HEALTHY MARKETS
TRANSPARENCY & TRUST

November 13, 2017

Chairman Jeb Hensarling
Ranking Member Maxine Waters
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Re: Committee Review of Key Issues Related to Capital Formation, the Consolidated Audit Trail, and Market Data

Dear Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

Thank you for your ongoing efforts to promote robust capital markets, which are the bedrock of a sound economy. We understand that the Committee has considered, and will continue to consider, several legislative proposals as part of these efforts.

We would like to offer our views and suggestions on three distinct needs:

1. The need to focus on investors' needs and promote balance in public capital raising to ensure a healthy capital formation process.
2. The need to implement a comprehensive "consolidated audit trail" without further delay.
3. The need to implement bipartisan reforms in US equity market structure.

About Healthy Markets

The Healthy Markets Association is an investor-focused, not-for-profit coalition working to educate market participants and promote data-driven reforms to market structure challenges.[1] Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets.

Since our launch in September 2015, we have become a leading voice for investors in the capital markets. We have:

[1] Launched in 2015 by five leading buyside firms, Healthy Markets has since expanded to include sixteen buyside and working group members and partners, including leading pension funds, investment advisers, broker dealers, data providers, and an exchange. For more information about our membership, please see our website, healthymarkets.org.

- Drafted dozens of unique reports and analyses regarding market structure and regulatory developments, including our industry-leading monthly publication, "Market Structure Insights";
- Created two industry-leading "due diligence" questionnaires to assist investors and brokers in evaluating order routing practices and off-exchange trading risks; and
- Offered significant input to Congress, the Securities and Exchange Commission, and the SEC's Equity Market Structure Advisory Committee through dozens of meetings, hearing statements, and comment letters.[2]

We appreciate your focus on ensuring that the US capital markets remain the most robust, vibrant, and efficient in the world.

Investors' Needs and the Need for Public Offerings in a Healthy Capital Formation Process

Over the past several months, the Committee has considered a number of legislative proposals to improve "capital formation." At the same time, both the Treasury Department and SEC Chairman have argued that improving the public capital markets should be a high priority. We agree that the Committee would be well-served to focus on improving the public markets.

Unfortunately, we believe that many of the legislative proposals recently considered by the Committee, as well as many currently under consideration, are likely to have the opposite effect. They will likely expand the share of private offerings and/or dilute the quality of public securities. Accordingly, we urge you to resist proposals that would either (1) expand exemptions from the Securities Act or (2) remove information or rights from investors.

For decades, corporate issuers, lawmakers, regulators, market participants, and others have struggled with finding the appropriate regulatory balance to ensure that (1) companies are able to raise the capital they need to survive and grow, and (2) investors are able to have a fair understanding of the reasonable risks and returns of the securities they buy.

For most of this period, the concerns have largely focused on the burdens facing corporate issuers of securities, particularly in the public markets. These arguments were well-articulated long before the Enron and Worldcom accounting scandals gave rise to the adoption of Sarbanes-Oxley Act. In fact, both before and after the passage of SOX, these arguments gave rise to an array of largely disconnected, discrete exemptions from the registration and trading restrictions of the federal securities laws, including the creation of the controversial "accredited investor" definition and related exemptions, and Rule 144A.

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[2] Healthy Markets Association, Comment Letters, *available at* https://www.healthymarkets.org/comment-letters.

In recent years, these same issues have given rise to new proposals, such as the creation of the so-called Regulation A+ and crowdfunding exemptions. Many of those efforts are remarkably similar to proposals currently pending before the Committee (e.g., expanding Regulation A+ or micro-offering exemptions).

Efforts to ease perceived burdens on corporate issuers have also led to the dramatic curtailment of securities litigation, embodied by the Private Securities Litigation Reform Act. Again, this litigation curtailment argument is remarkably similar to current efforts to encourage and empower corporate operational companies to forestall potential future litigation by using arbitration clauses in offering documents.

Nevertheless, despite all of the past efforts, the relative number and overall quality of public offerings has deteriorated. Predictably, the number, volume, and quality of "private" offerings has exploded, from once just a fraction of the overall markets to now more than 60%. There is no reason to believe that any of the current efforts, which are largely based on the same flawed premises, will lead to any different results.

Today, the public markets are no longer the primary way for companies to get the capital they need to survive and grow. Instead, companies and their executives are increasingly turning to the private markets for equity and debt offerings. That should give rise to concern.

There's good reason to focus on restoring the dominance of the public markets. When compared to private securities, public securities typically offer a number of significant advantages for investors, including:

- Public securities often are accompanied by more robust accounting and business disclosure practices.
- Information about public companies, including third party research, are much more readily available and fairly distributed (as required by SEC rules).
- Public securities are far more easily and reliably valued.
- Public securities offer a transparent and efficient method to liquidate shares of common stock.
- Liquidity risks and trading costs for public securities are often significantly lower than for similarly-situated private securities.
- Public securities are much more easily benchmarked, such as against the S&P 500.

Focusing on the absolute costs or burdens on issuers isn't going to solve the puzzle of increasing capital formation and the public markets. Rather, policymakers should evaluate the comparative cost of capital of public offerings versus various forms of private offerings, not just in the US, but also abroad. At the same time, policymakers also need to focus on the impacts of these various alternatives on investors--the providers of the essential capital.[3] Simply continuing to deteriorate

[3] For example, one recent study tied the rise of private offerings to the easing of rules designed to increase their usage. Elisabeth de Fontnay, The Deregulation of Private Capital and the Decline of the Public

the value of their investment by offering less information, less tradability, and fewer rights is likely to lead them to invest elsewhere, or invest at a discount.

On the other side of the coin, if a company can raise an unlimited sum from a practically unlimited number of investors using a satellite radio advertisement or Super Bowl halftime commercial, while not incurring basic accounting or corporate administrative costs, they will likely do so. This will be even more likely if traditional restrictions on trading of these "private" securities are loosened or repealed.

There are a number of concerning trends in our capital markets:

(1) Our public markets are increasingly concentrated on a decreasing number of corporate issuers;
(2) Many high quality companies are staying private for very long into their corporate life-cycle, denying most mutual fund investors and pension funds the opportunities to invest without incurring significant (and often unprecedented) levels of risk and costs;
(3) Companies that utilize the markets are typically bifurcated between (1) blank check companies and operational companies of dubious financial prospects[4] and (2) very large, established, multinational companies that may choose to list in the US market for a number of unique reasons, including that US regulators allow for greater shareholder disenfranchisement than other major market centers; and
(4) A significant portion of IPOs are simply exits for early investors and executives, and not traditional "capital raises" for companies to survive and grow their businesses.

Each of these trends comes with significant costs and risks for investors. Unfortunately, some corporate issuers and their allies have offered suggestions to make things worse. These efforts essentially fall into one of two buckets: (1) expanding private offerings or (2) decreasing investors' information or rights. These ideas include:

(1) Restricting information provided to investors (e.g., by repealing disclosures of various types);
(2) Increasing the riskiness of a company's financials (e.g., by repealing Section 404(b) of SOX);
(3) Increasing the valuation risks of a company (e.g., by eliminating accounting and risk disclosures);
(4) Increasing the costs of trading the securities (e.g., by eliminating the application of Reg NMS to smaller companies' stocks); and
(5) Decreasing corporate accountability to shareholders (e.g., by restricting the proxy access or shareholders' rights to litigation).

Company, 68 *Hastings Law Journal* 445-502 (2017), *available at* http://scholarship.law.duke.edu/faculty_scholarship/3741/.

[4] For example, a significant percentage of companies going public in recent years have been revenue negative or have disclosed notable accounting issues.

Importantly, not a single applicable study or any credible evidence exists to support how any of these changes individually or collectively would increase the number or dollars raised by IPOs. Nor would such a result reasonably follow. After all, the purported "beneficiary" of each of these proposals would be a potential corporate issuer. But none of these factors is likely to overcome the already relatively low cost of selling private corporate debt or equity.

Neither of these efforts will be effective at spurring additional IPOs. To the contrary, these efforts will divert companies and capital out of the public markets on the one hand, while also deteriorating the quality of public offerings and the rights afforded shareholders on the other.

We urge you to go in the opposite direction. We urge you to promote higher quality public markets with greater accountability, reliability, and price transparency. We urge you to reduce investors' risks and costs--so that more of their investment dollars go to the great companies that need the capital.

Implement a Comprehensive Consolidated Audit Trail Without Delay

On May 6, 2010, the "Flash Crash" opened the eyes of regulators to the very basic reality that they had, collectively, very little insight into who was doing what in the trading markets. In fact, it took nearly four and a half months for the regulators to publish a report as to why the market crash occurred.[5] Realizing its inability to provide answers to basic questions about the markets, the SEC proposed the Consolidated Audit Trail a few weeks after that event. After more than seven years of delays and disappointments, the exchanges are on the verge of finally starting to report information to the system that has been developed.

Unfortunately, since the SEC announced its data breach on September 20, the game plan for opponents to the Consolidated Audit Trail has been clear: claim that the CAT poses a data security risk, and should be delayed until appropriate assurances can be given that it doesn't pose such a risk.

The Committee recently approved a bill on a bipartisan basis that would indefinitely delay the CAT and other use of data by the SEC, FINRA, and academics using their data. We also understand that the Committee may consider further expanding that bill before passage on the House floor.

At the same time, we understand that the exchanges have pressed the SEC to delay the start of reporting to the database. We find it curious that the SEC's completely unrelated data breach related to its decades-old EDGAR system would have any impact on this modern database, which

[5] See Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, Sept. 30, 2010, *available at* https://www.sec.gov/news/studies/2010/marketevents-report.pdf.

is designed and operated by the same vendor that the SEC has used for years with its Market Information Data Analytics System (MIDAS) without incident.

To be clear, the CAT will be a valuable collection of market data, and its security should be an extremely high priority for regulators and market participants alike. However, it is unclear how the indefinite delay being sought will materially improve its security. Rather, the requests appear to be focused on simply opening the door to several more years of re-litigating the creation of the CAT itself.

Ultimately, if you elect to support a delay, we urge you to do so for very specific, narrow purposes, and also provide a temporal backstop, so that this important effort is not further delayed. After more than seven years of planning, enough is enough.

A comprehensive CAT is a long-overdue essential element for effective government oversight of our trading markets. Without it, our regulators are unable to detect a myriad of abuses, or accurately reconstruct complex market events.

Rather than simply delaying the CAT, we urge the Committee to consider efforts to improve it. For example, the CAT, as currently designed, will lack the futures data, legal entity identifiers, and timing precision that would make it truly useful. It is also not necessarily well-coordinated with FINRA's OATS system and other regulatory reporting requirements, creating potential redundancies and costs for market participants. These weaknesses should be addressed. We welcome your assistance in fixing these obvious shortcomings.

Adopt Reforms to US Equity Market Structure, Including Market Data

We urge the Committee to aggressively move to improve US equity market structure to help improve capital formation. These efforts should enhance transparency and reducing conflicts of interests facing market participants, and should include:

1. Finalizing the proposed enhancements to disclosures of order routing by brokers;
2. Significantly reducing or eliminating incentives that distort order routing behavior and pose conflicts of interest, including rebates and access fees;
3. Finalizing proposed enhancements to disclosures by execution venues, and particularly Alternative Trading Systems (ATSs);
4. Reducing conflicts of interest and improving access to market data;
5. Reducing the use of, and significantly reforming, NMS Plan structures; and
6. Offering guidance on the meaning of "best execution" for investment advisers.

Notably, these efforts all enjoy bipartisan support, and the first four are expressly recommended by the Treasury Department's recent Capital Markets Report.[6]

While most of these issues are relatively self-explanatory, we note that the current environment for market data is particularly dire.[7] Market data fees are little more than government-mandated and government-sanctioned monopolies for the now "for profit" exchanges. Unfortunately, the regulatory regime for market data has remained unchanged for over four decades. We urge you to take actions to modernize the oversight of market data to reduce the conflicts of interest and size of these private taxes on all market participants.

Conclusion

If the US capital markets are to remain the best in the world, we urge you to work with investors, other market participants, and regulators to implement some modest, but essential, reforms without delay.

We thank you again for undertaking this important effort and for the opportunity to have our views considered. If you or your staff have any questions or comments, please feel free to contact me at (202) 909-6138.

Sincerely,

Tyler Gellasch
Executive Director

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[6] U.S. Dep't of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets*, Oct. 2017, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[7] Healthy Markets in the process of finalizing an extensive report regarding the regulation, conflicts of interest, and costs of market data.