Written Testimony of

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Chairwoman Wagner, Ranking Member Sherman, and esteemed members of the subcommittee, thank you for the opportunity to appear before you today to discuss institutional reforms of the Securities and Exchange Commission (SEC).

My name is Alexandra Thornton. I am senior director of financial regulation at the Center for American Progress, an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans through bold, progressive ideas, as well as strong leadership and concerted action.

The Commission's Rulemaking and Comment Periods

The Administrative Procedure Act, which governs the procedures federal agencies must follow when making rules and adjudicating agency matters,[1] requires an agency in an informal rulemaking process to provide a meaningful opportunity for the public to provide written comments on a proposed rule.[2]

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[1] Administrative Procedure Act, 5 U.S.C. Sections 551-559.
[2] 5 U.S.C. Section 553(c).

Courts have made it clear that the point of this process is for the agency to solicit relevant information, so that it can "examine the relevant data and articulate a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'"[3]

Neither the statute nor the court opinions interpreting the statute require an agency to agree with, or make changes in response to, every comment. Rather, the agency is simply required to make a reasonable effort to collect relevant information and explain why it is taking a course of action, as informed by that information.

That is not what is happening now.

Instead, opponents of SEC rulemakings who seek to stop agency actions are misusing reasonable administrative process protections and turning them into years-long gauntlets for agency actions. Unfortunately, a handful of relatively recent court decisions have made this process far more burdensome on the agency and thrust important rules into jeopardy. These outside pressures have added unreasonable expectations for the administrative process, burdening the SEC and impeding its ability to do its job of protecting investors and promoting more fair, orderly, and efficient capital markets.

One of the most prominent ways to stop or slow agency actions is through manipulation of the comment process. Recently, opponents of commission actions have claimed that they have had inadequate time to consider proposals and offer meaningful insights. At the same time, opponents have also pursued a strategy of storming the agency with comment letters, often raising superfluous arguments. Thereafter, these opponents frequently challenge final rules in court, claiming that the agency inadequately addressed concerns they raised in their comments.

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[3] *Susquehanna Int'l Group v. SEC*, 866 F.3rd 442 (D.C. Cir. 2017) (citing *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. US*, 371 U.S. 156, 168 (1962).

In response to these attacks, the commission has begun to bend over backward to allow for lengthy periods of comment. The typical time between when an action is proposed and finalized is now one or more years. While a formal comment period may last 30 days, 60 days, or even more, the SEC routinely considers comments received well outside those windows, even though it is not legally required to do so. Further, the agency has repeatedly, for complex proposals, re-opened formal comment periods to seek further clarification and more detailed information. And the agency has also offered its own supplemental analyses to its proposals to the comment file, so that market participants may have further information for their own analysis. None of this was prevalent for most of the agency's history.

An even more striking change in how the agency approaches its rulemakings is that it seems to seek to address nearly every point raised by commenters, regardless of the relevance, and even with respect to comments submitted long after the end of the comment period. While this may have been possible in the days when the SEC commonly received only a handful of comments on even its most controversial proposals, the impact of this approach is nearly impossible today, when the SEC often receives hundreds, thousands, or even tens of thousands of comments on many rules. Even though the agency is not legally required to address all the issues raised by all commenters in its final rules, the agency staff have begun to dedicate hundreds of pages in their final rule releases to these not-legally-mandated reviews of what may be erroneous or irrelevant comments.

Separately, the commission's economic analyses have become longer and much more complex.

The two very different rules released on March 6—a couple weeks ago—are a perfect example.[4] That day, a divided commission adopted the climate disclosure rule, now stayed. And a unified commission adopted a rule to update disclosures by trading centers related to execution of equities orders.

Both rules adopted that day were contemplated by the SEC and businesses for well over a decade prior to the rules even being proposed.

The climate disclosure rule was preceded by 2010 guidance on disclosure of climate-related risks and a 2021 public Request for Information.[5] Market participants were calling for updates to order execution disclosures, called Rule 605, for years, and the SEC's Equity Market Structure Advisory Committee considered changes to the rule in 2016. Both rules had been the subject of petitions from industry seeking to have the SEC propose or modify rules. With a 90-day comment period in each case and well over a year between the proposed and the final rule in each case, during which the commission continued to accept and consider comments, the proposals subsequently advanced by the commission together totaled 1,472 pages.[6] Even before the economic analyses, which together amounted to more than 500 pages, the adopting releases contained hundreds of pages in which the commission restated and responded to issues raised in the thousands of comments received. As anyone who has reviewed these rules will admit, many of the comments and analysis are repetitive and either superfluous or arguably irrelevant.

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[4] See Open Meeting Agenda, Wednesday, March 6, 2024, available at https://www.sec.gov/os/agenda-open-030624, considering "The Enhancement and Standardization of Climate-Related Disclosures for Investors" and "Disclosure of Order Execution Information for National Market System Stocks" (Rule 605).

[5] See, Statement of Commissioner Allison Herron Lee, "Public Input Welcomed on Climate Change Disclosures," U.S. Securities and Exchange Commission, March 15, 2021, available at https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[6] Final rule, "Disclosure of Order Execution Information," 586 pages, available at https://www.sec.gov/files/rules/final/2024/34-99679.pdf; and Final Rules, "The Enhancement and Standardization of Climate-Related Disclosures for Investors, 886 pages, available at https://www.sec.gov/files/rules/final/2024/33-11275.pdf.

The result of all this analysis is paralysis. It is typically years from the time a rule is considered by businesses, investors, and other market participants to the development of a proposal, the submission and analysis of comments, and adoption of a final rule. As the agency's agenda shows, many rules sought by businesses and investors, respectively, have yet to be proposed, much less finalized.[7]

The ability of thousands of market participants, including larger companies and financial firms, to overwhelm the agency with letters far outstrips the agency's ability to sift through the morass. The agency simply does not have enough staff to engage in this strained analysis for thousands of comments on every single rulemaking.

Notably, this paralysis is typically one-sided. Despite the agency's clear mission to protect investors and to promote fair and efficient capital markets, there generally is not this type of analysis for deregulation. For example, a 2020 final rule released under Chair Jay Clayton that set up procedural hurdles for investors seeking to offer proxy proposals was only 247 pages long with only 72 pages of economic analysis.[8] Rules designed to protect investors, such as through requiring disclosures, are layered with a massive regulatory burden, while rule revisions to benefit industry at the expense of investors generally are not.

<u>Policy Interpretation</u>

At the request of market participants, the commission routinely provides interpretive guidance (including "frequently asked questions"), no-action letters, and exemptive orders, which lead to changes in how its rules are implemented and enforced. Over the past several years, the agency and its staff have

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[7] Office of Information and Regulatory Analysis, Agency Rule List – Fall 2023, Securities and Exchange Commission, available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode&showStage=active&agencyCd=3235.

[8] See "Exemptions from the Proxy Rules for Proxy Voting Advice," October 2020, available at https://www.sec.gov/files/rules/final/2020/34-89372.pdf.

taken hundreds of these actions, impacting nearly every aspect of the capital markets, ranging from how companies review shareholder proxy proposals, to how investment managers pay for research, to how brokers comply with their capital rules.[9] Like formal agency rules, these other agency activities are now also increasingly being challenged in the courts.[10]

No-action letters and exemptive orders have the effect of changing allowable behavior of market participants, often by effectively permitting what would otherwise not be permitted activity. Interpretive guidance provides more detail on how the commission will apply a rule and is often used to shape the policies, procedures, and practices of firms seeking to comply with rules. These actions, regardless of their statutory basis or standing as a "final action" of the agency, can materially change the contours of the rules and the markets. The processes used by the agency and its staff to issue guidance and no-action letters, in particular, usually do not involve obtaining broader public comment on the facts in advance. As such, they may be opaque or subject to potential errors.

While the SEC staff may do its best to identify the relevant facts and issues, they or the agency more broadly may take actions based on incomplete, inadequate, or erroneous information.

To ensure the integrity of agency actions, provide clarity to market participants, and preserve the agency's ability to interpret and apply its rules without unnecessary risk of judicial second-guessing, the agency should revise its internal procedures for adopting interpretive guidance, no-action letters, and exemptive orders to ensure that they are sufficiently public and detailed before their adoption or release. It is only through a transparent process that courts and the public can have confidence that

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[9] Staff No Action, Interpretive and Exemptive Letters, U.S. Securities and Exchange Commission, available at https://www.sec.gov/regulation/staff-interpretations/no-action-letters (last accessed March 2024).
[10] See, e.g., *CBOE Futures Exchange LLC v. SEC*, No 21-1038 (D.C. Cir. 2023), available at https://cases.justia.com/federal/appellate-courts/cadc/21-1038/21-1038-2023-07-28.pdf?ts=1690556595; and *Clarke, et.al. v. CFTC*, No. 22-51124 (5th Cir. 2023), available at https://www.ca5.uscourts.gov/opinions/pub/22/22-51124-CV0.pdf.

these activities are based upon the relevant facts and that the actions taken are reasonably connected to those facts.[11] This minimal procedural safeguard should apply to all interpretive guidance, no-action letters, and exemptive orders, regardless of their legal status.

Consolidated Audit Trail (CAT)

In 2012, two years after first proposing it, the SEC adopted a rule to provide for the creation and adoption of a consolidated audit trail. Now, more than a dozen years later, some in the financial services industry have continued to lodge substantive and procedural challenges to the Consolidated Audit Trail, arguing that it is somehow an unprecedented, illegal collection of information or subject to inadequate agency considerations. This is not true.

The SEC has clear statutory authority to oversee securities trading markets, and it has, for decades, ensured that orders to buy or sell securities, and trade executions, are reported to regulators. For decades, FINRA maintained the Order Audit Trail System (OATS), which it used to collect orders and trading-related information. FINRA (in conjunction with the SEC) has also developed very frequently used procedures to help match that trading to specific firms and individuals with which all broker-dealers are familiar.

Once the Consolidated Audit Trail (CAT) was up and running (after more than a decade of rulemakings, regulatory orders, and actions), FINRA retired OATS, essentially replacing brokers' reporting obligations under OATS with the revised CAT reporting obligations. As a result, the Consolidated Audit Trail provides the principal means for regulators to identify trading manipulations and abuses and investigate them.

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[11] See, e.g., Comment letter, Healthy Markets Assn., regarding Petition for Rulemaking for Exemption and NO-Action Relief Requests," Securities and Exchange Commission, October 18, 2023.

In today's high-speed markets, abuses are often undetectable without knowing who is doing the trading. If one trader enters 25 orders to buy stock in 25 different venues to create the appearance of broad "market demand," when there is no such demand, it may be engaging in illegal spoofing. However, if there really were 25 different traders submitting those orders, then nothing nefarious is occurring. The regulators need to know the difference if they are to protect the integrity of the markets.

This is not a hypothetical risk. Cross market, complex market manipulation strategies were sadly common prior to the implementation of the CAT, and even played a role in the May 6, 2010, Flash Crash.[12]

While the decades-old reporting requirements and regulatory processes allowed the SEC to ultimately link traders to their trading activities, it was not sufficiently automated to allow for effective oversight in the complex, high-speed, marketplace.

The CAT does not generally collect novel information that was previously unavailable to regulators. In fact, using the well-known "blue sheet" process, regulators can currently collect trader-specific personally identifiable information (PII). Specifically, as FINRA explains on its website:

> Electronic Blue Sheet (EBS) data files, which contain both trading and account holder information, provide regulatory agencies with the ability to analyze a firm's trading activity. Firms are expected to provide complete, accurate and timely Blue Sheet data in response to regulatory requests. Incomplete, inaccurate and untimely Blue Sheet data

[12] Andy Verity & Eleanor Lawrie, "Hound of Hounslow: Who is Navinder Sarao, the 'flash crash trader'?" BBC, January 28, 2020, available at https://www.bbc.com/news/explainers-51265169.

> compromises regulators' ability to identify individuals engaging in insider trading schemes and other fraudulent activity. [13]

The CAT simply ties together information that was historically available, but not in a useful way.

The complaints now being lodged against the CAT's purportedly unprecedented collection of information ring hollow, given that regulators have for decades collected and had access to the information.[14] The hyperbolic arguments being launched against the CAT simply were not made when OATS was adopted, nor are they being made now against the continuing blue sheet process. Further, many federal regulators, most notably, the Internal Revenue Service, collect far-more personal information than is being sought here.

Further, to address concerns raised by some market participants about the personally identifiable information (PII), in the more-than-a-decade since the CAT rule was first proposed, the agency and self-regulatory organizations in charge of it have taken unprecedented steps to protect PII. For example, regulators do not have access through the CAT to PII information directly now, but rather through a masked identifier. The actual human PII is only available upon further investigation.

There is no credible legal challenge to the SEC's authority to collect the information contained in the Consolidated Audit Trail. And given that the CAT has been subject to numerous rulemakings, orders, and implementation plans spanning over 14 years, it cannot be said that the CAT has not received sufficient regulatory consideration.

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[13] Electronic Blue Sheets, FINRA, available at https://www.finra.org/filing-reporting/electronic-blue-sheets-ebs.

[14] See generally, Statement of Tyler Gellasch, Executive Director of Healthy Markets Association, *Implementation and Cybersecurity Protocols on the Consolidated Audit Trail* Before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment, Nov. 30, 2017.

The renewed complaints about the CAT may relate to the SEC's recent approval of the funding mechanism used to pay for the creation and operation of the CAT. That Funding Order is also being challenged in court, but the challenge is not about the merits of the CAT.

Private Fund Advisers Rule

Among the legislative proposals being considered by the subcommittee today is one that calls for congressional disapproval of the Private Fund Advisers rule finalized last September.[15] The rule requires private funds and their advisers to provide investors with regular account statements, standardized fee and expense information, and basic disclosures regarding their conflicts of interest. It will also require private funds to have annual audits. And the rule is well within the commission's authority to adopt rules reasonably designed to prevent acts, practices, and business activities that are fraudulent, deceptive, or manipulative.[16]

The Investment Advisers Act of 1940 requires firms or sole practitioners compensated for advising others about securities investments to register with the SEC and conform to regulations designed to protect investors.[17] Private funds have grown in size, complexity, and number in the past decade since the Dodd-Frank Act required private fund advisers to begin registering with the SEC.[18] Private funds have trillions of dollars-worth of assets under management, and, according to the SEC, more than 5,000 SEC-

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[15] Securities and Exchange Commission, "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," 88 Fed. Reg. 63206 st seq., available at https://www.federalregister.gov/documents/2023/09/14/2023-18660/private-fund-advisers-documentation-of-registered-investment-adviser-compliance-reviews.
[16] 15 U.S.C. Section 80b-6(4).
[17] 15 U.S.C. Section 80b-1 through Section 80b-21.
[18] Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. Section 80b-4(b).

registered investment advisers, roughly 35 percent of all SEC-registered advisers, manage about $18 trillion in private fund assets.[19]

But while private fund advisers are theoretically already required to disclose significant relevant information under the Investment Advisers Act,[20] the SEC's Division of Examinations has found substantial concerns about the behavior of private fund advisers, including failure to act consistently with disclosures; use of misleading disclosures regarding performance and marketing; due diligence failures relating to investments or service providers; and use of potentially misleading "hedge clauses."[21] Another examination of private funds advisers found deficiencies relating to conflicts of interest; fees and expenses; and policies and procedures relating to material non-public information.[22]

The Private Fund Advisers rule addresses three common risks and harms in an adviser's relationship with private funds and their investors: lack of transparency, conflicts of interest, and lack of effective governance mechanisms for client disclosure, consent, and oversight.

Regular account statements and audits should be basic, mandatory protections for all investors against fraud and manipulation risks. Private fund advisers collecting hundreds of millions of dollars should be able to provide these basic protections. This should not be controversial.

Fees, costs, and performance information should be clearly disclosed and comparable, to prevent fraud and abuses. However, this information can be complicated and difficult to identify for even the most

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[19] See, Office of Compliance Inspections and Examinations (OCIE), "Observations from Examinations of Private Fund Advisers," U.S. Securities and Exchange Commission, January 27, 2022, available at https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.
[20] See, 15 U.S.C. Section 80b-4.
[21] OCIE, January 27, 2022.
[22] Office of Compliance Inspections and Examinations, "Observations from Examinations of Investment Advisers Managing Private Funds," U.S. Securities and Exchange Commission, June 23, 2020, available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

sophisticated investors. Adopting standardized practices for calculating and disclosing fees, costs, and performance information is squarely within the SEC's investor protection mandate.

Disclosures of special arrangements between investors and private advisers protects all investors, while also promoting competition between investment advisers, and identifying discriminatory practices in the marketplace. It also helps deter fraud and abuses. Again, it is squarely within the SEC's authority and mission to require this information from private fund advisers.

The final rule prohibits private fund advisers from providing certain preferential treatment to one investor or group of investors, such as redemption rights, that could have material, negative effects on other investors, while requiring disclosure of all other types of preferential treatment. Again, even the most sophisticated investor may be unaware of such preferential terms provided to other investors, especially in an environment where typical public company disclosures do not exist.

This essential rule takes on heightened importance due to the rapid growth of private markets generally. Today, teachers, firefighters, and millions of other workers with public and private retirement plans are materially exposed to the private markets. And private fund advisers have significant control over those investments.

Concerns with Growth of Private Markets Generally

Over the past few decades, Congress and the SEC have dramatically expanded exemptions from application of the federal securities laws, including the registration and ongoing public reporting requirements. This has led to the explosive growth of private markets, often at the expense of public markets.[23]

Now more capital is raised annually in the private markets than in the public markets. And while there has long been a requirement that companies with a large number of “holders of record” begin public disclosures and comply with the securities laws, a loophole has allowed companies to effectively avoid the law’s application, even if they may have thousands or even millions of beneficial owners.

There are now more than 600 private companies in the U.S. with purported valuations exceeding $1 billion. Many of these companies have thousands of employees and sell products and services to tens of millions of Americans.

By allowing extremely large companies or valuable companies to avoid basic disclosure rules and safeguards, the private markets allow for waste, fraud, and abuses, not unlike those that pre-dated the adoption of the federal securities laws. Valuations of assets, disclosures on financials, reviews of internal controls, and more may range from lax to materially flawed, leading to billions of dollars wasted and lost savings to millions of Americans. This is not just true in the private equity and venture capital markets, but in the private debt markets as well.

As private funds and private companies become ever more prevalent and connected to the financial system and the future of American families and businesses, policy makers and regulators must pay attention to the enormous distortions these markets enable. Unlike public markets, private markets

[23] See, generally, Tyler Gellasch, Alexandra Thornton, and Crystal Weise, “How Exemptions from Securities Laws Put Investors and the Economy at Risk,” Center for American Progress, March 22, 2023, available at https://www.americanprogress.org/article/how-exemptions-from-securities-laws-put-investors-and-the-economy-at-risk/

allow special treatment for the most connected and powerful players, including preferential redemption rights and liquidity preferences and greater investment protections.

The SEC was created to be a disclosure regulator, requiring information from companies that want to raise capital from the public. But the wholesale expansion of exemptions from the public disclosure framework are dismantling the securities laws that have served the capital markets for so long and made U.S. capital markets the most liquid and trusted in the world.

During consideration of securities legislation in the 1930s, Congress considered making the SEC a merit regulator with authority to prevent securities offerings that did not meet standards of quality.[24] It rejected that idea with the understanding that companies would be required to make any disclosures that the SEC found to be "in the public interest and for the protection of investors."[25] This language is repeatedly mentioned in the statutes and legislative history of the securities laws. But the wholesale exemption of securities offerings from the public disclosure framework, has undermined congress's intent. The solution is either to give the SEC a stronger hand in making regulations aimed at protecting investors from investments they cannot possibly understand well enough to make a sound investment decision or, alternatively, to shrink the exemptions and close loopholes so that larger companies comply with the public disclosure framework, essentially moving them out of the private markets, and prevent

[24] James M. Landis, "The Legislative History of the Securities Act of 1933," 28 Geo. Wash. L. Rev. 29 (1959-1960), available at https://heinonline.org/HOL/LandingPage?handle=hein.journals/gwlr28&div=7&id=&page=.

[25] See, for example, Securities Act of 1933, 15 U.S.C. Section 77g and Section 77j; Securities Exchange Act of 1934, 15 U.S.C. Section 78c(a)(27) regarding "rules of an exchange," Section 78c(51)(C) regarding rules for penny stocks, and Section 78c(f) on promotion of efficiency, competition, and capital formation." Section 78c(f) reads, "Whenever...the Commission is engaged in rulemaking...and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." See Legal Information Institute, "15 U.S. Code § 78c – Definitions and application," available at https://www.law.cornell.edu/uscode/text/15/78c (last accessed March 2024).

private companies from raising capital from retail investors directly or indirectly without providing the same types of disclosures that public companies make.

Thank you again for inviting me to testify today. I look forward to answering your questions.