

DARRELL E. ISSA, CALIFORNIA
CHAIRMAN

ONE HUNDRED TWELFTH CONGRESS

ELIJAH E. CUMMINGS, MARYLAND
RANKING MINORITY MEMBER

DAN BURTON, INDIANA
JOHN L. MICA, FLORIDA
TODD RUSSELL PLATTS, PENNSYLVANIA
MICHAEL R. TURNER, OHIO
PATRICK McHENRY, NORTH CAROLINA
JIM JORDAN, OHIO
JASON CHAFFETZ, UTAH
CONNIE MACK, FLORIDA
TIM WALBERG, MICHIGAN
JAMES LANKFORD, OKLAHOMA
JUSTIN AMASH, MICHIGAN
ANN MARIE BUERKLE, NEW YORK
PAUL A. GOSAR, D.D.S., ARIZONA
RAUL R. LABRADOR, IDAHO
PATRICK MEEHAN, PENNSYLVANIA
SCOTT DESJARLAIS, M.D., TENNESSEE
JOE WALSH, ILLINOIS
TREY GOWDY, SOUTH CAROLINA
DENNIS A. ROSS, FLORIDA
FRANK C. GUINTA, NEW HAMPSHIRE
BLAKE FARENTHOLD, TEXAS
MIKE KELLY, PENNSYLVANIA

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

2157 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515-6143

MAJORITY (202) 225-5074

FACSIMILE (202) 225-3974

MINORITY (202) 225-5051

<http://oversight.house.gov>

EDOLPHUS TOWNS, NEW YORK
CAROLYN B. MALONEY, NEW YORK
ELEANOR HOLMES NORTON,
DISTRICT OF COLUMBIA
DENNIS J. KUCINICH, OHIO
JOHN F. TIERNEY, MASSACHUSETTS
WM. LACY CLAY, MISSOURI
STEPHEN F. LYNCH, MASSACHUSETTS
JIM COOPER, TENNESSEE
GERALD E. CONNOLLY, VIRGINIA
MIKE QUIGLEY, ILLINOIS
DANNY K. DAVIS, ILLINOIS
BRUCE L. BRALEY, IOWA
PETER WELCH, VERMONT
JOHN A. YARMUTH, KENTUCKY
CHRISTOPHER S. MURPHY, CONNECTICUT
JACKIE SPEIER, CALIFORNIA

LAWRENCE J. BRADY
STAFF DIRECTOR

September 20, 2011

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street Northeast
Washington, D.C. 20549

RE: Cost-Benefit Analysis and Hedge Fund Regulation

Dear Chairman Schapiro:

In previous correspondence and hearings, you and I have discussed the need to ensure that U.S. securities regulation does not impose an unnecessary burden on companies seeking the capital they need. The careless imposition of complex, vague, or onerous regulations can restrain business growth, leading to fewer jobs and lost tax revenue. To ensure that new regulations do not unduly impair capital formation and economic growth, an objective cost-benefit analysis must inform the decision to issue every new proposed and final rule.

I am writing to follow up on my previous requests regarding barriers to capital formation and the Securities and Exchange Commission's ("Commission") procedures for analyzing the costs and benefits of new regulation. In addition, I am concerned that the Commission's proposed new disclosure requirements for advisers to private funds lack an objective cost-benefit analysis and will have serious consequences for economic growth and job creation.

Thank you for your continued work to improve our capital markets. In your efforts during these troubling economic times, please consider the continuing and additional concerns I describe below.

Cost-Benefit Analysis

As you may recall, we have corresponded regarding the Commission's approach to cost-benefit analysis.¹ I expressed my belief that qualified economists should be

¹ See Letter from Darrell Issa to Mary Schapiro, March 22, 2011 ("March 22 Issa Letter"), at request no. 25; Letter from Mary Schapiro to Darrell Issa, April 5, 2011 ("April 5 Schapiro Letter"), at 11; Letter from

placed in charge of evaluating the costs and benefits of proposed regulations, rather than simply acting as consultants.² I also expressed my concern about the incentives that exist when the same Commission staff members are responsible for both drafting proposed rules *and* preparing the related cost-benefit analyses.³ Clearly, staff members that draft proposed rules will often fail to identify their own errors or fail to admit or recognize their own bias. Additionally, staff of the same division or office may hesitate to question a proposal influenced by their own director. These staff are not in a position to properly evaluate the costs and benefits of their proposals. The Commission should not entrust a staff member who is responsible for the subject matter of a proposed rule with objectively evaluating its costs and benefits. And yet, according to your letters, this is exactly what is happening.⁴

In response to my previous inquiries, you have pointed out that the staff members responsible for the subject matter of a rule typically “work closely with the Commission’s economists in the Division of Risk, Strategy, and Financial Innovation (‘RiskFin’) to identify potential economic impacts, including the costs and benefits, as part of the development of a rule proposal.”⁵ But mere collaboration with economists cannot cause Commission lawyers and accountants to view their own work dispassionately. Nor can it rescue their cost-benefit analyses from bias.

Last month, the District of Columbia Circuit Court of Appeals struck down Exchange Act Rule 14a-11, which required corporations to include dissenting shareholders’ director nominees in their proxy materials, holding that the Commission had failed to adequately assess the economic effects of its rule.⁶ The court found that “the Commission *inconsistently and opportunistically framed the costs and benefits of the rule*; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.”⁷ (emphasis added). The court noted the following defects – among others – in the Commission’s adopting release for Rule 14a-11:

- The Commission suggested that corporate directors might choose not to oppose shareholder nominees, thus minimizing the costs of the proxy

Darrell Issa to Mary Schapiro, April 29, 2011 (“April 29 Issa Letter”), at 1-2; Letter from Mary Schapiro to Darrell Issa, May 25, 2011 (“May 25 Schapiro Letter”), at 1-2.

² March 22 Issa Letter at request no. 25.

³ See April 29 Issa Letter at 2.

⁴ April 5 Schapiro Letter at 11; May 25 Schapiro Letter at 1-2 (“Commission staff members from the division or office responsible for the subject matter of a rule typically are responsible for drafting the initial cost-benefit analysis”).

⁵ May 25 Schapiro Letter at 2; see also April 5 Schapiro Letter at 11.

⁶ *Bus. Roundtable and Chamber of Commerce v. Securities & Exchange Comm’n.*, No. 10-1305, slip op. (D.C. Cir. July 22, 2011).

⁷ *Id.* at 7 (emphasis added).

fighting enabled by Rule 14a-11. This prediction, said the court, “had no basis beyond mere speculation.”⁸

- The Commission made no attempt to estimate or quantify the costs companies might incur in Rule 14a-11 proxy fights, even though empirical evidence about the costs of proxy fights is readily available. “Because the agency failed to make tough choices about which of the competing estimates is most plausible, or to hazard a guess as to which is correct, we believe it neglected its statutory obligation to assess the economic consequences of its rule.”⁹
- “The Commission discounted the costs of Rule 14a-11 – but not the benefits – as a mere artifact of the state law right of shareholders to elect directors. ... As we have said before, *this type of reasoning, which fails to view a cost at the margin, is illogical and, in an economic analysis, unacceptable.*”¹⁰ (emphasis added)
- “*By ducking serious evaluation* of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily.”¹¹ (emphasis added)

In the light of the Commission’s statutory “obligation to consider the effect of a new rule upon efficiency, competition, and capital formation,” the court held that the promulgation of Rule 14a-11 with these defects and others was arbitrary, capricious, and not in accordance with law.¹² The holding clearly reflects a flawed cost-benefit analysis process, not just a flawed analysis. Such opportunistic framing of issues and inconsistencies are bound to occur when the drafter of a proposed rule is also in charge of its cost-benefit analysis.

To enable the Committee to better understand the flaws in the Commission’s cost-benefit analysis process, and evaluate the Commission’s efforts to fix them, I request that you provide responses to the following requests for information, producing documents as requested and as necessary to sufficiently support your answers. Please directly respond to each request as numbered herein. Please provide any documents requested, in electronic format, for the time period from January 1, 2008, to the present, unless otherwise specified:

⁸ *Id.* at 9.

⁹ *Id.* at 10-11 (internal citations omitted).

¹⁰ *Id.* at 12 (emphasis added).

¹¹ *Id.* at 15 (emphasis added).

¹² *Id.* at 6 (internal citations omitted).

1. Identify each Commission staff member who participated in the preparation or promulgation of the proposing release or the final release for Rule 14a-11, including research, drafting, editing, and approval. For each staff member so identified, identify that staff member's title(s) and Commission division(s) and office(s). For each staff member so identified, briefly describe that staff member's participation.
2. Describe the preparation and approval of all cost-benefit analyses associated with Rule 14a-11, including approximate dates of all research, drafts, edits, and approvals, and identifying each Commission staff member who engaged in each such activity.
3. Describe each action the Commission has taken and will take to change its cost-benefit analysis process in order to ensure that it properly considers the effects of each new rule on efficiency, competition, and capital formation. Provide an approximate date for each intended future action.
4. Will the Commission reassign the responsibility for drafting the cost-benefit analysis to an economist from a division or office not responsible for the proposed rule? Please explain.
5. Will the Commission ensure objectivity in cost-benefit analyses by assigning final approval authority of any cost-benefit analysis (subject to the Commissioners themselves) to its chief economist? Please explain.
6. Will the Commission repeat the cost-benefit analyses for all of its currently proposed rules in order to ensure that each analysis is consistent with the findings of the District of Columbia Circuit? Please explain.

Proposed Form PF

I am concerned that the Commission's proposed disclosure requirements under Form PF¹³ will impose a heavy compliance burden on investment advisers that will harm economic growth, reduce investment opportunities and reduce liquidity in our financial markets. I suspect that this rule, like the one the District of Columbia Circuit recently struck down, likely results from a flawed cost-benefit analysis process. The benefits of Form PF are too narrow and create a potential for fraud and abuse. Meanwhile the cost in terms of jobs and capital are ignored.

As proposed, Form PF requires detailed position information on a quarterly basis for those privately managed funds ("Funds") with \$1 billion in assets. Under proposed

¹³ Securities and Exchange Commission and Commodity Futures Trading Commission, "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF," Investment Advisers Act Release No. 3145, File No. S7-05-11, Jan. 26, 2011 ("Form PF Proposing Release"); Dodd-Frank Wall Street Reform and Consumer Protection Act sec. 404.

Form PF, Advisers to Funds must provide sensitivity analysis, position information and duration calculations that essentially amount to what financial industry participants generally refer to as “position reports.”¹⁴ This requirement would likely force advisers to perform customized analysis to adhere to the specific requirements relating to aggregation of portfolios and other factors required under Form PF. This customization would impose a heavy compliance burden while compromising the proprietary Fund positions.

The Commission (along with the Commodity Futures Trading Commission) has ostensibly proposed Form PF to allow the new Financial Stability Oversight Council (FSOC) to obtain “a baseline picture of potential systemic risk across both the entire private fund industry and in particular kinds of private funds, such as hedge funds.”¹⁵ But Form PF’s level of detail calls that stated goal into question. Instead it appears that the regulators seek to fully understand specific risk, as opposed to systemic risk.

Historically, even the largest publicly traded broker-dealers were not asked to regularly provide such detailed position information as the contents of Form PF. Now the Commission seeks to obtain this level of detail from advisers that only provide financial services to accredited and institutional investors. The related costs would inevitably be passed on to investors, including those investing in retirement plans.

I am concerned that such detailed position information has diminishing returns in its utility toward evaluating systemic risk. Meanwhile, the risk of misuse increases as position-specific detail expands. The proposed Form PF requires that previously proprietary position information must be compromised. Given the government’s trading of equities, asset-backed securities and Treasury and agency securities, we can no longer have complete confidence that our regulators will not consider the positions of private financial firms when making their own trading decisions. Nor can we have complete confidence that each federal employee with access to the trading information does not take advantage of that knowledge in some form.

These increased costs and risks arising out of Form PF may deter the formation of new Funds generally, may deter Funds from seeking to grow beyond \$1 billion in assets and may deter Funds from locating in the U.S. – directly harming economic growth and job creation. Form PF might also incentivize existing funds to shut down – taking away investment opportunities and hurting the liquidity of U.S. markets. In fact, this has arguably already occurred.¹⁶

I am also concerned that, as a result of increased costs and risks, reduced returns to investors may cause some investors to shift their capital abroad.

¹⁴ See Philip McBride Johnson and Thomas Lee Hazen, *Derivatives Regulation*, §3.13[17].

¹⁵ Form PF Proposing Release at 8.

¹⁶ See, e.g., Robert Holmes, “Soros Returns Capital, Avoids Dodd-Frank,” *The Street*, July 26, 2011, available at <http://www.thestreet.com/story/11198058/1/soros-returns-capital-avoids-dodd-frank.html>.

The consequences of such changes include a potential loss of tax revenue. If investors shift away from regulated Funds to offshore Funds, or the Funds themselves shut down or relocate, the loss of tax revenue may be substantial.

Liquidity begets liquidity and to the extent Funds or their investors relocate investments nearer to other markets and in other time zones, liquidity may tend to shift to those markets and the revenues to our domestic exchanges and broker-dealers may diminish. The impacts of globalization expand each day. We cannot risk the loss of Funds' liquidity when so many attractive alternative destinations and markets are forming or already exist. We must be ultra-vigilant in protecting advantages that result from maintaining the most liquid markets in the world. Proposed Form PF threatens this advantage.

7. The Commission's economic analysis of the Form PF proposal estimates the compliance costs that Form PF might impose on advisers.¹⁷ This analysis does not mention the likelihood that Form PF will deter the formation of new Funds, motivate existing Funds to shut down, deter existing Funds from seeking to grow beyond \$1 billion in assets, or drive existing Funds overseas. Has the Commission ever estimated broader impacts arising out of Form PF -- to investors, companies, markets, and the broader economy? Does the Commission intend to do so?
8. The proposing release states, "Systemic risk may arise from a variety of sources, including interconnectedness, changes in market liquidity and market concentrations, and so the information that Form PF elicits is intended to provide data that, individually or in the aggregate, would permit the [Financial Stability Oversight Council] to identify where systemic risk may arise across a range of sources."¹⁸ The Commission has not explained, in detail, how the Fund-specific position information that it proposes to collect on Form PF is necessary to allow the FSOC to discover systemic risk. Please explain how implementation of the proposed Form PF adds significant value to the regulators' ability to prevent systemic risk. Provide detailed examples on how such information could have averted past crisis. Please also explain, in detail, what the SEC intends to do with Funds' position information.
9. Fund Advisors will need to know what books and records to keep in order to comply with Form PF. Why has the Commission chosen to propose Form PF before proposing any rule relating to books and records requirements for Advisers?

¹⁷ Form PF Proposing Release at 81-86.

¹⁸ Form PF Proposing Release at 79.

10. Under the Dodd-Frank Act, the Commission is not obligated to seek detailed position information from advisers to private funds.¹⁹ Why did the Commission decide to seek the level of detail that is required by proposed Form PF? Has the FSO or the Office of Financial Research (OFR) within the Department of the Treasury confirmed that this level of detail is necessary to allow regulators to discern systemic risk?
11. Please identify and estimate all costs associated with the potential consequences of proposed Form PF, including:
 - a) the cost of compliance;
 - b) the risk that Form PF disclosures motivate investors or Funds to go offshore;
 - c) the risk that Form PF deters Funds from forming or from exceeding \$1 billion in assets;
 - d) the loss of investors to global competitors due to the increased cost of running a U.S. Fund under Commission regulation;
 - e) the risk that the government will take unfair advantage of Fund position information when trading for its own account, and
 - f) the reputational harm resulting from the perception that the government may take unfair advantage of Fund position information, irrespective of the likelihood this would actually occur.
12. Given the finding of the District of Columbia Circuit, in Business Roundtable and Chamber of Commerce v. Securities & Exchange Commission. (D.C. Cir. July 22, 2011), does the SEC intend to significantly revise its cost-benefit analysis for proposed Form PF?
13. Explain the reasoning behind the Commission's decision to propose that large private fund advisers be required to submit Form PF on a quarterly basis. Identify the reasons why the Commission has chosen to require large private fund advisers to report quarterly while broker-dealers need only report annually.²⁰
14. What steps has the Commission taken to coordinate the imposition of Form PF with the regulatory actions of other jurisdictions in order to prevent regulatory arbitrage? Please explain in detail.

The Committee on Oversight and Government Reform is the principal oversight committee of the House of Representatives and may at "any time" investigate "any matter" as set forth in House Rule X. An attachment to this letter provides additional information about responding to the Committee's request.

¹⁹ Cf. Dodd-Frank Wall Street Reform and Consumer Protection Act Sec. 404(b)(5) ("The Commission shall issue rules requiring each investment adviser to a private fund to file reports containing such information as the Commission deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk").

²⁰ See FOCUS Report (Form X-17A-5).

The Honorable Mary L. Schapiro

September 20, 2011

Page 8

We request that you provide the requested documents and information as soon as possible, but no later than 5:00 p.m. on October 4, 2011. When producing documents to the Committee, please deliver production sets to the Majority Staff in Room 2157 of the Rayburn House Office Building and the Minority Staff in Room 2471 of the Rayburn House Office Building. The Committee prefers, if possible, to receive all documents in electronic format.

If you have any questions about this letter, please contact Peter Haller or Hudson Hollister of the Committee Staff at 202-225-5074. Thank you for your attention to this matter.

Sincerely,



Darrell Issa
Chairman

Enclosure

cc: The Honorable Elijah E. Cummings, Ranking Minority Member

ONE HUNDRED TWELFTH CONGRESS
Congress of the United States
House of Representatives
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
2157 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6143

Majority (202) 225-5074
Minority (202) 225-5051

Responding to Committee Document Requests

1. In complying with this request, you should produce all responsive documents that are in your possession, custody, or control, whether held by you or your past or present agents, employees, and representatives acting on your behalf. You should also produce documents that you have a legal right to obtain, that you have a right to copy or to which you have access, as well as documents that you have placed in the temporary possession, custody, or control of any third party. Requested records, documents, data or information should not be destroyed, modified, removed, transferred or otherwise made inaccessible to the Committee.
2. In the event that any entity, organization or individual denoted in this request has been, or is also known by any other name than that herein denoted, the request shall be read also to include that alternative identification.
3. The Committee's preference is to receive documents in electronic form (i.e., CD, memory stick, or thumb drive) in lieu of paper productions.
4. Documents produced in electronic format should also be organized, identified, and indexed electronically.
5. Electronic document productions should be prepared according to the following standards:
 - (a) The production should consist of single page Tagged Image File ("TIF"), files accompanied by a Concordance-format load file, an Opticon reference file, and a file defining the fields and character lengths of the load file.
 - (b) Document numbers in the load file should match document Bates numbers and TIF file names.
 - (c) If the production is completed through a series of multiple partial productions, field names and file order in all load files should match.

6. Documents produced to the Committee should include an index describing the contents of the production. To the extent more than one CD, hard drive, memory stick, thumb drive, box or folder is produced, each CD, hard drive, memory stick, thumb drive, box or folder should contain an index describing its contents.
7. Documents produced in response to this request shall be produced together with copies of file labels, dividers or identifying markers with which they were associated when they were requested.
8. When you produce documents, you should identify the paragraph in the Committee's request to which the documents respond.
9. It shall not be a basis for refusal to produce documents that any other person or entity also possesses non-identical or identical copies of the same documents.
10. If any of the requested information is only reasonably available in machine-readable form (such as on a computer server, hard drive, or computer backup tape), you should consult with the Committee staff to determine the appropriate format in which to produce the information.
11. If compliance with the request cannot be made in full, compliance shall be made to the extent possible and shall include an explanation of why full compliance is not possible.
12. In the event that a document is withheld on the basis of privilege, provide a privilege log containing the following information concerning any such document: (a) the privilege asserted; (b) the type of document; (c) the general subject matter; (d) the date, author and addressee; and (e) the relationship of the author and addressee to each other.
13. If any document responsive to this request was, but no longer is, in your possession, custody, or control, identify the document (stating its date, author, subject and recipients) and explain the circumstances under which the document ceased to be in your possession, custody, or control.
14. If a date or other descriptive detail set forth in this request referring to a document is inaccurate, but the actual date or other descriptive detail is known to you or is otherwise apparent from the context of the request, you should produce all documents which would be responsive as if the date or other descriptive detail were correct.
15. The time period covered by this request is included in the attached request. To the extent a time period is not specified, produce relevant documents from January 1, 2009 to the present.
16. This request is continuing in nature and applies to any newly-discovered information. Any record, document, compilation of data or information, not produced because it has not been located or discovered by the return date, shall be produced immediately upon subsequent location or discovery.

17. All documents shall be Bates-stamped sequentially and produced sequentially.
18. Two sets of documents shall be delivered, one set to the Majority Staff and one set to the Minority Staff. When documents are produced to the Committee, production sets shall be delivered to the Majority Staff in Room 2157 of the Rayburn House Office Building and the Minority Staff in Room 2471 of the Rayburn House Office Building.
19. Upon completion of the document production, you should submit a written certification, signed by you or your counsel, stating that: (1) a diligent search has been completed of all documents in your possession, custody, or control which reasonably could contain responsive documents; and (2) all documents located during the search that are responsive have been produced to the Committee.

Definitions

1. The term "document" means any written, recorded, or graphic matter of any nature whatsoever, regardless of how recorded, and whether original or copy, including, but not limited to, the following: memoranda, reports, expense reports, books, manuals, instructions, financial reports, working papers, records, notes, letters, notices, confirmations, telegrams, receipts, appraisals, pamphlets, magazines, newspapers, prospectuses, inter-office and intra-office communications, electronic mail (e-mail), contracts, cables, notations of any type of conversation, telephone call, meeting or other communication, bulletins, printed matter, computer printouts, teletypes, invoices, transcripts, diaries, analyses, returns, summaries, minutes, bills, accounts, estimates, projections, comparisons, messages, correspondence, press releases, circulars, financial statements, reviews, opinions, offers, studies and investigations, questionnaires and surveys, and work sheets (and all drafts, preliminary versions, alterations, modifications, revisions, changes, and amendments of any of the foregoing, as well as any attachments or appendices thereto), and graphic or oral records or representations of any kind (including without limitation, photographs, charts, graphs, microfiche, microfilm, videotape, recordings and motion pictures), and electronic, mechanical, and electric records or representations of any kind (including, without limitation, tapes, cassettes, disks, and recordings) and other written, printed, typed, or other graphic or recorded matter of any kind or nature, however produced or reproduced, and whether preserved in writing, film, tape, disk, videotape or otherwise. A document bearing any notation not a part of the original text is to be considered a separate document. A draft or non-identical copy is a separate document within the meaning of this term.
2. The term "communication" means each manner or means of disclosure or exchange of information, regardless of means utilized, whether oral, electronic, by document or otherwise, and whether in a meeting, by telephone, facsimile, email, regular mail, telexes, releases, or otherwise.
3. The terms "and" and "or" shall be construed broadly and either conjunctively or disjunctively to bring within the scope of this request any information which might

otherwise be construed to be outside its scope. The singular includes plural number, and vice versa. The masculine includes the feminine and neuter genders.

4. The terms "person" or "persons" mean natural persons, firms, partnerships, associations, corporations, subsidiaries, divisions, departments, joint ventures, proprietorships, syndicates, or other legal, business or government entities, and all subsidiaries, affiliates, divisions, departments, branches, or other units thereof.
5. The term "identify," when used in a question about individuals, means to provide the following information: (a) the individual's complete name and title; and (b) the individual's business address and phone number.
6. The term "referring or relating," with respect to any given subject, means anything that constitutes, contains, embodies, reflects, identifies, states, refers to, deals with or is pertinent to that subject in any manner whatsoever.