CFA Institute

CFA INSTITUTE POLICY BRIEFING REPORT

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ABOUT THIS REPORT

DEAR CFA INSTITUTE MEMBER:

Consistent with the mission of CFA Institute to generate value for investment management professionals and engage with the core investment management industry to advance ethics, market integrity, and professional standards of practice, we are pleased to bring you the CFA Institute Policy Briefing Report. This new publication is a quick, handy reference guide to CFA Institute positions on selected industry issues. This report presents our comment letters to regulators regarding capital markets and investment issues and includes our remarks on regulations and regulatory proposals that CFA Institute deems important. It also provides examples of content that elucidate our position and outlook on these matters.

For ease of navigation, this report is presented in five broad sections:

1. Regulatory Spotlight (this section captures industry issues and proposed regulation that are particularly current or controversial);
2. Regulation of the Asset Management Industry;
3. Regulation of Investment Products and Services;
4. Regulation of Investment Professionals and Firms; and
5. Corporate Governance.

Each section addresses specific industry issues or questions and presents a general outlook along with the view held by CFA Institute. Although intended for a US audience, we note when a topic is relevant in other jurisdictions and discuss topics in greater depth when they overlap with the position taken in the United States.

The report will be updated as market issues evolve, new regulations are proposed and implemented, and old regulations are rescinded. For the most recent update of this *Policy Briefing Report*, please go to https://www.cfainstitute.org/ethics/integrity/Pages/index.aspx.

We view this *Policy Briefing Report* as a vehicle that provides you with core information to inform you and help you develop your advocacy outreach. We welcome your observations and suggestions about how we can make this report more relevant and valuable to you. Please contact us at advocacy@CFAInstitute.org.

Sincerely,

CFA Institute Advocacy Team

For additional information on policy positions, please visit our website to access the following resources:
comment letters to regulators, blogs on topical developments, policy briefs, and an overview of our Advocacy efforts.

CONTENTS

ACRONYMS AND ABBREVIATIONS

ABS	asset-backed securities
ATS	alternative trading systems
CD&A	compensation discussion and analysis
CFTC	US Commodity Futures Trading Commission
CME	Chicago Mercantile Exchange
CRA	credit rating agency
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
DOL	US Department of Labor
EBSA	Employee Benefits Security Administration
EFSF	European Financial Stability Facility
EGC	emerging growth company
EJR	Egan-Jones Rating
FDIC	Federal Deposit Insurance Corporation
FINRA	Financial Industry Regulatory Authority
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Commission
HFT	high-frequency trading
Investment Advisers Act	Investment Advisers Act of 1940
IOSCO	International Organization of Securities Commissions
JOBS Act	US Jumpstart Our Business Startups Act
MMF	money market fund
NAV	net asset value
OCC	Office of the Comptroller of the Currency
OFR	Office of Financial Research
Reg NMS	Regulation National Market System
RIA	registered investment adviser
SEC	US Securities and Exchange Commission
SME	small and medium-size enterprise
SOX	Sarbanes-Oxley Act of 2002
SRI	socially responsible investing
Volcker Rule	Dodd-Frank Act prohibition of proprietary trading by banks

REGULATORY SPOTLIGHT

FIDUCIARY DUTY

TALKING POINTS

- The CFA Institute Code of Ethics and Standards of Professional Conduct require members to put their clients' interests before their own.
- We believe that all who provide personalized investment advice to retail investors should be held to the same standard.
- We have called upon the SEC to create a uniform standard for these advice providers.
- Until the SEC acts, we support the US Department of Labor's (DOL's) attempts to require a fiduciary standard for investment advice providers in the retirement arena.
- We support an SEC approach to clarify the use of titles, whereby those calling themselves financial advisors or providing personalized investment advice would have to register as investment advisers, and adhere to a fiduciary standard of care.

OVERVIEW

Members and investors realize the importance of putting the client's interest first. Standard III.A. of the CFA Institute Code of Ethics and Standards of Professional Conduct requires that "Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests." Members also want an even playing field rather than one in which the lower behavior thresholds of one group damages the reputation of those held to higher standards of care.

Currently, those who provide financial advice adhere to two standards of conduct: (1) a fiduciary standard for "advisers" who are registered with the SEC under the Investment Advisers Act of 1940; and (2) a suitability standard for brokers and others that refer to themselves as "advisory" in nature. The suitability standard of care is lower than a fiduciary duty and requires only that the broker has a reasonable basis to believe a recommended course of action is suitable for the customer based on reasonable inquiry into the customer's investment profile.

This dual structure of care creates a number of serious problems, including the following:

- Brokers are able to take advantage of the goodwill and trust implied by the higher, fiduciary standard of care without placing the client's interests first.
- Those not subject to the fiduciary standard create confusion among investors, not least by calling themselves "advisers" even while not being registered as advisers.
- Those not subject to the fiduciary standard of care who act with self-interest undermine the goodwill and trust associated with the many prudent and client-oriented advisers.

REGULATION

The SEC is in the process of considering the applicable standard for those who provide personalized financial advice to retail investors. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gave the SEC authority to impose a fiduciary duty of care upon brokers or dealers that already was required of investment advisers when giving personalized investment advice, it stipulated that the broker/dealer would not "have a continuing duty of care of loyalty to the customer after providing" the advice. This solution was quickly recognized as unworkable. In the summer of 2017, the SEC indicated it would be considering a new standard.

The DOL, which has authority over some types of retirement plans under the Employee Retirement Income Security Act of 1974, adopted in 2016 a best interest standard of care for those who provide personalized investment advice for a fee to retirement fund and IRA account holders. The DOL rule became applicable 9 June 2017, with a full phase-in of all requirements extended to 1 July 2019. The Trump administration has directed the agency to review its rule, as adopted, as to whether it causes investors harm, among other things. In the meantime, the DOL is considering other approaches that may meet the best interest standard.

CFA INSTITUTE OUTLOOK

CFA Institute has long called on the SEC to adopt a fiduciary duty standard for all who provide personalized investment advice to retail investors. It also has advocated for an approach that makes it clear to investors the standard of care held by those servicing their accounts. In particular, we believe that clarification of the use of titles would substantially mitigate investors' confusion related to the standard of care under which their service provider operates. Those who refer to themselves as "financial advisors" and provide personalized investment advice should have to register with the SEC as investment advisers and be held to a fiduciary duty standard. Broker-dealers should have to disclose on client documents that they adhere to a suitability standard and are not required to have the client's best interests in mind.

CFA Institute had hoped the SEC would act first to address this issue, but it supported the underlying objective of the DOL rule—to act in the best interests of clients. Although the rule that was adopted addressed a number of concerns, it remains overly complex and difficult to apply. In addition, legal challenges to the rule and differing court rulings make the future of the DOL rule uncertain.

Meanwhile, the SEC has indicated that it is working on a new regulatory proposal to address the issues of titling and standards of care for financial advice providers.

CFA INSTITUTE CONTENT

Written Comments to the DOL and SEC

- Comment Letter to SEC on Standards of Conduct for Investment Advisers and Broker-Dealers, 10 January 2018
- Letter to SEC Chair Clayton on CFA Institute Regulatory Priorities for 2017, 13 June 2017
- Second comment about proposed delay of DOL's fiduciary duty rule, 17 April 2017
- Comment about proposed delay of DOL's fiduciary duty rule, 17 March 2017
- Third comment to DOL on 2015 fiduciary duty rule proposal, 24 September 2015
- Testimony on DOL conflict of interest rule, 12 August 2015
- Comment to DOL on definition of the term "fiduciary," conflict of interest rule, 20 July 2015
- Comment to SEC on Dodd-Frank Section 913 study of fiduciary duty rule, 3 July 2013
- Comment to DOL on 2011 fiduciary duty rule proposal, 2 February 2011
- Comment to SEC on enhancing adviser exams, 1 December 2010
- Comment to SEC suggesting studying terminology to distinguish advisers from salespeople, 30 August 2010

Audio/Video

- James C. Allen, CFA, describes to *Investment News* why terminology to distinguish advisers from salespeople would help, 5 April 2017
- Kurt N. Schacht, CFA, interviews CFA Institute staff members Jon Stokes, Linda L. Rittenhouse, CFA, and James C. Allen, CFA, for CFA Society Japan about CFA Institute professional standards of loyalty, prudence, and care; the state of a uniform fiduciary duty in the United States; and how Europe is addressing the standards of care issue, 9 May 2017
- Linda L. Rittenhouse, CFA, testifies to DOL on CFA Institute response to 2015 proposal, 22 August 2015
- John L. Bowman interview of James C. Allen, CFA, on political issues surrounding DOL's fiduciary duty rule, 15 December 2015
- US Rep. Robert Hurt of Virginia talks about the Republican response to the DOL rule, 29 October 2015
- Audio webcast considering the DOL's proposed fiduciary duty rule, with guests Timothy Hauser, deputy assistant secretary for program operations at Employee Benefits Security Administration (EBSA); Kathy Ireland, associate general counsel, Investment Advisers Association; and Blaine Aikin, CEO fi360. Hosted by James C. Allen, CFA, 17 July 2015

Articles

- James C. Allen, CFA, interviews for article in BenefitsPro.com concerning fiduciary rule proposals in Clayton letter, 20 June 2017
- Linda L. Rittenhouse, CFA, describes how EBSA has simplified compliance for its fiduciary rule while still protecting investors, 11 May 2017
- Linda L. Rittenhouse, CFA, projects what a rescission of the DOL's fiduciary rule would mean for investors, 2 May 2017
- Linda L. Rittenhouse, CFA, describes the rationale given by the Trump White House for considering delay of the DOL's fiduciary duty rule, 20 March 2017
- John Bowman calls to keep the DOL's fiduciary duty rule, 4 January 2017
- Linda L. Rittenhouse, CFA, writes in *CFA Institute Magazine* about how the duty owed to investors by advice providers has risen to the forefront of issues, June 2016
- James C. Allen, CFA, describes how the political origins of the DOL's fiduciary rule will make the issue a hot button for some time, 22 June 2016
- James C. Allen, CFA, notes Morningstar's research on how the DOL's fiduciary duty rule will affect the industry in the future, 7 June 2016
- Linda L. Rittenhouse, CFA, reports on the 6 June 2016 event at the New York Society of Security Analysts considering the DOL's fiduciary duty rule, 6 June 2016
- James C. Allen, CFA, describes how the final version of the DOL's fiduciary duty rule moves the investment advice model in the right direction. 7 April 2016
- Linda L. Rittenhouse, CFA, considers the implications of the DOL's fiduciary duty rule for the investment industry, 9 February 2016
- Paul Smith, CFA, considers the future of the investment industry in light of the DOL's proposed fiduciary rule, 20 April 2015
- Kurt N. Schacht, CFA, speaks on the difference between salespeople and advisers, 10 March 2015
- James C. Allen, CFA, describes in *The Hill* to the incoming Trump administration what investors want in financial regulation, 19 January 2017
- James C. Allen, CFA, states in *The Hill* that President Trump's memorandum calling for a review of the DOL's fiduciary rule is a step in the wrong direction, 9 February 2017
- James C. Allen, CFA, discusses with BenefitsPro.com the fiduciary rule inherent in the Investment Advisers Act, 6 January 2017
- James C. Allen, CFA, discusses how the regulatory freeze might affect pending financial regulatory rules, including the DOL's fiduciary duty rule, 25 January 2017

Blogs

- "Labor Fiduciary Rule Proposal Safe…for Now" (21 December 2015)
- "DOL Fiduciary Rule: Political Grandstanding, Fearmongering Overshadow Investor Needs" (15 December 2015)
- "Republican Hurt: Congress Could Use Funding Clout to Derail Fiduciary Rule Plan" (29 October 2015)
- "DOL Fiduciary Rule Proposal: Armageddon or Start of Promising New Era for Investors?" (1 October 2015)
- "DC Policy Update: Bill Giving SEC Priority in Fiduciary Rule Debate Set for Review" (28 September 2015)
- "Labor Department Fiduciary Rule Proposal Takes Important First Step" (22 July 2015)
- "Vantage Points: Investment Adviser Group Head Says SEC Rule on Broader Fiduciary Duty Long Overdue" (14 July 2015)
- "SIFMA Best Interests Standard for Broker-Dealers: Right Words, Wrong Substance" (4 June 2015)

- [“DOL Unveils Fiduciary Rules: One Step Forward for Investors”] (24 April 2015)
- [“Fiduciary Faceoff: America’s Investment Industry at Critical Juncture”] (20 April 2015)
- [“Fiduciary Duty Debate: Salespeople Are Not Investment ‘Advisers’”] (10 March 2015)
- [“Labor Department’s Pending Fiduciary Proposal Signals Tighter Broker Rules Ahead”] (25 February 2015)
- [“Restricting Investment Sales Inducements: Impact of Reform, Other Mis-Selling Solutions”] (18 February 2014)
- [“SEC Fiduciary Rule: Putting the Focus Back on Investors”] (10 September 2013)
- [“Should All Financial Advice Providers Be Required to Put Client Interests First?”] (4 April 2013)
- [“Investor Indifference to Fiduciary Care?”] (20 June 2011)
- [“The Fearless Fiduciary: A Sad Narrative of Rampant Mis-Selling of Financial Products”] (4 December 2012)
- [“A Higher Duty: SEC Concludes Study of Fiduciary Obligations”] (24 January 2011)

SEC FUNDING

TALKING POINTS

- The SEC needs adequate resources to perform its job.
- We particularly support funding to allow for a robust enforcement department and to increase the number of investment adviser examinations conducted.

OVERVIEW

The SEC is a federal government agency. Created by Congress in 1934 as the first federal regulator of US securities markets, the mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust. It also monitors corporate merger and acquisition activity in the United States.

Adequate funding is critical to enhance investor trust in the investment markets by facilitating sufficient resources to enable the SEC to effectively perform its regulatory and oversight duties. The agency has long argued that its funding levels are inadequate to fulfill its investor protection mandate. As currently structured, the SEC must go through the federal appropriations process for approval of its annual operating budget, even though it annually collects registration fees that exceed its appropriations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) added to the SEC's existing budgetary burdens by mandating new responsibilities for the oversight of advisers to private equity funds (including registration of hedge fund advisers), creation of a new Bureau of Credit Ratings, oversight of security-based swaps, creation of a whistleblower program, and registration of municipal securities advisers.

REGULATION

Self-funding was proposed for, but ultimately stricken from, Dodd-Frank. And significant problems in the overall US budget have reduced even further the willingness of Congress to fund the SEC to the level requested.

CFA INSTITUTE OUTLOOK

CFA Institute believes that the lack of adequate resources available to the SEC contributed to its inability to more aggressively police the financial markets in recent years. We support fully funding the SEC to alleviate market integrity problems, continue a robust enforcement program, and significantly increase the number of investment adviser examinations conducted.

CFA INSTITUTE CONTENT

Comment Letter on the SEC's Proposed Strategic Plan

- We support a self-funding mechanism that would allow the SEC to sufficiently plan for future needs. James C. Allen, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 5 January 2010

SYSTEMIC RISK

TALKING POINTS

- Systemic risk can result in large-scale financial system breakdowns.
- We sponsor the global Systemic Risk Council, which monitors and takes positions on issues that may contribute to systemic risk and proposes ways to mitigate risk.
- We also have stated a number of official views on factors that may contribute to systemic risk, including concern about the Federal Deposit Insurance Corporation's (FDIC's) authority to guarantee the liabilities of failing institutions and use of a single global approach to financial market regulation.
- In particular, we believe that the asset management industry does not pose the same systemic risk implications as does the banking sector.

OVERVIEW

Systemic risk refers to the risk of a breakdown of an entire system rather than simply the failure of individual parts. In a financial context, it denotes the risk of a cascading failure in the financial sector, caused by linkages within the financial system, resulting in a severe economic downturn. A key question for policymakers is how to limit the buildup of systemic risk and contain crises events when they do happen.

Reducing the likelihood and severity of future financial crises can be ensured by a coordinated global effort to monitor market trends and bubbles and to end government bailouts for failing financial institutions.

REGULATION

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created an Office of Financial Research (OFR) to monitor global market developments that might lead to systemic failure. The OFR is part of the US Department of the Treasury and supports the Financial Services Oversight Committee of federal financial regulators. The Financial Stability Oversight Commission (FSOC) directs the OFR and requests data and analyses to support its members' work. The FSOC also retains authority to deem nonbank institutions as systemically important financial institutions.

Despite warnings in Dodd-Frank that federal bailouts were a thing of the past, Dodd-Frank specifically authorizes the FDIC to guarantee the assets and liabilities of failing financial firms. It also calls on the Fed to create a list of systemically significant firms for special oversight. The FDIC is an independent federal agency created by the US Congress in 1933 in response to the thousands of bank failures that occurred in the 1920s and early 1930s. Its role is to maintain stability and public confidence in the nation's financial system by insuring commercial bank deposits; examining and supervising financial institutions for safety and soundness and consumer protection; making large and complex financial institutions resolvable; and managing receiverships.

A number of European and global entities have undertaken efforts to address systemic risk. For example, the G–20 nations agreed to reduce bank leverage by increasing the Basel III capital requirements for financial institutions. The European Union has worked to create a European Financial Stability Facility (EFSF) to provide temporary help to member states regarding fiscal debt burdens and fiscal deficits. The EFSF is a significant part of the €750 billion European Stabilization Mechanism to help member states.

CFA OUTLOOK

CFA Institute sponsors the Systemic Risk Council (SRC), composed of US and European market leaders, academics, and former policymakers. As sponsor of the SRC, CFA Institute actively monitors and encourages regulatory reform of systemic risk detection and mitigation in US capital markets, particularly in the areas of bank capital requirements, money market reform, and funding for financial regulators.

CFA Institute also has participated in a G–20 task force charged with making recommendations to harmonize financial regulatory standards worldwide.

Regarding the view of CFA Institute on systemic risk:

- We have called for monitoring of systemic factors on a global basis, and for regulators globally to work together to enable this monitoring.
- We called for the OFR in the United States to be independent of the member regulators of the FSOC.

- We are concerned that conflicts of interest inherent in the OFR's structure—answering to the regulators who may have created policies that are leading to systemic risks—will bias its analyses and that its findings will provide false comfort and cover for FSOC members.
- We believe that provisions giving the FDIC authority to guarantee the liabilities of failing institutions send a dangerous message to market participants. Specifically, we are concerned that this authority conveys to potential creditors that systemically significant firms continue to be too big to fail, and that their liabilities ultimately will receive federal bailouts to prevent systemic failures.
- We believe this creates moral hazard within the financial markets and should be replaced by mechanisms that deal with the failure of large financial institutions through a bankruptcy mechanism.
- Although we support higher capital requirements for financial institutions, including, in particular, large commercial banks, we urge caution in promoting a single global approach to financial market regulation. Such approaches have the potential to encourage coordinated decisions and activities that might exacerbate, rather than diminish, risk on a global basis.
- We are concerned that the Basel risk-weighting system is based on a static system that ignores the magnitude of the accumulated risks. In particular, the risk weightings continue to apply regardless of whether the exposure amounts to $10 million or $10 billion.
- We question regulators' concerns about the systemic risk implications of the asset management industry given, among other things, that asset managers do not own the underlying assets.

CFA INSTITUTE CONTENT

Do Asset Managers Pose a Systemic Risk?

- We urged additional research and analysis before reaching conclusions about whether stricter and more onerous banking and Federal Reserve regulation is needed for this industry. Kurt N. Schacht, CFA, *CFA Institute Magazine*, July/August 2015

Mitigating Systemic Risk in Europe

- Remaining vigilant about emerging systemic risks is essential for avoiding another crisis. Nitin Mehta, CFA, *CFA Institute Magazine*, March/April 2015

Systemic Risk, Governance, and Global Financial Stability

- Systemic risk can result in severe negative consequences for the real economy. Luci Ellis, Andy Haldane, and Fariborz Moshirian, *CFA Digest*, January 2015

Cyber-Crime, Securities Markets, and Systemic Risk

- Cybercrime in securities markets is evolving, and it poses a threat to fair and efficient functioning markets. Rohini Tendulkar, *CFA Digest*, November 2013

Issue Brief: Money Market Fund Reform—Measures to Reduce Systemic Risk in the Investment Industry

- When the Reserve Primary Fund "broke the buck" in 2008, the resulting run on redemptions in money market funds triggered a domino effect on global short-term credit markets. Linda L. Rittenhouse, CFA, CFA Institute, October 2013

Markets Insights: Misuse of Collateral Creates Systemic Risk

- An overview of how collateral, counterintuitively, creates more risks in the global financial system. Satyajit Das, *Financial Times*, 22 April 2013

Introducing the Systemic Risk Council

- How to face the challenge of restoring a sense of urgency about proper oversight of systemic risk. John Rogers, CFA, *CFA Institute Magazine*, September/October 2012

Comment Letter on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

- CFA Institute recommends a more principles-based approach rather than the proposed requirements mandating liquidity risk management programs by open-end investment companies. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to the Financial Stability Board, 21 September 2016

Risk-Based Regulation

- A risk-based approach is an appropriate means for regulators to monitor the risks associated with hedge funds and hedge fund managers. Charles Cronin, CFA, and Rhodri G. Preece, CFA, submitted to the International Organization of Securities Commissions, 30 April 2009

THE VOLCKER RULE

TALKING POINTS

- We support the general aim of the Volker Rule—to prohibit banks from using their own funds for speculative purposes, and thus taking on additional risk.
- We are concerned, however, that restrictions on market making may hurt markets for illiquid instruments and encourage regulators to monitor the rule's effects.

OVERVIEW

The so-called Volcker Rule is a federal regulation that prohibits banks from conducting certain investment activities with their own accounts and that limits their ownership of and relationship with hedge funds and private equity funds. The Volcker Rule's purpose is to prevent banks from making certain types of speculative investments that contributed to the 2008 financial crisis.

Named after former Federal Reserve Chairman Paul Volcker, the Volcker Rule disallows short-term proprietary trading of securities, derivatives, commodity futures, and options on these instruments for banks' own account under the premise that these activities do not benefit the bank's customers. In other words, banks cannot use their own funds to make these types of investments to increase their profits. The purpose of the Volcker Rule is to discourage banks from taking too much risk.

REGULATION

Five federal agencies—the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the US Commodity Futures Trading Commission (CFTC), and the SEC—approved the final regulations that make up the Volcker Rule. The rules went in into effect 1 April 2014, with banks' full compliance required by 21 July 2015.

The rule allows banks to continue market making; underwriting; hedging; trading government securities; providing insurance company activities; offering hedge funds and private equity funds; and acting as agents, brokers, or custodians. Banks may continue to offer these services to their customers and generate profits from providing these services. Banks cannot engage in these activities, however, if doing so would create a material conflict of interest, expose the institution to high-risk assets or trading strategies, or generate instability within the bank or within the overall US financial system.

The United Kingdom also has grappled with restrictions on banks engaging in proprietary trading. The Vickers Report from the Independent Commission on Banking called for "ring-fencing" of domestic retail depository institutions from global wholesale or investment banking operations. The ring-fenced institutions would have separate boards of directors from the parent company and capital of as much as 20%.

CFA INSTITUTE OUTLOOK

CFA Institute supports the general goal of the Volcker Rule—to prevent financial institutions from taking advantage of government-insured deposits and the capital of depository banking institutions to engage in proprietary trading or investing in hedge funds and private equity funds.

Affiliates within a bank holding structure should be permitted to invest in private equity funds, so long as the affiliate does not have access to either the depository institution's insured deposits or capital.

Separately capitalized and legally separate broker/dealer affiliates of a bank holding company should be permitted to engage in trading for the purposes of market making and hedging, so long as the affiliate does not have access to either the depository institution's insured deposits or capital.

CFA Institute has expressed concern that restrictions on market making could hurt markets for illiquid instruments like fixed-income securities and urged regulators to monitor implementation carefully to make changes quickly if the new rules are seen to significantly and negatively affect liquidity in these markets.

CFA INSTITUTE CONTENT

The Volcker Rule: The Long and Winding Road to a Mixed Result for Collateralized Loan Obligations

- As regulatory agencies work on implementing regulations designed to enforce the Volcker Rule, banks must consider the impact of the pertinent regulatory requirements on their collateralized loan obligation holdings. Elliot Ganz and Claire Emory, CFA (Reviewer), *CFA Digest,* May 2015

[The Final Volcker Rule—Impact on Securitization Transactions]

- US federal financial agencies approved the final Volcker Rule on 10 December 2013. It is aimed at preventing insured depository institutions from undertaking unduly risky activities. J. Paul Forrester, Carol Hitselberger, J. Bradley Keck, and David Sahr, *CFA Digest,* November 2014

[Volcker Rules?]

- “We have huge deficits today, and yet we have the lowest interest rates we could ever imagine,” because of Paul Volcker’s influence, says economist William Silber. Jonathan Barnes, *CFA Institute Magazine*, January/February 2013

[CFA Institute Comment Letter on Proposed Volcker Rule Ban on Proprietary Trading]

- The SEC, the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the FDIC published regulatory proposals and questions regarding implementation of the so-called Volcker Rule from Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to the SEC, 15 February 2012

DARK POOLS

TALKING POINTS

- We believe that regulation should not favor one type of entity over another when they engage in economically and functionally similar activities.
- We are concerned about the growth of dark pools in terms of market transparency and the undermining of improvements in trading costs.
- We support rules limiting dark pool trading to “large-in-scale” orders in certain instances.

OVERVIEW

The effective regulation of “dark pools,” which are private forums for trading securities, is necessary to secure efficient trade execution, and to ensure transparent and fair markets as a means to foster confidence and trust in trading markets.

Within the current, fragmented securities-trading market environment, off-exchange trading, including broker/dealer internalization and dark pools in which prices are not displayed before execution, has grown significantly. Nonexchange trading in the United States has surged in recent years, accounting for an estimated 40% of all US stock trades in spring 2017, compared with an estimated 16% in 2010. Dark pools have been at the forefront of this trend toward off-exchange trading, accounting for 15% of US volume as of 2014.

From a market integrity perspective, the growth in dark trading raises potential concerns, ranging from a perceived decline in the transparency of markets to a reduced willingness of investors to display quotes if dark venues free ride on those quotes and privatize order flow. CFA Institute members have raised concerns that the incentive to display orders in public markets is being undermined by certain off- exchange trading practices. In turn, these concerns have implications for public price discovery, liquidity, and the quality and integrity of markets.

REGULATION

The SEC issued an Equity Market Concept Release in 2010 that discussed, among other things, dark pools as part of alternative trading systems (ATS), and in terms of trade rule reporting, market liquidity, and order execution quality.

In 2009, the SEC proposed to amend the Exchange Act of 1934 regulations that apply to nonpublic trading in Regulation National Market System (Reg NMS) stocks, including dark pools.

In late 2015, the SEC proposed amendments to requirements under Regulation ATS pertaining to ATS that trade in Reg NMS stocks, including dark pools.

CFA INSTITUTE OUTLOOK

CFA Institute believes that regulation should not favor one type of firm or person over any other when they engage in economically and functionally similar activities. Consequently, any regulatory or legislative advantages, such as those that permit broker-internalization networks to operate under different rules from exchanges despite their similar activities, should be eliminated.

Our dark pools report identified how increasing the opacity of trading, principally through internalization, will undermine improvements in trading costs with impaired price determination and wider spreads. To avoid these negative repercussions, regulators should monitor growth of dark trading volume and improve reporting and disclosure around dark pool trading to enable appropriate measures by investors and regulators, alike.

CFA Institute also supports rules that would allow regulators to limit dark pools trading to “large-in-scale” orders if these systems become too dominant.

For firms to internalize retail orders, they should have to provide meaningful price improvement or route the orders to regulated exchanges to interact with displayed quotations in the order book.

CFA INSTITUTE CONTENT

Do Dark Pools Harm Price Discovery?

- Dark pools—that is, equity trading systems that do not publicly show orders—have raised concerns with such groups as the European Commission and the US SEC because they may diminish price discovery. Haoxiang Zhu, and Mark K. Bhasin, CFA (Reviewer), *CFA Digest,* December 2014

Policy Brief: Dark Trading, Market Quality, and Global Policy Developments

- Dark pools are trading systems operated by banks and other firms that match trading interest without pretrade transparency. This policy brief examines the regulatory issues associated with dark trading. Rhodri G. Preece, CFA, CFA Institute, July 2014

Dark Pool DNA: Improving Dark Pool Assessment

- The purpose of this study is to determine the optimal liquidity-seeking algorithm strategy for dark pools and to present practical applications for practitioners. Ben Polidore, CFA, and Heather K. Traficanti, CFA (Reviewer), *CFA Digest,* August 2012

Ten Questions Every Institution Should Ask Their Dark Pool Providers

- The authors survey users of dark pools and posit that institutional investors "blindly" engage in dark liquidity pool arrangements, with many unable to distinguish among various dark pools. Jay Bennett, John Colon, John Feng, Jennifer Litwin, and Tokunboh Ishmael, CFA (Reviewer), *CFA Digest,* February 2011

Comment Letter on Regulation of NMS Stock Alternative Trading Systems

- This rule will require ATS to file a new registration form that would include a description of its activities and the activities of its broker/dealer operator and other affiliates. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US SEC, 26 February 2016

Comment Letter to SEC on NYSE Proposal to Establish a Retail Liquidity Program—Amendment No. 2

- This consultation addresses the NYSE's proposal to establish a nondisplayed retail liquidity pool. Kurt N. Schacht, CFA, James C. Allen, CFA, and Rhodri G. Preece, CFA, submitted to US SEC, 21 March 2012

Comment Letter to US SEC on Equity Market Structure

- In providing input on the SEC Concept Release, CFA Institute focused on the following key areas: implementation of a trade-at rule, the focus on long-term versus short-term investors, high-frequency trading, colocation services, and dark pools. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 22 June 2010

Letter to US SEC on Subpenny Trading on Regulated Markets

- Exemptions in Rule 612 of Regulation NMS have created a two-tiered equities marketplace in which certain broker/dealers and dark pool participants are permitted to trade at subpenny increments, whereas the remainder of the market is not. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US SEC, 6 January 2010

HIGH-FREQUENCY TRADING

TALKING POINTS

- We believe that while not inherently manipulative, the use of high-frequency trading (HFT) may lead to manipulative or fraudulent activity.
- We therefore support the right of firms to engage in HFT under meaningful regulation and oversight.
- We do not support broker/dealers bypassing their own control systems by giving HFTs unfiltered direct market access.

OVERVIEW

HFT is a type of algorithmic trading characterized by high speeds, high turnover rates, and high order-to-trade ratios that leverages high-frequency financial data and electronic trading tools. Effective regulation of this activity is necessary to ensure that traders who trade on the basis of momentary price disparities and trends do not engage in market manipulation or undermine the ability of other investors to buy and sell securities.

A combination of rapid advances in computing power, improvements in trading algorithms, massive investments in technology, and regulatory leeway has made HFT pervasive in equity markets.

A number of high-profile failures have been linked to HFTs in recent years. HFT firms received significant criticism for their role in fleeing the market during the May 2010 "Flash Crash." A 45-minute computing glitch at Knight Capital in August 2012 cost the firm $460 million. More recently, "latency" issues at the Chicago Mercantile Exchange (CME)—that is, delays between the time that CME computers execute trades and report them to the market—allowed some HFTs to take advantage of trading information ahead of others. Many fear the lack of required capital, opaqueness of their financial condition, and rapid trading algorithms pose a risk to trading-market integrity, stability, and trust.

REGULATION

The SEC introduced rules against flash orders (a flash order is a marketable order sent to a market center that is not quoting the industry's best price or that cannot fill that order in its entirety) and imposed mandatory circuit breakers for trading platforms following the Flash Crash in 2010. Regulators in Europe and the United States have considered minimum resting times for orders, but most have resisted calls to ban HFTs.

In 2011, the SEC adopted a new rule to help it identify and obtain trading information on market participants that conduct a substantial amount of trading activity.

In 2015, the SEC issued a rule proposal to require broker/dealers active in off-exchange markets to become members of a national securities association.

CFA INSTITUTE OUTLOOK

CFA Institute believes HFT is not inherently manipulative or fraudulent, but the application of this "tool" by firms may lead to manipulative or fraudulent activity. Such actions by HFTs should be addressed through existing antifraud and antimarket manipulation rules. CFA Institute also believes that HFTs provide certain benefits to the market, including (1) narrower bid–ask spreads; (2) increased market liquidity in normal times; (3) improved price discovery; and (4) significant volume on transparent, traditional exchanges.

CFA Institute supports the right of firms to engage in HFT under appropriate rules and regulation:

- Firms should be subject to meaningful regulation and oversight.
- Firms should not have access to the market order book in the same manner as market makers unless they also are subject to market-maker obligations.
- Firms should have to maintain controls and oversight of their trading algorithms to ensure that mistakes are addressed automatically and quickly.

We also do not believe that broker/dealers should bypass their own control systems by giving HFTs unfiltered direct market access. We believe that flash orders are a means of manipulating the market. Regulatory steps aimed at strengthening the testing and controls around algorithms and improving network resiliency, especially during bouts of volatility, should make markets safer for investors. Arbitrary restrictions on order submission are less likely to be effective.

CFA INSTITUTE CONTENT

Algorithmic Trading and High-Frequency Trading (2018)

- This reading is a direct excerpt from the CFA® Program curriculum and is provided as a benefit to members who wish to revisit or relearn certain concepts. Refresher Readings, CFA Institute, 2018 Curriculum, Level 2

Expected Return in High-Frequency Trading

- The article develops the alpha attribution model for HFT by explaining its components and the trading tactics used to implement high-frequency strategies. Rick Cooper, Ben Van Vliet, and Rich Wiggins, CFA (Reviewer), *CFA Digest,* October 2015

High-Frequency Trading: Beyond the Hype

- “We’re concerned about the multiple points of vulnerability that a decentralized equity market implies and have urged regulators to require that firms control algorithms’ access to market systems and frequently test system resiliency.” Bob Dannhauser, CFA, *CFA Institute Magazine*, July/August 2015

Policy Brief: High-Frequency Trading—Investor Issues and Perspectives

- CFA Institute staff have tracked the evolution of HFT in global capital markets over the past five years, with a view toward understanding potential impacts on market integrity and efficiency as well as to inform perspectives on public policy and regulatory initiatives. Bob Dannhauser, CFA, CFA Institute, 17 April 2014

Comment Letter to International Organization of Securities Commissions (IOSCO) Consultation Report on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency

- This consultation addresses the current state of the markets and the risks posed by certain technological and market developments; HFT and the potential risks it poses to market efficiency, integrity, and stability; and the regulatory initiatives taken to date. Rhodri G. Preece, CFA, submitted to IOSCO, 18 August 2011

Comment Letter to US SEC on Equity Market Structure

- In providing input on the SEC Concept Release, CFA Institute focused on the following key areas: implementation of a trade-at rule; the focus on long-terms versus short-term investors, high-frequency trading, co-location services, and dark pools. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 22 June 2010

Comment Letter to the Committee of European Securities Regulators on Micro-Structural Issues of the European Equity Markets

- CFA Institute responded to the Committee of European Securities Regulators’ consultation request seeking evidence from stakeholders. Charles Cronin, CFA, and Rhodri G. Preece, CFA, submitted to Committee of European Securities Regulators, 30 April 2010

SMALL- AND MEDIUM-SIZE ENTERPRISE FINANCE

TALKING POINTS

- We support efforts to provide venture funding for small- and medium-size enterprises (SMEs), subject to certain conditions that provide transparency for investors.
- In our Venture Exchange Report, we support the creation of a venture exchange for these companies as a means to provide clarity to the investor that SMEs may not adhere to the reporting requirements imposed on larger companies.

OVERVIEW

To achieve an effective balance between facilitating the delivery of needed capital to small- and medium-size enterprises (SMEs) with the basic transparency and investor protection needs of small investors, effective regulation is imperative.

During the tech/telecom bubble of the 1990s (the so-called tech bubble represented a pronounced and unsustainable market rise attributed to increased speculation in technology stocks in the 1997–2001 period), large numbers of small companies failed, leaving investors with hundreds of billions of dollars in financial losses. That, and high-profile governance and fraud cases at Enron and WorldCom, prompted new governance rules to prevent recurrence.

REGULATION

The Sarbanes-Oxley Act of 2002 (SOX) imposed criminal penalties on senior management for fraudulent or misleading financial reporting and required governance structures such as audits on company internal controls. Its internal controls section (Section 404(b)) was amended in 2007 to focus solely on financial reporting. Despite these changes, the Dodd-Frank Wall Street Reform and Consumer Protection Act specifically exempted companies with market capitalizations of less than $75 million from Section 404, and called on the SEC to study exempting companies with market capitalizations up to $250 million.

The US Jumpstart Our Business Startups Act (JOBS Act), which was enacted in 2012, granted further exemptions to transparency requirements, took Dodd-Frank up on increasing the Section 404 exemption to companies with market capitalizations of up to $250 million, and allowed smaller companies to raise capital via crowdfunding sources.

CFA INSTITUTE OUTLOOK

CFA Institute supports efforts to provide venture funding for SMEs. At the same time, we believe that such efforts must be balanced with the transparency needs of investors. To achieve this balance, we believe companies should adhere to the following safeguards:

- Undergo annual financial audits and include them in annual reports to shareowners and investors;
- Provide at least semi-annual updates on performance and financial condition;
- Disclose all important company news through normal public distribution channels;
- Hold principals liable for fraudulent representations made in offering documents, financial statements, or company announcements delivered through these channels; and
- Trade shares only on special exchanges or trading platforms dedicated to such companies to ensure that investors are aware that the shares do not have to adhere to the same transparency and governance requirements as are required of traditionally listed companies.

CFA INSTITUTE CONTENT

Venture Exchange Report

- The JOBS Act created a dual regulatory structure by which certain small and start-up companies do not have to adhere to the same standards as others. This report discusses the opportunities and challenges of a venture exchange with a “lighter regulatory touch” that would encourage these start-ups to use the public markets to raise capital. Listing on this exchange would also put investors on notice of the higher risk profile of these companies. James C. Allen, CFA, and Matthew Orsagh, CFA, CIPM, Codes, Standards, and Position Papers, CFA Institute, 2016

Policy Brief: United States Venture Market—Has the Time Come?

- CFA Institute supports a venture exchange rather than an ATS for small companies to ensure investors are aware of regulatory exemptions that may create higher levels of risk for these companies relative to other publicly traded companies. We also believe that all the shares of companies listed on the exchange should trade on that exchange to ensure investors are not investing blindly. These types of exchanges should have regulatory flexibility in terms of trading structures and rules to permit experimentation to address trading anomalies. Finally, we believe the SEC should have the authority, but not a requirement, to grant charters to more than one venture exchange to ensure trading costs and listing fees are transparent and competitive. CFA Institute, May 2017

SME Financing and Investors' Needs

- As policymakers take action to improve access to finance for SMEs, it is critically important that these efforts balance the needs of SMEs with the needs of investors, including transparency and other protections. Claire Fargeot and James C. Allen, CFA, *CFA Institute Magazine*, May/June 2013

CROWDFUNDING AND RELATED REGULATIONS FOR SMALLER COMPANIES

TALKING POINTS

- We support efforts to better provide small companies access to the capital markets.
- This access, however, must be balanced against important investor safeguards and their needs for transparent information.
- The lack of audited financial statements and looser governance structures pose threats to investors who need full information in order to make meaningful investment decisions.

OVERVIEW

The US Jumpstart Our Business Startups Act (JOBS Act) seeks to increase the flow of investor capital to so-called emerging growth companies (EGCs) by providing them exemptions from many of the requirements for listed companies, including governance structures, disclosure requirements, and shareowner-rights provisions. These exemptions seek to create a more hospitable environment for EGCs by reducing regulatory costs and disclosures and by giving owners and insiders a freer hand at making changes to governance structures.

REGULATION

The SEC has adopted a number of regulations to help facilitate the growth of EGCs, as mandated by the JOBS Act.

Crowdfunding is the practice of funding a project or venture by raising small amounts of money from a large number of people, typically via the Internet. The SEC adopted *Regulation Crowdfunding* in 2015, which allows individuals to invest in securities-based transactions subject to certain investment limits. An issuer is limited to the amount of money it can raise and has to meet certain disclosure requirements about their business and securities offering. *Regulation Crowdfunding* also governs the activities of broker/dealers and funding portals that are involved in the crowdfunding transactions.

The rapid growth in low-documentation, start-up-phase financing of small projects and companies has created a need to ensure that the interests of small companies seeking capital are appropriately balanced against investment protection and the needs of investors to obtain information vital for their investment decisions.

The SEC also adopted amendments to *Regulation A* to allow smaller companies to offer and sell up to $50 million in securities during a 12-month period without having to comply with all requirements applicable to registered securities. Two tiers of offerings (up to $20 million and up to $50 million) are subject to differing disclosure and reporting requirements.

Amendments to *Rule 147* allow issuers to engage in intrastate offers and sales of securities without having to federally register them.

Individual state regulations often require registration of offerings of a specified amount. The SEC also has adopted a rule that allows issuers to use mechanisms such as email to advertise offerings to state residents (even if the advertising is received by residents of other states), as long as the sale is made only to those who reside within the state.

CFA INSTITUTE OUTLOOK

Although beneficial to issuers, changes adopted under the JOBS Act mandate increase the risks for those who invest in them. Without adequate information and without audited financial statements, investors are unsure of the veracity of claims by insiders regarding performance and financial conditions. Moreover, additional risks are created through looser governance structures that do not protect external investors against fraudulent financial reporting and dilution of their share values, among other risks.

CFA Institute supports efforts to enhance small-company access to the capital markets for equity and debt funding. We believe this goal should be balanced with the transparency needs of investors. CFA Institute believes that the following safeguards are needed to balance the capital needs of small companies and the transparency and protections investors deserve:

- Integrity of platforms' operations: appropriate regulatory structures and guidance in place;
- Transparency by issuers and platforms: presubscription and ongoing disclosures and warnings;
- Investor access and appropriateness: limiting access for and educating unsophisticated investors;
- Due diligence and safeguards: reviews of issuers by offering platforms and managing conflicts;

- Small- and medium-size enterprise (SME) access and focus: limit participation to SMEs and EGCs; and
- Corporate governance protections: platforms conduct background checks on issuing principals.

CFA INSTITUTE CONTENT

Does Crowdfunding Pose a Threat to Investors?

- Sacrificing investor protections in the capital markets isn't worth the purported economic benefits of allowing emerging companies relatively unfettered access to public capital. Kurt N. Schacht, CFA, *CFA Institute Magazine*, May/June 2014

Policy Brief: Investment-Geared Crowdfunding

- This issue brief provides perspectives on the growth and incipient regulation of loan-based and securities-based crowdfunding around the world. Mirzha de Manuel Aramendía, CFA Institute, March 2014

D.C. Policy Update: Dissecting SEC and Financial Industry Regulatory Authority (FINRA) Crowdfunding Proposals, MBS Reform

- CFA Institute responds to crowdfunding proposals from the SEC and FINRA. The podcast provides an update on mortgage-market reform, including commentary on the Corker–Warner Housing Finance Reform Bill. James C. Allen, CFA, Market Integrity and Advocacy Webcast, 4 February 2014

The Way Companies Are Getting Financed Is Completely Changing

- Financing for start-ups is changing rapidly. New methods of financing include crowdfunding, accelerators, super-angels, late-stage private equity, and the long-delayed initial public offering. Pascal-Emmanuel Gobry, *Business Insider,* 2 November 2011

Comment Letter on Exemptions to Facilitate Intrastate and Regional Securities Offerings

- CFA Institute supports efforts to foster capital formation while preserving important investor protections. CFA Institute recommends lifting some of the issuer restrictions on intrastate offerings but preserving certain disclosure requirements. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 11 January 2016

Comment Letter to SEC on Crowdfunding

- The SEC's proposed rules to implement the requirements of Title III of the JOBS Act, which allow unregistered offerings through crowdfunding transactions, overall balances the need for flexibility with that of preserving important investor protections. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 3 February 2014

Jumpstart Our Business Startups (JOBS) Act—Proposed Funding Portals

- FINRA's proposed rules for funding portals contain a number of investor protection provisions, but they need to more broadly align themselves with certain provisions in the SEC's proposed regulations on crowdfunding activities. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to FINRA, 3 February 2014

REGULATION OF THE ASSET MANAGEMENT INDUSTRY

RISK PROFILE

TALKING POINTS

- CFA Institute supports meaningful measures to reduce systemic risk in the financial industry.
- We also believe that the concerns about the systemic risks inherent in the asset management industry are misplaced.
- We question the effort to mandate "risk contagion" measures across the mutual fund industry and instead recognize that some degree of risk is inherent in, and vital to, our capital markets.

OVERVIEW

The SEC, Office of Financial Research (OFR), Financial Stability Oversight Commission (FSOC), and the European Financial Stability Board (FSB) have all issued reports or proposals focused on the supposed risks of the asset management industry. The gist of these reports and consultations is the supposition that the asset management industry—particularly because of its size—poses systemic risk implications that require additional regulating.

REGULATION

In 2013, the OFR published a report highlighting the risks of asset management (on which the SEC sought public comment). In 2014, the FSOC issued for public comment a notice on what it considered to be asset management risks, particularly focusing on systemic risk implications of the transfer of a significant number of accounts from one asset manager to another.

In 2016, the SEC proposed (and adopted) requirements that investment management funds have liquidity management programs, and the optional use of swing pricing.

The European FSB also has raised numerous issues in consultations about the potential systemic risk implications of the asset management industry. In 2017, the FSB issued recommendations to address those risks.

CFA INSTITUTE OUTLOOK

CFA Institute believes the systemic risk concerns specific to the asset management industry are misplaced and may reflect a lack of understanding regarding the ways that this industry differs from other financial services industries, such as the banking industry. The asset management business is fundamentally different from bank and insurance institutions in that asset managers typically do not own the assets they manage and assets managed are typically marketable and highly liquid securities.

CFA Institute supports meaningful measures to reduce systemic risk in the financial industry. We believe, however, that it is important to balance the actual need for additional regulation with the industry. This industry is already highly regulated, and it showed little systemic implications stemming from the 2007–2008 financial crisis. In fact, it has shown resiliency during tumultuous times.

We are unsure that a systemic risk issue exists in regard to the vast majority of open-end funds. The regulatory requirements already in place under the Investment Company Act of 1940 provide a robust barrier against that kind of contagion. It is important that policymakers base their regulatory framework on a thorough understanding of the industry they seek to regulate.

We question the utility and appropriateness of regulatory actions to mandate "risk contagion" efforts across the fund industry, particularly where there are substantial questions about their effectiveness. Instead, we recognize that some degree of risk is inherent in, and vital to, our capital markets.

CFA INSTITUTE CONTENT

DC Policy Update: Systemic Risk of Asset Managers and Congress' Financial Policy Agenda

- James C. Allen, CFA, head of Americas capital markets policy at CFA Institute, previews how CFA Institute will respond to the FSOC's calls for comments on whether asset management products and activities pose systemic risk. James C. Allen, CFA, Market Integrity and Advocacy Webcasts, 20 February 2015.

Safeguarding the System: Promoting Stability and Minimizing Systemic Risk

- Sheila C. Bair, senior adviser at Pew Charitable Trusts, discusses the political heart for true financial reform. She examines what can be done to alleviate systemic risk and discusses why financial reforms are important to a banking sector that supports a functional free market economy. Bair's presentation is preceded by the opening remarks for the CFA Institute 67th Annual Conference by CFA Institute President and CEO John Rogers, CFA, 5 May 2014

Systemic Risk Council: A Call to Action

- The Systemic Risk Council (SRC) is a private sector, nonpartisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues relating to systemic risk in the United States. To that end, the SRC focuses on six main issues that require priority attention by the FSOC and its members. CFA Institute, 18 June 2012

Comment Letter on Open-End Fund Liquidity Risk Management Program; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release

- CFA Institute recommends a more principles-based approach rather than the proposed requirements mandating liquidity risk management programs by open-end investment companies. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 12 January 2016

Comment Letter on Investment Company Reporting Modernization

- CFA Institute supports updated information, and in a structured data format, on investment company activities to help assess potential risks across the asset management industry. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 10 August 2015

Comment Letter on FSOC's Notice Seeking Comment on Asset Management Products and Activities

- CFA Institute supports the monitoring of asset management firms for their potential to create risks to the financial system and believes that direct oversight and regulation of that sector should remain with the SEC. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to the FSOC, 25 March 2015

CFA Institute Comment Letter on the Report Issued by the Office of Financial Research on Asset Management and Financial Stability

- The OFR issued a report on potential risk implications of the asset management industry. James C. Allen, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 4 December 2013

REGULATION OF INVESTMENT PRODUCTS AND SERVICES

MONEY MARKET FUNDS

TALKING POINTS

- We recognize the systemic risk implications of money market funds (MMFs).
- We agree with the move to require institutional MMFs to use a variable net asset value (NAV) for pricing.
- We understand the decision to allow retail and government funds to continue using a stable NAV, but we support future action to eventually move all MMFs to a variable NAV pricing method.

OVERVIEW

MMFs, which are sometimes called money funds, are a type of mutual fund developed in the 1970s as an option for investors to purchase a pool of securities that generally provide higher returns than interest-bearing bank accounts. MMFs invest in high-quality, short-term debt securities and pay dividends that generally reflect short-term interest rates. Many investors use MMFs to manage their cash and other short-term funding needs. These funds currently hold some $3 trillion in assets. The aggregate size of MMFs, combined with the demand nature of their short-term assets, creates a significant potential for liquidity challenges in the sector, which can have negative implications for corporate commercial paper funding, banks' short-term funding, and US Treasury offerings.

The run by institutional investors after the Reserve Primary Fund "broke the buck" in 2008 resulted in significant MMF redemptions and a run on institutional prime MMFs that caused a domino effect on global short-term credit markets. (Breaking of the buck is when the NAV of an MMF falls below $1. Breaking the buck can happen when the MMF's investment income does not cover operating expenses or investment losses.)

This effect culminated with the US government intervening to offer to insure any MMF, giving rise to the expectation that it would do so again if another such calamity were to occur. The extraordinary measures taken by the US government in 2008, and the effect felt by the short-term credit markets globally, ignited a debate about whether the MMF structure posed a systemic risk.

REGULATION

In 2014, the SEC adopted new rules to permit MMFs directed at retail investors and funds that invest solely in government securities to continue to offer a stable NAV. Institutional prime MMFs (including institutional municipal MMFs) are required to maintain a floating NAV.

The new rules allowed funds to use liquidity fees and to impose "gates" (temporary suspension of redemptions) in times of stress. These funds also are subject to enhanced diversification, disclosure, and testing requirements.

The European Commission has published proposed reforms for European MMFs, but instituting regulations across all 28 member countries is a laborious process; reforms likely will not become effective until late 2018 or early 2019.

CFA INSTITUTE OUTLOOK

In a September 2013 comment letter to the SEC, CFA Institute reiterated its concerns about the potential systemic risk implications of MMFs that maintain stable NAVs, as well as additional concerns that investors perceive investments in these instruments to be risk free. The letter also reiterated a longstanding position in favor of fair-value reporting.

CFA Institute has long advocated for fair-value reporting for financial reporting and with regard to financial instruments. We believe it provides investors with a more accurate picture of an entity's financial condition. We thus agree with requiring institutional MMFs (as defined in the regulation) to use a variable NAV. Although the first alternative allows retail and government funds (as defined) to continue using a stable NAV, we encourage further regulatory or industry-driven action ultimately to move all MMFs, including retail and government funds, to a variable NAV pricing method.

We believe in providing investors with options by allowing sponsors to offer MMFs with different structures wherever practicable and provided they (1) are required to provide investors with meaningful disclosures that fully address the investment risks, and (2) do not put the financial system at risk of collapse.

Although we recognize the current confusion surrounding investing in MMFs with a stable NAV, we believe the proposed disclosure requirements go a long way toward mitigating this confusion. As noted, we hope that over time, investors will appreciate the benefits and value of investing in variable NAV funds and that the industry will move, of its own accord, in that direction without the need for regulatory intervention.

Mark-to-Market Valuation

CFA Institute supports mark-to-market valuation methodologies. At the same time, we recognize that investors, including investment managers, use MMFs for a variety of purposes and understand that not all of the investment instruments used by MMFs have active trading markets that use mark-to-market valuations.

Improved Regulation for Stable NAV Funds

In particular, we recommend (1) that sponsors who provide capital guarantees be required to maintain capital reserves, (2) the adoption of enhanced liquidity structures, and (3) better disclosures aimed at informing investors that MMFs are not “riskless.” We also support imposing capital buffers on stable NAV MMFs that would be financed by fund sponsors.

Although we support enhanced liquidity mechanisms, CFA Institute members do not support imposing a liquidity fee on investors that redeem first to prevent runs on the fund. Instead, members have expressed support for the use of redemption restrictions that include holding back a small minimum balance. Restrictions of this sort should be used only in times of extreme market stress and periods of heavy redemptions.

CFA INSTITUTE CONTENT

Money Market Fund Reforms Long Overdue

- To reduce implications for systemic risk, reform of money funds must combine short- and long-term approaches. Kurt N. Schacht, CFA, *CFA Institute Magazine*, January/February 2014

Issue Brief: Money Market Fund Reform—Measures to Reduce Systemic Risk in the Investment Industry

- When the Reserve Primary Fund “broke the buck” in 2008, the resulting run on redemptions in MMFs triggered a domino effect on global short-term credit markets. Linda L. Rittenhouse, CFA, CFA Institute, October 2013

Comment Letter on Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule

- CFA Institute comments on the SEC’s proposal to remove certain references to credit ratings agencies to diversifications requirements in money market funds. James C. Allen, CFA, Head, Capital Markets Policy Americas, and Matthew Orsagh, CFA, CIPM, Director, Capital Markets Policy, submitted to US SEC, 14 October 2014

Comment Letter on Money Market Reform; Amendments to Form PF (File No. S7-03-13)

- CFA Institute supports the SEC’s efforts to address systemic risk implications of the money market industry. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 19 September 2013

Comment Letter to SEC in Response to the Call for Comments on the President’s Working Group Report on Money Market Fund Reform

- CFA Institute noted that although its support for fair-value accounting was more in line with the floating NAV suggested by the SEC and the President’s Working Group report, the practical difficulties of altering a $3 trillion sector would make such a move infeasible. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US SEC, 28 April 2011

TRANSPARENCY IN ASSET-BACKED SECURITIES/MORTGAGE-BACKED SECURITIES MARKETS

TALKING POINTS

- We believe investors need the information ahead of time to help inform their decision making.
- Issuers of asset-backed securities (ABS) should have to provide relevant information to investors at least 24 hours before offering the securities for purchase.
- Issuers also should have to report on certain corporate events, including on the creation of a direct financial obligation and changes in control of the issuer.
- ABS servicers should have repositories on their websites to provide information to all investors at the same time.

OVERVIEW

Before the 2008 financial crisis, markets in ABS and mortgage-backed securities (MBS) were important sources of funding for consumer lenders and consumers. By providing a secondary market for the loans originated by banks and other financial firms, investors enabled financial firms to leverage their balance sheets, boost noninterest income, and increase the level of funding in these markets. At the same time, the increased funding for these markets helped to reduce the costs of funding for mortgages and other consumer finance products.

Before the financial crisis, investors often had to invest in these instruments sight unseen. Issuers and securities underwriters regularly delivered one-page term sheets to potential investors as little as an hour before the offering, forcing such investors to make decisions on the basis of limited information. Making decisions in this manner is contrary to the fiduciary obligations that such investors owe to their customers, investors, and beneficiaries.

REGULATION

The SEC adopted revisions to Regulation AB to require prospectuses for public offerings and reports of certain ABS to include specific asset-level information about each asset in the pool. The SEC also revised the filing deadlines for offerings to give investors more time to consider transaction-specific information.

CFA OUTLOOK

CFA Institute believes issuers must provide comprehensive, accurate, timely, and relevant information to investors at least 24 hours before offering securities for them to purchase. This requirement should prevail regardless of whether the offering consists of traditional equity or bond securities, or more structured instruments such as ABS and MBS.

Without appropriate information, issuers, underwriters, and regulators are compelling investors to make decisions without having conducted adequate due diligence. Moreover, such offerings subject institutional and fund investors to legal and financial risk should a deal subsequently default.

ABS Prospectuses

Issuers of ABS should have to provide information about the structure of the deal, historical performance of similar or related transactions, and financial and legal information about the entities involved in the offering. Information about the structure, performance, issuer, servicer, and originator of the securities offered will give investors the vital information they need to understand the risks involved in the securities offered.

Reporting on Corporate Events

Issuers or sponsors of ABS should have to notify ABS investors about the following:

- The creation of a direct financial obligation;
- An obligation under an off-balance sheet arrangement; and
- Changes in control of the issuer.

Typically, the entity that receives payments from borrowers and pays interest and principal to ABS investors, known as the “servicer,” is the same company whose activities gave rise to the issuance of the ABS securities. ABS investors need relevant information about the servicer to understand the long- and short-term risks associated with receiving their principal and interest payments when due. An exemption from reporting on these corporate events would put ABS investors at a disadvantage to both the company and to investors in other securities issued by the company.

Pre-ABS Offering Documents

Issuers of ABS should be required to ensure that investors have received relevant prospectus and computational information about an offering at least 24 hours before being permitted to issue ABS securities. Permitting ABS offerings to proceed without giving investors sufficient information and time to review that information puts investors at legal and financial risk should a deal subsequently default.

Communications between Investors and Services

Servicers of ABS should create repositories on their websites to ensure that all investors receive answers simultaneously to any parties' questions about the relevant securities. Such website repositories would ensure that all investors receive the same relevant information at the same time and ensure that the information is widely distributed in a timely manner.

CFA INSTITUTE CONTENT

Comment Letter on Re-Proposal of Asset-Backed Securities

- This letter was a response to the second re-proposal of new disclosure regulations per the Dodd-Frank Wall Street Reform and Consumer Protection Act for issuers of ABS and MBS. James C. Allen, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 28 April 2014

REGULATION OF INVESTMENT PROFESSIONALS AND FIRMS

EXPANDED SEC EXAMINATION PROGRAM FOR ADVISERS

TALKING POINTS

- We recommend that examinations of advisers should be performed by those with experience in and understanding of the Investment Advisers Act of 1940, under which advisers are registered.
- We support the SEC, and not the Financial Industry Regulatory Authority (FINRA), to conduct these examinations.

OVERVIEW

In light of the more than 11,000 investment adviser firms registered with the SEC at the end of 2015, we are concerned that the SEC's examinations of these advisers fail to adequately monitor activity at firms and protect investors.

As a result, the Dodd-Frank Wall Street Reform and Consumer Protection Act called on the SEC to study how to improve oversight of registered investments advisers (RIAs) and to report to Congress within a year. The SEC's staff recommended that the SEC retain oversight, but that funding be increased to pay for the agency's expanded examination and enforcement, either through appropriations or through the retention of examination fees.

Since Dodd-Frank was passed in July 2010, various bills and reports have recommended solutions to the problem of inadequate examination frequency of RIAs by the SEC, including the formation of a separate oversight body to examine advisers, housing an adviser examination program within FINRA, and funding an augmented SEC-examination program through fees assessed on the firms being examined.

A number of factors will constrain the final structure of RIA oversight. First among these is opposition by RIAs to FINRA oversight. Second, the SEC is unlikely to see its budget increase significantly or sufficiently to fund additional exams until or unless economic growth reduces fiscal deficits to a more manageable level. Third, Congress is unlikely to grant the SEC authority to collect and retain examination fees from RIAs. It is also highly unlikely that the SEC will receive self-funding authority in the near future, nor is it likely that FINRA will oversee RIAs.

CFA INSTITUTE OUTLOOK

Investment adviser oversight requires experience in, and an understanding of, the Investment Advisers Act and the practical application of its fiduciary-duty requirements, the investment advisory business, and operation of the financial markets.

Given this requirement, CFA Institute believes the SEC is the best entity to conduct these examinations. It needs sufficient resources to do this, however, through congressional funding that would allow it to meet its regulatory mandates. A November 2010 CFA Institute member survey supports this view, particularly in the examination and enforcement areas.

CFA Institute does not support FINRA's oversight of advisers for two reasons. First, FINRA lacks the expertise of SEC staff in the rules and regulations of the Investment Advisers Act. Second, FINRA uses a rules-based system of oversight, which we believe is not appropriate for this segment of the investment industry.

CFA INSTITUTE CONTENT

CFA Institute Letter to House Financial Services Committee on Investment Adviser Oversight

- The House Financial Services Committee was scheduled to hold a hearing on the proposed Investment Adviser Oversight Act of 2012 that would require all RIAs, whether registered with the SEC or regulated by state agencies, to apply to become a member of a registered national investment adviser association. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US House of Representatives, Financial Services Committee, 5 June 2012

[Comment Letter to US SEC on Enhancing Investment Adviser Examinations]

- CFA Institute stated that increased funding for the SEC would be the best way to improve the frequency and quality of RIA exams. John D. Rogers, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 1 December 2010

BUSINESS CONTINUITY PLANS FOR ADVISERS

TALKING POINTS

- With little evidence that advisers fail to manage investor interests (even during times of stress), we question the need for a new, highly specified regulation.
- Instead, we support an overarching requirement for adopting a business continuity plan, but with flexibility for advisers to tailor the plan to address risks of its specific business.

OVERVIEW

Following the financial crisis, the asset management industry has been under scrutiny with regard to whether certain practices and products create systemic risk (see the policy briefing “Systemic Risk”). Thus, advisers should implement and maintain business continuity plans that allow them to continue serving clients uninterrupted during periods of disruptions and transition.

REGULATION

As regulators focused on industry practices that may be risky, former SEC Chair Mary Jo White targeted investment adviser practices that could result in disruptions of service to investors, whether through business disruptions or transitions. A 2016 SEC proposal on business continuity planning went so far as to assert that advisers who undertake to provide advisory services without implementing steps to safeguard client assets in times of disruption or transition are acting in a “fraudulent and deceptive” manner. Under the proposal, advisers would be required to have a business continuity plan that would have to include specific components.

CFA INSTITUTE OUTLOOK

Little evidence indicates that advisers have failed to manage investor interests, even during times of severe stress during the financial crisis. CFA Institute therefore questions the need for widely expanded requirements in this regard.

CFA Institute recommended that the SEC impose an overarching requirement that advisers adopt and implement a business continuity plan. But rather than mandate specific requirements regarding what the plan needs to address, we recommended that the SEC provide guidance. This approach would obligate the adviser to commit to adopting and implementing a plan that reasonably addresses the risks of its specific business without the overlay of additional regulations, the cost of which ultimately may be borne by investors.

CFA INSTITUTE CONTENT

Succession Planning for Business Owners

- The importance of succession planning arises from two major needs: (1) business continuity and (2) obtaining and transferring value. Succession planning can be accomplished with either a transactional approach or a wealth management approach. Sean Sebold, CFA, *CFA Institute Conference Proceedings Quarterly*, October 2005

Comment Letter on Adviser Business Continuity and Transition Plans

- CFA Institute recommends that the SEC impose a requirement on advisers to adopt and implement a business continuity plan, but provide guidance (rather than requirements as to specifics) on the components that should be included in those plans. Kurt N. Schacht, CFA, and Linda L. Rittenhouse, CFA, submitted to US SEC, 16 September 2016

CREDIT RATING AGENCIES

TALKING POINTS

- Past regulations that required certain credit ratings created a captive market for credit rating agencies (CRAs) and insulated them from the consequences of poor ratings.
- We support the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) provisions to subject CRAs to liability for conflicted ratings.
- We support eliminating from statutes and regulations the requirement to use credit ratings.

OVERVIEW

Effective regulation of CRAs is necessary to encourage high-quality credit ratings and increased accountability for CRAs. A CRA is a company that assigns credit ratings, which rate a debtor's ability to pay back debt by making timely interest payments and the likelihood of default. The "big three" CRAs are Standard & Poor's, Moody's Investors Service, and Fitch Group.

Before the passage of Dodd-Frank, securities regulations required funds to maintain certain ratings supplied by nationally recognized statistical rating organizations, which is the formal designation regulators have given CRAs. Many believed this led to a "captive market" in which the issuer-pay business model of traditional CRAs created potential conflicts of interest. Many critics believe these conflicts led to credit ratings that were intended to please issuers—in return for higher revenues—rather than an accurate assessment of credit and default risk.

REGULATION

In the United States, Dodd-Frank took a number of steps to address these concerns:

- Made CRAs liable for faulty ratings;
- Removed statutes and regulations requiring use of credit ratings;
- Created the Office of Credit Ratings within the SEC;
- Increased oversight of internal controls; and
- Increased transparency about ratings methodologies and performance.

In Europe, the focus has been on many of the same issues as in the United States.

CFA INSTITUTE OUTLOOK

CFA Institute supports the elimination of requirements in statutes and regulations to use credit ratings, which gave CRAs a captive market and insulated them from the consequences of poor ratings. Credit ratings can be useful benchmarks, but we do not believe it is prudent to require investors, institutions, and regulators to rely on the ratings of these agencies given the poor quality of their past work. We therefore support the Dodd-Frank provision to subject CRAs to liability for conflicted ratings as a means of holding these firms accountable for such ratings.

We do not believe that public bodies could provide a better alternative to private credit ratings, as no evidence suggests that public ratings would be subject to even greater conflicts of interest than private ratings. Rather, authorities should lower the barriers to entry to the credit ratings industry and provide a level playing field to enable meaningful private competition.

Firms using an investor-pays business model are limited in the scope of their coverage. This would make important macro information about debt markets unavailable to investors.

We support increased transparency about conflicts, ratings performance, and methodologies to help investors compare and contrast the accuracy and approaches of competing CRAs.

Provide a Reasonable Bases for Ratings

CRAs should refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating. Credit rating analysts should have a reasonable and adequate basis, supported by appropriate research and investigation, for any ratings they issue. New structured products rarely have sufficient performance data to enable rating agencies to have an adequate basis for a rating. Only after sufficient data are available to help the analyst recognize how these instruments will function in different circumstances should a rating be given.

Prevent Ratings Confusion

Policymakers and regulators should refine or otherwise eliminate the concept of “investment grade” wherever possible to reduce the incidence of misconception about the purpose of the CRAs’ ratings. The statutory and regulatory references to credit ratings have had a number of negative effects on the markets. First, they have given the rating agencies a captive market independent of the quality of their analyses and ratings. Regulatory and statutory requirements for institutional investors to rely on these ratings also has reduced the need for investors to conduct their own due diligence on securities and rating agencies. Second, the term “investment grade” has given many investors a false sense of security about the purpose of the rating and the quality of the rated instrument. To prevent these misperceptions, we believe the term “investment grade” and the related reliance on credit ratings should be removed.

Provide Notification of Pending Debt Rating Action

Companies should have to immediately disclose to the market when they are notified by a rating agency of any initiation, withdrawal, or change in credit rating, including guaranteed or contingent obligations.

A credit downgrade can affect not only the price of a company’s debt securities, but also the value of its equity securities.

Use Rating Terms

Rating agencies should use rating nomenclature or categorization that distinguishes structured products from corporate and commercial paper ratings to help investors recognize the differences. Some rating agencies use alternative nomenclature to distinguish between different asset classes, such as traditional debt and commercial paper. Because of the different payment mechanisms and issue structures, these instruments need a different nomenclature to help less-sophisticated investors recognize that these are different from traditional sovereign securities.

Prohibit Notching

CRAs should develop global best practices on prohibiting the practice of “notching.” Notching occurs when a CRA unilaterally issues a rating on an entity or structure to punish an issuer who has chosen a different rating agency.

Notching has the potential to give the market conflicted signals. To prevent confusion, CRAs should not issue an unsolicited rating to punish a company that has declined to hire the agency. This, however, would not prevent small ratings firms from issuing ratings on specific companies or securities for the benefit of their clients but without issuer approval.

CFA INSTITUTE CONTENT

Credit Rating Agency Survey

- In a 2014 CFA Institute member survey, 82% of respondents said they believe rating agencies remain under pressure from issuers to give them higher-than-deserved ratings. Eighty-four percent said they are more cautious about using credit ratings than they were seven years ago. CFA Institute, 2014

Gauging Investor Attitudes about Credit Ratings

- “Overreliance on ratings undermined the forces that might have prevented the rating agencies’ startling fall from grace.” James C. Allen, CFA, *CFA Institute Magazine,* September/October 2014

Ratings Agencies: Credit Where Credit’s Due

- Although CRAs received plenty of criticism and experienced a temporary decrease in profits after the 2008 financial crisis, they have quickly recovered. Servaas Houben, CFA (Reviewer), *CFA Digest*, August 2014

Can Investor-Paid Credit Rating Agencies Improve the Information Quality of Issuer-Paid Rating Agencies?

- The information quality of ratings from an issuer-paid rating agency, such as Standard & Poor’s, changed when investor-paid rating agency Egan-Jones Rating (EJR) entered the market. The author finds that after EJR’s coverage began, S&P’s ratings were more responsive to changes in credit risk and that the market reacted more to S&P’s rating changes. Han Xia, and Clifford S. Ang, CFA (Reviewer), *CFA Digest,* April 2014

The Ethics of Credit Rating Agencies: What Happened and the Way Forward

- In 2008, $14 trillion of highly rated bonds fell to junk status, resulting in the largest US financial crisis since the Great Depression. Steven Scalet, Thomas F. Kelly, and Martin A. Wildy, CFA (Reviewer), *CFA Digest,* August 2013

[Comment Letter on Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule]

- CFA Institute Comments on the SEC's proposal to remove certain references to CRAs to diversifications requirements in money market funds. James C. Allen, CFA, Head, Capital Markets Policy Americas, and Matthew Orsagh, CFA, CIPM, Director, Capital Markets Policy, submitted to US SEC, 14 October 2014

CORPORATE GOVERNANCE

SMALL COMPANY GOVERNANCE

TALKING POINTS

- Although we support efforts to provide small companies with access to the capital markets, these efforts must be balanced against investors' need for transparency.
- Small companies should have to provide annual audits of companies included in annual reports, use GAAP, publicly disclose important company news, and provide at least semi-annual updates on performance and condition, among other things.
- We do not support an exemption for small companies from rules imposed on large companies for shareholder nomination of directors.

OVERVIEW

Good governance of small companies is necessary to ensure that shareowners in these companies have the same rights and privileges as owners in larger companies.

The US Jumpstart Our Business Startups Act (JOBS) Act exempts small companies, called emerging growth companies (EGCs), from many of the governance structures, disclosure requirements, and shareowner rights provisions that exist under US securities laws.

REGULATION

According to the US Jumpstart Our Business Startups Act (JOBS Act), small companies are exempt from the following:

- Disclosure of pay versus performance;
- Requirements for more than two years of audited financials in registration forms;
- Accounting rules that apply to firms other than private firms;
- Internal audit requirements;
- Auditor rotation requirements; and
- Underwriter research restrictions (during and after an IPO).

CFA INSTITUTE OUTLOOK

CFA Institute supports efforts to enhance small company access to the capital markets for equity and debt funding. But we believe this goal should be balanced with the transparency needs of investors. CFA Institute believes the following safeguards are needed to balance the capital needs of small companies and the transparency and protections investors require:

- Annual audits of companies included in annual reports;
- Use of GAAP;
- At least semi-annual updates on performance and condition;
- Public disclosure of all important company news;
- Liability of company principals who make fraudulent representations;
- Separate exchanges for companies subject to the Act's exemptions; and
- Shares sold through crowdfunding to remain unregistered.

No Exemption for Small Companies

Small companies should have to abide by the same rules as large companies for permitting shareowners to nominate directors. Excluding small companies from such requirements may deny their shareowners the ability to exercise an important right to hold board members accountable, particularly when considering that small companies may have more corporate governance issues than larger entities.

CFA INSTITUTE CONTENT

Letter to US Senate Opposing Small Company Exemption from Sarbanes-Oxley 404(b)c

- This letter was intended to dissuade the US Senate from adopting legislation to exempt smaller public companies from the Sarbanes-Oxley Act of 2002 (SOX) Section 404(b) internal audit requirements, as part of the Senate's consideration of a financial regulatory reform bill. Kurt N. Schacht, CFA, JD, submitted to the US Senate, Committee on Banking, Housing, and Urban Affairs, 19 May 2010

Joint Letter to US Senate on Sarbanes-Oxley Section 404(b) Exemption

- This joint letter, written with the Council of Institutional Investors and the Center for Audit Quality, was intended to dissuade the US Senate from exempting smaller public companies from the SOX Section 404 (b) internal audit requirements, as part of the Senate's consideration of a financial regulatory reform bill. Kurt N. Schacht, CFA, Cindy Fornelli, and Jeff Mahoney, submitted to US Senate, Committee on Banking, Housing, and Urban Affairs, 22 April 2010

EXECUTIVE COMPENSATION AND DISCLOSURE

TALKING POINTS

- Although we support shareowner say-on-pay, we do not support rules requiring institutions to disclose details of their incentive-based compensation arrangements to the SEC.
- Compensation for senior company executives and incentive structures for asset managers should be linked to long-term financial and operating performance.
- We have asked the SEC to provide better guidance pertaining to compensation discussion and analysis.

OVERVIEW

We need increased disclosure of senior executives' compensation practices at companies and prudent pay structures through performance-based metrics. Now that a say-on-pay vote is part of the proxy process, better disclosure around executive pay is imperative so that investors can make informed decisions.

REGULATION

In May 2016, the SEC proposed rules prohibiting certain institutions (including brokers, dealers, and investment advisers) with at least $1 billion in assets from having incentive-based pay arrangements (as opposed to base pay) that encourage excessive risk-taking. The rules also would require the institutions to disclose details of their incentive-based compensation arrangements to the SEC.

In addition, larger companies (those with $50 billion or more in total consolidated assets) would have to defer half of the incentive compensation for executive officers over a three-year period. The boards of these institutions also would have to identify individuals other than executive officers who have the ability to affect risk and approve the compensation arrangements of those people.

Pay disclosure in the United States has improved since 2006, as more companies view the compensation discussion and analysis (CD&A) in a proxy statement as a communications document rather than simply a compliance document. But this view is still an exception rather than the norm.

CFA INSTITUTE OUTLOOK

Executive Compensation

The rule in the United States intrudes into areas in which regulators lack required knowledge and expertise. We have misgivings about their ability to correlate pay at diverse financial institutions with "excessive risk" without causing undue harm. Moreover, although we support shareowner say-on-pay, the costs of delving into company compensation outweigh their intended benefits.

Compensation for senior company executives and incentive structures for asset managers should be explicitly linked to long-term financial and operating performance. Creating a link between compensation and fundamental performance for company executives and for asset managers will better serve investors' interests.

Issuers should have a remuneration committee of independent directors to determine the compensation of senior officers and directors. This committee will enable members to act independently in determining what to offer senior executives in compensation, without influence from those whose interests are conflicted.

Disclosure

CFA Institute has called on the SEC to provide shareowners and issuers with better guidance around the CD&A and the process around the creation of the CD&A. This guidance would emphasize the element of engagement with shareowners to address their legitimate concerns. It also would provide guidance about how to better frame the CD&A as a communications tool that clearly and concisely tells the story of a company's compensation practices and their relation to overall strategies rather than simply as tick boxes using boilerplate legalese.

CFA INSTITUTE CONTENT

Comment Letter to SEC on a Proposed Rule Concerning Incentive-Based Compensation Arrangements

- CFA Institute comments on the SEC's proposed rule concerning incentive-based compensation. James C. Allen, CFA, and Matthew Orsagh, CFA, CIPM, submitted to US SEC, 22 July 2016

Comment Letter on SEC Pay versus Performance Rule

- CFA Institute offers comments on the SEC's proposed pay versus performance rule. James C. Allen, CFA, and Matthew Orsagh, CFA, CIPM, submitted to US SEC, 6 July 2015

Improving Compensation Disclosure

- Because CD&A is a company's primary engagement tool with investors, it must tell a company's compensation story in a concise manner that investors will understand. Matthew Orsagh, CFA, CIPM, *CFA Institute Magazine*, July/August 2015

Issue Brief: CD&A Template Improves Compensation Disclosure

- The CD&A Template was developed by a CFA Institute–led working group of issuers, investors, and associations concerned about this issue. The group sought to achieve two goals: help issuers tell a story about their compensation policies, practices, and decisions; and guide issuers in creating a CD&A that could be read and understood by average retail investors. Matthew Orsagh, CFA, CIPM, CFA Institute, March 2012

Comment Letter to US SEC on Executive Compensation and Related Party Disclosure

- CFA Institute provides recommendations for improving the content and quality of executive compensation information as a follow-up to April 2006 comment letter. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US SEC, 20 December 2007

Comment Letter to the US SEC on Executive Compensation and Related Party Disclosure

- CFA Institute supports proposals to provide shareowners and investors with better information and improve corporate governance, and offers suggestions for further improving disclosures. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US SEC, 13 April 2006

PROXY ACCESS

TALKING POINTS

- We believe shareowners should have the means to nominate directors in certain circumstances.
- Providing shareowners reasonable involvement in the nominating process will lead to a more accountable board and nominees.

OVERVIEW

Proxy access enables shareowners in certain circumstances to nominate individuals for company boards of directors directly through company proxy statements. US rules have restricted the ability of shareowners to nominate individuals to company boards of directors directly through company proxy statements.

REGULATION

Since 2002, the SEC has twice tried to enable shareowners to directly submit board nominees, but in each case, federal courts struck down its rules.

Most recently, the SEC, under authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), gave investors proxy access when the nominating shareowner or group owned at least 3% of the company's shares for at least three years. In 2011, the Court of Appeals for the District of Columbia vacated the rule, saying the SEC failed to address whether the rule would facilitate enough election contests to be of net benefit.

CFA INSTITUTE OUTLOOK

The proxy process should provide mechanisms that enable shareowners to nominate directors under certain circumstances. Such mechanisms should not be used to further the interests of nominating investors, promote their agendas, or benefit anyone other than shareowners.

Directors should act on behalf of shareowners by overseeing corporate management. Giving shareowners reasonable involvement in the nominations process will help make board members and nominees more accountable.

Preliminary results from a research report commissioned by CFA Institute suggest that the real-world benefits to investors of an expectation that shareowners would have access to the company proxy statement are positive.

CFA INSTITUTE CONTENT

Does Proxy Access Benefit Shareholders?

- A recent study shows that the positive effects of proxy access outweigh any costs. Rhea Wessel, *CFA Institute Magazine*, November/December 2014

Proxy Access in the United States: Revisiting the Proposed SEC Rule

- Proxy access refers to the ability of shareowners to place their nominees for director on a company's proxy ballot. This right is available in many markets, although not in the United States. Chiara Trabucchi, Ellen Fitzgerald, Matthew Orsagh, CFA, CIPM, Robert W. Dannhauser, CFA, and James C. Allen, CFA, Codes, Standards and Position Papers, CFA Institute, August 2014

The Market Reaction to Corporate Governance Regulation

- The authors examine the reaction of the markets to the proposed regulations of corporate governance practices, such as limiting executive pay and proxy access. David F. Larcker, Gaizka Ormazabal, Daniel J. Taylor, and Natalie Schoon, CFA (Reviewer), *CFA Digest*, August 2011

Letter to US Congress on Proxy Access in Financial Reform Legislation

- CFA Institute expressed concern about a legislative proposal to permit proxy access only to investors who, on a stand-alone basis, have held at least five percent (5%) of the shares outstanding, which we believed would render this important shareowner right useless. Kurt N. Schacht, CFA, submitted to US Senate, Committee on Banking, Housing, and Urban Affairs, 17 June 2010

Statement of James C. Allen, CFA, on Corporate Governance and Shareholder Empowerment before the US House of Representatives Subcommittee

- In response to proposed legislation, CFA Institute provided testimony before the US House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. James C. Allen, CFA, reiterated prior CFA Institute positions with respect to advisory votes on proxy access, executive compensation, the independence of board chairs, and majority voting. James C. Allen, CFA, submitted to US House of Representatives, 21 April 2010

Comment Letter to US House of Representatives on Proxy Access

- CFA Institute expressed support for an amendment to legislation (ultimately leading to the Dodd-Frank Act) submitted by US Rep. Maxine Waters and US Rep. Gary Peters, referred to SEC Authority to Issue Rules on Proxy Access. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US House of Representatives, 2 November 2009

Letter to US SEC on Facilitating Shareholder Director Nominations

- CFA Institute believed the proposed changes would strike an appropriate balance between giving large, longer-term shareowners a voice in board nominations while not allowing those shareowners to misuse the process or otherwise overwhelm the existing board. Kurt N. Schacht, CFA, and James C. Allen, CFA, submitted to US SEC, 24 September 2009

DUAL-CLASS SHARES

TALKING POINTS

- We believe company rules should ensure that each share has one vote.
- A structure that permits one group of shareowners disproportionate votes per share creates the potential for a minority shareowner to override the wishes of the majority of owners for personal interest.
- Dual-class share structures and other alternatives to the one-share-one vote standard, including shares offering shareowners no voting rights, are on the rise globally. This has the potential to disenfranchise shareowners.
- Research consistently shows that on the whole dual-class share companies tend to underperform their one-share-one vote counterparts over the long-term.

OVERVIEW

Dual-class share issuance is on the rise in a number of markets around the world. Such a development threatens to disenfranchise investors.

REGULATION

Many jurisdictions allow dual-class share structures, including the United States, Canada, Brazil, France, and Italy. Other economies such as Singapore and Hong Kong are reconsidering whether to allow dual-class share structures to attract more IPO business.

CFA INSTITUTE OUTLOOK

Company rules should ensure that each share has one vote. A structure that permits one group of shareowners to have disproportionate votes per share creates the potential for a minority shareowner to override the wishes of the majority of owners for personal interest. In cases in which such dual structures are legal, companies should disclose such arrangements and the situations, the manner, and the extent to which those arrangements may affect other shareowners.

CFA INSTITUTE CONTENT

CFA Institute sent letters to index providers FTSE Russell, S&P Dow Jones, and MSCI on whether to allow zero voting shares or low voting shares. These letters were intended to dissuade index providers from allowing companies with zero voting shares to be allowed in their indices.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES

TALKING POINTS

- Environmental, social, and governance (ESG) issues increasingly are becoming part of the investing process.
- Asset owners and investors are increasingly asking asset managers to incorporate ESG analysis in the investment process.
- Institutional investors have expanded their ESG teams in recent years to better incorporate ESG information into the investment process.
- CFA Institute has expanded its educational offerings around ESG in the curriculum and our advocacy efforts to better educate our members on the topic.
- ESG integration is not socially responsible investing (SRI). Incorporating ESG data into the investment process can give investors a better understanding of a company's business.

OVERVIEW

ESG analysis has become an increasingly important part of the investment process. Investors are starting to incorporate ESG data into the investment process to gain a fuller understanding of the companies in which they invest.

REGULATION

Many jurisdictions—either through regulation or listing standards—require a certain level of ESG reporting and disclosure from companies to provide investors with material ESG-related information.

The topic of materiality is a big one. Investors, regulators, and the industry continue to hold discussions as to whether to adopt standards on material ESG information, but definitional and "what is considered material" issues still need to be sorted out.

CFA INSTITUTE OUTLOOK

CFA Institute encourages the incorporation of ESG data into the investment process so that investors can be more informed about the decisions they are making. This approach sees value in the incorporation of ESG data into the investment process, but it is agnostic on the value-investing argument more pertinent in the SRI community.

CFA INSTITUTE CONTENT

ESG Manual

- CFA Institute has published an ESG manual to inform investors about the current state of ESG integration, best practices, and pertinent information. Codes, Standards, and Position Papers, CFA Institute, 2015

ESG Survey

- We surveyed our membership on the topic in 2015 and completed a repeat of that survey in 2017. CFA Institute, June 2017
- We currently engaged in a number of partnerships around ESG, including one with PRI that will culminate in holding 16 events at societies around the world and result in a best practices white paper (to be published in 2018) on the current state of ESG integration.

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