/2017-237*.

To be sure, statistics—such as an 88 percent completion rate—often fail to tell more than a narrow story. Main Street investors—the market participants we have at the front of our minds—will not assess our work by the number or percentage of rules and initiatives we complete, but rather will be looking at what our efforts substantively do for them. With this metric—the interests of our long-term Main Street investors—in mind, I will discuss in more detail a few examples of our work in 2018.

*Standards of Conduct Proposals*

In April 2018, the Commission proposed for public comment a significant rulemaking package designed to serve Main Street investors that would: (1) require broker-dealers to act in the best interest of their retail customers; (2) reaffirm, and in some cases clarify, the fiduciary duty owed by investment advisers to their clients; and (3) require both broker-dealers and investment advisers to state clearly key facts about their relationship, including their financial incentives.[11] This package of rulemakings is intended to enhance investor protection by applying fiduciary principles across the spectrum of investment advice, bringing the legal requirements and mandated disclosures of financial professionals in line with investor expectations.

Broker-dealers and investment advisers both provide investment advice to retail investors, but their relationships are structured differently and are subject to different regulatory regimes. However, it has long been recognized that many investors do not have a firm grasp of the important differences between broker-dealers and investment advisers—from differences in the types of services that they offer and how investors pay for those services, to the regulatory frameworks that govern their relationships. This confusion could cause investor harm if, for example, investors fail to select the type of service that is appropriate for their needs or if conflicts of interest are not adequately understood and addressed. Our proposals would work together to better align the standards of conduct and mandated disclosures for both broker-dealers and investment advisers with what investors expect of these financial professionals, while preserving investor access and investor choice.

Specifically, proposed Regulation Best Interest would enhance broker-dealer standards of conduct by establishing an overarching obligation requiring broker-dealers to act in the best interests of the retail customer when making recommendations of any securities transaction or investment strategy involving securities. Simply put, under proposed Regulation Best Interest, a broker-dealer cannot put her or his interests ahead of the retail customer's interests. The proposal incorporates that key principle and goes beyond and enhances existing suitability obligations under the Federal securities laws. To meet this requirement, the broker-dealer would have to satisfy disclosure, care, and conflict of interest obligations.

Among other things, the obligations under proposed Regulation Best Interest would put greater emphasis on costs and financial incentives as factors in evaluating the facts and circumstances of a recommendation. Additionally, the proposed standard would require broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and eliminate material conflicts of interest, or disclose and mitigate, material conflicts of interest related to financial incentives. This is a significant and critical enhancement as today the Federal securities laws largely center on conflict disclosure rather than conflict management.

Proposed Regulation Best Interest and its "best interest" standard draw upon fiduciary principles in other contexts, including those underlying an investment adviser's fiduciary duty, recognizing that while their relationship models differ, both broker-dealers and investment advisers often provide advice in the face of conflicts of interest. These common principles are easier to compare given that we issued as another part of our reform package a proposed interpretation reaffirming—and, in some cases, clarifying—the fiduciary duty that investment advisers owe to their clients. This interpretation is designed to provide advisers and their clients with a reference point for understanding the obligations of investment advisers to their clients and, specifically, reaffirms that an investment adviser also must act in the best interests of her or his client.

While the two standards are based on common principles, under the proposal, some obligations of broker-dealers and investment advisers will differ because the relationship models of these financial professionals differ. But—importantly—the principles are the same, and I believe the outcomes under both models should be

[11] See Press Release 2018-68, "SEC Proposes To Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Investment Professionals" (Apr. 18, 2018), available at *https://www.sec.gov/news/press-release/2018-68.*

the same: retail investors receive advice provided with diligence and care that does not put the financial professional's interests ahead of the investor's interests. I believe our proposals are designed to make investors get just that whether they choose a broker-dealer or an investment adviser.

In order to hear first-hand from retail investors who will be directly impacted by the rulemaking package, the staff organized seven roundtables across the country to provide Main Street investors the opportunity to speak directly with me, my fellow Commissioners and senior SEC staff to tell us about their experiences and views on what they expect from their financial professionals. I had the opportunity to lead five of these discussions—in Houston, Atlanta, Miami, Denver, and Baltimore—and attend another in Washington, DC. These candid, experience-based conversations were incredibly valuable and are informing our work moving forward. The transcripts from these roundtables are included in our public comment file. We also have invited investors to view samples of the proposed disclosure form to share their insights and feedback with the Commission by going to *https://www.sec.gov/tell-us.* In addition, our Office of the Investor Advocate engaged RAND Corporation to perform investor testing of the proposed disclosure form. The results of the investor testing are available on the SEC's website in order to allow the public to consider and comment on this supplemental information. [12]

The staff of the Division of Trading and Markets and the Division of Investment Management are reviewing all of this information, and the more than 6,000 comment letters, [13] as they work diligently together to develop final rule recommendations.

*Facilitating Capital Formation*

The SEC took meaningful steps during FY2018 to encourage capital formation for emerging companies seeking to enter our public capital markets while maintaining, and, in many cases, enhancing investor protections. Doing so provides greater investment opportunities for Main Street investors, as it is generally difficult and expensive for them to invest in private companies. As a result, Main Street investors may not have the opportunity to participate in the growth phase of these companies if they choose not to enter our public markets or do so only later in their life cycle. Additionally, it is my experience that companies that go through the SEC public registration and offering process often come out as better companies, providing net benefits to the company, investors, and our capital markets.

As a result of the July 2017 expansion of the draft registration statement submission process to all first-time registrants and newly public companies conducting initial public offerings (IPOs) and offerings within one year of an IPO, the Division of Corporation Finance (Corporation Finance) has received draft submissions for more than 40 IPOs and from more than 75 existing reporting companies that have utilized the expanded accommodation. This change has given companies more control over their offering schedules and has limited their exposure to market volatility and competitive harm—providing a benefit to their shareholders without diminishing investor protection.

Additionally, in June 2018, the Commission voted to adopt amendments to the "smaller reporting company" definition that expand the number of companies that can qualify for certain existing scaled disclosure requirements. [14] The new definition recognizes that a one-size regulatory structure for public companies does not fit all and will allow approximately 1,000 additional companies to benefit from smaller reporting company status. The amended definition should benefit both smaller companies, by making the option to join our public markets more attractive, and Main Street investors, who, in turn, will have more investment options.

The Commission also has taken steps to simplify and update financial disclosures. In July 2018, we proposed amendments to financial disclosures to encourage guaranteed debt offerings to be conducted on a registered rather than a private basis. [15]

[12] See Press Release 2018-257, "Investor Testing of the Proposed Relationship Summary for Investment Advisers and Broker-Dealers" (Nov. 7, 2018), available at *https://www.sec.gov/news/press-release/2018-257.*

[13] See Comments on "Proposed Rule: Regulation Best Interest", available at *https://www.sec.gov/comments/s7-07-18/s70718.htm.* Of the more than 6,000 comment letters, approximately 3,000 were unique letters.

[14] See Press Release 2018-116, "SEC Expands the Scope of Smaller Public Companies That Qualify for Scaled Disclosures" (June 28, 2018), available at *https://www.sec.gov/news/press-release/2018-116.*

[15] See Press Release 2018-143, "SEC Proposes Rules To Simplify and Streamline Disclosures in Certain Registered Debt Offerings" (July 24, 2018), available at *https://www.sec.gov/news/press-release/2018-143.*

I believe these measures have the potential to save issuers significant time and expense, enhance the quality of disclosure and increase investor protection.

Further, in August 2018, the Commission adopted final rules that simplify and update disclosures by eliminating requirements that are outdated, overlapping or duplicative of other Commission rules or U.S. GAAP.[16] These amendments were part of a larger initiative by Corporation Finance to review disclosure requirements applicable to issuers and consider ways to improve the requirements for the benefit of investors and issuers. While these rule changes may appear technical, I anticipate that they will yield substantial benefits for public companies and investors, especially when taken together with other capital formation initiatives at the Commission. Importantly, they will not adversely affect the availability of material information and, in many cases, will enhance the quality of available information and increase investor protection.

Corporation Finance has several proposals on the horizon designed to encourage capital formation for emerging companies seeking to enter our public capital markets. Specifically, I anticipate the Commission will consider a proposal to amend the definition of "accelerated filer" that triggers Section 404(b) of the Sarbanes–Oxley Act of 2002, which requires registrants to provide an auditor attestation report on internal control over financial reporting, that if adopted will have the effect of reducing the number of companies that need to provide the auditor attestation report, while maintaining appropriate investor protections.[17] While Section 404(b) has become a familiar, and in many cases important, component of our public company regulatory regime, we have heard from market participants and our former Advisory Committee for Small and Emerging Companies that, particularly for smaller companies, the costs associated with this requirement can divert significant capital from the core business needs of companies without a corresponding investor benefit. I look forward to considering the staff's recommendations.

Additionally, I anticipate that the Commission will consider expanding the ability of companies that are contemplating raising capital to "test-the-waters" by engaging in communications with certain potential investors prior to or following the filing of a registration statement for an IPO. I have seen firsthand how this has benefited companies considering an IPO, as they are able to engage investors earlier to explain their business and obtain feedback in advance of an offering. This also benefits investors and shareholders as companies are better able to determine the appropriate time for an offering and to more effectively size and price the offering. I look forward to the Commission considering this initiative in the coming year.

Further, I expect that the Commission will consider a proposal, as required by the Economic Growth, Regulatory Relief, and Consumer Protection Act, to expand Regulation A offering eligibility to public reporting companies.

Finally, I believe it is important to encourage long-term investment in our country. I expect that the Commission will soon consider a release soliciting input on how we can reduce compliance burdens on reporting companies with respect to quarterly reports while maintaining, and in some cases enhancing, investor protections. There is an ongoing debate regarding our approach to mandated quarterly reporting and the prevalence of optional quarterly guidance, and whether our reporting system more generally drives an overly short-term focus. I encourage all market participants to share their views and to let us know if there are other aspects of our regulations that drive short-termism inappropriately.

Beyond our public markets, I anticipate the Commission will take a fresh look at the exempt offering framework to consider whether changes should be made to harmonize and streamline the framework. Congress and the SEC have taken a number of steps to expand the options that small businesses have to raise capital. Small businesses today have more options to reach investors within their State using the intrastate exemption, or tap the "crowd" using the power of the Internet through Regulation Crowdfunding offerings. Small businesses can decide to limit their offerings to sophisticated investors in reliance on Regulation D, or open those offerings to retail investors using Regulation A.[18]

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[16] See Press Release 2018-156, "SEC Adopts Amendments To Simplify and Update Disclosure Requirements" (Aug. 17, 2018), available at *https://www.sec.gov/news/press-release/2018-156.*

[17] See "Amendments to Smaller Reporting Company Definition", 83 *Federal Register* 31,992 (July 10, 2018).

[18] See "Remarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival" (Aug. 29, 2018), available at *https://www.sec.gov/news/speech/speech-clayton-082918.* Since these rules have gone into effect, small businesses have conducted over 900 offerings that reported raising more than $90 million collectively using Regulation Crowdfunding. And there have been over 300 offerings that reported raising a total in excess of $1 billion pursuant to Regulation A. Those amounts, however, are eclipsed by the $147 billion reportedly raised in 2017 using Rule 506(c) of Regulation D, the new exemption that lifted the ban on general solici-

Additionally, pursuant to the Economic Growth, Regulatory Relief, and Consumer Protection Act, the SEC recently expanded the exemption that permits private companies to issue securities to employees, consultants and advisors as compensatory awards—a transaction that preserves cash for the company's operations and aligns the incentives of employees with the success of the company—and solicited comment on further ways to modernize the rules related to these compensatory arrangements.[19] The so-called "gig economy" has changed how companies and individuals design alternative work arrangements, and, therefore, individuals may not be "employees" eligible to receive securities as compensatory awards under our current exemption.

While the options to raise capital in exempt offerings have grown significantly since the JOBS Act, there has not been a comprehensive review of our exemptive framework to ensure that the system, as a whole, is rational, accessible, and effective. In fact, I doubt anyone would have come up with anything close to the complex system we have today if they were starting with a blank slate. So, I believe we should take a critical look at our exemption landscape, which can be fairly described as an elaborate patchwork.[20] The staff is working on a concept release that I expect will bring to the forefront these and other topics on how we can harmonize exempt offerings. Receiving input from investors, startups, entrepreneurs and other market participants who have first-hand experience with our framework is extremely important to make sure we get it right.

*Improving the Proxy Process*

Another significant initiative for 2019 is improving the proxy process. Last month, the SEC staff held a proxy roundtable to discuss: (1) the proxy solicitation and voting process; (2) shareholder engagement through the shareholder proposal process; and (3) the role of proxy advisory firms.[21] I was pleased with this solutions-oriented event, which included a diverse group of panelists representing the views of investors, companies and other market participants. While we heard a wide range of views, we saw more agreement than disagreement, and I believe that we should act to improve each of these areas.

There was consensus among the panelists that the proxy "plumbing" needs a major overhaul. I encourage market participants to explore what such an overhaul would entail and to consider how technology, including distributed ledger technology, could improve the proxy plumbing. I realize a major overhaul could take time. So, I believe we should focus on what the Commission can do in the interim to improve the current system. The comment box for the roundtable remains open, and I encourage all those interested in improving the proxy plumbing to share their thoughts, particularly regarding actionable, interim improvements.

I also believe it is clear that we should consider reviewing the ownership and resubmission thresholds and related criteria for shareholder proposals. The current $2,000 ownership threshold and related criteria were adopted 20 years ago in 1998, and the resubmission thresholds have been in place since 1954. A lot has changed since then. We need to be mindful of these changes, and make sure our approach to the very important issue of shareholder engagement reflects the realities of today's markets and today's investors. As I have said before, when looking at the ownership and resubmission thresholds and related criteria, we need to consider the interests of the long-term retail investors who invest directly in public companies and indirectly through mutual funds, ETFs and other products. With these long-term, retail investors in mind, we also should consider whether there are factors, in addition to the amount invested and the length of time shares are held, that reasonably

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tation. And even that is dwarfed by use of the traditional private placement exemption in Rule 506(b) of Regulation D to raise over $1.7 trillion in 2017. Id.

[19] See Press Release 2018-135, "SEC Adopts Final Rules and Solicits Public Comment on Ways To Modernize Offerings Pursuant to Compensatory Arrangements" (July 18, 2018), available at *https://www.sec.gov/news/press-release/2018-135.*

[20] As we embark on this project, I believe there are several things we should consider. We should evaluate the level of complexity of our current exemptive framework for issuers and investors alike, and consider whether changes should be made to rationalize and streamline the framework. For example, do we have overlapping exemptions that create confusion for companies trying to navigate the most efficient path to raise capital? Are there gaps in our framework that impact the ability of small businesses to raise capital at key stages of their business cycle? We also should consider whether current rules that limit who can invest in certain offerings should be expanded to focus on the sophistication of the investor, the amount of the investment, or other criteria rather than just the wealth of the investor. And we should take a look at whether more can be done to allow issuers to transition from one exemption to another and, ultimately, to a registered IPO, without undue friction.

[21] See November 15, 2018: "Roundtable on the Proxy Process", available at *https://www.sec.gov/proxy-roundtable-2018.*

demonstrate that the proposing shareholder's interests are aligned with those of a company's long-term investors.

For proxy advisory firms, I believe there is growing agreement that the current dynamics among four parties, (1) proxy advisory firms, (2) investment advisers who employ those firms and have a fiduciary duty to their investors, (3) issuers, and (4) investors at large, including our Main Street investors, can be improved. For example, there should be greater clarity regarding the division of labor, responsibility and authority between proxy advisors and the investment advisers they serve. We also need clarity regarding the analytical and decision-making processes advisers employ, including the extent to which those analytics are company or industry specific. On this last point, it is clear to me that some matters put to a shareholder vote can only be analyzed effectively on a company-specific basis, as opposed to applying a more general market or industrywide policy.

Finally, there were other issues raised at the roundtable that we should consider, including: (1) the framework for addressing conflicts of interests at proxy advisory firms, and (2) ensuring that investors have effective access to issuer responses to information in certain reports from proxy advisory firms.

The staff is looking at these and other issues, and I have asked them to formulate recommendations for the Commission's consideration. On timing, it is clear to me that these issues will not improve on their own with time, and I intend to move forward with the staff recommendations, prioritizing those initiatives that are most likely to improve the proxy process and our markets for our long-term Main Street investors.

*Modernizing Trading and Market Structure*

Another area of focus for the Commission is ensuring fair and efficient trading markets for our Main Street investors. We know that transparency is a bedrock of healthy and vibrant markets, and I am pleased to report that we have taken significant steps to make our trading markets more transparent.

In July 2018, we adopted amendments that enhance the transparency requirements governing alternative trading systems, commonly known as "ATSs." [22] These amendments provide investors, brokers and other market participants—and the Commission—with increased visibility into the operations of these important markets for equity trading. Additionally, last month, the Commission adopted amendments to Regulation NMS to provide investors with greater transparency concerning how brokers handle and execute their orders. [23]

Further, in March 2018, the Commission proposed a transaction fee pilot for National Market System (NMS) stocks, which, if adopted, would provide the Commission with data to help us analyze the effects of exchange fees and rebates on order routing behavior, execution quality and our market structure generally. [24] This topic has received significant attention ever since the implementation of Regulation NMS. More recently, the development of a pilot program on transaction fees was one of the SEC's Equity Market Structure Advisory Committee's most prominent recommendations to the Commission. [25] In my view, the proposed pilot—which I expect the Commission to consider for adoption in the near future—would lead to a more thorough understanding of these issues, which would help the Commission make more informed and effective policy decisions in the future, all to the benefit of retail investors.

Our fixed income markets are also critical to our economy and Main Street investors, though historically, less attention has been focused on these relative to the equity markets. With large numbers of Americans retiring every month and needing investment options, fixed income products attract more and more Main Street investors. Yet, many of those investors may not appreciate that fixed income products are part of markets that differ significantly from the equity markets.

In November 2017, the SEC created the Fixed Income Market Structure Advisory Committee (FIMSAC) to provide diverse perspectives on the structure and operations of the U.S. fixed income markets, as well as advice and recommendations on

[22] See Press Release 2018-136, "SEC Adopts Rules To Enhance Transparency and Oversight of Alternative Trading Systems" (July 18, 2018), available at *https://www.sec.gov/news/press-release/2018-136.*

[23] See Press Release 2018-253, "SEC Adopts Rules That Increase Information Brokers Must Provide to Investors on Order Handling" (Nov. 2, 2018), available at *https://www.sec.gov/news/press-release/2018-253.*

[24] See Press Release 2018-43, "SEC Proposes Transaction Fee Pilot for NMS Stocks" (Mar. 14, 2018), available at *https://www.sec.gov/news/press-release/2018-43.*

[25] See "Equity Market Structure Advisory Committee, Recommendation for an Access Fee Pilot" (July 8, 2016), available at *https://www.sec.gov/spotlight/emsac/recommendation-access-fee-pilot.pdf.*

fixed income market structure. The Committee has held four public meetings and has provided the Commission with five thoughtful recommendations on ways to improve our fixed income markets.[26] I look forward to an equally successful second year.

Finally, new FINRA and MSRB requirements regarding the disclosure of corporate and municipal bond mark-ups and mark-downs went into effect, and I am pleased that investors now have substantially greater transparency into the costs of participating in those markets. I believe this transparency will increase competition and reduce trading costs, all to the benefit of Main Street investors.

*Consolidated Audit Trail*

Another market structure initiative that is garnering significant staff attention is the implementation of the Consolidated Audit Trail (CAT). The CAT is designed to provide a single, comprehensive database that, when fully implemented, will allow regulators to more efficiently and accurately track trading in equities and options throughout the U.S. markets. Among other things, the CAT is intended to allow the Commission to better carry out its oversight responsibility by improving our ability to reconstruct trading activity following a market disruption or other event, which in turn would allow us to more quickly understand the causes of such an event and respond appropriately.

Under the CAT NMS Plan, the self-regulatory organizations (SROs)—the national securities exchanges and FINRA—are responsible for developing and implementing the CAT and were required to begin reporting data to the CAT by November 15, 2017. The SROs missed that deadline. While the CAT has now begun receiving equity and options data with limited functionality, the SROs remain out of compliance with the CAT NMS Plan today.

The SROs are making some progress, but the development and implementation process remains slow and cumbersome due largely to what I believe are project governance and project management issues experienced by the SROs. While, pursuant to SEC staff requests, the SROs recently set forth a revised timeline with detailed milestones, more recently Thesys (the plan processor) informed the SROs that it does not plan to deliver full functionality of CAT's first phase in accordance with these milestones. The SROs have reported to our staff that they currently expect to deliver the first phase of CAT (which, again, was required to be delivered by November 15, 2017) by March 31, 2019. We remain frustrated with failure of the SROs to meet their obligations and the delays in the development of the CAT.

I know there are substantial concerns about the protection of investors' personally identifiable information (PII) that would be stored in the CAT. I have the same concerns and continue to make the protection of CAT data, particularly any form of PII, a threshold issue. In November 2017, I asked the Commission staff to evaluate the need for PII in the CAT. This evaluation includes consideration of, among other things, what PII data elements need to be collected and retained in the CAT in order to achieve the regulatory goals of the CAT, and how PII in the CAT would be used by the SEC and the SROs. We are considering what alternatives to the scope of PII that would be collected and retained by the CAT under the current plan could provide the Commission and the SROs with the market surveillance and reconstruction data necessary to conduct our regulatory and enforcement functions. As I have stated before, as the SROs continue to make progress in the development, implementation and operation of the CAT, I believe that the Commission, the SROs and the plan processor must continuously evaluate their approach to the collection, retention and protection of PII and other sensitive data. More generally, I have made it clear that the SEC will not retrieve sensitive information from the CAT unless we have a regulatory need for the information and believe appropriate protections to safeguard the information are in place.

[26] See "Fixed Income Market Structure Advisory Committee", available at *https://www.sec.gov/spotlight/fixed-income-advisory-committee.* FIMAC's recommendations include the following: (1) the development of a pilot program to delay public dissemination for 48 hours of trades in any investment grade corporate bond above $10 million and any high-yield corporate bond above $5 million (requires Financial Industry Regulatory Authority (FINRA) rulemaking); (2) the formation of a joint SEC, FINRA, and Municipal Securities Rulemaking Board (MSRB) working group to review the regulatory framework for electronic trading platforms in corporate and municipal bonds; (3) the adoption of a comprehensive classification scheme for exchange traded products; (4) for the SEC to encourage the formation of an industry group to promote investor education and work towards the establishment of a centralized and widely accessible database of key ETF data; and (5) that the SEC, in conjunction with FINRA, establish a new issue reference data service for corporate bonds that would be widely accessible on commercially reasonable terms.

*Distributed Ledger Technology, Digital Assets, and Initial Coin Offerings*

The Commission and its staff have been focusing a significant amount of attention and resources on digital assets and initial coin offerings (ICOs). I am optimistic that developments in distributed ledger technology can help facilitate capital formation, providing promising investment opportunities for both institutional and Main Street Investors. Overall, I believe we have taken a balanced regulatory approach that both fosters innovation and protects investors. For example, our staff meets regularly with entrepreneurs and market professionals interested in developing new and innovative investment products in compliance with the Federal securities laws. Recently, Corporation Finance's Director, Bill Hinman, outlined factors for participants to consider when evaluating whether a digital asset is a security [27] and also named a new Associate Director in Corporation Finance to serve as the Senior Advisor for Digital Assets and Innovation and coordinate efforts in this area across the agency. [28] SEC staff is also meeting regularly with staff from other regulatory agencies to coordinate efforts and identify any areas where additional regulatory oversight may be needed. Divisions and offices across the Commission have worked together, as well as with other regulators, to issue public statements regarding ICOs and virtual currencies. [29]

In an effort to further coordinate the Commission's work on these important issues, in October of this year the SEC announced the formation of a FinHub within the agency. [30] Staffed by representatives from across the Commission, the FinHub will serve as a public resource for FinTech-related issues at the SEC, including matters dealing with distributed ledger technology, automated investment advice, digital marketplace financing, and artificial intelligence/machine learning. In addition to serving as a portal for public engagement, FinHub will also serve as an internal resource within the SEC, coordinating the agency staff's work on these and other FinTech-related issues. As the work of FinHub and our other activities demonstrate, the agency is focused on issues presented by new technologies, and our door remains open to those who seek to innovate and raise capital in accordance with the law.

Unfortunately, while some market participants have engaged with our staff constructively and in good faith with questions about the application of our Federal securities laws, others have sought to prey on investors' excitement about cryptocurrencies and ICOs to commit fraud or other violations of the Federal securities laws. Enforcement has recently brought a number of landmark cases in this area, and I have asked the Division's leadership to continue to police these markets vigorously and recommend enforcement actions against those who conduct ICOs or engage in other actions relating to digital assets in violation of the Federal securities laws. The Commission acted swiftly to crack down on allegedly fraudulent activity in this space, particularly where the misconduct has targeted Main Street investors. Regardless of the promise of this technology, those who invest their hard-earned money in opportunities that fall within the scope of the Federal securities laws deserve the full protections afforded under those laws.

*Modernizing Asset Management Regulations*

In June 2018, the Commission proposed for public comment a new rule to replace the process of individually issued orders for exemptive relief for certain exchange traded funds (ETFs). [31] The proposal is designed to create a consistent, transparent, and efficient regulatory framework for ETFs would facilitate greater competition and innovation among these products. The ETF market, which has a volume of approximately $3.6 trillion, currently operates under more than 300 individually issued exemptive orders that have varied over time in wording and terms. I anticipate that the Commission will consider recommendations to adopt a final ETF rule in the coming year, which will enable staff to focus more time and attention on novel or unusual ETF products instead of more routine ETF-related issues.

The agency is working to promote research in the ETF market and provide investors greater access to that research. On November 30, 2018, the Commission adopted rules and amendments that are intended to reduce obstacles to providing re-

[27] See William Hinman, "Digital Asset Transactions: When Howey Met Gary" (Plastic) (June 14, 2018), available at *https://www.sec.gov/news/speech/speech-hinman-061418.*

[28] See Press Release 2018-102, "SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation" (June 4, 2018), available at *https://www.sec.gov/news/press-release/2018-102.*

[29] See "Statement on Digital Asset Securities Issuance and Trading" (Nov. 16, 2018), available at *https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.*

[30] See Press Release 2018-240, "SEC Launches New Strategic Hub for Innovation and Financial Technology" (Oct. 18, 2018), available at *https://www.sec.gov/news/press-release/2018-240.*

[31] See Press Release 2018-118, "SEC Proposes New Approval Process for Certain Exchange-Traded Funds" (June 28, 2018), available at *https://www.sec.gov/news/press-release/2018-118.*

search on investment funds in furtherance of the Fair Access to Investment Research Act of 2017. The adopted rules seek to harmonize the treatment of investment fund research with research on other public companies by establishing a safe harbor for a broker-dealer to publish or distribute research reports on investment funds under certain conditions. Overall, these rules aim to promote research on mutual funds, ETFs, registered closed-end funds, business development companies (BDCs) and similar covered investment funds and provide investors with greater access to research to aid them in making investment decisions.

Additionally, the Small Business Credit Availability Act directs the Commission to revise certain securities offering and proxy rules in order to harmonize existing registration and reporting requirements to allow BDCs to be treated in the same manner as public corporate issuers. The Economic Growth, Regulatory Relief, and Consumer Protection Act similarly directs the Commission to issue rules to allow certain registered closed-end funds to use the securities offering and proxy rules that are available to public corporate issuers. The Division of Investment Management is working to develop rule recommendations related to these two bills.

*Improving the Investor Experience*

The Division of Investment Management is leading a long-term project to explore modernization of the design, delivery and content of fund disclosures and other information for the benefit of investors. These initiatives are an important part of how the Commission can serve investors in the 21st century. Fund disclosures are especially important because millions of Americans invest in funds to help them reach personal financial goals, such as saving for retirement and their children's educations. As of the end of 2017, over 100 million individuals representing nearly 60 million households, or 45 percent of U.S. households, owned funds (generally ETFs or open-ended mutual funds).[32]

In June 2018, the Commission issued a request for comment on enhancing disclosures by mutual funds, ETFs and other types of investment companies to improve the investor experience and to help investors make more informed investment decisions (Fund Disclosure RFC).[33] The Fund Disclosure RFC seeks input from retail investors and others on how they use fund disclosures and how they believe funds can improve disclosures to aid investment decision making. In order to facilitate retail investor engagement and comment on improving fund disclosure, the Commission has provided a short Feedback Flier on Improving Fund Disclosure, which can be viewed and submitted at *www.sec.gov/tell-us.*

The Commission also adopted a new rule that creates an optional "notice and access" method for delivering fund shareholder reports.[34] The reforms include protections for those without internet access or who simply prefer paper by preserving the ability to continue to receive reports in paper. Under the rule, a fund may deliver its shareholder reports by making them publicly accessible on a website, free of charge, and sending investors a paper notice of each report's availability by mail. To inform investors in advance of this new delivery method, there is an extended transition period so that the earliest a fund could begin to rely on the rule would be January 1, 2021. During this time, funds that choose to implement the new delivery method must provide prominent disclosures in prospectuses and certain other shareholder documents that will generally notify investors of the upcoming change in delivery format on a recurring basis for a period of 2 years.

*Security-Based Swaps and Other Interagency Efforts*

With respect to our security-based swap regime, the Commission has finalized many, but not all, of the security-based swap rules mandated by Title VII of the Dodd–Frank Act. In the coming year, I anticipate that the Commission will continue with our efforts to lay out a coherent package of rules to finalize our statutory security-based swap rulemaking obligations.

As part of this effort, our staff has been actively engaged with our counterparts at the Commodity Futures Trading Commission (CFTC) to explore ways to further harmonize our respective security-based swap rules with the swap rules developed by the CFTC to increase effectiveness and reduce complexity and costs. I am pleased to note that earlier this year CFTC Chairman Giancarlo and I executed a memo-

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[32] "2018 Investment Company Fact Book", supra note 4, at ii.

[33] See Press Release 2018-103, "SEC Modernizes the Delivery of Fund Reports and Seeks Public Feedback on Improving Fund Disclosure" (June 5, 2018), available at *https://www.sec.gov/news/press-release/2018-103.*

[34] Id.

randum of understanding (MOU) between our two agencies.[35] The MOU explicitly acknowledges where we have shared regulatory interests, including but not limited to Title VII, and reconfirms our commitment to work together to facilitate efficient markets for the benefit of all market participants.

In addition to continued discussions with the CFTC regarding Title VII harmonization, the Commission and staff has engaged with our fellow financial regulators to address the key issues in our markets in a holistic, consistent manner. These efforts will continue, including efforts to simplify, tailor, and make more effective the Volcker Rule, cooperate on innovative issues like distributed ledger technology and digital assets and address emerging risks to the financial sector through the Financial Stability Oversight Council.

*Other Dodd–Frank Act Issues*

The Commission also has several other outstanding mandates from the Dodd–Frank Act. Earlier this year, I addressed how I plan to prioritize and tackle these remaining responsibilities.[36] Generally speaking, in addition to the Title VII regime, there are three categories of Dodd–Frank Act-mandated rules remaining:

1. Executive compensation rules for both public companies and SEC-regulated entities, for which, as a result of the complexity and scope of the existing executive compensation disclosure regime, as well as the nature of the mandates, I believe a serial approach is likely to be most efficient and best serve the SEC's mission;
2. Specialized disclosure rules, such as resource extraction disclosure, which pose additional challenges, including how the SEC can meet its obligations under the Administrative Procedure Act and, in the case of resource extraction, the Congressional Review Act; and
3. Mandates, some of which overlap with examples given above, for which market developments—including developments resulting from shareholder engagement—have, at least in part, mitigated some of the concerns that motivated the statutory requirements.[37] Our rulemaking priorities, as well as the rules themselves, should reflect these observable developments.

Several of these, including hedging disclosure and resource extraction disclosure, are on the Commission's near-term agenda. Overall, it is the SEC's obligation to complete the rules mandated by Congress in Dodd–Frank, and I intend to do so.

**Enforcement and Compliance**

*Pursuing Enforcement Matters That Are Meaningful to Main Street Investors*

The ongoing efforts made by Enforcement to deter misconduct and punish securities law violators are critical to safeguarding millions of investors and instilling confidence in the integrity of our markets. The nature and quality of the SEC's enforcement actions during the last year speak volumes to the hard work of the women and men of the agency. The efforts of the Enforcement staff over the past year have made our capital markets a safer place for investors to put their hard-earned money to work.

As noted by Enforcement's Co-Directors, Stephanie Avakian and Steven Peikin, in their Annual Report, our success is best judged both quantitatively and qualitatively and over various periods of time.[38] Relevant qualitative factors include, among other things, asking whether we are: bringing meaningful actions that target the most serious violations, pursuing individual sanctions in appropriate cases, obtaining punishments that deter unlawful conduct and returning money to harmed investors. Based on such an evaluation—and in my opinion by any measure—Enforcement has been successful. I can assure you that the Division will continue its vigorous enforcement of the Federal securities laws and hold bad actors accountable, whether on Main Street or Wall Street.

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[35] See Press Release 2018-114, "SEC and CFTC Announce Approval of New MOU" (June 28, 2018), available at *https://www.sec.gov/news/press-release/2018-114.*

[36] See "Opening Remarks at the Securities Regulation Institute" (Jan. 22, 2018), available at *https://www.sec.gov/news/speech/speech-clayton-012218.*

[37] For example, several companies already have made public their policies regarding compensation clawbacks. Some of these policies go beyond what would be required under Dodd–Frank. We have seen a few companies attempt to claw back compensation from their executives under these policies.

[38] See U.S. Sec. and Exch. Comm'n, Div. of Enforcement, "Annual Report: A Look Back at Fiscal Year 2018" (Nov. 2, 2018), available at *https://www.sec.gov/files/enforcement-annual-report-2018.pdf.*

I would like to highlight the work of four investor-oriented enforcement initiatives over the past year that show the Enforcement staff's commitment to investor protection: (1) the Retail Strategy Task Force, (2) the Cyber Unit, (3) the Share Class Selection Disclosure Initiative and (4) Enforcement's work in returning funds to harmed investors.

In September 2017, the SEC announced the formation of a Retail Strategy Task Force (RSTF), which has two primary objectives: (1) to develop data-driven, analytical strategies for identifying practices in the securities markets that harm retail investors and generating enforcement matters in these areas; and (2) to collaborate within and beyond the SEC on retail investor advocacy and outreach.[39] Each of these objectives directly impacts the lives of Main Street investors and involves collaboration between many divisions and offices. We anticipate that new data-driven approaches will yield significant efficiencies in case generation and resource allocation by targeting enforcement efforts where the risks to Main Street investors are the most significant. Although it has been operative for only a little over a year, the RSTF has already undertaken a number of lead-generation initiatives built on the use of data analytics (i.e., promptly searching for matters to investigate on behalf of retail investors).

Enforcement also in September 2017 announced the creation of a Cyber Unit to combat cyber-related threats. The Cyber Unit focuses the Division's resources and expertise on, among others things, hacking to obtain material, nonpublic information, violations involving distributed ledger technology and cyberintrusions.[40] Together with the FinHub, discussed above, the resources we have dedicated to the Cyber Unit's important work demonstrate the high priority that we continue to place on cyber-related issues affecting investors and our markets. In its first year, the Cyber Unit led investigations that resulted in several emergency actions to stop ongoing alleged frauds against retail investors that involved ICOs, as well as charges against a bitcoin-denominated platform and its operator for running an unregistered securities exchange and defrauding users of that exchange.

Beyond ICOs and digital assets, the Cyber Unit also led important investigations that resulted in SEC actions involving alleged cyber-related market manipulations, account takeovers and other cyber-related trading violations. The cases brought by the SEC in FY2018 included charges for allegedly scheming to manipulate the price of a stock by making a phony regulatory filing and for allegedly hacking into over 100 online customer brokerage accounts and making unauthorized trades to manipulate stock prices and profit from the artificial price movements.

Additionally, Enforcement expanded its efforts to identify advisers that did not disclose conflicts as a result of their receipt of compensation in the form of 12b-1 fees. Prior efforts by Enforcement and the Office of Compliance Inspections and Examinations (OCIE) suggested that many investment advisers were not disclosing conflicts of interest to their retail customers relating to the selection of more-expensive mutual fund share classes, which involved the receipt of 12b-1 fees, when cheaper alternatives were available. Enforcement announced a Share Class Selection Disclosure Initiative in February 2018, representing an innovative approach intended to facilitate the efficient return of money to harmed investors and prompt remediation of misconduct.[41]

Finally, in my view, protecting retail investors also means, whenever possible, putting money back in their pockets when they are harmed by violations of the Federal securities laws. In FY2017 and FY2018, the Commission returned $1.07 billion and $794 million to harmed investors, respectively. We remain committed to this important part of our work, and we expect to continue our efforts to return funds to victims this year as well.

The unanimous Supreme Court decision in Kokesh v. SEC, however, has impacted our ability to return funds fraudulently taken from Main Street investors. In Kokesh, the Supreme Court found our use of the disgorgement remedy operated as a penalty, which time limited the ability of the Commission to seek disgorgement of ill-gotten gains beyond a 5-year statute of limitations applicable to penalties.

I do not believe it is productive to debate the merits of the Kokesh decision. I agree that statutes of limitation serve many important functions in our legal system, and certain types of actions as well as penalties and certain other remedies

[39] See Press Release 2017-176, "SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors" (Sept. 25, 2017), available at *https://www.sec.gov/news/press-release/2017-176.*

[40] Id.

[41] See Press Release 2018-15, "SEC Launches Share Class Selection Disclosure Initiative To Encourage Self-Reporting and the Prompt Return of Funds to Investors" (Feb. 12, 2018), available at *https://www.sec.gov/news/press-release/2018-15.*

should have reasonable limitations periods. Civil and criminal authorities, including the SEC, should do everything in their power to bring appropriate actions swiftly, and, in our markets, particularly our public markets, the certainty brought by reasonable limitations periods has value for investors.

However, as I look across the scope of our actions, including most notably Ponzi schemes and affinity frauds, I am troubled by the substantial amount of losses that we may not be able to recover for retail investors. Said simply, if the fraud is well-concealed and stretches beyond the 5-year limitations period applicable to penalties, it is likely that we will not have the ability to recover funds invested by our retail investors more than 5 years ago. Allowing clever fraudsters to keep their ill-gotten gains at the expense of our Main Street investors—particularly those with fewer savings and more to lose—is inconsistent with basic fairness and undermines the confidence that our capital markets are fair, efficient and provide Americans with opportunities for a better future.

I welcome the opportunity to work with Congress to address this issue to ensure defrauded retail investors can get their investment dollars back. I believe that any such authority should be narrowly tailored to that end while being true to the principles embedded in statutes of limitations.

*Protecting Main Street Investors and Improving Investment Options by Promoting Compliance*

Earlier this year, our OCIE published its 2018 examination priorities, which reflected a continued focus on the SEC's commitment to protecting retail investors.[42] In particular, OCIE has looked closely at products and services offered to retail investors, the disclosures they receive about those investments and the financial services professionals who serve them. OCIE has also focused its attention on several other areas that present heightened risks, including: (1) compliance and risks in critical market infrastructure, such as exchanges and clearing agencies; (2) the continued growth of cryptocurrencies and ICOs; (3) cybersecurity; and (4) anti–money laundering programs.

OCIE conducts risk-based examinations of SEC-registered entities, including broker-dealers, investment advisers, investment companies, municipal advisors, national securities exchanges, clearing agencies, transfer agents, and FINRA, among others. During FY2018, OCIE conducted over 3,150 examinations, an overall increase of 11 percent from FY2017. This includes a 17 percent coverage ratio for investment advisers—which increased 13 percent from FY2017, even as the number of registered investment advisers increased by approximately 5 percent. OCIE also continued to leverage data analysis to identify potentially problematic activities and firms as well as to determine how best to scope the examinations of those activities and firms.

In conjunction with our examination activities, OCIE published a number of risk alerts to inform registered firms and investors of common compliance issues we observed.[43] This year, OCIE risk alerts addressed topics ranging from municipal advisor examinations to fee and expense compliance issues for investment advisers. These alerts sharpen the identification and correction of potentially deficient practices, maximize the impact of our examination program and better protect the interests of Main Street investors.

**Enterprise Risk and Cybersecurity**

Cybersecurity at the SEC continues to be a top priority. The SEC and other agencies are the frequent targets of attempts by threat actors who seek to penetrate our systems, and some of those actors may be backed by substantial resources. Recognizing the twin realities that electronic data systems are essential to our mission and no system can ever be entirely safe from a cyberintrusion, it is incumbent upon us to devote substantial resources and attention to cybersecurity, including the protection of PII. Over the past year, we have been focused on a number of areas for improvement, including with respect to IT governance and oversight, security controls, risk awareness related to sensitive data, incident response, and reliance on legacy systems—and much work remains to be done.

We are closely scrutinizing how we can reduce any potential exposure of PII contained in SEC systems, including EDGAR. In this regard, earlier this year, the Commission acted to eliminate the collection of social security numbers and dates

[42] U.S. Sec. and Exch. Comm'n, Off. of Compliance Inspections and Examinations, "2018 Nat'l Exam Program Examination Priorities" (Feb. 7, 2018), available at *https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf.*

[43] U.S. Sec. and Exch. Comm'n, Off. of Compliance Inspections and Examinations, "Risk Alerts", available at *https://www.sec.gov/ocie.*

of birth on a number of EDGAR forms where we concluded that the information was not necessary to our mission.[44] Moreover, return copies of test filings are no longer stored within the EDGAR system. The staff also continues to explore alternatives to the current approach, including the possibility of implementing a new electronic disclosure solution.

The agency has also focused closely on its cybersecurity risk governance structure. We now have a Chief Risk Officer who helps coordinate our risk management efforts across the agency. We have worked to promote a culture that emphasizes the importance of data security throughout our divisions and offices. The staff has also been engaging with outside experts to assess and improve our security controls. For example, on a technical level, these efforts include the deployment of enhanced security capabilities, additional penetration testing and code reviews, investment in new technologies and experienced cybersecurity personnel and acceleration of the transition of certain legacy information technology systems to modern platforms. We will also continue to coordinate and partner with both other Federal agencies to identify and mitigate risks to our information technology environment and assets.

We also look at cybersecurity from perspectives outside of our internal risk profile. From an issuer disclosure perspective, it is important that investors are sufficiently informed about the material cybersecurity risks and incidents affecting the companies in which they invest. Earlier this year, the Commission issued interpretive guidance to assist public companies in preparing these types of disclosures.[45] The guidance also emphasized the importance of disclosure controls and procedures that enable public companies to make accurate and timely disclosures about material cybersecurity events, as well as policies that protect against corporate insiders trading in advance of company disclosures of material cyberincidents. Further, the guidance expanded on prior staff guidance by addressing the board's oversight functions. Existing SEC rules require a company to disclose the extent of the board's role in risk oversight. The guidance noted that this disclosure should specifically include a discussion of the board's role in overseeing cybersecurity risk management, to the extent those risks are material. We are monitoring the market's response to our guidance.

From a market oversight perspective, we continue to prioritize cybersecurity in our examinations of market participants, including broker-dealers, investment advisers, and critical market infrastructure entities. In assessing how firms prepare for a cybersecurity threat, safeguard customer information and detect red flags for potential identity theft, for example, we have focused on areas including risk governance, access controls, data loss prevention, vendor management and training, among others. And given the interconnectedness of our markets, we will continue to work closely with our counterparts at other Federal financial regulatory agencies and the international community to discuss cybersecurity risks and coordinate potential response efforts.

From an enforcement perspective, as previously mentioned, our Cyber Unit is dedicated to targeting cyber-related misconduct in our markets, including failures by issuers to make material disclosures.[46] And finally, from an investor education perspective, our Office of Investor Education and Advocacy has worked hard to inform investors about cybersecurity hygiene and red flags of cyberfraud, in order to prevent investors from becoming victims in the first place.

**Increasing Engagement With Investors and Other Market Participants**

To effectively fulfill our responsibility to American investors and markets, it is essential that the SEC maintain an open line of communication with investors and other market participants. In FY2018, the SEC substantially increased its engagement with an array of market participants to help us improve our work and better focus our resources and efforts.

*Engagement With Main Street Investors*

Over the past year, SEC staff, my fellow Commissioners and I have engaged directly with Main Street investors from around the country through town halls, outreach tours, new digital tools, and other methods.

In a first-of-its-kind event, on June 13, 2018, the full Commission—all five Commissioners—and SEC leadership met with more than 400 members of the public

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[44] Amendments to Forms and Schedules To Remove Provision of Certain Personally Identifiable Information, Rel. Nos. 33–10486, 34–83097, IC–33077 (Apr. 24, 2018), available at *https://www.sec.gov/rules/final/2018/33-10486.pdf.*

[45] Press Release 2018-22, supra note 7.

[46] See Press Release 2018-71, "Altaba, Formerly Known as Yahoo!, Charged With Failing To Disclose Massive Cybersecurity Breach; Agrees To Pay $35 Million" (Apr. 24, 2018), available at *https://www.sec.gov/news/press-release/2018-71.*

during an investor town hall at the Georgia State University College of Law in Atlanta, Georgia. This event, organized by the SEC's Office of the Investor Advocate and the Atlanta Regional Office, marked the first time the full Commission met with Main Street investors outside of Washington, DC. During the main session of the town hall meeting, Commissioners provided a range of information to investors and answered questions from attendees. My fellow Commissioners, other SEC leaders and I also participated in break-out sessions with smaller groups of investors to hear their views on specific investor-oriented topics such as combating fraud. The following day, the agency's Investor Advisory Committee hosted a meeting at the same location, providing another opportunity for the public to engage with the Commission.

This event kicked off the SEC's "Tell Us" campaign, which included the additional roundtable meetings with retail investors I mentioned in Houston, Miami, Washington, DC, Philadelphia, Denver, and Baltimore. As mentioned, to complement these open discussions, the agency also developed a new "Tell Us" website and feedback flier, specifically designed for Main Street investors to provide feedback on the proposed disclosures in the standards of conduct proposals without needing to write a formal letter.

The SEC also conducted investor research and surveys in FY2018 in order to better understand how investors interact with markets. The agency conducted eight surveys and conducted four rounds of qualitative research involving focus groups and one-on-one interviews. In addition to these events, day in and day out the SEC staff engages with individual investors as well as with investor groups to promote awareness of the SEC's work and to solicit feedback.

*Empowering Main Street Investors Through Information and Education*

Across our seven investor town halls, one common theme—regardless of demographics and geography—was that investors wished they had known more about investing and our markets earlier in their lives. This sentiment was universal and deeply held and, while not entirely within the purview of the Commission to address, will continue to resonate with me during my tenure at the Commission.

The SEC promotes informed investment decision making through education initiatives aimed at providing Main Street investors with a better understanding of our capital markets and the opportunities and risks associated with the array of investment choices presented to them. Our Office of Investor Education and Advocacy spearheads these efforts and participation extends throughout our divisions and offices.

In FY2018, the SEC conducted over 150 in-person investor education events focused toward various segments of the population, including senior citizens, military personnel, younger investors and affinity groups. In addition to in-person education events, we developed informative, innovative, and accessible educational initiatives.

A primary focus of our educational efforts is preventing fraud. Unfortunately, it does not cost much to finance a scam, and it often is easy for bad actors to reach their targets, particularly over the internet. If investors know that, as well as some of the hallmarks of fraud and key questions to ask before they invest or provide personal information, they are less likely to become victims.

We use a variety of channels to deliver this message to investors. For example, we created a website to educate the public about frauds involving ICOs and just how easy it is for bad actors to engineer this type of fraud—Our HoweyCoins.com mock website promoted a fictional ICO.[47] The website was created in-house, very quickly and with few resources. It attracted over 100,000 people within its first week. We also published a variety of investor alerts and bulletins to warn Main Street investors about other possible schemes, including certain using celebrity endorsements, self-directed individual retirement accounts, the risks in using credit cards to purchase an investment and the potential harm resulting from sharing their personal contact information with online investment promoters.

We also continued to promote our national public service campaign, "Before You Invest, Investor.gov". This initiative encourages investors to research the background of their investment professional. Our experience demonstrates that working with unlicensed promoters who have a history of misconduct greatly increases the risk of fraud and losses. In May 2018, we supplemented this information service with a new online search tool, the SEC Action Lookup for Individuals—or SALI.[48] This tool enables investors to find out if the individual or firm he or she is dealing

[47] See Press Release 2018-88, "The SEC Has an Opportunity You Won't Want To Miss: Act Now!" (May 16, 2018), available at *https://www.sec.gov/news/press-release/2018-88.*

[48] See Press Release 2018-78, "SEC Launches Additional Investor Protection Search Tool" (May 2, 2018), available at *https://www.sec.gov/news/press-release/2018-78.*

with has been sanctioned as a result of SEC action, for both registered and unregistered individuals. SALI continues to be updated on an ongoing basis, making it an ever better resource for Main Street investors. We are encouraged by the fact that unique page views on Investor.gov increased by 45 percent compared to FY2017.

SEC regional offices also engaged in investor initiatives in their local communities. For example, the San Francisco Regional Office has conducted extensive outreach to California teachers through its Teacher Investment Outreach Initiative. This project seeks to help teachers make informed decisions on investment portfolio options, fees, and risk. Regional staff, many of whom have personal connections to the teaching community, created this initiative in response to learning about the limitations of the investment options offered to public school teachers under the defined contribution portion of their retirement plans.

*Engagement With Market Participants*

Our capital markets are far different today than they were a decade ago. They are increasingly global and highly data dependent. Investments are channeled through intermediaries and vehicles, such as mutual funds and ETFs, to a much greater extent. Our markets also are ever changing and the pace of that change has increased. It is essential that the SEC understand the markets of today and continually prepare for and adjust to market developments. As a result, engagement with those who participate in our markets extensively, including public and private companies, institutional investors, broker-dealers and auditors, as well as those who monitor and oversee markets, including U.S. and foreign authorities, elected officials and academics, is essential.

In 2018, the SEC held numerous public roundtables at which the Commission and SEC staff engaged in an open forum with market participants on some of the most salient issues affecting our markets today.

- In April, the Division of Trading and Markets hosted a roundtable on market structure for thinly traded securities, both equities and exchange-traded products. The panelists discussed the challenges faced by participants in the market for thinly traded exchange-listed securities, including small and medium-sized companies looking to enter our public markets, and potential actions to address those concerns. The staff is analyzing a number of the suggestions and comments made at that roundtable, and, more generally, is considering ways to improve secondary market liquidity for smaller companies.
- In September, the Division of Trading and Markets hosted a roundtable on regulatory approaches to combating retail investor fraud. At this event, a broad range of market participants, regulators, and industry experts shared their views on potential steps that might be taken to enhance the ability of regulators, broker-dealers, and others to combat retail investor fraud.
- In October, the Division of Trading and Markets hosted a roundtable on market data and market access. At this event, a diverse group of panelists, representative of a broad spectrum of perspectives and views—including those of exchanges, market participants and various industry experts—discussed the current landscape of market data products and market access services. The panelists also provided views on potential steps to improve market data products and access services.
- In November, the Divisions of Corporation Finance and Investment Management held a roundtable, discussed above, focusing on key aspects of the U.S. proxy system.

In addition to events of this type, the leadership in our divisions and offices, as well as our dedicated staff, is open to hearing from and meeting with investors and market participants on areas where our markets are not working as they should or can be improved—particularly as it relates to our long-term Main Street investors.

**Emerging Market Risks and Trends**

I want to briefly discuss two risks, in addition to cybersecurity risks, we are monitoring closely: the impact to reporting companies of the United Kingdom's exit from the European Union, or "Brexit"; and the transition away from the London Interbank Offered Rate, or "LIBOR," as a reference rate for financial contracts. While these are not the only areas of market risk that the Commission is monitoring, their impacts are likely significant for American investors.

*Brexit*

First, the potential effects of Brexit on U.S. investors and securities markets, and on global financial markets more broadly, is a matter of increased focus for me and many of my colleagues at the SEC. To be direct, I am concerned that:

1. The potential adverse effects of Brexit are not well understood and, in the areas where they are understood, are underestimated.[49]
2. The actual effects of Brexit will depend on many factors, some of which may prove to be beyond the control of the U.K. and EU authorities.
3. Our markets, at many levels—from multinational companies, to market infrastructure, to investment products and services—are international, and the effects of Brexit will be international, including on U.S. markets and our Main Street investors.
4. The actual effects of Brexit are likely to manifest themselves in advance of implementation dates and, based on corporate disclosures, some of those effects are upon us.
5. The actual effects of Brexit will depend in large part on the ability of U.K., EU, and EU member State officials to provide a path forward that allows for adjustment without undue uncertainty, disruption, or cost. That is a tall order that I believe requires: (a) a broad understanding of market interdependencies—knowledge that goes well beyond the labor and financial markets; (b) foresight—people and firms will act in their own interests and the interests of their shareholders; and (c) flexibility—miscalculations are inevitable and will need to be addressed promptly. More generally, limiting the adverse effects of Brexit requires a willingness of governmental authorities to look beyond potential immediate, local economic and other opportunities provided by a blunt transition and pursue a course that focuses on broad, long-term economic performance and stability. While many involved in the Brexit process agree with this perspective, and some important steps have been taken,[50] I do not yet see wide acceptance of this principle.

To be clear, these are my personal views, but it is appropriate to share them as they are reflective of the SEC's approach to Brexit. The SEC's responsibility is primarily related to the effects of Brexit on our capital markets. For example, I have directed the staff to focus on the disclosures companies make about Brexit and the functioning of our market utilities and other infrastructure.

We have seen a wide range of disclosures, even within the same industry. Some companies have fairly detailed disclosures about how Brexit may impact them, while others simply state that Brexit presents a risk. I would like to see companies providing more robust disclosure about how management is considering Brexit and the impact it may have on the company and its operations.

With regard to market utilities and infrastructure, following the 2016 Brexit vote, SEC staff commenced discussions with other U.S. financial authorities, with our U.K. and EU counterparts, and with market participants, all with an eye toward identifying and planning for potential Brexit-related impacts on U.S. investors and markets. These discussions are ongoing, and I expect their pace to increase.

*Transition Away From LIBOR*

The second risk that I want to highlight relates to the transition away from LIBOR as a benchmark reference for short-term interest rates. LIBOR is used extensively in the U.S. and globally as a benchmark for various commercial and financial contracts, including interest rate swaps and other derivatives, as well as floating-rate mortgages and corporate debt. It is likely, though, that the banks currently reporting information used to set LIBOR will stop doing so after 2021, when their commitment to reporting information ends. The Federal Reserve estimates that in the cash and derivatives markets, there are approximately $200 trillion in notional transactions referencing U.S. Dollar LIBOR and that more than $35 trillion will not mature by the end of 2021.[51]

The Alternative Reference Rate Committee (Committee)—a group convened by the Federal Reserve that includes major market participants, and on which SEC staff and other regulators participate—has proposed an alternative rate to replace U.S.

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[49] Chris Giles and Sylvia Pfeifer, "BoE Sounds Alarm Over No-Deal Brexit Planning", *Fin. Times*, Nov. 29, 2018 (noting that the Bank of England's Governor Mark Carney says that less than half of the businesses in the U.K. are not prepared for the risk of a no-deal Brexit).

[50] European Commission Communication, "Preparing for the Withdrawal of the United Kingdom From the European Union on 30 March 2019: A Contingency Action Plan (Nov. 13, 2018), available at *https://ec.europa.eu/info/publications/communication-preparing-withdrawal-united-kingdom-european-union-30-march-2019-contingency-action-plan-13-11-2018_en.*

[51] These estimates are as of the end of 2016. Of the $200 trillion in notional exposure, approximately 95 percent relates to derivatives products. Over $8 trillion of exposure relates to business loans, consumer loans, floating/variable rate notes, and securitizations. See "Second Report of the Alternative Reference Rates Committee" (March 2018), available at *https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.com.*

Dollar LIBOR—the Secured Overnight Financing Rate, or "SOFR." The Committee has identified benefits to using SOFR as an alternative to LIBOR. For example, SOFR is based on direct observable transactions and based on a market with very deep liquidity, reflecting overnight Treasury repurchase agreement transactions with daily volumes regularly in excess of $700 billion.

A significant risk for many market participants—whether public companies who have floating-rate obligations tied to LIBOR, or broker-dealers, investment companies or investment advisers that have exposure to LIBOR—is how to manage the transition from LIBOR to a new rate such as SOFR, particularly with respect to those existing contracts that will still be outstanding at the end of 2021. Accordingly, although this is a risk that we are monitoring with our colleagues at the Federal Reserve, Treasury Department, and other financial regulators, it is important that market participants plan and act appropriately.

For example, if a market participant manages a portfolio of floating rate notes based on LIBOR, what happens to the interest rates of these instruments if LIBOR stops being published? What does the documentation provide? Does fallback language exist and, if it exists, does it work correctly in such a situation? If not, will consents be needed to amend the documentation? Consents can be difficult and costly to obtain, with cost and difficulty generally correlated with uncertainty.

In the area of uncertainties, we continue to monitor risks related to the differences in the structure of SOFR and LIBOR. SOFR is an overnight rate, and more work needs to be done to develop a SOFR term structure that will facilitate the transition from term-based LIBOR rates. [52]

To be clear, a lot of progress has been made to facilitate the transition from LIBOR to SOFR. We have started to see more SOFR-based debt issuances, and we have seen promising developments in the SOFR swaps and futures markets. [53] But I want to make sure that market participants are aware of the need to plan for this important transition, as a lot of the work will fall on them.

**Conclusion**

Thank you for the opportunity to testify today and for the Committee's continued support of the SEC, its mission and its people. I look forward to working with each of you to advance our mission to the benefit of our capital markets and our Main Street investors.

[52] Relying on daily compounding over a 3-month period, for example, may result in issuers not having certainty about the size of their interest payment until the end of the period. Also, SOFR does not correspond one-to-one with LIBOR; LIBOR incorporates a credit risk premium whereas SOFR is a secured rate. In a transition, a methodology needs to be developed to determine fair spreads between the two rates.

[53] For example, trading in SOFR futures in the U.S. commenced in May. See "CME Group Announces First Trades of New SOFR Futures" (May 8, 2018), available at *https://www.cmegroup.com/media-room/press-releases/2018/5/08/cme__group__announcesfirsttradesofnewsofrfutures.html.* The market's first-ever SOFR-linked debt securities were issued in July, and since then additional issuances have occurred. See "Fannie Mae Pioneers Market's First-Ever Secured Overnight Financing Rate (SOFR) Securities" (July 26, 2018), available at *http://www.fanniemae.com/portal/media/financial-news/2018/fannie-mae-pioneers-sofr-securities-6736.html.* In addition, central counterparties have commenced clearing of SOFR swaps. See "LCH Clears First SOFR Swaps" (July 18, 2018), available at *https://www.lch.com/resources/news/lch-clears-first-sofr-swaps.* See also "CME Group Announces First OTC SOFR Swaps Cleared" (Oct. 9, 2018), available at *https://www.cmegroup.com/media-room/press-releases/2018/10/09/cme__group__announcesfirstotcsofrswapscleared.html.*

**Appendix A**

**FY 2018 One-Year Agenda (Published in the Fall of 2017)[54]**

**(Strikeouts Reflect Completion of Indicated Stage of Rulemaking)**

| Agency | Agenda Stage of Rulemaking | Title | RIN |
|---|---|---|---|
| SEC | Proposed Rule Stage | Amendments to Financial Disclosures About Acquired Businesses[55] | 3235-AL77 |
| SEC | Proposed Rule Stage | Guide 3 Bank Holding Company Disclosure[56] | 3235-AL79 |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Amendments to Implement FAST Act Report~~ | ~~3235-AM00~~ |
| SEC | Proposed Rule Stage | Disclosure of Payments by Resource Extraction Issuers[57] | 3235-AM06 |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Amendments to the Financial Disclosures for Registered Debt Security Offerings~~ | ~~3235-AM12~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Exchange-Traded Funds~~ | ~~3235-AJ60~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Enhanced Disclosure for Separate Accounts Registered as Unit Investment Trusts and Offering Variable Annuities~~ | ~~3235-AK60~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Personalized Investment Advice Standard of Conduct~~ | ~~3235-AL27~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Amendments to Securities Act Rules Under the Fair Access to Investment Research Act of 2017~~ | ~~3235-AM24~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Transaction Fee Pilot~~ | ~~3235-AM04~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Prohibitions and Restrictions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds~~ | ~~3235-AM10~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Harmonization of Certain Title VII Rules~~[58] | ~~3235-AM13~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Auditor Independence With Respect to Loans or Debtor-Creditor Relationships~~ | ~~3235-AM01~~ |

[54] The list in Appendix A reflects the near-term initiatives identified in the fall of 2017 for completion by the fall of 2018.

[55] I estimate completion of this initiative by April 30, 2019.

[56] I estimate completion of this initiative by April 30, 2019.

[57] I estimate completion of this initiative by September 30, 2019.

[58] In October 2018, the Commission issued a statement on certain provisions of business conduct standards for security-based swap dealers and major security-based swap participants, which was the culmination of outreach by Commission staff and their counterparts at the U.S. Commodity Futures Trading Commission, consistent with the agencies' shared commitment to achieving greater harmonization of the Title VII rules. Other harmonization initiatives are ongoing.

| | | | |
|---|---|---|---|
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Proposed Amendment to Rule for Nationally Recognized Statistical Rating Organizations~~ | ~~3235-AM05~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Amendments to the Commission's Whistleblower Program Rules~~ | ~~3235-AM11~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Treatment of Certain Communications Involving Security-Based Swaps That May be Purchased Only by Eligible Contract Participants~~ | ~~3235-AL41~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to Interactive Data (XBRL) Program~~ | ~~3235-AL59~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Modernization of Property Disclosures for Mining Registrants~~ | ~~3235-AL81~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Disclosure Update and Simplification~~ | ~~3235-AL82~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to Smaller Reporting Company Definition~~ | ~~3235-AL90~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Investment Company Reporting Modernization; Option for Website Transmission of Shareholder Reports~~ | ~~3235-AL42~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to Investment Advisers Act Rules to Conform to the FAST Act~~ | ~~3235-AM02~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Regulation of NMS Stock Alternative Trading Systems~~ | ~~3235-AL66~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Disclosure of Order Handling Information~~ | ~~3235-AL67~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Covered Securities Pursuant to Section 18 of the Securities Act of 1933~~ | ~~3235-AM07~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to Municipal Securities Rules~~ | ~~3235-~~ |

**Appendix B**

**FY 2019 One-Year Agenda (Published in the Spring and Fall of 2018)[59]**

**(Strikeouts Reflect Completion of Indicated Stage of Rulemaking)**

| Agency | Agenda Stage of Rulemaking | Title | RIN |
|---|---|---|---|
| ~~SEC~~ | ~~Prerule Stage~~ | ~~Fund Retail Investor Experience and Disclosure Request for Comment~~ | ~~3235-AM28~~ |
| SEC | Prerule Stage | Harmonization of Exempt Offerings | 3235-AM27 |
| SEC | Prerule Stage | Earnings Releases/Quarterly Reports | 3235-AM40 |
| SEC | Proposed Rule Stage | Modernization of Investment Company Disclosure | 3235-AM28 |
| SEC | Proposed Rule Stage | Amendments to Financial Disclosures About Acquired Businesses | 3235-AL77 |
| SEC | Proposed Rule Stage | Business, Financial and Management Disclosure Required By Regulation S-K | 3235-AL78 |
| SEC | Proposed Rule Stage | Guide 3 Bank Holding Company Disclosure | 3235-AL79 |
| SEC | Proposed Rule Stage | Filing Fee Processing | 3235-AL96 |
| SEC | Proposed Rule Stage | Disclosure of Payments by Resource Extraction Issuers | 3235-AM06 |
| SEC | Proposed Rule Stage | Extending the Testing the Waters Provision to Non-Emerging Growth Companies | 3235-AM23 |
| SEC | Proposed Rule Stage | Accelerated Filer Definition | 3235-AM41 |
| SEC | Proposed Rule Stage | Regulation A | 3235-AM42 |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Exchange-Traded Funds~~ | ~~3235-AJ60~~ |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Enhanced Disclosure for Separate Accounts Registered as Unit Investment Trusts and Offering Variable Insurance Products~~ | ~~3235-AK60~~ |
| SEC | Proposed Rule Stage | Use of Derivatives by Registered Investment Companies and Business Development Companies | 3235-AL60 |
| SEC | Proposed Rule Stage | Amendments to the Marketing Rules Under the Advisers Act | 3235-AM08 |

[59] The list in Appendix B reflects a combination of the near-term initiatives identified in the spring of 2018 and the fall of 2018 for completion by April and October 2019, respectively.

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|---|---|---|---|
| SEC | Proposed Rule Stage | Fund of Funds Arrangements | 3235-AM29 |
| SEC | Proposed Rule Stage | Offering Reform for Business Development Companies under the Small Business Credit Availability Act and Closed-end Funds under the Economic Growth, Regulatory Relief, and Consumer Protection Act | 3235-AM31 |
| SEC | Proposed Rule Stage | Transfer Agents | 3235-AL55 |
| SEC | Proposed Rule Stage | Harmonization of Certain Title VII Rules | 3235-AM13 |
| SEC | Proposed Rule Stage | Volcker Rule Community Bank Relief and Removing Naming Restrictions | 3235-AM43 |
| ~~SEC~~ | ~~Proposed Rule Stage~~ | ~~Investment Company Liquidity Disclosure~~ | ~~3235-AM30~~ |
| SEC | Final Rule Stage | Disclosure of Hedging by Employees, Officers and Directors | 3235-AL49 |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Modernization of Property Disclosures for Mining Registrants~~ | ~~3235-AL81~~ |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Disclosure Update and Simplification~~ | ~~3235-AL82~~ |
| SEC | Final Rule Stage | Amendments to Implement FAST Act Report | 3235-AM00 |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to the Commission's Freedom of Information Act Regulations~~ | ~~3235-AM25~~ |
| SEC | Final Rule Stage | Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures to Retail Communications and Restrictions on the use of Certain Names or Titles | 3235-AL27 |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to Securities Act Rules Under the Fair Access to Investment Research Act of 2017~~ | ~~3235-AM24~~ |
| SEC | Final Rule Stage | Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation | 3235-AM36 |
| SEC | Final Rule Stage | Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Capital Requirements for Broker-Dealers | 3235-AL12 |
| SEC | Final Rule Stage | Reporting and Recordkeeping Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants | 3235-AL45 |
| SEC | Final Rule Stage | Definition of "Covered Clearing Agency" | 3235-AL48 |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Disclosure of Order Handling Information~~ | ~~3235-~~ |

| | | | |
|---|---|---|---|
| | | | ~~AL67~~ |
| SEC | Final Rule Stage | Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps | 3235-AL76 |
| SEC | Final Rule Stage | Transaction Fee Pilot | 3235-AM04 |
| SEC | Final Rule Stage | Prohibitions and Restrictions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds | 3235-AM10 |
| SEC | Final Rule Stage | Regulation Best Interest | 3235-AM35 |
| ~~SEC~~ | ~~Final Rule Stage~~ | ~~Amendments to Municipal Securities Disclosure~~ | ~~3235-AL97~~ |
| SEC | Final Rule Stage | Auditor Independence With Respect to Loans or Debtor-Creditor Relationships | 3235-AM01 |
| SEC | Final Rule Stage | Amendments to the Commission's Whistleblower Program Rules | 3235-AM11 |

**Appendix C**

U.S. Securities and Exchange Commission, Division of Enforcement Annual Report, 2018

U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, 2018 National Exam Program Examination Priorities

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM JAY CLAYTON**

**Q.1.** The Consolidated Audit Trail (CAT) plan processor, Thesys CAT LLC, announced last month the initiation of reporting by exchanges and FINRA of order and transaction data. As Trading and Markets Division Director Redfearn noted, the Master Plan first phase launch on November 15, 2018, reflects a 1-year delay from the original plan.

Thesys CAT's press release noted that it "continues to work to provide the capabilities required for the first reporting phase," and that it expects to complete full functionality on or before March 31, 2019.

Given that each successive phase of the CAT was delayed by at least one year, please explain the significance of the delay in achieving full functionality described by Thesys CAT and whether following phases will further delayed.

**A.1.** The SROs have missed numerous deadlines relating to the CAT required in the CAT NMS Plan, as well as various milestones set by the SROs and communicated to the Commission. This failure to meet these deadlines and milestones has become a clear pattern over the course of the CAT's development.

As background, shortly after my arrival at the Commission in May 2017, I was informed by the CEO of Thesys, the firm engaged by the SROs to build and deliver the CAT, that they were on track towards launching the CAT for SRO reporting on November 15, 2017. The SROs were aware of this information. Similarly, until late summer 2017, the Commission was led to believe that the November 15, 2017, deadline for SRO reporting to the CAT was achievable. This information proved to be incorrect.

In the fall of 2017, when it was readily apparent that Thesys and the SROs would fail to deliver the CAT as required, I asked for a revised time table and work plan. The SROs developed a time table and work plan, which contained a number of milestones, including SRO reporting to the CAT by November 15, 2018, a year past the deadline in the CAT NMS Plan. The SROs subsequently informed Commission staff that certain functionalities that were supposed to be part of that first phase of reporting would not be available until March 31, 2019. Shortly after that, it became clear that Phase 1 would not be complete in March since the SROs announced that they are transitioning away from Thesys and have selected FINRA to be the new plan processor. The SROs are currently revising their master plan.

Further, the SROs have not yet begun collecting data from industry members. I expect the SROs to work diligently to ensure that industry member reporting begins as soon as possible. I have asked the staff to explore potential amendments to the CAT NMS Plan in light these significant delays. Compliance with the CAT NMS Plan is the legal obligation of the SROs. Separately, I have hired Manisha Kimmel, who has a wealth of experience and expertise in audit trail reporting, as a Senior Policy Advisor for Regulatory Reporting. In this capacity, she will coordinate the Commission's oversight of the SROs' creation and implementation of the CAT.

**Q.2.** In your testimony, you discussed the standards for investment advisers and brokers and the Regulation Best Interest proposal.

Specifically, you stated that under current standards the "baseline adviser standard is the adviser cannot put their interests ahead of the client's interests". You added that, "with informed consent they can cut back on that standard. That is not well understood."

Please explain what constitutes informed consent in such a relationship?

How has the SEC evaluated situations where informed consent was given to allow reducing the adviser's standard of care?

Also, what has the SEC done, or what can it do, to make sure the potential of a lower standard is better understood?

**A.2.** In the proposed Commission interpretation of the standard of conduct for investment advisers, the Commission stated that the client cannot waive the Federal fiduciary duty. Although the investment adviser fiduciary duty is not waivable, it is well established that the terms of the investment adviser relationship—and therefore the scope of the duty in that relationship—may be shaped by disclosure and informed consent. Our proposed interpretation provides further details on this widely accepted process—that disclosures regarding the scope and terms of the relationship should be sufficiently specific so that a client is able to decide whether to provide informed consent.

This process of scoping the terms of the advisory relationship, which is regularly effectuated through account agreements and Form ADV, is widely accepted in the industry and provides for arrangements such as limited account services and certain third-party compensation to the investment adviser. Our proposed relationship summary, if adopted, will increase retail investor awareness of the material terms of common arrangements with investment professionals, and the fees and conflicts of interest that apply. I have been surprised that, with all of the public dialogue about the fiduciary duty, there is not more acknowledgment of the fact that the application of that duty can and does vary depending on the terms of the agreement between the client and adviser. The proposed requirements of the relationship summary would highlight the nature of an advisory relationship and the scope of services that the investment adviser provides.

We have received a lot of thoughtful comments on the proposed interpretation of the standard of conduct for investment advisers and Commission staff is reviewing comments carefully, engaging further with commenters and thinking about what next steps it might recommend to the Commission.

**Q.3.** The Conflict of Interest Obligations in the Regulation Best Interest proposal requires that: a broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations.

A broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

Please provide examples of "material conflicts of interest" that are distinguishable from "material conflicts of interest arising from financial incentives".

Also, please provide examples of how material conflicts of interest arising from financial incentives can be mitigated.

**A.3.** Proposed Regulation Best Interest reflected our concern that disclosure alone may not be enough when a conflict involves a financial incentive.

Our proposal would require broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest related to financial incentives, in addition to the proposed requirement to establish, maintain and enforce written policies and procedures reasonably designed to identify and at a minimum disclose or eliminate general material conflicts of interest.

As a practical matter, the vast majority of broker-dealer conflicts would likely be "financial incentives," and the proposed conflict and disclosure obligations would require broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to, at a minimum, mitigate and disclose those conflicts. The proposal defined financial incentives broadly to cover a wide variety of compensation practices established by the broker-dealer, including quotas, bonuses, sales contests, special awards, differential, or special compensation, as well as the sale of proprietary products and effecting transactions in a principal capacity. So, for example, if a broker-dealer provides incentives to its representatives to favor one type of large cap mutual fund over another, under the proposal, the broker-dealer would need to mitigate that conflict to minimize the potential for the conflict to taint the recommendation.

The proposal aimed to provide broker-dealers flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures, based on each firm's circumstances. We gave examples of potential mitigation measures in the release, such as minimizing compensation incentives to favor certain products over others and enhanced supervision of recommendations involving higher compensating products.

The proposal also acknowledged that some material conflicts may be too difficult to mitigate and may be more appropriately avoided entirely or for certain categories of retail customers. For example: payment or receipt of certain noncash compensation that presents conflicts of interest for broker-dealers, such as certain sales contests, trips, prizes, and other similar bonuses.

The proposal requested comment on whether the Commission should prohibit receipt of certain noncash compensation. We have received a lot of thoughtful comments on this issue and Commission staff is reviewing comments carefully, engaging further with commenters and developing a recommendation for the Commission.

I believe the mitigation requirement is a very significant step forward in aligning the broker-dealer standard of conduct with retail customers' reasonable expectations. Investors can generally understand a commission-based model and, if the commission structure is reasonable and understandable, existing supervisory requirements supplemented with disclosure would be sufficient. However, I do not believe a reasonable investor would expect that disclosure alone would be enough to effectively reduce the impact of certain sales incentives on a broker-dealer's recommendations and, therefore, I believe those incentives would need to be mitigated or eliminated, which is consistent with what a reasonable retail investor would expect.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM JAY CLAYTON**

**Q.1.** I would like to elaborate on your recent efforts to increase cybersecurity at the SEC, which you mentioned briefly in your opening statement. On September 20th you announced the establishment of a senior-level cybersecurity working group and the creation of a Chief Risk Officer position.

Can you provide a detailed update on these efforts?

Who participates in the working group and when are recommendations expected?

**A.1.** The SEC has appointed a Chief Risk Officer (CRO), Mr. Gabriel Benincasa, whose background includes significant senior leadership experience in enterprise risk and compliance in the financial sector. The SEC's Cybersecurity Working Group's membership includes senior leadership in the agency's divisions and major offices, the Chief Operating Officer, Chief Information Officer, Chief Information Security Officer, and the Cybersecurity Adviser to the Chairman. The purpose of the group is to coordinate information sharing, risk and threat monitoring, incident response and other cross-divisional and inter-agency efforts. During the past year, the group coordinated, among other things, an update to the agency's procedures for handling cybersecurity incidents and participated in tabletop exercises to train staff on the new procedures.

**Q.2.** In your submitted testimony you also indicate that you are contracting with outside entities to perform penetration testing.

How were vendors selected for penetration testing and how often are comprehensive source code reviews being conducted?

**A.2.** The SEC obtains penetration testing services from cybersecurity experts at the Department of Homeland Security (DHS) and the private sector, which allow us to periodically assess and continuously improve the security of our network and information systems. The agency's agreement with DHS enables us to receive operational and technical assistance at no cost. The agency through our Office of Acquisitions has also leveraged government-wide acquisition contracts to obtain penetration testing services from multiple third-party entities, who are selected based on their ability to provide thorough testing services. These outside vendors are also required to meet certain prescriptive personnel security requirements. With respect to code reviews, the SEC is utilizing such reviews to assist in our efforts to uplift our EDGAR system as well as other critical agency systems. To facilitate additional code review, the SEC's Office of Information Technology has acquired and is currently integrating the use of newly acquired code review tools into the agency's application development process. We expect these tools to be implemented during 2019.

**Q.3.** Within the SEC's Division of Enforcement, can you characterize how much enforcement activity takes place within the newly created Cyber Unit?

Of the 754 enforcement actions and $3.8 billion in penalties in 2017, how much of this activity was cyber-related?

How much was related to fraud against retail investors of ICOs?

How much was related to failures by issuers to make material disclosures?

How many employees are staffing this unit and how aggressively are they targeting fraud?

**A.3.** The Division of Enforcement's Cyber Unit centralizes, leverages and builds upon the significant expertise that the SEC's Enforcement Division has developed on cyber-related issues over the past several years. Because cyber is a growing threat to the markets, this area benefits from specialization, formalization and enhanced coordination. The Cyber Unit is staffed by 30 personnel nationwide, and each of the SEC's regional offices has a liaison to the Unit who serves as a resource to non-Unit personnel conducting cyber-related investigations and litigation. The Cyber Unit focuses its efforts on the following key areas:

- Market manipulation schemes involving false information spread through electronic and social media;
- Hacking to obtain material nonpublic information and trading on that information;
- Violations involving distributed ledger technology and initial coin offerings;
- Misconduct perpetrated using the dark web;
- Intrusions into retail brokerage accounts; and
- Cyber-related threats to trading platforms and other critical market infrastructure.

Since the formation of the Cyber Unit at the end of FY2017, the Division's focus on cyber-related misconduct has steadily increased. In FY2017 and FY2018, the Commission brought a combined 26 standalone cases, including cases involving ICOs and digital assets. So far, more than $120 million has been ordered in 10 of the 26 cases. The other 16 cases are still in litigation. At the end of FY2018, the Division had more than 225 cyber-related investigations ongoing. These cases and ongoing investigations are being handled by both Unit and non-Unit personnel. Thanks to the work of the Cyber Unit and other staff focusing on these issues, in FY2018 the SEC's enforcement efforts impacted a number of areas where the Federal securities laws intersect with cyberissues.

Cyber Unit personnel, as well as other staff of the Division of Enforcement who are conducting cyber-related investigations and litigation, are aggressively targeting fraud and other types of misconduct in this space. For instance, last year, the SEC brought charges against a second defendant in connection with a scheme to allegedly manipulate the price of Fitbit securities through false regulatory filings.[1] The SEC also charged a day trader with allegedly participating in a scheme to access the brokerage accounts of more than 100 unwitting victims and make unauthorized trades to artificially inflate the stock prices of various companies.[2] And, at the end of FY2018, the SEC brought settled proceedings against an Iowa-based broker-dealer and investment adviser related to its failures in cybersecurity policies and procedures surrounding a cyberintrusion that compromised personal information of thousands of its customers, in violation of Regulations S-P and S-ID. This was the SEC's first action charging violations of Regulation S-ID, known as the Identity Theft Red Flags Rule, which is designed to protect customers from the risk of identity theft.[3]

The Division, including its Cyber Unit, is focused on issues related to ICOs and digital assets. Many of the cases that have resulted from this focus have involved allegations of fraud. Since the Commission's publication of The DAO 21(a) Report in FY2017,[4] the Commission has brought 19 actions involving ICOs, 10 of which involved allegations of fraud, and has utilized its trading suspension authority to suspend trading in the stock of over a dozen publicly traded issuers because of questions concerning, among other things, the accuracy of assertions regarding their investments in ICOs and operation of cryptocurrency platforms.[5]

Aside from ICOs, fulsome disclosure of cyber-related issues is a priority. In FY2018, the Commission brought its first enforcement action involving charges against a public company for failing to properly inform investors about what was then the largest known cyberintrusion in history. The SEC's order found that Yahoo! failed to properly assess the scope, business impact, or legal implications of the breach, including whether, when, and how the breach should have been disclosed. To settle the action, the entity formerly known as Yahoo! agreed to pay a $35 million penalty.[6]

**Q.4.** There is no existing requirement in securities law that explicitly refers to cyber risks, and SEC policy regarding the necessary disclosure of breaches on the part of public companies is murky at best. Last month, for example, Marriott International disclosed a data breach to the SEC that may have exposed the personal information of up to 500 million guests and that has been going on undetected since 2014.

[1] Press Release 2018-130, "SEC Files Additional Charges in Fitbit Stock Manipulation Scheme" (July 11, 2018), available at *https://www.sec.gov/news/press-release/2018-130*. The first defendant was charged in 2017. Press Release 2017-107, "SEC Charges Fake Filer With Manipulating Fitbit Stock" (May 19, 2017), available at *https://www.sec.gov/news/press-release/2017-107*.

[2] Press Release 2017-202, "Day Trader Charged in Brokerage Account Takeover Scheme" (Oct. 30, 2017), available at *https://www.sec.gov/news/press-release/2017-202*.

[3] Press Release 2018-213, "SEC Charges Firm With Deficient Cybersecurity Procedures" (Sept. 26, 2018), available at *https://www.sec.gov/news/press-release/2018-213*.

[4] Press Release 2017-131, "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities; U.S. Securities Laws May Apply to Offers, Sales, and Trading of Interests in Virtual Organizations" (July 25, 2017), available at *https://www.sec.gov/news/press-release/2017-131*.

[5] A full list of the ICO- and cyber-related actions that the Commission has brought is catalogued on Sec.gov. U.S. Sec. and Exch. Comm'n, *Cyber Enforcement Actions*, *https://www.sec.gov/spotlight/cybersecurity-enforcement-actions*.

[6] Press Release 2018-71, "Altaba, Formerly Known as Yahoo!, Charged With Failing To Disclose Massive Cybersecurity Breach; Agrees To Pay $35 Million" (Apt. 24, 2018), available at *https://www.sec.gov/news/press-release/2018-71*.

How can this process be improved, rather than considering whether companies are properly disclosing “material information” on a one-off basis?

**A.4.** In February 2018, the Commission issued interpretative guidance to assist public companies in preparing disclosures concerning material cybersecurity risks and incidents. The guidance highlights the disclosure requirements under the Federal securities laws that public companies must evaluate when considering their disclosure obligations with respect to cybersecurity risks and incidents.

The existing disclosure framework seeks to elicit disclosure of cybersecurity incidents and risks that are material to investors in a timely fashion. Generally, information is material if the information would be viewed by the reasonable investor as important in making an investment decision or as having significantly altered the total mix of information available. As the cybersecurity landscape and the risks associated with it continue to evolve, the Commission and staff will continue to evaluate the guidance in light of such disclosures, the cybersecurity environment, and its impacts on issuers and the capital markets generally and consider feedback about whether any further guidance or rules are needed.

**Q.5.** What oversight authority does the SEC have when a digital asset is not considered a security, or when there is dispute about whether an asset meets the definition of a security or commodity?

**A.5.** The SEC has jurisdiction over securities, securities market participants and securities-related conduct. Even if a digital asset is not a security, the SEC could have jurisdiction over a particular activity if a digital asset is used in connection with some securities-related conduct or product. For example, even when a digital asset is not itself a security, the SEC has jurisdiction over a security that references that digital asset, such as a structured note referencing a digital asset. Whether a token or a digital asset called a cryptocurrency is a security is determined by applying long established law, including the Howey test, to the facts and circumstances of the particular instrument being sold.

As part of the legal framework regulating financial instruments, the Commodity Exchange Act and the Federal securities laws contain provisions that determine which regulatory scheme applies to different financial instruments. As a general matter, the SEC has jurisdiction over derivatives (such as options) based on securities. The Commodity Futures Trading Commission (CFTC) has jurisdiction over swaps, but the SEC has jurisdiction over swaps based on a single security or narrow-based security index and has antifraud authority over swaps based on a broad-based security index. The CFTC and the SEC have joint jurisdiction over security-futures and share jurisdiction over mixed swaps. For example, the SEC and the CFTC would share jurisdiction over a future on a digital asset that is a security and the SEC would have jurisdiction over an option or a swap on a digital asset that is a security.

Staff of the CFTC and SEC coordinate and have frequent discussions about novel products, including in the digital asset space.

**Q.6.** When we communicated last February regarding cryptocurrencies, you indicated that the SEC has generally developed their regulatory approach on a case-by-case basis, primarily focusing on fraudulent initial coin offerings (ICOs). While I believe blockchain technology and virtual currencies have the potential for positive disruption of our institutions and processes, one recent study indicated that roughly 80 percent of all ICOs were found to be scams.

You may have seen that this Committee held a hearing in October considering opposing perspectives on the benefits of virtual currencies.

Based on your perspective as a regulator, what are the potential benefits and drawbacks of ICOs?

**A.6.** Blockchain technology and the creative use of digital tokens that are recorded on distributed ledgers offer opportunities for new forms of capital raising and finance, can facilitate allocations of capital and can reduce the costs of funding by making that process more efficient. We meet with industry participants to learn about innovative blockchain mediated business. We also recognize that much of this promise is yet to be realized. Although the ICOs we have seen to date involve the offer and sale of securities, many of those offerings are not following our securities laws. These unlawful offerings seek all the benefits of a registered public offering—such as broad investor solicitation, no investor sophistication requirement and immediate secondary market liquidity—and also all the benefits of an exempt private offering, such as reduced regulatory costs and disclosure requirements. However, these offerings often are not following the private placement rules that limit the purchases to high net-worth or high income investors and are not registered offerings that must provide investors with full disclosures and the protections that follow from registration.

This is something we are very focused on, as some of our recent enforcement actions reflect. The Federal securities laws provide important market and investor protections in connection with the offer and sale of securities—regardless of whether they are called shares of stock or digital assets or tokens. If you are offering digital asset or tokens that are securities to U.S. investors, you have two options: (1) comply with an exemption from registration; or (2) register the offering with the SEC.

Secondary market activities in the digital asset markets also raise concerns. As currently operating, trading platforms in this space often permit the trading of securities but offer substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.

Finally, ICO markets span national borders and significant trading may occur on systems and platforms outside the U.S. As a result, risks can be amplified, including the risk that market regulators, like the SEC, may not be able to effectively pursue bad actors or recover funds.

We are cognizant of both the benefits and risks presented by this rapidly evolving area. We recognize its potential to facilitate capital formation—one of our three core missions. At the same time we continuously balance that goal with our other two core missions—to protect investors and maintain fair, orderly and efficient markets.

**Q.7.** For example, is it fair to say that ICOs have the potential to expand access to capital for small businesses?

If so, do you have any data that indicates this?

**A.7.** I have said before that technological innovations have improved our markets, including through increased competition, lower barriers to entry and decreased costs for market participants. Distributed ledger and other emerging technologies have the potential to further influence and improve the capital markets and the financial services industry. Businesses, especially smaller businesses without efficient access to traditional capital markets, can be aided by financial technology in raising capital to establish and finance their operations, thereby allowing them to be more competitive both domestically and globally. And these technological innovations can provide investors with new opportunities to offer support and capital to novel concepts and ideas.

But technological advancement—including the introduction of technological developments into our securities offering and trading infrastructure and the raising of capital to fund technological advancement—must be pursued in harmony with our Federal securities laws. These laws reflect our tripartite mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. We should embrace beneficial innovations, including new techniques for capital raising, but not at the expense of the principles undermining our well-founded and proven approach to protecting investors and markets.

We have not performed a quantitative study of this nature; however, we have implemented a number of initiatives designed to aid innovators, including those in the distributed ledger technology space. In October 2018, the SEC announced the formation of the Strategic Hub for Innovation and Financial Technology (FinHub), which serves as a public resource for FinTech-related issues at the SEC, including matters dealing with distributed ledger technology. The FinHub provides a portal for industry and the public to engage directly with SEC staff on innovative ideas and technological developments. Additionally, the FinHub is a warehouse of information regarding the SEC's activities and initiatives involving FinTech and will serve as a platform and clearinghouse for SEC staff to acquire and disseminate information and FinTech-related knowledge within the agency.

**Q.8.** In your testimony, you mention regular meetings with other agencies to consider areas where additional regulatory oversight of ICOs and digital assets may be necessary.

Can you provide specific updates on the changes that you are considering to your policy and oversight of virtual currencies?

**A.8.** The SEC will continue to closely coordinate with our regulatory and law enforcement partners across the globe on these issues. Through collaborations such as cross-agency working groups like the Financial Stability Oversight Council's Digital Assets and DLT Working Group, and in other contexts, we will continue to explore whether there are regulatory gaps and consider the appropriate regulatory approach going forward. To the extent that new issues arise in our markets that the SEC is unable to address, we will alert Congress to gaps in authority and request additional authority where necessary.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR COTTON FROM JAY CLAYTON**

**Q.1.** I want to draw your attention to a concerning trend: U.S.-listed, Cayman-incorporated, Chinese companies continue to exploit American capital markets at the expense of American investors. After enjoying the benefits of a U.S. listing, a controlling Chinese shareholder takes the company private at a low valuation, then relists in Shanghai or Hong Kong at a dramatically higher price. Through this scheme, Chinese shareholders are making billions at the expense of American minority investors.

What tools does the SEC currently have—or need—to protect U.S. investors, maintain fair markets, and prevent Chinese exploitation of take-private transactions?

**A.1.** Going-private transactions are subject to both Federal and State (or foreign) law. The Federal securities laws are focused on the disclosure of material information in a going-private transaction and the imposition of liability for such disclosures. State or foreign law (such as Cayman law) governs the other important issues in a going-private transaction that your question raises, such as the board of directors' fiduciary duties (including with respect to the consideration offered in the transaction), procedural safeguards to address self-dealing concerns and the requisite security holder votes needed for approval of the transaction.

Exchange Act Rule 13e-3 is the key SEC rule that governs going-private transactions. Under the rule, a disclosure document (Schedule 13E-3) must be publicly filed and delivered to all security holders of the target company prior to the closing of the transaction. Schedule 13E-3 requires disclosure specifically targeted at the fairness of the consideration offered in a going-private transaction and possible conflicts of interest, including: (1) the negotiations leading up to the execution of a transaction agreement, including any alternative transactions proposed; (2) the purposes of the transaction; (3) any plans or proposals for the company following the transaction; (4) historical and pro forma financial statements, in certain circumstances; and (5) the substantive and procedural fairness of the transaction to unaffiliated security holders, including: whether a report or opinion about the transaction's fairness was received; whether the controlling security holder reasonably believes the transaction is fair to unaffiliated security holders; and the factors considered by the controlling security holder in making this fairness determination.

This disclosure is subject to staff review and the liability provisions of Rule 13e-3, which prohibits any materially false misstatement or omission, and to the general anti-fraud provisions of the Federal securities laws.

The SEC has pursued securities law violations by foreign-based issuers involving market manipulation, accounting and disclosure violations and auditor misconduct, among others. The SEC has various tools at its disposal for doing so. For instance, it can conduct investigations to determine whether any Federal securities laws have been violated, and, if there is evidence of any violation, it can bring charges in Federal district court against the entity. To conduct these investigations, the SEC can utilize tools such as the IOSCO Multilateral Memorandum of Understanding to obtain documents and testimony from foreign jurisdictions, as well as leverage Mutual Legal Assistance Treaties with the assistance of the U.S. Department of Justice.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR ROUNDS FROM JAY CLAYTON**

**Q.1.** I understand that the SEC has delegated the authority for creating accounting standards to the Financial Accounting Standards Board or FASB. FASB has led the way globally when it comes to accounting regulation. In light of pressure for the International Accounting Standards Board to assume a greater importance compared to FASB or perhaps even replace FASB, this may be an appropriate time to reevaluate FASB's standard-setting practices.

To that end it would be helpful to hear your perspective as to how the SEC estimates the impact of new accounting rules before they're implemented. The Current Expected Credit Loss (CECL) and Long Duration Contract rules in particular seem like they are having adverse consequences that could have been fixed before the respective rules had been finalized if there had been a more thorough vetting process.

Is the SEC still accountable for understanding the full impact of new accounting rules? If so, do you think it's appropriate to require field testing, stakeholder input, and cost-benefit analyses before moving forward with new accounting standards?

**A.1.** Consistent with Federal law, in 2003 the SEC determined that the FASB and its parent organization, the Financial Accounting Foundation (FAF), satisfy the criteria Congress set forth in Section 108 of the Sarbanes–Oxley Act and, accordingly, the FASB's financial accounting and reporting standards are recognized as "generally accepted" for purposes of the Federal securities laws.

As a result, the Commission necessarily oversees the FASB's activities in order to carry out our responsibilities under the Federal securities laws in an effective manner and works with the FAF and the FASB to ensure that the FASB continues to meet the required characteristics of a designated accounting-standard setter under the Sarbanes–Oxley Act. At the same time, we also recognize the importance of the FASB's independence.

I believe the FASB must use independent judgment in setting accounting standards and not be constrained in its discussion of issues. This is necessary to ensure that the standards developed have the highest degree of credibility in the business and investing communities. The alternative, whereby FASB sets accounting standards that privilege certain economic activities or are designed to achieve certain economic results, could result in many harms, including causing investors to lose confidence in the accuracy or quality of the reported information. Such an outcome could hinder our markets and raise the cost of capital for everyone.

That being said, I believe it is useful for the FASB to perform field testing, gather stakeholder input and conduct cost-benefit analyses as it already does as part of its deliberative process. The process benefits from a two-way dialogue between the FASB and its constituents, as the FASB develops standards that meet a specific need with justification that balances the related costs and benefits. Specifically, when setting standards, the FASB states that it weighs whether the expected improvement in the quality of the information provided to users justifies the cost of preparing and providing that information.

For example, the CECL outreach included significant outreach, including meeting with over 200 users of financial statements, and holding more than 85 meetings and workshops with preparers (including field work at 25 company locations) to get direct input on the proposed standard. Overall, I also remain supportive of all parties engaging in productive dialogue regarding the new accounting standard to further our shared goal of maintaining high-quality financial reporting for the benefit of investors in the U.S. capital markets and addressing unintended negative consequences.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM JAY CLAYTON

**Q.1.** Some have criticized the SEC's February 21, 2018, Cybersecurity Guidance for not being clear enough about when companies should disclose cybersecurity incidents. In your testimony, you footnote to an April 24, 2018, SEC press release announcing that the "entity formerly known as Yahoo! Inc. has agreed to pay a $35 million penalty to settle charges that it misled investors by failing to disclose one of the world's largest data breaches in which hackers stole personal data relating to hundreds of millions of user accounts." The release notes that the cyberintrusion occurred in December 2014, but states that "when Yahoo filed several quarterly and annual reports during the 2-year period following the breach, the company failed to disclose the breach or its potential business impact and legal implications."

Based on the SEC's 2018 Cybersecurity Guidance, when should Yahoo have disclosed this breach?

**A.1.** The Commission's February 2018 Guidance on Public Company Cybersecurity Disclosures expresses our belief that it is critical that public companies take all required actions to inform investors about material cybersecurity risks and incidents in a timely fashion. The guidance also stresses the importance for public companies to have disclosure controls and procedures in place to, among other things, help ensure that the company makes timely disclosures of material events, including those related to cybersecurity.

Although our disclosure rules do not specifically refer to cybersecurity risks and incidents, a number of the requirements impose an obligation to disclose such risks and incidents depending on a company's particular circumstances. [1] In addition, a company generally

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[1] You note that some have criticized this approach and called for greater specificity. On occasions where these concerns have been raised to me, I have requested that those commentators provide specific language that would address their objectives in a manner consistent with the

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must disclose such material information as may be necessary to make the company's required disclosures not misleading. Generally, the Commission considers information to be material if it would be viewed by the reasonable investor as important in making an investment decision or as having significantly altered the total mix of information available. Where a company has become aware of a material cybersecurity incident or risk, it must make timely disclosures pursuant to its obligations in periodic or current reports under the Exchange Act, and in registration statements under the Securities Act.

As outlined in its April 24, 2018, order, the Commission found that when Yahoo filed several quarterly and annual reports during the 2-year period following the breach, the company failed to disclose the breach or its potential business impact and legal implications. Instead, the company's SEC filings stated that it faced only the risk of, and negative effects that might flow from, data breaches. The Commission found that Yahoo! knew, or should have known, that its disclosures in its annual reports on Form 10-K for the fiscal years ending December 31, 2014, and December 31, 2015, and in its quarterly reports on form 10-Q for the first three quarters of 2015 and the first two quarters of 2016, among other filings, were materially misleading.

**Q.2.** You have called for more robust disclosures in certain instances, such as Brexit related risks. However, according to a February 2018 GAO report, the "SEC faces constraints in reviewing climate-related and other disclosures because it primarily relies on information that companies provide. SEC senior staff explained that SEC's Division of Corporation Finance staff . . . do not have the authority to subpoena additional information from companies." In the same report, GAO notes that "in an investigation of Peabody Energy under a New York State law, the Attorney General of New York State subpoenaed the company's internal documents and found that although the company's disclosures denied it had the ability to reasonably predict the impact of future climate change laws and regulations on its business, Peabody had made internal market projections showing severe negative impacts from certain potential laws and regulations and failed to disclose those projections to the public."

How is the SEC addressing the constraints identified in the GAO report regarding the SEC's ability to review disclosures effectively?

**A.2.** In its February 2018 report, the GAO noted that the scope of a compliance review conducted by our Division of Corporation Finance differs from the scope of an investigation by our Division of Enforcement, State attorneys general or other law enforcement authorities who have authority to require the production of nonpublic information for law enforcement purposes. As a result, as GAO noted, the detailed information companies rely on in making materiality decisions when providing disclosures in compliance with the Federal securities laws is generally not available in the course of a compliance review by SEC Division of Corporate Finance staff.

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Commission's long-standing and proven approach to disclosure mandates, including materiality. We have not received any such submissions for consideration.

Regardless of the availability of such information during a compliance review, the company is subject to provisions in the Federal securities laws and well established case law precedent that specify what information it must disclose in its filings. Our staff approaches each filing review with professional skepticism and does not, in the normal course, question disclosures that appear to be in compliance with our rules and the Federal securities laws. Many of these disclosures are in response to principles-based requirements based upon materiality.

The SEC's regulatory, disclosure-based framework is working as designed. The Commission establishes rules and regulations; the Commission and staff communicate requirements and encourage full compliance; the Division of Corporation Finance, through its selective review of company filings, may question disclosure decisions, request support for those decisions as it assesses compliance and may refer instances of material noncompliance to our Division of Enforcement; and our Division of Enforcement investigates potential violations, including exercising the Commission's subpoena authority, after which the Commission may file an action in Federal district court or institute an administrative proceeding. Although the GAO stated that our compliance review staff faces constraints because it does not have access to all of the information companies use to determine materiality, the Federal securities laws and well established case law precedent provide ample incentive for companies to take these disclosure decisions seriously. Furthermore, after a thorough evaluation of our filing review process to assess compliance with the identified disclosure requirements, the GAO did not have any recommendations for improving the process or changing the way in which the Commission delegates or exercises its subpoena power.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM JAY CLAYTON

**Q.1.** Please provide a timeline for the SEC's work on the five remaining executive compensation rules mandated by the Dodd–Frank Street Reform and Consumer Protection Act.

**A.1.** On December 18, 2018, the SEC approved final hedging disclosure rules. Those rules, which were mandated by the Dodd–Frank Act, require companies to disclose in proxy and information statements their practices or policies regarding the ability of employees or directors to engage in certain hedging transactions with respect to company equity securities.

The remaining Dodd–Frank Act executive compensation rulemakings are on the Commission's rulemaking agenda, and we are continuing our work to finalize them. As I noted in my written testimony, as a result of the complexity and scope of the existing executive compensation disclosure regime, as well as the nature of the mandates, I believe a serial approach is likely to be the most efficient and best serve the SEC's mission.

**Q.2.** According to the SEC's joint statement with the PCAOB, there are 224 companies listed on U.S. exchanges with a combined market capitalization of $1.8 trillion that are located in countries, primarily China, that make it difficult for U.S. regulators to review their financial reporting. This presents a major risk to U.S. investors who may assume that the financial reporting of these companies is in line with U.S. requirements. Moreover, it's fundamentally unfair for Chinese companies to take advantage of the strength and liquidity of U.S. capital markets, but not have to play by the rules.

The U.S.–China Economic and Security Review Commission recommended that Congress consider legislation providing authority to ban and delist companies that have refused to sign reciprocity agreements with the Public Company Accounting Oversight Board.

Despite the SEC and PCAOB's best efforts to reach an agreement, it appears unlikely that Beijing will cooperate.

Would such authority strengthen your hand in negotiations with your Chinese counterparts?

**A.2.** The joint statement by SEC Chief Accountant Wes Bricker, PCAOB Chairman William D. Duhnke III and me outlines current challenges facing U.S. regulators to obtain information related to U.S. listed companies with significant operations in China, and how they may adversely affect investors in the U.S. markets and the interests they own in these companies. For example, these challenges impact the PCAOB's ability to inspect the audits of these companies in question.

I understand that the PCAOB has been in negotiations with foreign audit regulators in certain countries, including China, that currently prevent the PCAOB from carrying out its inspection process with respect to the audits of companies based in those countries. I note that even while these negotiations are continuing, a refusal to cooperate by an audit firm, either in an inspection or an investigation, could subject the firm to SEC or PCAOB sanctions and remedial measures. Having the ability to impose sanctions and remedial measures certainly may enhance the ability to make further progress with respect to such negotiations, although the imposition of such sanctions and remedial measures would require an assessment of their potential impact on U.S. investors and the broader capital markets.

As we continue our efforts to obtain appropriate access to information, I would welcome an opportunity to further discuss these issues with you and to have SEC staff provide technical assistance or other information about draft legislation.

**Q.3.** The statement mentions "remedial actions involving U.S.-listed companies" as a possible consequence for in certain company-specific issues.

Under existing authorities, what are the specific remedial actions the SEC and PCAOB could employ to address such issues?

**A.3.** The joint statement noted that if information barriers continue to exist, we may consider remedial actions, which could include, among other things: (1) requiring affected companies to make additional disclosures to investors; (2) placing additional restrictions on new securities issuances from companies with activities in China; and (3) bringing actions against auditors who do not meet our requirements.

All of these actions have collateral consequences that must be carefully evaluated as we and the PCAOB seek to meet our objectives.

**Q.4.** I noted your recent comments on the implications of Brexit for our own financial sector.

In light of the recent collapse of the plan to vote on a Brexit deal last week, will you provide the Commission's current view of the options facing the U.K. in its dealings with the EU, with a focus on the implications for the U.K. financial sector and the risks to the many U.S. banks that base their European options in the U.K.?

**A.4.** I continue to be concerned that the effects of Brexit will be international, including on our U.S. markets and our investors. I am encouraged by memoranda of understandings entered into by the European Securities Markets Authority and the Bank of England and the U.K. Financial Conduct Authority in February 2019. These agreements are important steps towards preventing significant disruption of securities and derivatives transactions in the event that the U.K. exits from the European Union without a deal in place.

The Commission's responsibility with respect to Brexit is focused on its potential effects on U.S. investors and securities markets. The Brexit-related concerns you have highlighted with the U.K. financial sector will have international effects given the interconnectedness of our global financial markets. We are monitoring company disclosure concerning the potential impact that Brexit may have. This effort includes monitoring disclosures made by banks and financial institutions with significant U.K. exposure. Additionally, we continue to engage and communicate with other U.S. financial authorities, with our U.K. and EU counterparts, and with market participants to consider the effects of Brexit to our market utilities and infrastructure. We will remain focused on identifying and planning for potential Brexit-related impacts on U.S. investors and markets.

**Q.5.** I worked to include the honest broker provision in the Wall Street Reform law, and our clear intent was for the SEC to establish a uniform standard of conduct, if warranted by a study. Despite the 2011 SEC study recommending a uniform standard of conduct for brokers and investment advisers, the SEC's recent proposal fails to establish a uniform standard of conduct for broker-dealers and investment advisers, and it puts the burden on the customer to understand the difference between brokers and investment advisers—ignoring the SEC's own findings.

Moreover, the SEC's own Investor Advisory Committee recommended in November that everyone—investment advisers and brokers—be held to a uniform standard.

Will you commit to personally taking another look at the SEC's 2011 study on the issue as well as the recommendations from the SEC's Investor Advisory Committee before you move forward with a formal rule?

**A.5.** The recommendations of the staff's 2011 study were useful to us in evaluating how to specifically enhance investor protection and improve the obligations that apply to broker-dealers when making recommendations to retail customers. After considering the staff's recommendations from the 2011 study, the information that the public has submitted over the years and our extensive experience regulating broker-dealers and investment advisers, the Commission proposed an approach focusing on enhancements to broker-dealer regulation, taking into consideration the characteristics of the broker-customer relationship. The broker-dealer relationship generally is different from the investment adviser-client relationship.

I believe our proposal requires financial professionals, whether broker-dealers, investment advisers, or both (aka "dual-hatted persons"), to follow standards of conduct that reflect key fiduciary principles tailored to the client relationship. This framework draws from the recommendations of the 2011 study.

The staff is considering all comments, including recommendations from the SEC's Investor Advisory Committee and the SEC 2011 study, as it develops a recommendation for the Commission.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM JAY CLAYTON**

**Q.1.** *SEC Disgorgement*—In your written testimony you mentioned the effects that the Supreme Court case Kokesh v. SEC has had on the SEC's ability to recover ill-gotten gains from bad actors and return them to wronged investors. The most recent SEC enforcement report said that to date the SEC may have to forgo $900 million in disgorgement from cases filed in the last year and a half. That's a significant number, particularly in light of the fact that the SEC recently reported that in its last fiscal year it collected $3.9 billion in total enforcement actions returned $794 million to harmed investors in 2018.

Can you describe in more detail how Kokesh is affecting the SEC's ability to return illegally obtained funds to investors?

Can you explain what this means for the average investor who is the victim of fraud?

**A.1.** In Kokesh v. SEC, the Supreme Court held that our claims for disgorgement are subject to a 5-year statute of limitations. From a remediation standpoint, I am concerned that we may be unable to recover a fraudster's illegal profits to remedy the losses of investors, particularly retail investors, if they were defrauded in well-concealed and long-running frauds. Said simply, if the fraud is well-concealed and stretches beyond the 5-year limitations period applicable to penalties, it is likely that we will not have the ability to recover funds invested by our retail investors more than 5 years ago. And our experience under Kokesh is showing that this already is happening. With respect to matters that have already been filed, the Division of Enforcement estimates that the Court's ruling in Kokesh may cause the Commission to forgo up to approximately $900 million in disgorgement, of which a substantial amount potentially could have been returned to retail investors. As we continue to bring new Enforcement actions, this number is likely to increase.

**Q.2.** *Human Capital Management Disclosure*—Earlier this summer I sent you a letter describing my belief that time is past due for the SEC to provide more requirements and guidance regarding human capital management disclosure. Currently, the only data required to be disclosed under SEC rules are the number of employees a company has, the median pay of those employees and the compensation of the CEO. But other information is clearly important to investors, including the amount spent by the company on worker training, and average turnover, among others. Increasing disclosure requirements doesn't mean we have to impose significant costs on businesses. A Harvard Law School study finds that a majority of companies in their dataset already collect a variety of human capital metrics of increasing interest to investors through their internal management processes. I appreciate your response to my letter on this topic and the discussions we've had on it.

Do you agree that human capital management issues are very important to businesses?

Will you work with me to expand human capital management disclosure requirements and improve disclosures in this area?

**A.2.** I appreciate your focus on the importance of human capital management. As I stated in my response to your letter, I believe the strength of many of our public companies is due, in important part, to their human capital.

In February 2019, I shared some thoughts on human capital disclosure on a call with members of the SEC's Investor Advisory Committee. Specifically, I expressed that human capital, like intellectual property, often represents an essential resource and driver of performance for many of today's companies. While I am wary of rules or guidance that would mandate rigid human capital standards or metrics for all public companies given that each industry, and even each company within a specific industry, has its own human capital circumstances, I believe investors would be better served by understanding the lens through which each company looks at their human capital. For example, does management focus on the rate of turnover, the percentage of their workforce with advanced degrees or relevant experience, the ease or difficulty of filling open positions, or some other factors? The principles of materiality, comparability, and efficiency should be guideposts for human capital disclosure. I have asked the Investor Advisory Committee for their input and feedback on what they look for as investors and, when making an investment decision, what questions they ask issuers relating to human capital.

Additionally, the Division of Corporation Finance has been working to evaluate and recommend improvements to our public company disclosure requirements. I expect human capital disclosures will be among the issues under consideration. I have asked the Division of Corporation Finance to consider feedback from investors, registrants, and other parties, and make recommendations to the Commission regarding additional action, as appropriate.

I welcome further engagement with you as we continue as to consider the best way forward.

**Q.3.** *Volcker Rule*—I have a question about the covered funds section of the Volcker Rule and the recent proposed rulemaking. Despite very clear legislative intent, banks are prohibited under the current rule from investing in certain fund structures that would otherwise be permitted investments if a bank made a direct investment from its own balance sheet, even if the fund simply wants to extend credit or make long-term investments to potential investors (such as startup companies). Investing through a fund structure supports safety and soundness due to the ability to diversify risk as well as ensuring that companies looking to grow and innovate have the capital that they need. It is clear to me that the agencies have the legal authority they need since they've already allowed for certain specific exclusions for permissible investments in fund structures.

Wouldn't you agree that if a bank can make an investment on its balance sheet that it should be allowed to make that same investment through a fund structure?

**A.3.** Since the adoption of the Volcker Rule in 2013, banking entities and the agencies charged with implementing the rule have gained experience through its implementation, including through examinations. Based on that experience, and in response to feedback received in the course of administering the Volcker Rule, we and the other agencies have identified opportunities, consistent with the statute, for improving the implementation of the Volcker Rule. In short, we recognize that to effectively implement the Volcker Rule its terms should reflect our collective experience with prudential regulation and market activities.

The amendments we proposed June 2018 included a request for comment regarding issues relating to the "covered fund" definition. Among the requests for comment are requests generally about whether the definition of "covered fund" effectively implements the statute and is appropriately tailored. We have received many comments responding to these requests, as well as the multiple other requests about the "covered fund" definition. SEC staff is carefully reviewing these comments and remains engaged in regular and ongoing dialogue with the staffs at our fellow Federal financial regulators. I look forward to considering the issues raised, including concerns about the scope of the "covered fund" definition.

## RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM JAY CLAYTON

**Q.1.** In response to my suggestion that you reduce investor confusion by using the same language for investment advice standards that apply to registered investment advisers and for those that apply to broker-dealers, you indicated that the SEC is considering doing so, saying that "we may do that."

To clarify that statement, will you commit that, in its finalized form, Regulation Best Interest will comply with section 913(g) of the Dodd–Frank Wall Street Reform and Consumer Protection Act, in that "the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940," and that broker-dealers and registered investment advisers will all be required to give advice "without regard to [their] financial or other interest?" [1]

**A.1.** We believe our proposal is consistent with the underlying intent of Section 913, including that a broker-dealer should not put its interests ahead of the retail customer's interests when making a recommendation to a retail customer.

Our proposal sets a clear, enhanced standard of conduct for broker-dealers that is drawn from the principles applicable to an

[1] *https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf*

investment adviser's fiduciary duty. The commonality of these conduct standards is clear when the requirements of proposed Regulation Best Interest are compared to the standards of conduct required of investment advisers under the Advisers Act.

While the two standards draw from common principles, under the proposal, their application would differ in practice because the relationship models of broker-dealers and investment advisers differ. But—importantly—the overall principles are the same, and the proposal is designed to make sure that, at the point in time at which the recommendation or advice is provided, the analytical process followed by the financial professional should be the same regardless of whether the retail investor chooses an investment adviser or broker-dealer: advice provided with diligence and care by a financial professional that is prohibited from placing its own interests ahead of the retail investor's interests.

**Q.2.** In response to my suggestion that broker-dealers should be held to the same fiduciary standard that investment advisers are held to, you stated that, "Investment Advisers are allowed to contract around this standard. It's not well known. This is something that we want people to understand. The baseline Advisers standard is the Adviser cannot put their interests ahead of the client's interests. Now, they are able to say 'But I'm going to do these things' and with informed consent, they can cut back on that standard."

While investors may consent to limitations on a broker-dealer's or investment adviser's services, and to the existence of certain conflicts of interest, do you believe that a reasonable investor would ever consent to be harmed?

Will you commit that, for both broker-dealers and investment advisers alike, disclosure and consent to conflicts of interest will never be deemed to satisfy either a broker-dealer's or investment adviser's obligations to act in the best interests of the customer if the advice results in harm to the investor?

**A.2.** Under proposed Regulation Best Interest, a broker-dealer would be required to act in the best interest of the retail customer when making a recommendation, and would be prohibited from placing its financial or other interest ahead of the interest of the retail customer. In order to discharge the duty, a broker-dealer would need to: first, disclose material facts relating to its relationship with the customer; second, enhance its current compliance framework to meet the demands of a more rigorous best interest standard; and third, eliminate, or mitigate and disclose, material conflicts of interest related to financial incentives. In other words, even if a broker-dealer has mitigated and disclosed its conflicts, it must still have a reasonable basis to believe that a recommendation is in the best interest of the retail customer and the broker-dealer must have written policies and procedures reasonably designed to prevent it from placing its interests ahead of the interest of the retail customer.

In the proposed Commission interpretation of the standard of conduct for investment advisers, the Commission stated that the client cannot waive the Federal fiduciary duty. Although the investment adviser fiduciary duty is not waivable, it is well established that the terms of the investment adviser relationship—and therefore the scope of the duty in that relationship—may be shaped by disclosure and informed consent. Our proposed interpretation provides further details on this widely accepted process—that disclosures regarding the scope and terms of the relationship should be sufficiently specific so that a client is able to decide whether to provide informed consent.

This process of scoping the terms of the advisory relationship, which is regularly effectuated through account agreements and Form ADV, is widely accepted in the industry and provides for arrangements such as limited account services and certain third-party compensation to the investment adviser. Our proposed relationship summary, if adopted, is designed to increase retail investor awareness of the material terms of common arrangements with investment professionals, and the fees and conflicts of interest that apply. I have been surprised that, with all of the public dialogue about the fiduciary duty, there is not more acknowledgment of the fact that the application of that duty can and does vary depending on the terms of the agreement between the client and adviser. The proposed requirements of the relationship summary would highlight the nature of an advisory relationship and the scope of services that the investment adviser provides.

We have received a lot of thoughtful comments on the proposed interpretation of the standard of conduct for investment advisers and Commission staff is reviewing comments carefully, engaging further with commenters and thinking about what next steps it might recommend to the Commission.

**Q.3.** When the SEC proposed the Standards of Conduct for Investment Professionals Rulemaking Package in April, you stated that you intend for it to "rais[e] the standard of conduct for broker-dealers when they provide recommendations to retail investors." [2]

Please list any broker-dealer practices that are permitted under current FINRA suitability rules but that would be prohibited under the SEC's proposal.

**A.3.** Under current standards, it has been argued that broker-dealers are permitted to recommend to their retail customer a product that is suitable but more costly for the customer than another product that the broker-dealer offers—because the first product makes the broker-dealer more money.

Proposed Regulation Best Interest would address this concern. Under proposed Regulation Best Interest, a broker-dealer, when making a recommendation of a securities transaction or investment strategy to a retail customer, will be required to act in the best interest of that customer at the time the recommendation is made, including the broker-dealer being prohibited from placing its financial or other interest ahead of the interest of the retail customer.

The proposal acknowledged that the cost (including fees, compensation, and other financial incentives) associated with a recommendation would generally be an important factor in evaluating whether a recommendation is in the best interest of a retail customer. Specifically, the proposal noted that in order to meet its Care Obligation, when a broker-dealer recommends a more expen-

[2] *https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking*

sive product over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that the higher cost is justified based on other factors (e.g., the product's objectives, characteristics, liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions), in light of the retail customer's investment profile.

**Q.4.** In August, you stated that, based on what you heard at a series of investor roundtables, "Main Street investors have no tolerance for certain questionable sales practices such as high-pressure, product-based sales contests," that you believe "these practices should be eliminated," and that their elimination "would enhance investor protection but would not adversely affect investor choice and opportunity." [3]

Do you believe that firms should be permitted to use other sales practices that create harmful conflicts of interest, including sales contests based on total production, bonuses for recommending certain products, and quotas for sales of certain products (such as proprietary funds)?

Why or why not?

**A.4.** I do not believe that broker-dealers or investment advisers should be permitted to use sales practices that harm retail investors. As I have stated publicly, I believe that certain questionable sales practices such as high-pressure, product-based sales contests should be eliminated. In my view, eliminating these practices would enhance investor protection but would not adversely affect investor choice and opportunity. However, there is an important distinction between compensating individuals based on broad performance metrics—an important component of the compensation structure of many professional services firms that have served clients well—and incentivizing individuals to recommend a particular product through time-based quotas, bonuses, or sales contests.

As proposed, Regulation Best Interest would not specify particular compensation practices as impermissible. Broker-dealers, however, would be required to act in the best interest of the retail customer when making recommendations, without placing the financial or other interest of the broker-dealer making the recommendation ahead of the interest of the customer. The proposed rule includes specified requirements to meet this obligation. Importantly, even if a broker-dealer has eliminated or appropriately mitigated and disclosed its conflicts, it still must have a reasonable basis to believe that its recommendations are in the best interest of the retail customer.

For example, it would be inconsistent with the Care Obligation of proposed Regulation Best Interest if the broker-dealer made the recommendation to a retail customer in order to: maximize the broker-dealer's compensation (e.g., commissions or other fees); further the broker-dealer's business relationships; satisfy firm sales quotas or other targets; or win a firm-sponsored sales contest.

To be clear, the proposal acknowledges that broker-dealers may not be able to appropriately address certain conflicts through disclosure and mitigation and that such conflicts may be more appro-

[3] *https://www.sec.gov/news/public-statement/statement-clayton-082218*

priately avoided entirely. For example: payment or receipt of certain noncash compensation that presents conflicts of interest for broker-dealers, such as certain sales contests, trips, prizes, and other similar bonuses. The Commission requested comment on whether the Commission should prohibit receipt of certain noncash compensation. We have received a lot of thoughtful comments on this issue, and Commission staff is reviewing comments carefully, engaging further with commenters and developing a recommendation to the Commission. In developing our final rule, I believe we should address the issues of elimination and mitigation with the goal of better aligning the legal obligations with retail investors' reasonable expectations.

**Q.5.** Will you commit that any final Standards of Conduct for Investment Professionals rule will prohibit firms from creating incentives that would result in recommendations based on the financial interests of the firm or financial professional rather than the best interests of the investor?

For example, will you commit than any final Standards of Conduct will prohibit: sales quotas, bonuses for recommending certain products, and other forms of sales contests; the use of trips and other awards for meeting production thresholds that may encourage inappropriate rollover recommendations; and ratcheted compensation grids, which retroactively and precipitously increase professionals' compensation?

**A.5.** I do not believe that broker-dealers should be permitted to use sales practices that harm retail investors. As I have stated publicly, I believe that certain questionable sales practices such as high-pressure, product-based sales contests should be eliminated. In my view, eliminating these practices would enhance investor protection but would not adversely affect investor choice and opportunity.

To be clear, the proposal acknowledges that broker-dealers may not be able to appropriately address certain conflicts through disclosure and mitigation and may be more appropriately avoided entirely. For example: payment or receipt of certain noncash compensation that presents conflicts of interest for broker-dealers, such as certain sales contests, trips, prizes, and other similar bonuses. The Commission requested comment on whether the Commission should prohibit receipt of certain noncash compensation. We have received a lot of thoughtful comments on this issue and Commission staff is reviewing comments carefully, engaging further with commenters and developing a recommend to the Commission. In developing our final rule, I believe we should address the issues of elimination and mitigation with the goal of better aligning the legal obligations with investors' reasonable expectations.

**Q.6.** Will you commit that any final rule will include strong enforcement mechanisms to enforce such a prohibition, including a private right-of-action to allow investors to sue advisers and broker-dealers who cheat them through the use of these practices?

If not, why not?

**A.6.** Regulation Best Interest is designed to enhance the Commission's enforcement mechanisms. We do not believe it would create any new private right of action or rescission, nor did we intend for it to do so.

The Commission has experience examining and enforcing compliance with a variety of obligations under the Federal securities laws, including existing obligations that are more principles-based or that are based on facts-and-circumstances, such as suitability, which is enforced under our anti-fraud authority.

If Regulation Best Interest is adopted, I would expect our exam and enforcement staff to assess compliance and potential violations, as is the case with any rule. Commission staff is engaging with experienced professionals from our Division of Enforcement and our Office of Compliance Inspections and Examinations to help ensure that if Regulation Best Interest is adopted, compliance with the rule can be efficiently examined and breaches of the rule can be effectively addressed. We have encouraged public comment on any potential issues or concerns and have received a lot of thoughtful comments on this issue, which Commission staff is considering.

**Q.7.** Section 913(g) of the Dodd–Frank Act states that, "The Commission shall . . . examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

The Regulation Best Interest proposal does not include an indepth discussion of broker-dealer compensation structures or a meaningful examination of how certain sales practices, conflicts of interest, and compensation schemes can be and often are contrary to the public interest and harmful to investors. Similarly, the Investment Adviser guidance provided no discussion of these topics. Has the Commission completed this Dodd–Frank regulatory requirement elsewhere? If so, please provide a written copy of your analysis on these matters.

To the extent that the Commission has not satisfied this regulatory requirement, will you commit to doing so before you issue a final rule?

**A.7.** In proposing Regulation Best Interest, the Commission examined the impact that financial professionals' conflicts of interest—specifically those caused by financial incentives—can have on the provision of recommendations to retail investors. The rule proposing release also discussed certain existing sales practices and compensation structures, drawing on a range of sources, including our own experience overseeing and examining broker-dealers. The Commission recognized the harm that conflicted recommendations can cause investors and also discussed that conflicts of interests can be particularly significant when involving certain types of sales practices and compensation structures. The staff continues to consider these issues through the ongoing review of comment letters and economic studies, as well as discussions with market participants and investors.

**Q.8.** The one-on-one interviews conducted as part of the RAND report on investor testing are an importance source of data for understanding the ability of the SEC's proposed disclosures to enable investors to make informed decisions.

Will you commit to publishing full transcripts of these interviews?

If not, why not?

**A.8.** The Commission and staff have made significant efforts to connect directly with investors, including through investor testing and outreach. The SEC's Office of the Investor Advocate and the RAND Corporation prepared a research report that sought to determine how well investors understood the retail market for investment advice. The report was added to the public comment file for the Commission's package of rulemakings regarding standards of conduct for financial professionals on October 12, 2018.

The SEC's Office of the Investor Advocate also engaged the RAND Corporation to conduct investor testing of a sample of the Commission's proposed Form CRS Relationship Summary. On November 7, 2018, the results of this investor testing were added to the public comment file. The testing consisted of a nationwide survey and qualitative one-on-one interviews. In the report, the RAND Corporation synthesizes its findings from the one-on-one interview component of the investor testing, noting that although the one-on-one interviews have certain limitations, they serve as a valuable complement to the nationally representative quantitative survey that the RAND Corporation conducted. At that time, we issued a press release encouraging the public to submit comments on RAND's investor testing report by December 7, 2018.

The Commission staff also organized seven roundtables across the country to provide Main Street investors the opportunity to speak directly to me, my fellow Commissioners and senior SEC staff to tell us about what they expect from financial professionals. These candid, experience-based conversations were incredibly valuable and are informing the staff's work moving forward. The transcripts from these roundtables have been added to the comment files. The Commission has also invited investors to share their insights and feedback on the proposed Relationship Summary by going to a new "Tell Us" website. Through these efforts, the Commission has received nearly 100 individual feedback submissions.

The rules' comment files continue to receive and publish public comments, and the staff will continue to consider the rulemaking record as it develops a recommendation.

**Q.9.** If the SEC's own research, such as the data included in the RAND report, does not indicate that the SEC's proposed disclosures serve their intended purpose of enabling investors to make an informed decision between brokerage and advisory accounts, will you consider applying a strong, uniform fiduciary standard across all accounts, so that investors will be protected regardless of whether they fully understand the disclosures?

**A.9.** All of the feedback we have received, including the data included in the RAND report regarding the proposed disclosure form, has been very helpful. The staff is considering all comments and will take them under consideration in developing a recommendation for the Commission.

## RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM JAY CLAYTON

**Q.1.** *Protecting Investors With "Best Interest" Standard*—Can you name one or more broker-dealer practice that is permitted under current FINRA suitability rules that would be prohibited under the proposal?

**A.1.** Under current standards, it has been argued that broker-dealers are permitted to recommend to their retail customers a product that is suitable but more costly for the customer than another similar product that the broker-dealer offers—because the first product makes the broker-dealer more money.

Proposed Regulation Best Interest would address this concern. Under proposed Regulation Best Interest, a broker-dealer, when making a recommendation of a securities transaction or investment strategy to a retail customer, would be required to act in the best interest of that customer at the time the recommendation is made. This would prohibit the broker-dealer from placing its financial or other interest ahead of the interest of the retail customer.

The proposal acknowledged that the cost (including fees, compensation, and other financial incentives) associated with a recommendation would generally be an important factor in evaluating whether a recommendation is in the best interest of a retail customer. Specifically, the proposal noted that when a broker-dealer recommends a more expensive product over another reasonably available alternative offered by the broker-dealer, in order to meet its Care Obligation, the broker-dealer would need to have a reasonable basis to believe that the higher cost is justified based on other factors (e.g., the product's objectives, characteristics, past preference, liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions), in light of the retail customer's investment profile.

**Q.2.** Does this proposal require all financial professionals who make investment recommendations related to retail customers to do so as fiduciaries?

**A.2.** Proposed Regulation Best Interest and its "best interest" standard draws upon principles that apply to investment advice in other contexts. Simply put, under proposed Regulation Best Interest, a broker-dealer cannot put her or his interests ahead of the retail customer's interests. The similar levels of protection are clear when proposed Regulation Best Interest is compared to the standards of conduct applicable to investment advisers.

Specifically, our proposal is designed to enhance broker-dealer regulation by building upon, and being tailored to, the unique structure and characteristics of the broker-dealer relationship with retail customers and existing regulatory obligations, while taking into consideration and drawing on (to the extent appropriate) the duties of loyalty and care as interpreted under the Advisers Act.

Our proposal is designed to make sure that, at the point in time at which the recommendation or advice is provided, the analytical process followed by the financial professional should be the same regardless of whether the retail investor chooses an investment adviser or broker-dealer: advice provided with diligence and care by a financial professional that is prohibited from placing its own interests ahead of the retail investor's interests. I believe our proposals are designed to make investors get just that whether they choose a broker-dealer or an investment adviser. And I believe that they should have that choice.

**Q.3.** Does this proposal require financial professionals to provide retail customers with the best available options?

**A.3.** Under the proposed Regulation Best Interest's Care Obligation, a broker-dealer would be required to have a reasonable basis to believe, based on its diligence and understanding of the risks and rewards of the recommendation, and in light of the retail customer's investment profile, that a recommendation is in the best interest of the retail customer.

As described in the proposal, the broker-dealer's diligence and understanding of the risks and rewards of the recommendation would generally involve consideration of factors, such as the costs, the investment objectives and characteristics associated with a product or strategy (including any special or unusual features, liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions), as well as the financial and other benefits to the broker-dealer. The broker-dealer would be required to match this understanding of the security or strategy to the particular retail customer to form a reasonable belief that the security or strategy is in the retail customer's best interest.

This "facts and circumstances" approach is similar to "best interest" approaches under other advice standards, including the fiduciary standard applicable to investment advisers. These approaches do not specifically define "best interest" but provide principles-based guidelines. Another similarity with those approaches is the recognition that a requirement for financial professionals to provide retail customers with the "best available option" or "perfect advice" would create a standard that would be virtually impossible to meet, particularly with 20-20 hindsight. Instead, the proposed standard of conduct for broker-dealers requires the recommendation to be in the best interest of the retail customer at the time and in the circumstances in which it is made, which is similar to how I view the duty of care of an investment adviser.

**Q.4.** *Cryptocurrencies*—Will the SEC continue to reject creating a cryptocurrency-linked ETF?

**A.4.** Certain national securities exchanges registered with the SEC have filed proposed rule changes seeking to list and trade shares of exchange-traded products based on digital assets, such as bitcoin and ether. The proposed exchange-traded products have been structured as commodity trusts directly holding the digital assets, as trusts holding exchange-traded futures on digital assets, managed funds issuing shares whose value relates to digital assets, or instruments based on digital assets held by the fund. Several of these proposals have been disapproved by the Commission, or by the Division of Trading and Markets acting pursuant to its delegated authority, and several have been withdrawn.

To approve an exchange's proposed rule change—such as a proposal to list a new exchange-traded product—the Commission must find that the proposed rule change is consistent with the applicable requirements of the Securities Exchange Act of 1934 (Exchange Act) and the rules and regulations thereunder. The Commission's Rules of Practice provide that the submitting exchange bears the burden to demonstrate that its proposed rule change is consistent with the requirements of the Exchange Act.

The Commission has emphasized in its disapproval orders that its actions to date regarding digital-asset exchange-traded products have not rested on an evaluation of whether bitcoin, or blockchain technology more generally, has utility or value as an innovation or as an investment.

Instead, the Commission's actions have reflected a finding, in each case, that the submitting exchange had not met its burden to demonstrate that the proposal was consistent with the requirements of the Exchange Act, including Section 6(b)(5), which requires that the rules of a national securities exchange be designed to "prevent fraudulent and manipulative acts and practices" and "protect investors and the public interest."

The Commission has also specifically noted that bitcoin markets are in the early stages of their development and that, over time, regulated bitcoin-related markets may continue to grow and develop. Should circumstances change in this manner or in a way that otherwise affects the Commission's analysis under the Exchange Act, the Commission would then have the opportunity to consider, among other things, whether a digital-asset exchange-traded product would be consistent with the requirements of the Exchange Act.

**Q.5.** How is the SEC coordinating with State Attorneys General on oversight of cryptocurrencies?

**A.5.** Federal and State regulators share an interest in making sure investors in digital asset securities and related investment products are appropriately protected. SEC staff have ongoing interactions with State regulators about securities law issues involving digital assets that may affect the citizens of their States. We also communicate about digital asset related conduct that may be occurring in their States—such as initial coin offerings (ICOs). Last year, together with former Commissioners Kara Stein and Michael Piwowar, I commended the North American Securities Administrators Association on their release highlighting important issues and concerns relating to ICOs, among other digital asset products.

**Q.6.** Have you collaborated on any enforcement actions related to fraud in cryptocurrencies? Please describe.

**A.6.** Yes. As a general matter, we closely coordinate with our domestic and international regulators and law enforcement partners in this space. The AriseBank ICO matter is one example of a case involving parallel SEC and criminal investigations. In that case, two former executives behind an allegedly fraudulent ICO settled the SEC's charges brought in the Northern District of Texas. The U.S. Attorney's Office in that district also brought parallel criminal charges against one of the executives.

**Q.7.** Nearly two dozen Nevadans have complained to the Consumer Financial Protection Bureau about virtual currencies using the Consumer Complaint Database. The Bureau has nearly 2,000 complaints about virtual currencies in its Consumer Complaint Database.

Is the SEC collaborating with the Consumer Bureau to respond to frauds in cryptocurrencies?

**A.7.** Yes. SEC staff continues to closely coordinate with our regulatory partners in this space, including with staff of the CFPB.

**Q.8.** Has the SEC endorsed any cryptocurrencies?

Does the SEC have any plans to endorse a cryptocurrency as a valid investment?

**A.8.** The SEC does not endorse any investments, including digital assets, and has no plans to do so.

**Q.9.** *Disclosure Rules (Pay Gap)*—Wells Fargo announced on February 1, 2018, that they would voluntarily disclose disparities in pay broken down by gender and minority status. They are among a few big banks that already disclose this data, although not required to by law. The SEC has purview over similar compensation disclosure regulations (e.g., the CEO-median worker pay ratio rule or the pay for performance incentive structures for management).

Since companies are already headed this direction, would you favor disclosure requirements for publicly traded companies regarding compensation gaps regarding gender, ethnicity, and race?

**A.9.** The Commission's disclosure requirements are rooted in the concept of materiality, and what a reasonable investor would consider material today may be different than when those requirements were first adopted. As such, the SEC regularly evaluates our existing rules and attempts to ensure that they have not become outdated. In the context of our disclosure requirements under Regulation S-K, this means ensuring that public company disclosures allow investors to make informed investment decisions.

Materiality will continue to be the touchstone through which we approach our efforts in this area. I do note that compensation is an area where the marketplace is continually active in shaping policies and practices, and the staff and I regularly engage with investors on compensation disclosure and related matters. A requirement of the type you cite is not under consideration. When we consider changes to our approach to disclosure, I believe it is important to remain mindful that, while there are many factors that drive the decision of whether to be a public company, increased disclosure and other burdens may render alternatives for raising capital, such as the private markets, increasingly attractive to companies that only a decade ago would have been all but certain candidates for the public markets. I would be happy to discuss this issue with you.

**Q.10.** *Proxy Advisors*—Shareholder proposals as early warning signs about potential problems at a company. For example, shareholders sought proposals seeking votes to get more information from Wells Fargo about its employee compensation system in 2014 and information on predatory lending activities from Washington Mutual, Merrill Lynch, and Lehman Brothers. Yet, at the request of those companies, the SEC denied the proposal under the "ordinary business exclusion." The SEC agreed to prevent the shareholder proposal from coming to a vote.

Do you agree that history has shown it can be far more detrimental to make errors of omission than inclusion when considering shareholder proposals?

**A.10.** The SEC's shareholder proposal rule, Rule 14a-8, enables a shareholder to have a proposal included in a company's proxy materials for a vote by shareholders if certain requirements are met. The rule provides a number of procedural and substantive bases on which a proposal can be excluded from a company's proxy statement. A company that believes it has a basis to exclude a proposal may seek the staff's views regarding whether the staff would recommend enforcement action to the Commission if the proposal were excluded. In such cases, the staff carefully evaluates the proposal and the arguments made by the company and shareholder proponent, if any, to determine whether it would recommend enforcement action to the Commission if the company were to exclude the proposal. The staff applies the requirements of Rule 14a-8 and is not charged with weighing the merits of a proposal or the underlying policy issues it may raise when deciding whether the proposal falls within one or more bases for exclusion under the rule. It is important to note that the staff's shareholder proposal process reflects only informal views of the staff regarding whether it is appropriate for the Commission to take enforcement action based on a violation of the Commission's proxy rules. The views expressed by the staff are not binding on the Commission or other parties and do not and cannot definitively adjudicate the merits of a company's position with respect to the legality of a shareholder proposal. Shareholder proponents and issuers have the ability to seek a more definitive determination from a court of competent jurisdiction.

**Q.11.** How will ensure that your legacy at the SEC is not marred by SEC staff decisions to kill shareholder proposals that warned us of pending problems?

Like not acting on Wells Fargo incentive pay problems or WAMU's predatory loans?

**A.11.** Above all, it is important that the shareholder proposal process is administered fairly, consistently and without bias, and the staff is committed to administering the process in this manner. In evaluating a company's arguments for excluding a shareholder proposal from its proxy materials, the staff does not consider the merits of a shareholder proposal or the underlying policy issues. Instead, the staff's evaluation is limited to whether there is a basis for excluding the proposal under Rule 14a-8. Stakeholders are best served when the rule is administered in such a fair and consistent manner.

As noted above, the staff's shareholder proposal process reflects only informal views of the staff regarding whether it is appropriate for the Commission to take enforcement action based on a violation of the Commission's proxy rules. The views expressed by the staff are not binding on the Commission or other parties and do not and cannot definitively adjudicate the merits of a company's position with respect to the legality of a shareholder proposal. Shareholder proponents and issuers have the ability to seek a more definitive determination from a court of competent jurisdiction.

**Q.12.** The consensus problem at the SEC's proxy advisors roundtable was vote accuracy. Proxy votes seem to have a high incidence of over and under voting as well as absence of retail investors.

If you engage in any changes to the proxy system, would you prioritize election accuracy first?

**A.12.** Improving the proxy process will be a significant SEC initiative for 2019. The fundamental right of shareholders to participate in the governance of their companies can be fully exercised only to the extent shareholders are assured that their votes are accurately counted. While the current proxy process has worked well for the vast majority of public company meetings, legitimate concerns have been raised about the accuracy and efficiency of the proxy voting process. Complications and delays in tabulating the final votes at several recent shareholder meetings highlighted the need for the SEC to renew its focus on this important area.

The SEC staff's recent proxy roundtable led to a productive dialogue among issuers, investors, proxy service providers and others about the current proxy voting process and important developments since the Commission's 2010 proxy plumbing concept release. Perhaps most encouraging was the common desire expressed by all the roundtable participants to work collaboratively to explore possible improvements to the proxy process, including through the use of distributed ledger technology and other promising new innovations. As I noted in my written testimony, we should focus on what the Commission can do in the interim to improve the current system, and I encourage all those interested in improving the proxy plumbing to share their thoughts, particularly regarding actionable, interim improvements. As a part of this effort, I have therefore asked the staff to facilitate discussions among market participants for possible private-sector solutions and to formulate recommendations for interim improvements that the Commission could consider as well.

**Q.13.** *IPOs*—Mr. Chairman, you have made boosting Initial Public Offerings (IPOs) one of your top priorities. The decline in IPOs is mostly due to mergers and acquisitions, not regulations. Entrepreneurs can more easily—and profitably—sell their firms to another corporation or wealthy individual than going public.

Do you agree that the regressive tax bill that has led to much higher corporate profits and greater wealth for CEOs and executives is exacerbating the decline in publicly traded firms?

Will you take steps to strengthen transparency and investor protections in the private markets, so investors better understand the private market? Then, there would be less of a gap with the public markets?

Have you thought about deploying the tools that the SEC has to take on monopoly—such as enhanced disclosure of competition?

Will you commit to use normal administration process for all your substantive actions regarding IPOs? We need transparency about what the impact of various rule changes might be.

**A.13.** I have long viewed with concern the reduction in the number of public companies because it has resulted in fewer investment opportunities for Main Street investors. I believe we can attribute the reduction to a number of reasons, including economic and regulatory factors, such as the cost of compliance. I am not in a position to comment on whether the Tax Cuts and Jobs Act legislation has affected the decline, though I would note that this decline has been occurring over a longer period of time. Based on my review and discussions with Commission staff, issuers, long-term investors, entrepreneurs and others, it is clear that the reporting, compliance, and oversight dynamic between private and public markets, as well as the costs associated with being a public company, may incent certain companies to remain private or stay private longer. The SEC has taken meaningful steps during my tenure to encourage capital formation for companies seeking to enter our public capital markets while maintaining, and in many cases, enhancing investor protections. While we do not take credit for the numbers, I am encouraged by reports indicating that the number of IPOs in the United States increased year-over-year from 2016 to 2018 in both volume and dollar amount raised.

One of our upcoming capital formation initiatives is to look at the private offering framework. The Division of Corporation Finance is working on a concept release to take a critical look at our "patchwork" private offering system to see how it can be improved, harmonized, and streamlined, while at the same maintaining or enhancing investor protection. I look forward to receiving comments from entrepreneurs, investors and other market participants on this release.

In furtherance of promoting capital formation, the Commission promulgates rules and regulations, which have the force and effect of law. Such rules and regulations generally take effect only after the Commission publishes a notice of proposed rulemaking in the *Federal Register* and adopts a final rule that considers public comments on the proposal in accordance with the Administrative Procedure Act. As I stated in my Statement Regarding SEC Staff Views in September 2018, any views of the staff of the SEC are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties.

With respect to your question on monopoly concerns, the Federal securities laws do not give the SEC jurisdiction over antitrust issues. The Commission's disclosure requirements seek to provide investors with material information in order to make informed investment decisions. Item 101 of Regulation S-K requires disclosure on competitive business conditions. The Division of Corporation Finance selectively reviews filings both to monitor and to enhance compliance with disclosure requirements, including the requirements of Item 101 of Regulation S-K.

**Q.14.** *Enforcement*—Individual accountability has a greater deterrent effect across the market. One such tool to hold individuals accountable is the so-called "Yates Memo" from the previous Administration. This memo outlined six key steps prosecutors should take to quote, "strengthen the pursuit of individual corporate wrongdoing." Last week, the Department of Justice changed how the Yates Memo was implemented. No longer would companies seeking cooperation credit need to identify "all" individuals "all" individuals involved in the wrongdoing, so long as the companies identify those who were "substantially involved" in the misconduct. We are already seeing this at the Consumer Financial Protection Bureau.

Enforcement actions are taken against firms without naming those who defrauded consumers.

Does the SEC have any plans to avoid identifying all individuals involved in misconduct?

**A.14.** As we have discussed, I strongly believe in the deterrent effect of enforcement proceedings pursuing individual accountability and believe that individual accountability drives behavior more than corporate accountability. I also recognize that bad actors undermine the hard-earned confidence that is essential to the efficient operation of our capital markets.

The Commission considers individual liability in every case; it is a core principle of our enforcement program and holding individuals accountable for wrongdoing is a priority for me. To date, the Commission's enforcement actions have borne out the premium I place on individual accountability; during fiscal years 2017 and 2018, the SEC has charged individuals in more than 70 percent of our stand alone cases. As I continue to serve as Chairman, I will continue to support the Enforcement Division's efforts to hold individuals accountable when it is appropriate to do so under the facts and the law. To evaluate whether, and how much, to credit entity self-policing, self-reporting, remediation, and cooperation, the Commission looks to the criteria described in the Seaboard 21(a) report.[1] Among the criteria described in the report are whether the company "promptly, completely and effectively disclosed the existence of the misconduct to the public, to regulators and to self-regulators."[2]

**Q.15.** Does the Department of Justice's changes to the Yates Memo impact your work with your law enforcement partners? If so, how?

**A.15.** Our work with our law enforcement partners has not been impacted. In each case, the Commission, acting upon recommendations from Enforcement staff, makes an independent decision as to whether the facts and the law support charging an individual with misconduct and, in cases involving entities, whether and to what extent to credit self-policing, self-reporting, remediation, and cooperation.

**Q.16.** In his famous retirement speech, SEC attorney James Kidney cautioned against "bosses who mouthed serious regard for the mission of the SEC—to be a strong public protector in the securities market—but their actions were tentative and fearful in many instances. They see an agency that polices the broken windows on the street level and rarely goes to the penthouse floor."

Are the SEC's investigation resources well-spent and properly distributed? If not, what challenges remain? What funding level is needed to properly staff the SEC regarding investigations, cybersecurity, investor protection, etc.?

**A.16.** The SEC—agency wide—has approximately 4,400 people. Approximately 6.3 million people work in the financial services sector in the United States. We are less than one-one thousandth of that

[1] U.S. Sec. and Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001), available at *http://www.sec.gov/litigation/investreport/34-44969.htm.*

[2] Id.

amount. In order to adequately police this sector for wrongdoing, it is important that the agency have adequate resources to do so.

Over the past year, the SEC generally, and the Enforcement Division specifically, have been focused on maximizing our impact with the resources we have. The sheer size of the financial industry and the volume of potential wrongdoing mean that we will always have to make decisions about where to allocate our resources and how best to coordinate with other authorities for the maximum impact.

I believe that the Commission's enforcement resources are well spent and properly allocated to address key priorities—retail investor protection (both directly and through institutional enforcement actions) and the investigation and prosecution of cyberbased threats—as well as other critical areas including, but not limited to, investment professional misconduct, insider trading, market manipulation, and accounting fraud.

For FY2019, the Commission requested funds for critical investments in our ability to protect investors by restoring 17 positions for Enforcement to support key enforcement priorities, including expanding the work of the Cyber Unit and the Retail Strategy Task Force, and I am pleased that Congress recently provided those resources. Moving forward, I will continue working with the Division of Enforcement to evaluate their resource needs to ensure they can continue vigorously protecting investors and expect to request additional resources in FY2020.

**Q.17.** The President required a hiring freeze at the SEC.

How has this hiring freeze—two years now—made your work more difficult—from everything from investigating fraud to strengthening your defenses against cyberattacks?

**A.17.** The Commission has operated under an agency-wide hiring freeze since late 2016. Consequently, the Division of Enforcement's employee and contractor staffing levels have decreased since the freeze was imposed. The combined number of positions in the Division and the number of contractors supporting our investigation and litigation efforts fell by approximately 10 percent between FY2016 and FY2018. These reductions in human capital have created challenges for the Division of Enforcement in staffing, resource allocation, and prioritizing investigations and litigation. But despite these challenges, the Division has risen to the challenge and continued to exhibit significant enforcement-related activity.

On a qualitative basis, which I believe is the most meaningful basis by which to judge the Division's effectiveness, the SEC achieved many notable enforcement-related successes in FY2018—recommending that the Commission bring significant actions against important individuals and market participants, achieving successes for retail investors, fashioning meaningful and effective remedies and relief, and addressing emerging and developing risks. And, while I believe that often cited quantitative metrics such as number of cases filed or the total amounts of fines and penalties assessed, do not provide, without substantial additional information, a meaningful measure of the effectiveness of an enforcement program, FY2018 nonetheless reflected a high level of enforcement-related activity by the Commission. The Commission brought 821 actions (490 of which were "stand alone" actions) and obtained judgments and orders totaling more than $3.9 billion in disgorgement and penalties. Significantly, it also returned $794 million to harmed investors, suspended trading in the securities of 280 companies, and obtained nearly 550 bars and suspensions.

While these achievements are a testament to the hardworking women and men of the Division, with more resources the SEC could focus more on individual accountability, as individuals are more likely to litigate and the ensuing litigation is resource intensive. Moreover, additional resources that we requested for FY2019 will support two key priorities of the Division: protecting retail investors and combating cyber-related threats.

**Q.18.** How have two recent Supreme Court decisions—Kokesh v. SEC and Lucia v. United States—made SEC enforcement actions more difficult?

**A.18.** The Supreme Court's decisions in Kokesh v. SEC and Lucia v. SEC have significantly impacted the Commission's enforcement program. In Kokesh v. SEC, the Supreme Court held that our claims for disgorgement are subject to a 5-year statute of limitations. The Supreme Court's holding in Kokesh is obviously a very significant decision, and one that has limited our ability to return ill-gotten gains to Main Street investors in longer running frauds. I do not believe it is productive to debate the merits of the Kokesh decision. I agree that statutes of limitation serve many important functions in our legal system, and certain types of claims should have reasonable limitations periods. Civil and criminal authorities, including the SEC, should do everything in their power to bring appropriate actions swiftly, and, in our markets, particularly our public markets, the certainty brought by reasonable limitations periods has value for investors.

However, as I look across the scope of our actions, including most notably Ponzi schemes and affinity frauds, which often target retail investors, I am troubled by the substantial amount of losses that we may not be able to recover for retail investors. Said simply, if the fraud is well-concealed and stretches beyond the 5-year limitations period applicable to penalties, it is likely that we will not have the ability to recover funds invested by our retail investors more than 5 years ago. Allowing clever fraudsters to keep their ill-gotten gains at the expense of our Main Street investors—particularly those with fewer savings and more to lose—is inconsistent with basic fairness and undermines the confidence that our capital markets are fair, efficient and provide Americans with opportunities for a better future.

And, our experience post-Kokesh is showing that this may already be happening. With respect to matters that have already been filed, the Division of Enforcement has estimated that the Court's ruling in Kokesh may cause the Commission to forgo up to approximately $900 million in disgorgement, of which a substantial amount potentially could have been returned to retail investors. I welcome the opportunity to work with Congress to address this issue to ensure defrauded retail investors can get their investment dollars back. I believe that any such authority should be narrowly tailored to that end while being true to the principles embedded in statutes of limitations.

In Lucia v. SEC, the Court held that the Commission's Administrative Law Judges (ALJs) were inferior officers of the United States who must be appointed in the manner required by the Appointments Clause of the U.S. Constitution. The Court held that the SEC's ALJs had not been appointed in a manner consistent with the Appointments Clause and that the appropriate remedy for an adjudication tainted with an appointments violation was a new hearing before a properly appointed official. Examining the facts of Lucia, the Court further held that, the adjudication at issue could not occur before the same ALJ who heard the case, even if she or he had now received a constitutional appointment. According to the Court, having already both heard Lucia's case and issued an initial decision on the merits, she or he could not be expected to consider the matter as though she or he had not adjudicated it before. The court ruled that to cure the constitutional error, another ALJ (or the Commission itself) must hold the new hearing.

After Lucia, the Commission stayed all pending administrative proceedings. The Commission lifted the stay on August 22, 2018, and approximately 200 administrative proceedings were reassigned at that time. Many of the 200 administrative proceedings have now been substantially resolved. The remaining reassigned APs will require substantial litigation resources going forward.

**Q.19.** The Dodd–Frank Act included a provision (Sec. 954) that would require public companies to clawback compensation that were erroneously awarded to executives whenever their companies had accounting restatements. The SEC proposed a rule in 2015.

What is the status of this rule?

When will it be final?

**A.19.** Because of the complexity and scope of the SEC's existing executive compensation disclosure regime, as well as the nature of the Dodd–Frank Act's executive compensation rule mandates, I believe a serial approach to these rules is likely to be most efficient and best serve the SEC's mission. To that end, we issued final rules in December 2018 to implement Section 955 of the Dodd–Frank Act to require companies to disclose in proxy and information statements their practices or policies regarding the ability of employees or directors to engage in certain hedging transactions with respect to company equity securities.

The clawbacks rule and the remaining Dodd–Frank Act executive compensation rulemakings are on the Commission's rulemaking agenda, and we are continuing our work to finalize them. As I noted in my written testimony, several companies already have made public their policies regarding compensation clawbacks, and some of these policies go beyond what would be required under the Dodd–Frank Act. We have seen a few companies attempt to claw back compensation from their executives under these policies. Our rulemaking priorities, as well as the rules themselves, should reflect these observable developments.

**Q.20.** The Dodd–Frank Wall Street Reform and Consumer Protection Act included other permissive rules.

What are the status of those rules?

**A.20.** The Commission has had an active rulemaking calendar in recent years, focusing on, among other things, the 80 mandatory rulemaking requirements applicable to the SEC under the Dodd–Frank Act, congressional mandates in the Economic Growth, Regulatory Relief, and Consumer Protection Act, and responding to major events and changes in the broader regulatory landscape that have required our immediate attention.

With respect to the Dodd–Frank Act, the Commission has undertaken both mandatory and permissive rulemakings. For example, the Commission has now completed many, but not all, of the security-based swap rules mandated by Title VII of the Act, and I anticipate that in the coming year the Commission will move forward with a package of rulemakings to complete our Title VII rulemaking obligations. The Commission also has taken action on some of the permissive rulemakings under the Act. For example, the Commission proposed Regulation Best Interest regarding the standard of conduct for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.

**Q.21.** *Information in the Market*—What is the status of Inline-XBRL—eXtensible Business Reporting Language—that makes it easier to search data in an open and interactive way?

**A.21.** In June 2018, the Commission adopted amendments requiring the use of Inline XBRL for the submission of operating company financial statement information and fund risk/return summary information. The amendments are intended to improve the data's usefulness, timeliness, and quality, benefiting investors, other market participants, and other data users. The amendments are also intended to decrease, over time, the cost of preparing the data for submission to the Commission.

The amendments will go into effect in phases. Operating companies that are currently required to submit financial statement information in XBRL will transition to Inline XBRL on the following phased basis:

- Large accelerated filers that use U.S. GAAP will be required to comply beginning with fiscal periods ending on or after June 15, 2019.
- Accelerated filers that use U.S. GAAP will be required to comply beginning with fiscal periods ending on or after June 15, 2020.
- All other filers will be required to comply beginning with fiscal periods ending on or after June 15, 2021.

Funds that are currently required to submit risk-return summary information in XBRL will transition to Inline XBRL on the following phased basis:

- Large fund groups (net assets of $1 billion or more as of the end of their most recent fiscal year) will be required to comply 2 years after the effective date of the amendments.
- All other funds will be required to comply 3 years after the effective date of the amendments.