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Testimony of Professor S.P. Kothari

House Financial Services Committee, Subcommittee on Capital Markets

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Chairman Wagner, Ranking Member Sherman and Members of the Subcommittee, thank you for inviting me to appear before you today.

I have been on the faculty of the Massachusetts Institute of Technology ("MIT") Sloan School of Management since 1999. I currently hold the Gordon Y Billard Professorship of Accounting and Finance. From March 2019 to January 2021, I served as Chief Economist and Director of the Division of Economic and Risk Analysis at the U.S. Securities and Exchange Commission. In that role, I led a team of 160 economists and data scientists focused on securities regulation, domestic and international prudential regulation, and data analytics.

Given my expertise and background, over the past few years, I have submitted several comments in response to various rules proposed by the SEC. My comments have noted deficiencies in the comprehensiveness and quality of the Commission's cost-benefit analyses of the proposed rules. As a result of such deficiencies, there are risks that the costs of such rules will exceed the benefits, harming the competitiveness and efficiency of U.S. capital markets and the U.S. economy.

I will use my comments to illustrate examples of the recent deficiencies in economic analyses.

Private Funds Regulations

In February 2022, the Commission proposed new rules affecting the reporting and management of the private funds industry.[1] The industry represents a significant sector of U.S. capital markets, including venture capital, private equity, hedge funds, real estate, and private credit funds. Private funds were estimated to manage $18 trillion of assets.[2] Importantly, the private fund industry is highly competitive and open to sophisticated investors, including institutions and accredited investors.[3] The Commission proposed disclosure requirements and prohibitions on certain practices. In response to public comments, the final rules were more limited in their requirements, and certain otherwise prohibited practices were instead allowed, subject to disclosure and investor consent requirements.[4]

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[1] Release Nos. IA-5955; File No. S7-03-22.
[2] As of February 9, 2022. Release Nos. IA-5955.
[3] Accredited investors meet either income, net worth, or qualifications criteria. It is generally acknowledged that accredit investors have the financial qualifications and/or sophistication to make higher risk investments without the protections typically afforded by investment only in registered securities.
[4] Release No. IA-6383; File No. S7-03-22.

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In my view, in its proposed rulemaking, the Commission did not consider the full economic context of certain activities (or made certain unsupported assumptions about that context), and consequently failed to consider the full set of costs and benefits related to its proposed rules.

As a threshold matter, the Commission's analysis did not fully consider the market context for private funds in which contracts between fund managers and investors are negotiated by sophisticated parties, and significant investment choices ensures that fund managers compete on cost, performance, and reputation. By ignoring this context, the Commission's economic analysis failed to consider how market participants would react to proposed rules and prohibitions. For example, the Commission originally proposed that private fund managers be prohibited from passing through compliance costs to fund investors.[5] Under existing contracts, though, pass through of such costs ensures that managers will be willing to incur such costs on behalf of a fund. Prohibiting pass-through of such costs could lead to managers considering the expense in comparison to their 20% interest in profits – likely resulting in diminished commitment to compliance expenses.

More generally, the Commission did not consider that in a competitive market with sophisticated negotiating parties existing contracts likely represent the most efficient outcome. In such a setting, the prohibition of various practices and the requirement of other practices would likely lead to renegotiation of contracts to second-best outcomes – for example, prohibiting fees for compliance expenses may lead managers to raise other fees instead. Indirect costs resulting from renegotiated contracts would likely be significant, potentially harming innovation and efficiency in the private fund capital market.

As another example, the Commission sought to prohibit private funds from charging for "accelerated payments," which the Commission characterized as "services the investment advisor does not, or does not reasonably expect to, provide to the portfolio investment."[6] The Commission argued that such fees presented a conflict of interest in benefiting the management company at the expense of fund investors. However, the Commission did not consider whether such fees – which relate to monitoring of portfolio companies – are a fee-for-service versus a fee-for-value-added by the investment manager in its contributions to management oversight, strategic decision-making, capital management, or transaction support. The more successful an investment is, the earlier the fund may exit its position – but that is exactly the situation where the manager had added the most value and the fee is most justified by performance.

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[5] Release Nos. IA-5955; File No. S7-03-22; p. 226-7.
[6] Release Nos. IA-5955; File No. S7-03-22; p. 136.

Best Execution and Order Competition Rules

In December 2022, the Commission proposed rules related to best execution regulations for broker-dealers. The rules would require detailed, written policies and procedures for all broker-dealers, imposing additional requirements for conflicted transactions with retail customers.[7] Payment for order flow is one such purported conflict transaction, in which a market maker compensates a broker for routing its clients trades to it.

To support this rule, the Commission relied on an economic analysis on the relationship between payment for order flow ("PFOF") and the prices received by retail investors ("execution quality"). The Commission's economic analysis, however, was fundamentally flawed.[8] The Commission used a regression analysis of 12-14 million observations that intended to control for differences in stocks traded by customers of PFOF brokers and Non-PFOF brokers. However, the main variable of interest, PFOF amount, is not available in the consolidated audit trail (CAT) data. As a result, the Commission used brokers' disclosures mandated by Rule 606, lumping together all executions in each month by order type. The data did not contain information about how PFOF varies across specific stocks, weeks within a month, or order size buckets – factors that could affect the impact of PFOF on execution quality. Ultimately, the Commission's analysis overstated the number of independent observations (12-14 million vs. the 5,160 distinct observations of PFOF amount); relied on an unsupported (and likely incorrect) assumption that PFOF is the same across all stock/quantities within each Rule 606 grouping; and omitted important control variables known to affect market makers (such as order size, short interest, and return volatility). Thus, the Commission's economic analysis was biased toward finding an effect where none existed and overstated in finding statistical significance. Moreover, putting aside the flaws in its regression analysis, the Commission did not consider how even its flawed analysis implied an economically miniscule effect of PFOF on execution quality, indicating that PFOF rates were, at best, a second order determinant of execution quality.

Climate-related Disclosures

In March 2022, the Commission proposed rules requiring climate-related disclosures in the narrative portion of financial statements and quantitative metrics to be incorporated into the notes to financial statements.[9] There are fundamental problems with the proposed rule on climate-related disclosures. First, the rule subverted the existing standard-setting process in which the Financial Accounting Standards Board (FASB) set accounting disclosures (albeit under the SEC's oversight and authority).

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[7] Release No. 34-96496; File Number S7-32-22.

[8] Comment Letter from S.P. Kothari and Travis L. Johnson, Request for Comment on the Proposed Best Execution Rule (File Number S7-32-22), June 19, 2023.

[9] Release Nos. 33-11042; 34-94478; File No. S7-10-22.

Second, the proposed disclosure requirements were inconsistent with multiple, existing accounting standards. For example:

- They established a 1% threshold on *a line-item basis*, even though the accounting profession's rule of thumb is a 5% threshold on financial statements *as a whole*.
- They required an explanation of inputs, assumptions, and policy decisions for each financial statement footnote disclosure, even though no such requirements exist for any other impacts disclosed under Generally Accepted Accounting Principles.

In addition to the fundamental problems with the proposed climate-related disclosures, the Commission failed to provide an adequate cost-benefit analysis of its proposal. Although the Commission estimated compliance costs (which it most likely underestimated), it did not even attempt to quantify the benefits of the proposal, but instead noted that the proposed disclosures "could" or "may" be of value to investors. However, there are many economic reasons to believe the disclosures would provide limited, if any, benefit to investors:

- Existing standards already required disclosure of material risks and financial impacts (e.g., FASB standards related to loss contingency environmental obligations or tangible and intangible impairment testing, which may be impacted by environmental factors), it is therefore unlikely that the incremental information would provide any additional material information to investors.
- The proposed disclosures would not require uniform metrics across companies. As a result, even if investors read, understood, and compared companies' explanations of how their climate impact figures were derived, inconsistent metrics across companies would make such information of limited, if any, value to investors.
- The meaning of materiality would be diluted by the proposal's requirement to make disclosures without regard to netting positive and negative impacts against each other.

Not only did the Commission propose disclosure rules without quantified economic benefits to investors – the primary users of financial statements – it also failed to quantify the potential impacts of the proposals to the economy overall. For example, the Commission stated that firms may choose to change suppliers or disengage from certain clients due to the effect on the firm's "Scope 3 emissions."[10] Yet the Commission failed to quantify such potential economic costs.

<u>Share Repurchase Disclosure</u>

In December 2021, the Commission proposed disclosure rules expanding required disclosures of corporate share repurchases. Instead of requiring quarterly disclosures of aggregate repurchases, the new standard would require daily disclosures of all repurchases.[11] After the

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[10] Release Nos. 33-11042; 34-94478; File No. S7-10-22; p. 403.
[11] Release Nos. 34-93783; File No. S7-21-21.

initial comment period, the Commission relented somewhat–it would still require disclosure of daily repurchases, but would allow those disclosures to be reported at the end of each quarter rather than every day (conceding that daily disclosures would have provided informational advantages to traders who might take advantage of share repurchasing by bidding up the market price of the stock).[12]

The Commission's rationale for the share repurchase disclosure rule was tied to the potential for managers to use share repurchases for their own benefit, e.g., by decreasing share count to manipulate compensation targets (e.g., earnings per share). However, the Commission ignored the empirical research (including my own) on this issue, which found no evidence to support the notion that there was any systematic problem of share repurchases motivated by manager self-interest. [13] But rather than be satisfied with the existing regime, which allows for enforcement actions against a company that repurchases shares for improper reasons, the Commission sought to expand disclosure requirements on all companies – raising costs to all companies. This includes direct compliance costs and indirect costs (such as dissuading companies from otherwise efficient capital allocation decisions or revelation of competitive activities). Moreover, the Commission did not offer any evidence of any benefits (for example, that the new disclosures would help it identify potential enforcement actions that would not otherwise be identified).[14]

Litigation has commenced related to the share repurchase rule. The Commission's legal briefs concede the lack of rigorous economic analysis supporting its rule: "the Commission need not base its every action upon empirical data, and may reasonably conduct a general analysis based on informed conjecture."[15] Thus, in the absence of any empirical support for its position (and, indeed, ample evidence pointing to the lack of systematic abuse of share repurchases to benefit managers at shareholder expense), the Commission relies on "informed conjecture." I offer no comment on whether such conjecture is legally sufficient for its rulemaking, but from an economic perspective, the Commission cannot meet its burden of showing that the rules' benefits outweigh the costs.

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[12] SEC.gov | SEC Reopens Comment Period for Proposed Rule on Share Repurchase Disclosure Modernization
[13] Nicholas Guest, S.P. Kothari & Parth Venkat, "Share Repurchases on Trial: Large-Sample Evidence on Share Price Performance, Executive Compensation, and Corporate Investment," 52 *Financial Management* 19 (2023).
[14] The Commission also rejected lower cost alternatives such as (1) requiring companies to discuss the link between compensation and EPS-based bonuses in the Compensation Discussion and Analysis section of proxy materials, or (2) issuing guidance of when repurchase disclosure is warranted to avoid an adverse enforcement action. *Chamber of Commerce of the United States of America, et al, v. United States Securities and Exchange Commission*, Brief for S.P. Kothari and James Overdahl as Amici Curiae in Support of Petitioners, Case 23-60255, July 17, 2023.
[15] *Chamber of Commerce of the United States of America, et al, v. United States Securities and Exchange Commission*, Brief of Respondent Securities and Exchange Commission, Case 23-60255, August 9, 2023, p. 32 (quoting *Nasdaq Stock Mkt. LLC v. SEC*, 34 F.4th 1105, 1111 (D.C. Cir. 2022).

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Concluding Thoughts

The above examples illustrate a concerning lack of rigor and completeness in the Commission's economic analysis of its proposed rules. Absent appropriate economic analysis, there is significant risk that proposed rules will impose more costs on the U.S. economy than benefits, potentially eroding the competitiveness and efficiency of our capital markets. Of concern is not just the quality of specific analysis (such as the biased and statistically inadequate regression analysis underlying certain Best Execution rules), but also the broader failures to quantify the indirect costs of proposed regulations (which are likely to be much larger than the direct costs of compliance) and quantify benefits (which may be limited in comparison to costs).

My comments have focused on the Commission's analysis with respect to individual proposed rules, but it should be noted that there may be cumulative impacts across all its rulemaking that the Commission has not analyzed. Compliance costs to registrants may be particularly burdensome given the breadth of new disclosure requirements such as those related stock repurchases or climate risk that I discussed, or other new requirements (such as the "pay versus performance" disclosure rule[16]). Increased compliance costs can be detrimental to the competitiveness of U.S. public capital markets, lead to effects such as dissuading foreign firms from registering in U.S. capital markets or motivating firms to remain private.[17] The cumulative impact on investment advisors and broker-dealers may also be substantial, raising costs to investors or, on the margin, limiting competition to the detriment of investors who will ultimately bear a substantial portion of the incremental compliance costs.

Thank you for the opportunity to share my thoughts. I welcome any questions the Subcommittee may have.

Sincerely,

S.P. Kothari

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[16] Release No. 34-95607; File No. S7-07-15.

[17] For example, the Sarbanes-Oxley Act negatively impacted firms' decisions to list publicly in the United States. Hostak, Peter, et al. "An examination of the impact of the Sarbanes–Oxley Act on the attractiveness of US capital markets for foreign firms." *Review of Accounting Studies* 18 (2013): 522-559 and Mohan, Nancy J., and Carl R. Chen. "The impact of the Sarbanes–Oxley act on firms going private." *Research in Accounting Regulation* 19 (2007): 119-134.