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United States House of Representatives
Committee on Financial Services
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Memorandum

To: Members, Committee on Financial Services
From: Financial Services Committee Majority Staff
Subject: June 25, 2020 Investor Protection, Entrepreneurship, and Capital Markets Subcommittee Hearing: "Capital Markets and Emergency Lending in the COVID-19 Era"

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "Capital Markets and Emergency Lending in the COVID-19 Era," on Thursday, June 25, 2020 at 12:00 p.m., in 2128 Rayburn House Office Building. Virtual participation will be accommodated. This single-panel hearing will have the following witness:

- **The Honorable Jay Clayton**, Chairman, U.S. Securities and Exchange Commission

Overview

The Coronavirus Disease 2019 (COVID-19) pandemic has caused significant disruptions to the U.S. capital markets. In response, the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System (Federal Reserve or Fed), and the Department of the Treasury (Treasury) have pursued a variety of significant actions to maintain liquidity and stability in financial markets. Congress has also passed the Coronavirus Aid, Relief, and Economic Security Act (CARES) Act which has supported these efforts in a number of ways. This memo summarizes recent regulatory activity that has affected the capital markets, as well as a number of issues associated with these actions.

Impact of COVID-19 on U.S. Capital Markets

Economic uncertainty arising from the COVID-19 pandemic has led to a significant increase in market volatility and trading activity. In equity markets, trading volumes have reached historic levels with the top ten days of number of shares traded all occurring in 2020.[1] Stock market volatility as measured by the VIX index reached an all-time high of 82.7 on March 16, up from an average of 12.5 in January 2020.[2] Stock market volatility has declined since its peak in March but remains elevated with the VIX now at 33.93.[3] Between February 19 and March 23 of this year, the value of the S&P 500 fell from its all-time high by over 30 percent.[4] Though the index has begun to recover in recent weeks, the stock market has experienced renewed volatility in response to speculation that a second wave of COVID-19 may stifle the economy's recovery.[5]

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[1] SEC, *Remarks to the Financial Stability Oversight Council, Chairman Jay Clayton*, May 14, 2020 at https://www.sec.gov/news/speech/clayton-remarks-financial-stability-oversight-council-051420.
[2] Cboe Exchange, *VIX Index Charts & Data*, June 16, 2020 at http://www.cboe.com/vix.
[3] *Id.*
[4] CNBC, *S&P 500 Index*, June 15, 2020, at https://www.cnbc.com/quotes/?symbol=.SPX&tab=profile.
[5] Fortune, *Is a second wave inevitable? The stock markets seem to think so*, June 15, 2020, at https://fortune.com/2020/06/15/second-wave-inevitable-stock-markets-think-so/.

Credit markets have experienced a similar increase in trading activity and volatility as investors tried to anticipate the economic impacts of COVID-19 on businesses, states, and local governments, particularly in the corporate and municipal bond markets. Daily municipal bond trades rose from approximately 34,000 in mid-February to an average of 50,000 in March with a peak of 75,000 per day on March 23.[6] As of May 4, average daily transactions of publicly traded corporate bonds were 14 percent greater in 2020 as compared to 2019.[7] Much of this increased trading activity represents a sell-off in assets by investors, especially in the weeks prior to the Fed announcing it would intervene to "backstop" credit markets.[8] During the week of March 18, U.S. corporate investment-grade bond funds experienced a $35.6 billion selloff, the largest one-week decline in history.[9] As credit market investors sold positions the cost of borrowing for corporate and municipal bond issuers increased significantly.[10]

Securities and Exchange Commission

Budget

The SEC 's mission is to (1) protect investors; (2) maintain fair, orderly, and efficient capital markets; and (3) facilitate capital formation. The SEC oversees $140 trillion a year in securities trading and more than 28,000 market participants that employ over one million people in the United States. For the past several years the SEC's budget has remained flat despite being responsible for overseeing securities market trading and participants that have both increased in number and complexity. To manage cost increases over two fiscal years of flat funding, the SEC imposed a hiring freeze that the SEC estimates resulted in a 9 percent loss of its workforce by the end of FY 2018. The President's Fiscal Year (FY) 2021 budget request for the SEC is $1.89 billion. The FY 2021 request also proposes to eliminate the Public Company Accounting Oversight Board (PCAOB), a self-regulatory organization created in the wake of the Enron scandal to oversee the audits of public companies, transfers its duties to the SEC, and requests an additional $55 million over FY 2020 for the SEC to carry out these functions.[11]

Regulatory Relief and Guidance

Despite historic volatility and a temporary closing of several exchange trading floors, U.S. stock markets have continued to operate since the start of the COVID-19 crisis. However, for the first time since 1997 market-wide circuit breakers, which are designed to pause trading during steep sell offs, have been triggered on several occasions.[12] The SEC has also taken steps to provide regulatory flexibility to market participants. On March 4, the SEC announced that companies would be provided an additional 45 days to file certain disclosures due between March 1 and April 30. Companies taking advantage of this relief are also required to disclose the reason for the delay in filing as well as any risk factors related to the impact of COVID-19 in a Form 8-K or Form 6-K filing.[13] The SEC also extended comment periods that expired in March for certain pending actions, including amendments to the "accredited investor definition" and changes to the National Market System (NMS) plan. Commenters were granted until May 1 to submit comments.

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[6] SEC, *Remarks to the Financial Stability Oversight Council*, Chairman Jay Clayton, May 14, 2020, at https://www.sec.gov/news/speech/clayton-remarks-financial-stability-oversight-council-051420.

[7] SIFMA, *US Corporate Bond Trading Volume*, June 11, 2020, at https://www.sifma.org/resources/research/us-corporate-bond-trading-volume/.

[8] J.P. Morgan Securities, *COVID-19 almost broke the bond market. Then the Fed stepped in*, March 30, 2020, at https://www.jpmorgan.com/securities/insights/covid-19-almost-broke-the-bond-market-then-the-fed-stepped-in.

[9] Bloomberg, High-Grade Bond-Fund Outflows Hit $35.6 Billion, Smashing Record, March 19, 2020, at https://www.bloomberg.com/news/articles/2020-03-19/investors-pull-record-35-6-billion-from-investment-grade-debt.

[10] Federal Reserve Bank of St. Louis, *Corporate Bond Spreads and the Pandemic*, Miguel Faria-e-Castro and Julian Kozlowski, April 9, 2020, at https://www.stlouisfed.org/on-the-economy/2020/april/effects-covid-19-monetary-policy-response-corporate-bond-market.

[11] For reference, the PCAOB's 2020 budget is $284.7 million.

[12] Wall Street Journal, *Wall Street Explores Changes to Circuit Breakers After Coronavirus Crash*, Alexander Osipovich and Dawn Lim, April 15, 2020, at https://www.wsj.com/articles/wall-street-explores-changes-to-circuit-breakers-after-coronavirus-crash-11586952558.

[13] SEC, *Securities Exchange Act of 1934 Release No. 34-88318*, March 4, 2020, at https://www.sec.gov/rules/other/2020/34-88318.pdf.

COVID-19 Related Enforcement

The pandemic has generated new risks for retail investors in the form of COVID-19-based investment scams. On February 4, the SEC's Offices of Investor Education and Advocacy issued an Investor Alert regarding promotions or claims of products or services of publicly-traded companies that can prevent, detect, or cure coronavirus, including "pump and dump" schemes. As of May 6, the SEC has suspended the trading of stock of thirty companies linked to these types of COVID-19 related scams.

Non-COVID-19 Related Rulemakings

Shortly after the start of the COVID-19 crisis, over forty non-profit public advocacy organizations[14] as well as SEC Commissioner Allison Lee[15] and lawmakers[16] called on the Commission to temporarily suspend rulemaking activity not related to the pandemic. However, the SEC continues to propose and adopt rulemakings unrelated to the pandemic, including regulatory changes that revise disclosures, broaden the legal definition of an accredited investor, expand private market exemptions, and change how investors can receive information from proxy advisors.

Last year, the Commission proposed rules to expand the definition of an accredited investor[17] and place new requirements on proxy advisory firms. The proposed reforms would require proxy advisers to disclose conflicts of interest, and require advisors to provide the companies and others an opportunity to review and provide feedback on the contents of the advisor's recommendation before providing it to the advisor's client, shareholders.[18] The Commission is reportedly considering changes to its initial proposal, and appears close to finalizing its recommendations.[19]

On March 4, 2020, the SEC proposed changes to its exempt securities offering framework to expand the ability of companies ("issuers") to raise capital without having to register their securities.[20] Among other changes, the revisions would raise the limits for how much issuers can raise on a single offering, establish new safe harbors from integration, which occurs when a regulator determines that multiple offerings should be considered to be one "integrated" offering, and eases rules preventing certain communications between issuers and investors designed to prevent insider trading.[21]

On May 21, 2020, the SEC announced that it adopted amendments to portions of Regulation S-X, which dictates the disclosures SEC registered companies must make when they acquire or sell other businesses or real estate.[22] These changes reduce the information required to be disclosed in financial statements in connection with these

[14] Better Markets, *Request to suspend all non-COVID-19 rulemaking during the public health emergency*, March 24 2020, at https://bettermarkets.com/sites/default/files/Joint_Letter_Requesting_a_Stop_to_all_Rulemaking_During_this_Public_Health_Emergency.pdf.
[15] SEC, Regulatory Priorities and COVID-19, Commissioner Allison Herren Lee, April 3, 2020 at https://www.sec.gov/news/public-statement/statement-lee-regulatory-priorities-covid-19-2020-04-03.
[16] House Committee on Financial Services, *Committee Democrats Roll Out Legislation to Provide Comprehensive Stimulus and Public Policy Response to Coronavirus Pandemic*, March 23, 2020, at https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=406446.
[17] SEC, *SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments*, December 18, 2019, at https://www.sec.gov/news/press-release/2019-265.
[18] SEC, *SEC Proposes Rule Amendments to Improve Accuracy and Transparency of Proxy Voting Advice*, November 5, 2019, at https://www.sec.gov/news/press-release/2019-231.
[19] Financial Times, *SEC abandons key plank of proposal to curb proxy advisers*, April 29, 2020 https://www.ft.com/content/02bbd829-6266-46da-8e8d-742d8b34b66e.
[20] SEC, *SEC Proposes Rule Changes to Harmonize, Simplify and Improve the Exempt Offering Framework*, March 4, 2020, at https://www.sec.gov/news/press-release/2020-55.
[21] CFA Institute, *CFA Institute Comments to the SEC on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, June 12, 2020, https://www.cfainstitute.org/-/media/documents/comment-letter/2020-2024/20200612-1.ashx
[22] SEC, *SEC Adopts Amendments to Improve Financial Disclosures about Acquisitions and Dispositions of Businesses*, May 21, 2020, https://www.sec.gov/news/press-release/2020-118.

transactions, and clarify these rules as they apply to investment companies.[23] Commissioner Lee critiqued these revisions, noting that the amended regulations provide less transparency for investors and may accelerate merger and acquisition activity, potentially facilitating predatory takeovers of smaller businesses struggling under the current economic conditions.[24]

Federal Reserve Interventions

Beginning on March 17, the Fed established several emergency lending facilities under section 13(3) of the Federal Reserve Act, designed to maintain stability and address liquidity constraints in U.S. credit markets.[25] Through the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Congress restricted the Fed's 13(3) authority to ensure emergency lending facilities are, among other things, broadly available to a range of institutions. The CARES Act provided $454 billion to Treasury to backstop such Federal Reserve facilities established in response to the COVID-19 pandemic crisis,[26] and any direct loans utilizing CARES funds through a Fed facility are required to comply with restrictions on stock buybacks, dividend payments, and executive compensation.[27]

To support U.S. markets and the economy during the pandemic, the Fed established the Primary Dealer Credit Facility (PDCF), Commercial Paper Funding Facility (CPFF), Money Market Mutual Fund Liquidity Facility (MMLF), Primary Market Corporate Credit Facility (PMCCF), Secondary Market Corporate Credit Facility (SMCCF), Term Asset-Backed Securities Loan Facility (TALF), and Municipal Liquidity Facility (MLF). Each of these facilities are intended to stimulate demand and maintain liquidity in the corporate and municipal bond markets by directly purchasing or financing the purchase of securities.

In general, the PDCF, CPFF, and MMLF serve as backstops to the commercial paper market, a major lending market used by corporate and municipal issuers for short-term borrowing. On average, total monthly transactions in the U.S. commercial paper market are valued at over $1 trillion.[28] The PMCCF, SMCCF, and MLF serve a similar role for corporate and municipal bond markets, which provide long-term financing. The TALF is designed to support consumer and business credit markets by purchasing asset-backed securities (ABS) and other similar structured investment products.[29]

On April 9, the Fed announced it would increase the size and scope of the PMCCF through a $50 billion equity investment from the Treasury using CARES Act funds. This facility is purchasing "eligible corporate bonds as the sole investor in a bond issuance," but the Fed has indicated that corporate issuers will not have to comply with the CARES Act loan conditions because it argues the Act excludes debt securities.

Credit Ratings and Fed Facility Eligibility

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[23] SEC, *SEC Adopts Amendments to Improve Financial Disclosures about Acquisitions and Dispositions of Businesses*, May 21, 2020, https://www.sec.gov/news/press-release/2020-118.

[24] SEC, *Statement on Financial Disclosures About Acquired and Disposed Businesses*, Commissioner Allison Herren Lee, May 21, 2020, at https://www.sec.gov/news/public-statement/lee-statement-financial-disclosures-about-acquired-disposed-businesses.

[25] Boardof Governors of the Federal Reserve, Funding, Credit, Liquidity, and Loan Facilities Municipal Liquidity Facility, at https://www.federalreserve.gov/funding-credit-liquidity-and-loan-facilities.htm.

[26] Congressional Research Service, *Treasury and Federal Reserve Financial Assistance in Title IV of the CARES Act*, April 28, 2020, https://www.crs.gov/Reports/R46329.

[27] CARES Act §4003(c)(3)(A)(ii), though the Treasury Secretary has the authority to waive these conditions.

[28] Board of Governors of the Federal Reserve, *Commercial Paper Rates and Outstanding Summary*, June 17, 2020, https://www.federalreserve.gov/releases/cp/default.htm.

[29] Federal Reserve Bank of New York, FAQs: Term Asset-Backed Securities Loan Facility, June 15, 2020, https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-faq.

In order for securities to be purchased or used as collateral by a Fed facility, the Federal Reserve requires a credit rating from one or more "major" nationally recognized statistical rating organizations (NRSROs). The Fed initially only accepted ratings from the "big three," Fitch, S&P, or Moody's, but has since allowed ratings from other agencies for three of the facilities. However, currently there are nine firms registered with the SEC's Office of Credit Ratings as NRSROs. As a result of the Fed's decision, some municipalities and businesses with investment-grade ratings from other NRSROs could be excluded from accessing these critical facilities.

Legislative Proposals

- **H.R. 6270, The Uyghur Forced Labor Disclosure Act of 2020 (Wexton).** This bill would require the SEC to issue rules requiring US-traded companies to disclose imports of specific manufactured goods from the Xinjiang Uyghur Autonomous Region (XUAR) in China.
- **H.R. 6371, To amend the Securities Exchange Act of 1934 to require issuers to disclose risks related to global pandemics, and for other purposes(Sherman).** This bill would require that in the event of a World Health Organization declaration of a pandemic, public companies to file supplementary disclosures regarding any material impacts that the pandemic is expected to have on its business, including impacts on its workforce.
- **H.R. 6375, To amend the Securities Exchange Act of 1934 to require issuers to make disclosures related to supply chain disruption risk, and for other purposes (Velazquez).** This bill would require public companies to disclose in their annual reports risks to the disruption of their supply chains, including the risks disruptions would have on the workforce, and to develop and disclose supply chain disruption contingency plans.
- **H.R. 6790, The Business Borrowers Protection Act (Sherman).** This legislation would prevent private creditors from enforcing loan covenants that require an accelerated repayment of existing private loans in the event a business borrower obtains a COVID-19 government relief loan.
- **H.R.6934, To amend the CARES Act to require the uniform treatment of nationally recognized statistical rating organizations under certain programs carried out in response to the COVID–19 emergency, and for other purposes, (Dean).** This legislation would amend the CARES Act to require the uniform treatment of nationally recognized statistical rating organizations under certain programs carried out in response to the COVID-19 emergency.
- **H.R. 7000, The Holding Foreign Companies Accountable Act (Sherman).** This legislation would suspend trading in the stock of a foreign company listed on a U.S. exchange if the independent auditor of that company is not subject to full PCAOB oversight for three consecutive years.
- **H.R. ____, To apply certain terms and conditions on making direct loans under the CARES Act to certain purchases of debt by the Federal Government, and for other purposes (Sherman).** This legislation would subject Primary Market Corporate Credit Facility beneficiaries to CARES Act limits on stock buybacks, dividend payments, and executive compensation.
- **H.R. ___ To temporarily halt the Federal financial regulators from carrying out rulemakings unrelated to the COVID-19 emergency until the end of such emergency (Meeks).** This legislation would temporarily prohibit federal financial regulators from adopting rules not directly related to responding to the coronavirus response through the length of the crisis.
- **H.R. ___, To enhance civil penalties under the Federal securities laws for violations related to an attempt to exploit investors related to the COVID-19 crisis.** This legislation would increase civil monetary penalties for COVID-related securities misconduct.
- **H.R. ____, The CARES Act Section 4014 Technical Corrections Act (Sherman).** This legislation would amend the CARES Act to ensure that the temporary relief from CECL standards does not terminate in the middle of a company's fiscal year.