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ENHANCED INVESTOR PROTECTION AFTER THE FINANCIAL CRISIS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

SURVEYING THE INVESTOR PROTECTION PROVISIONS CONTAINED IN THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT ONE YEAR AFTER ITS IMPLEMENTATION

JULY 12, 2011

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C O N T E N T S

TUESDAY, JULY 12, 2011

ENHANCED INVESTOR PROTECTION AFTER THE FINANCIAL CRISIS

TUESDAY, JULY 12, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. The Committee will come to order.

Today, the Committee will examine "Enhanced Investor Protection After the Financial Crisis." This hearing will survey the investor protection provisions contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act as we approach its 1-year anniversary.

About one-half of American households are invested in the securities markets, directly or indirectly. During the financial crisis, retail as well as institutional investors suffered financial harm when their retirement and other securities accounts lost value. Some had invested in companies with compensation systems that encouraged executives to take on unmanageable risks. Some had bought asset-backed securities based on inflated credit ratings. Many were victims of the market decline when the public lost confidence in the markets and their regulators.

This last financial crisis highlighted the need for stronger investor protections to mitigate the negative impact of future crises.

Congress responded by passing the Wall Street Reform Act, which contains robust investor protection provisions and other new reforms. These provisions sought to strengthen the financial system by improving the accuracy of credit ratings, better aligning the economic interests of securitizers and investors, boosting the effectiveness of the SEC, giving shareholders a greater voice over compensation, regulating municipal advisors and hedge fund advisors, and encouraging credible whistleblowers to come forward and report fraud and abuse by providing them enhanced protections and incentives.

As we approach this 1-year anniversary, it is timely for us to survey investor protection provisions in the Wall Street Reform Act, many of which are still in the process of being finalized. While some have criticized reforming Wall Street, I believe we must give these provisions a chance to work to protect investors and American families who depend on our financial system.

I remember the economic nightmare we lived though 3 years ago and am proud that the Senate could act to pass these historic reforms last year. I take my responsibility as Chairman of the Banking Committee to oversee implementation of this new law seriously and look forward to hearing from the witnesses about these investor protections.

Now I will turn to Ranking Member Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this hearing.

Mr. Chairman, I noted with interest we have the former Chairman, Mr. Harvey Pitt, among the panelists—all of them are welcome—and also Paul Atkins, former Commissioner. A good panel.

The title of today's hearing is "Enhanced Investor Protection After the Financial Crisis." The reality, however, is that the passage of Dodd-Frank did little to improve investor protection. Instead, the act codifies a series of special interest provisions of questionable value to the average investor. In fact, several of these provisions threaten to harm investors.

For example, under the proxy access provision, the SEC adopted a rule that would grant shareholders with a mere 3 percent of a company's shares the special right to have their board of director nominees include in a company's proxy material. Three percent.

Special interest groups, like unions, State pension funds, and hedge funds will now have the leverage to force companies to adopt politically motivated agendas, regardless of whether doing so would benefit all shareholders.

As a result, Dodd-Frank's corporate governance provisions could move control of corporations away from average investors to special interests with minority positions and political clout.

Another troubling Dodd-Frank provision is that the mandate that the SEC pay whistleblowers. Although encouraging people to inform the SEC of corporate misdeeds I believe is a good idea, the whistleblower provision in Dodd-Frank is drafted in a way that could actually harm investors. Whistleblowers, even those who are part of the scheme, will receive 10 to 30 percent of fines that the SEC collects as a result of their tips. Rewards in a single case could run into tens of millions of dollars. This will be a huge windfall for whistleblowers and their attorneys. It would also be far in excess of the amount needed, I believe, to encourage whistleblowers.

Recent history has demonstrated that the problem has not been a lack of tips but, rather, the SEC's failure to follow up on tips. Perhaps the millions that will go to whistleblowers under Dodd-Frank should be redirected to harmed investors.

Finally, the Dodd-Frank's mandated internal changes at the SEC I believe are symbolic of the Act's empty promise of investor protection. Dodd-Frank requires the SEC to set up an Office of Investor Advocate and an Ombudsman for that office.

Think about it. The SEC is supposed to be the investor's advocate already and has an Office of Investor Education and Advocacy. Adding another two layers of bureaucracy I believe is not the kind of help that investors need.

It is now 1 year since the passage of Dodd-Frank, and we can see more clearly the consequences of a special interest agenda. The Act, I believe, again, has not helped investors but has saddled Main Street and providers of capital—the engines of economic growth, in other words—with a long list of new regulatory requirements and more to come. At a time when the unemployment rate is at 9.2 percent, this hardly seems like a wise course to me.

Thank you, Mr. Chairman.

Chairman JOHNSON. Are there any other Members who wish to speak? If not, we are fortunate to have a distinguished panel of regulators and experts before the Committee today.

Mr. David Massey is the President of the North American Securities Administrators Association. Mr. Massey is also the Deputy Securities Administrator of North Carolina Securities Division and serves as a member of the Financial Stability Oversight Council.

Ms. Lynnette Hotchkiss is the Executive Director of the Malpractice Securities Rulemaking Board, a self-regulatory organization whose mission is to promote a fair and efficient municipal securities market.

Mr. Harvey Pitt is currently the Chief Executive Officer of the consulting firm Kalorama Partners. Previously he served as the Chairman of the SEC from 2001 to 2003.

Ms. Barbara Roper is the Director of Investor Protection at the Consumer Federation of America and has in the past served as a member of the Investor Advisory Committee at the SEC.

Ms. Anne Simpson is Senior Portfolio Manager at the California Public Employees' Retirement System, where she heads the corporate governance program.

Mr. Paul Atkins is a Visiting Fellow at the American Enterprise Institute. From 2002 to 2008 he served as a Commissioner at the SEC.

Our final witness is Mr. Lynn Turner. In addition to his decades of experience in the accounting field, from 1998 to 2001 he served as the Chief Accountant at the SEC.

I would like to welcome our witnesses and thank them for their willingness to testify at this important hearing.

Mr. Massey, please proceed with your testimony.

STATEMENT OF DAVID MASSEY, NASAA PRESIDENT AND NORTH CAROLINA DEPUTY SECURITIES ADMINISTRATOR

Mr. MASSEY. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I am David Massey, the Deputy Securities Administrator for the State of North Carolina and the current President of the North American Securities Administrators Association, known as NASAA. Thank you for the opportunity to offer NASAA's view of the gains made in investor protection since the passage of the Dodd-Frank Act 1 year ago.

The Wall Street reforms and investor protections in Dodd-Frank Act were born out of necessity. The financial crisis made it clear that the existing securities regulatory landscape needed an overhaul.

This comprehensive law was developed to promote stronger investor protection and more effective oversight to help prevent another economic crisis from threatening the financial security of

Main Street investors. State securities regulators were pleased that the Dodd-Frank Act addresses a number of critical issues for investors by incorporating disqualification provisions to prevent people who violate securities law from selling unregistered securities offerings under Rule 506 of Regulation D, by strengthening the “accredited investor” definition, and by increasing State oversight of investment advisors. Dodd-Frank also includes a provision to safeguard senior investors from unqualified advisors and creates an investor advisory committee to provide input to the SEC on its regulatory priorities.

Dodd-Frank took a necessary first step toward reducing risks for investors in unregistered private offerings by requiring the SEC to write rules to prevent known offenders from using the Regulation D, Rule 506 exemption from registration. In 1996, the National Securities Markets Improvement Act curtailed the authority of State securities regulators to oversee these unregistered private offerings before and while they are being sold to the public.

In the years since, these private offerings have become a favorite vehicle for unscrupulous promoters and brokers with criminal and disciplinary records to prey on investors. The SEC recently proposed rules mandated by Dodd-Frank to close this avenue to known violators of our securities laws.

Unregistered private offerings were originally intended only for institutional investors and sophisticated individuals. These accredited investors were presumed capable of assessing risks and making investment decisions without the protection of regulatory review and registration. However, the net worth standard the SEC uses to determine the eligibility of an investor to participate in private offerings has remained unchanged since 1982. Dodd-Frank improved the way eligibility is determined by excluding the value of individual investors’ homes in the calculation of their net worth.

NASAA will continue to push for additional improvements to the accredited investor standard, and we urge Congress to go further by reinstating State regulatory authority and oversight of all Rule 506 offerings.

Dodd-Frank recognized the strong investor protection record of the States with its provision to expand State authority to include mid-sized investor advisors with $25 million to $100 million in assets under their management. Investors will benefit from this change because it will enable the SEC to focus on the largest investment advisors while mid-sized and smaller advisors will be subject to the strong State system of oversight and regulation.

State securities regulators are preparing for this increased responsibility. We now employ a more automated and uniform exam process as well as risk assessment analyses to better prioritize our exams. This enables States to do more intelligent and effective exams.

Finally, NASAA members have launched an aggressive outreach effort to prepare the investment advisor industry for State oversight and to enable new registrants to set up their business operations the correct way and avoid inadvertent noncompliance.

Last month, the SEC extended its timeline for the completion of this investment advisor switch into the middle of 2012. Dodd-Frank outlined many ambitious reforms to be implemented by Federal regulatory agencies. Some delay is to be expected. However, State securities regulators are concerned about any effort that might derail or delay important investor protections. A lack of adequate funding already has forced the SEC to defer a number of valuable investor protections promised by Dodd-Frank, such as the creation of the Investor Advisory Committee.

Also, controversies over the Consumer Financial Protection Bureau have indefinitely delayed the creation of a senior investor protection grant program that would support State initiatives to protect vulnerable senior investors from individuals using misleading professional designations.

What NASAA asks of the Congress is simple and clear: Please continue your commitment to protecting investors and do not weaken the critical investor protections of Dodd-Frank, either directly through legislative repeals or indirectly through a lack of adequate funding.

We look forward to working with the Committee, as well as all Members of Congress and fellow regulators, to ensure that the Dodd-Frank Act's investor protections are implemented fully.

Thank you.

Chairman JOHNSON. Thank you, Mr. Massey.

Ms. Lynnette Hotchkiss, please proceed.

STATEMENT OF LYNNETTE HOTCHKISS, EXECUTIVE DIRECTOR, MUNICIPAL SECURITIES RULEMAKING BOARD

Ms. HOTCHKISS. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I appreciate the opportunity to testify here this morning on behalf of the Municipal Securities Rulemaking Board.

Congress created the MSRB in 1975 to protect investors in the municipal market, and last year, in Dodd-Frank, you expanded our jurisdiction to include the protection of State and local government bond issuers as well as public pension plans. To the best of our knowledge, this is the first time ever that a securities regulator has been charged with protecting an issuer of securities. You also gave us jurisdiction to regulate municipal advisors in addition to our existing jurisdiction over dealers in this market. We appreciate the opportunity to report to you today on how we have responded to these increased responsibilities.

As you can see from the chart, the municipal securities market makes up just over $3.7 trillion of the total U.S. debt market. Additionally, about $150 billion is invested in 529 college savings plans, another kind of municipal securities which fall under our jurisdiction.

The second chart shows how the $382 billion of municipal securities issued since the enactment of Dodd-Frank last July are being used. It is hard to imagine a street, airport, school, park, or town hall in this country not financed through the issuance of municipal securities, and I do not need to tell those of you who have served in State or local office just how important the municipal bond market is to the continued health and vitality of our States, cities, towns, schools, and universities.

Like every market, transparency and disclosure are critical to investing protectors. Our free online resource called EMMA does exactly that. As you can see, EMMA provides investors with free access to disclosures and pricing data, information they need to make informed investment decisions. An example of information on EMMA from a recent issuance in your respective States is included with my written testimony.

In fact, a journalist from Reuters reported just last week that, and I quote, "Since the Municipal Securities Rulemaking Board made their EMMA system operational, transparency in muni land is an order of magnitude better than any other bond market."

Because retail accounts for two-thirds of all investors and over 80 percent of all customer transactions in municipal securities, we designed our EMMA system to be easily usable by the general public.

The MSRB has undertaken other substantial initiatives to protect investors. We are in the process of implementing a Federal fiduciary duty standard, additional restrictions on "pay to play" activities, and mandated disclosures of all conflicts of interest. These are described in detail in my written testimony.

In Dodd-Frank, Congress gave the MSRB the authority to regulate municipal advisors and swap advisors. Mr. Chairman, as you and Ranking Member Shelby are well aware, the events of Jefferson County, Alabama, made it very clear that vast improvement in the municipal derivatives market was needed, and the MSRB has already taken significant steps in this area: first, by ensuring that State and local governments are given impartial professional advice by qualified advisors; and, second, by ensuring that underwriters that recommend swaps explain in clear language all of the risks attendant to that transaction.

In a similar way, our expanded authority allows us to further protect investors in competitive bidding situations. Just last week, the SEC and the Department of Justice announced settlements with JPMorgan Securities in connection with bid rigging. Earlier this year, UBS and Bank of America Securities entered into similar agreements.

Until now, the SEC could only address this egregious behavior through its anti-fraud jurisdiction. But now, under recent initiatives of the MSRB, such conduct would be a clear violation of our fair dealing and fiduciary duty rules, providing additional fire power to the SEC to go after these wrongdoers.

The MSRB is dedicated to ensuring that the municipal market regulations we promulgate and the transparency afforded by our EMMA system promote an open, fair, and efficient market, one that protects issuers and investors alike, and one that continues to fund the critical public infrastructure needs of our country.

Thank you again for the invitation to testify, and I look forward to any questions that you might have.

Chairman JOHNSON. Thank you, Ms. Hotchkiss.

Mr. Pitt, please proceed.

STATEMENT OF HARVEY L. PITT, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. PITT. Good morning, Chairman Johnson, Ranking Member Shelby, Members of the Committee. I am pleased to be back before you today to respond to the Committee's invitation to testify about the critical issue of "Enhanced Investor Protection After the Financial Crisis."

The Committee has specifically requested that today's testimony focus on Titles IV and IX of the Dodd-Frank Act and the extent to which those provisions enhance investor protection or could be improved.

I would like to highlight five overarching observations about Dodd-Frank in Titles IV and IX from my written statement for your consideration.

First, the financial crisis that began in 2007–08 was the product of the failure of our outmoded and cumbersome financial regulatory system and the lack of adequate tools that would have enabled regulators to respond effectively, efficiently, and with alacrity both to the warning signs that a crisis was imminent and to what eventually became a full-blown crisis. I believe that Dodd-Frank unfortunately represents a missed opportunity to fix that which was clearly broken and to provide a better arsenal of regulatory rules to detect and cope with the next financial crisis, which sadly is not all that far away.

Instead of producing a more nimble regulatory regime, we have saddled regulators with a more cumbersome regulatory system that almost ensures that we will not be any better equipped to respond to future financial and capital markets developments than we were for this last crisis. And, worse, we have created the possibility that the independence of three critical financial regulators—the Federal Reserve Board, the SEC, and the CFTC—will be impaired by subjecting these agencies to the dictates of the new Financial Stability Oversight Council that is led by the Treasury Secretary and, therefore, must be responsive to policies pushed by whatever Administration is in power at that particular time.

Second, I am deeply concerned that Dodd-Frank sets financial regulators, and particularly the SEC, up for failure. The SEC has been saddled with extensive new regulatory obligations, but has been denied the necessary resources with which to fulfill those obligations. In particular, the Act imposes or expands SEC jurisdiction and oversight over more than 10,000 new and potential regulatees. Despite the agency's good-faith and diligent efforts, the public will be lulled into believing that we have solved the problems that caused our most recent economic collapse. But in my view, Dodd-Frank represents only the triumph of optimism over decades of hard-learned, real-world experience.

Third, Dodd-Frank tackles significant and difficult issues of corporate governance in awkward and potentially pernicious ways. Among such provisions, Dodd-Frank's whistleblower bounty program threatens to undermine corporate governance and compliance programs by encouraging potential whistleblowers to evade internal corporate policies and ethical precepts in order to maximize the potential lucre these whistleblowers may demand from the SEC. Similarly, the Act's say-on-pay provisions have usurped the proper province of State corporation laws and potentially subject shareholders to a steady stream of frivolous litigation, which has already begun, designed to force those companies whose shareholders object to specific compensation programs into treating what was intended as an advisory expression of shareholder sentiment into a binding declaration that potentially any corporate officer's or director's compensation package is too high.

Equally troublesome is the approach toward proxy access that Dodd-Frank has encouraged the SEC to adopt. The solution to proxy access issues, in my view, is to permit proxies to be solicited electronically rather than by snail-mailed hard copy. That simple change would reduce rather dramatically the current fervor with which corporate shareholder activists seek to append their agendas and proposals onto management's proxy-soliciting materials.

But even in the absence of such a change, the easiest solution to the so-called proxy access issue is to permit shareholders to amend their companies' by-laws to the extent such power is granted under the law of the State of incorporation by whatever majority vote State law requires. All the SEC would need do in such an environment is prescribe the disclosures that must be made as well as the length of time and the number of shares any shareholder must hold the company's securities to entitle any shareholder to propose a by-law amendment.

Fourth, Dodd-Frank imposes upon the SEC a new Office of the Investor Advocate, a position clearly designed to permit a non-Presidential appointee to second-guess, challenge, and attack virtually any action or any inaction of the Commission with which the Investor Advocate disagrees. Investor advocacy is one of the two critical objectives of the SEC, the other being to facilitate the development of effective capital markets that can compete with markets anywhere in the world. Creating a special position whose principal function apparently will be to harangue the Commission without any censorship of any kind, including rational and intelligent common sense, is something that can create the seeds of further SEC dysfunctionality.

Fifth, there are ways to ameliorate Dodd-Frank's unintended consequences, but they require this Committee to approach this legislation in a nonpartisan and evenhanded manner. Among other things that should be considered are: mandating the development of an independent compliance audit process, akin to the financial audit process that currently exists; ensuring that the SEC has appropriate resources to fulfill its new compliance examination and broad regulatory oversight responsibilities; extending the existing deadlines for SEC rulemaking beyond their current artificial and often impossible dates; and providing a better means for the Government to assess the true costs and benefits of each of the hundreds of new regulations that Dodd-Frank requires.

Dodd-Frank was intended to address laudable goals. Unfortunately, it creates perverse incentives that will likely undermine the intended benefits to investors. With care and a bipartisan effort, the Act can be tailored so that it more likely accommodates its original objectives.

Thank you again for the invitation to appear here, and I will be happy to respond to any questions the Committee Members may have.

Chairman JOHNSON. Thank you, Mr. Pitt.

Ms. Roper, please proceed.

STATEMENT OF BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

Ms. ROPER. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I appreciate the invitation to appear before you today.

Improving protections for average investors has been a priority for CFA for roughly a quarter-century. The issue has taken on new urgency, however, in the wake of a devastating financial crisis that has left average investors, American investors, as fearful for their financial security as the events of September 11 left them fearful for their physical safety.

Among the lesser known achievements of the Dodd-Frank Act is its creation of a multi-faceted investor protection framework that, if properly and effectively implemented, could significantly improve regulation of the securities markets and with it protection of investors. My written testimony discusses a broad range of the Act's investor protection provisions. In my oral testimony, however, I focus on just a couple of the bill's provisions, starting with its provisions to strengthen credit rating agency regulation.

Before the crisis, the entire system of regulating asset-backed securities was built on the assumption that credit rating agencies could reliably assess the risks associated with these complex and opaque investments, an assumption that proved to be disastrously misguided. Title IX of the Dodd-Frank Act seeks to address this fundamental weakness in the regulatory system with a package of measures designed to make credit ratings more reliable.

Among the most important are provisions to improve the SEC's oversight of ratings agencies, to strengthen the agency ratings agencies' internal controls over the rating process, to make the assumptions behind the ratings more transparent to users of those ratings, to hold rating agencies legally accountable for following sound procedures, and to reduce regulatory reliance on ratings. Implementation of these provisions is still a work in progress and we would simply note that, with the major ratings agencies still subject to massive conflicts of interest, a lot hinges on the SEC's ability to provide tough and effective oversight.

The Act also includes provisions addressing more generic weaknesses in securities regulation, and among these are provisions designed to provide investors with greater input into the SEC's policymaking process by creating a potentially powerful new Office of Investor Advocate within the SEC and establishing a permanent Investor Advisory Committee. I think it will come as no surprise that I view these provisions very differently than former Chairman Pitt.

Some question the need for these provisions because the SEC is supposedly the investor advocate, but it is not. Its job is to protect investors, which is different from advocating for investors. And the simple fact is that investors lack the organization, manpower, and resources to monitor agency actions and effectively interact with SEC leaders and staff. As a result, the agency's agenda is often developed and specific proposals to implement that agenda are developed with minimal impact for investors, at least until the public comment process, while industry is involved at every step of the process. Once the Office of Investor Advocate and the Advisory

Committee are up and running, investors should benefit from an agency that is more attuned and responsive to their concerns.

Another set of little noticed provisions in the bill have the potential to transform the disclosures retail investors rely on in making investment decisions. The Act requires the SEC to identify ways to improve the timing, content, and format of disclosures. It authorizes the agency to engage in investor testing of new and existing disclosures to ensure their effectiveness. And it authorizes the agency to require pre-sale disclosures with regard to investment products and services. Together, these provisions give the agency the tools and authority it needs to develop disclosure documents that are more timely, relevant, and comprehensible to retail investors.

All of the many investor protection provisions in the Act will depend for their effectiveness on the SEC's receiving the funding necessary to carry them out. Unfortunately, after three decades in which our securities markets experienced explosive growth in size, complexity, technological sophistication, and international reach, the SEC today is critically underfunded and understaffed to carry out its existing responsibilities, let alone take on the vast new responsibilities entrusted to it in Dodd-Frank.

Congress attempted to address this problem in Dodd-Frank by authorizing funding increases that would roughly double the agency budget by 2015. Unfortunately, the debates over the fiscal year 2011 and 2012 budgets have already made clear that turning those authorizations into appropriations is going to be a tough fight, and we appreciate the leadership that you, Chairman Johnson, and Members of this Committee have played in fighting for that full SEC funding. While we are sympathetic to those who argue that money alone cannot solve all the agency's problems, we also believe that without additional funding, the agency cannot reasonably be expected to effectively fulfill its investor protection mission.

In conclusion, the investor protection framework provided in Dodd-Frank is a sound one, but it only takes us so far. For it to succeed, regulators will have to demonstrate a willingness to use their authority aggressively and effectively, and Congress will have to provide them with both the resources and the backing to enable them to do so.

Chairman JOHNSON. Thank you, Ms. Roper.

Ms. Simpson.

STATEMENT OF ANNE SIMPSON, SENIOR PORTFOLIO MANAGER, GLOBAL EQUITIES, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Ms. SIMPSON. Thank you. Good morning. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you very much for the opportunity to come and speak to you this morning. My name is Anne Simpson. I am Senior Portfolio Manager in the Global Equity's Division of CalPERS. So my purpose this morning is really to share with you some practical insight into how Dodd-Frank is working, emphasize to you how important the corporate governance provisions are, and if anything, to remind the Committee that there is still further work to be done.

But let me start at the most important point, which is explaining something about CalPERS and the size and significance of our fund in the market. As you will be aware, CalPERS is the largest public pension fund in the United States. We have approximately $235 billion in global assets and our equity holdings extend to something like 9,000 companies worldwide.

Now, this money is invested for an extremely serious purpose. We provide retirement benefits to more than 1.6 million public workers, retirees, and their families. And if you want to think about that in terms of its economic impact, this year, we will have paid out something in the order of $11 billion in benefits. Seventy cents on every dollar that we pay out typically comes from investment return. So think of the number of people reliant on the market through the activities of our investment fund. This is not a theoretical exercise.

The people that we are investing for, generally, they are on modest incomes. On average, a CalPERS beneficiary will be living on benefits from the fund on the order of $2,000 a month. Today, we have released a report actually looking at the economic impact through those payments, if you would be interested in a copy.

So for this reason, we have a very serious fiduciary duty to pay attention to the safety and soundness of the market, and this is why corporate governance is, to us, absolutely fundamental to the security of those returns, which we have to think about on a risk-adjusted basis over a very long investment time horizon.

Our size and our very long-term liabilities mean that we cannot ignore problems in the market. There is no safe place for CalPERS to go when things go wrong. We are simply too big. There is not a corner of the stock market where everything is working wonderfully well and you can talk over $200 billion and hope these difficulties will somehow go away. So we have been paying very close attention to Dodd-Frank's reform proposals and we are also very glad to be working within the new rigor, the new transparency and accountability that this Act is providing.

I also would like to draw to your attention that in addition to the corporate governance reforms, CalPERS has been actively supportive of other elements of Dodd-Frank, the proposals around systemic risk oversight, proper funding and independence for regulators, which has just been touched on, proper derivatives reform, credit rating agency overhauls, and consumer protection. We see these as a package of measures that need to be carefully coordinated. Corporate governance will not do the job on its own.

So let me then just turn to a number of corporate governance provisions in Dodd-Frank which we see as particularly important, and I would be glad in the questions to explain further why that is so.

I think it is fair to say it is almost commonplace now that we acknowledge that the financial crisis was fueled by a toxic combination of lax oversight and misaligned incentives. This is why governance reform is vital. It is through improved transparency and accountability that we will be able to address these sorts of systemic weakness. Too many chief executives pursued risky strategies or investments that bankrupted their companies or weakened them financially for years to come, and we know the knock-on effect in the economy has been devastating for millions. Boards were often complacent. They were blinded by group-think, which is also why we regard board divestiture so important, and unwilling to challenge or rein in reckless executives who threw caution to the wind. We know that accountability is critical to motivating people to do a better job. This is why sound pay is so important.

We also think it is vital that proxy access is finally introduced in order that we can hold boards to account. Our significant and most important role is to be able to vote on the hiring, the firing, and the removal of board directors, and without proxy access and its companion piece, majority voting, we are not in a position to do that. We are simply those with bark but no bite.

Finally, we would like to encourage the further improvement of disclosure, which Dodd-Frank has begun, notably around important subjects like board leadership, for example, the separation of the chairman and the chief executive. And we welcome the efforts that are being made to give investors the information they need that is critically important, but also it is very important that that information can be matched by appropriate action, which is where proxy access will give us an extremely useful tool for improving the situation, not just for the benefit of our beneficiaries, but we think it will have a systemically useful impact.

Thank you.

Chairman JOHNSON. Thank you, Ms. Simpson.

Mr. Atkins is a visiting scholar instead of a fellow, as was said at the beginning of the hearing. I regret that.

STATEMENT OF PAUL S. ATKINS, VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. ATKINS. That is OK. Thank you very much, Mr. Chairman and Ranking Member Shelby and Members of the Committee for inviting me to appear today at this hearing.

I come before you today not only as a former Commissioner of the Securities and Exchange Commission, but also a member of the former Congressional Oversight Panel for the TARP program and, of course, as a Visiting Scholar at AEI. It is a privilege for me to be able to participate in the public discussion about the issues of the day in the context of my years of work in the public and private sectors.

The news of this past week has highlighted the disappointing state of affairs in our economy. The unemployment rate increased to 9.2 percent while the labor force itself shrank by more than a quarter of a million people. More than 14 million Americans are out of work, and almost half of those have been out of work for more than 6 months.

Uncertainty in the legal and regulatory landscape of the financial services industry is a major cause of why the economy is doing so poorly, because it discourages investment and extensions of credit to entrepreneurs. A primary reason for this uncertainty is Government policy, particularly Dodd-Frank, which was ostensibly enacted for the sake of market stability and investor confidence. Because most of the provisions were not directly related to the underpinnings of the financial crisis, investors ultimately will pay for the increased costs associated with the mandates without receiving commensurate benefits. Further exacerbating uncertainty, legal challenges to Dodd-Frank and the rules that the various agencies will issue are inevitable, not just as to the technicalities of the rules and whether they have been properly promulgated, but also as to basic questions of jurisdiction and, yes, constitutionality.

As the past year has shown, Dodd-Frank also mandates very tight deadlines for Federal agencies to draft and implement these rules. Members of this Committee have been justifiably concerned that Federal agencies are sacrificing quality for speed as they neglect to properly weigh the costs and benefits to the economy of their proposed rules. These are complicated concepts with huge ramifications and the regulators have got to get it right.

Today, you have asked specifically that we address Titles IV and VII of Dodd-Frank. Title IV and the rules that the SEC adopted effectively force all investment advisors managing more than $150 million in assets to register with the SEC. Even advisors to venture capital funds, which Congress specifically exempted from registration, effectively are caught up in the SEC's new registration and examination scheme. These rules will have a multi-pronged effect. They will burden advisors and thus investors with costs, increasing barriers to entry. They will strain SEC resources and divert its attentions from protecting retail investors, which is what its primary focus should be. And the effect of these two situations will foster a mistaken sense of security among investors so that they may think that SEC registration means that they can let their guard down. Bernie Madoff indicates otherwise.

Now, moving on to Title IX, which encompasses a wide range of issues, including credit rating agencies, whistleblowing, fiduciary duties, SEC management, and then a grab-bag of issues that have been pushed for years by special interest groups of politicized investors and trial lawyers, I just want to make a few points in the time remaining.

This Committee took action with respect to the Credit Rating Agency Reform Act of 2006 to address the troubling oligopoly of credit rating agencies and the SEC's opaque method of designating these agencies as nationally recognized statistical rating organizations. Ultimately, unfortunately, Dodd-Frank has taken an inconsistent approach with respect to credit rating agencies. The threats currently being levied by Government officials in Europe demonstrate that rating agencies are susceptible to political pressure as to the supposed correctness of their ratings. Congress should consistently push transparency, accountability, and competition instead of Government control and second-guessing of ratings so that investors can get high quality and objective advice from credit rating agencies.

Now, with respect to whistleblowers, I agree with the remarks of Chairman Pitt. Under Section 913, the SEC has recommended that Congress harmonize a standard of care for investment advisors and broker-dealers. I think it is important to remember that not all investors are the same. The standard of care as has developed over the past 75 years for brokers is robust and has features that vindicate grievances that are more streamlined than what investors face in State court with a fiduciary duty standard. In those cases, the contract rules—the fine print under the contract, especially.

Some investors perhaps want and need a fiduciary who possesses intimate knowledge of their financial condition and can advise them accordingly. On the other hand, some investors would prefer to have a true broker who is engaged on a transaction basis and is compensated accordingly. These two kinds of activities should have different standards of care attached to them.

Title IX contains many other provisions, most of which have nothing to do with the causes of the financial crisis, and in my short window of time today, I cannot discuss all of these sections, but I do want to make one special plea. I encourage this Committee to exercise its oversight over SEC management. Just last week, the SEC Chairman testified about the recent leasing decision and suggested that the SEC should no longer have leasing authority. In contrast, last year, some were suggesting that the SEC should have a self-funding mechanism outside of the normal Congressional appropriations process.

In the meantime, the SEC has pursued an extremely divisive agenda marked by more than a dozen three-to-two votes in the past 2 years alone. I have never witnessed such a division. This record is in marked contrast to my experience of 10 years total at the SEC, first as a staffer in two Chairmen's offices and then as a Commissioner under three Chairmen. The dissenters today are reasonable people and their dissents are not always fundamentally opposed to the rulemaking itself. But the sad fact is that it appears that the leadership of the SEC does not engage effectively on the finer points of the policy issues. Thus, I encourage this Committee to continue to exercise oversight of SEC management.

Thank you.

Chairman JOHNSON. Thank you, Mr. Atkins.

Mr. Turner.

STATEMENT OF LYNN E. TURNER, FORMER CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

Mr. TURNER. Thank you, Chairman Johnson and Ranking Member Shelby. It is always a pleasure and, quite frankly, an honor to be back here in front of this Committee, and it is especially a pleasure with our distinguished Senator from Colorado.

I have listened to the comments today and I guess we can all agree that we do not all agree. But it is fascinating to me, in light of the fact that here we are, 4 years after the subprime crisis imploded on us, the worst since the Great Depression. Investors around the globe lost $28 trillion in the capital markets in value. That was half of the entire world's GDP at the time. Ten to 11 trillion was lost here in the United States, and that does not include the loss in value of their homes.

People have said Dodd-Frank was the cause of this. Dodd-Frank was not even passed at the time that this occurred. What Dodd-Frank tried to deal with was the outcome of that. It was the crisis that started and caused the lost jobs we have heard about, tens of millions of lost jobs, lost wages, and lost homes.

If Congress had not have acted as it did, I believe we would have been in a Hooveresque-type depression at this point in time, and it certainly was not brought on by a regulatory structure that was out of whack, although certainly I think Dodd-Frank fixed some of the problems that are there, and on that point, I think I would agree with Harvey that there were some changes that did need to be made. But it was regulatory inaction leading up to and throughout the crisis that caused us problems.

As Dr. Greenspan has noted himself, there were things they could have done, they had the power to do. Congress had given them the power. This Banking Committee had given the Fed the right to regulate those bad loans that were made, and the Fed chose not to regulate. That is what has caused the unemployment and jobs, and I congratulate Congress for acting on that.

In my 35 years of experience, though, as a banker, an auditor, a regulator, investor, and teacher, I have always found that if you are going to have markets work, they have got to have five basic fundamental pillars to work. There has got to be transparency. You have got to have the information you need to make the investments. You have got to have accountability, the people who take that money, including the management teams, the boards, have got to be accountable for their actions, as do the regulators. It is up to this Committee to oversee those regulators, and I agree with Paul that good oversight at the SEC is important. There has to be independence. The conflicts that we saw at the credit rating agencies were outrageous and certainly contributed to the problems. You have got to have effective regulators. And, finally, you have got to have enforcement of the laws.

Yet, as we look back at the mayhem of this last decade, we see that there was absolutely a dearth of transparency, accountability, law enforcement by the regulators and investors, and regulators alike. No one could decipher the financial statements from an AIG, a Lehman, a Merrill Lynch. Assets and capital were inflated, liabilities understated, and profits upon which huge compensation packages were granted were a mirage.

So in light of that, in this hearing on Title IX, let me get back to some of my comments. First of all, the whistleblower issue. A lot of people have different views on whistleblowers. Business in general does not like them. Investors like them. Some people think they go too far. Some do not. Senator Shelby, you mentioned that they could pay out tens of millions, and you are absolutely right. But if they are paying out tens of millions, that means the SEC will have been imposing fines of $30 to $300 million. That means that you have got huge financial restatements out there of the like we saw at WorldCom, where it was restated $11 billion. Those financial statements were fictional. They were like watching a movie called "Fantasia."

If it is that big, I do want to see that whistleblower come in and alert the SEC at the earliest possible date. The Association of Certified Fraud Examiners has shown that it takes on average 27 months to find a fraud. Why would we not, in a situation like that, want that tipster to come in at a much earlier date so people do not have those great big losses from a WorldCom or an Enron or some of these things we have seen in the bank.

I have served as an audit committee chair on public companies overseeing whistleblower and compliance programs. I think the

SEC was very reasonable in their final rulemaking back in May, and if anything, it is going to result in better internal compliance and hotlines. They encourage people to go to the business first, which is good. But 89 percent of the frauds that the SEC investigated from 1998 to 2007 involved the CEO and/or CFO at the company. There is a reason whistleblowers are hesitant, quite frankly, to go to the top. So giving them the chance to come into the SEC, I think, is great.

Quickly, on proxy access, it was mentioned that just 3 percent. That is actually not correct, because it takes a majority. All I am asking for investors is give investors the same right, the owners of the business the same right that the management team that they have hired has to the proxy to vote the directors. And it is not 3 percent. The labor unions never will be able to control this. That is a figment of someone's imagination, because it takes a majority of the shareholders to put it through. That is excellent.

As far as the SEC funding, I would just say I totally agree with Ms. Roper. From 2005 to 2007, the staff of the SEC was cut by 10 percent. Its spending was cut by $75 million. As a business executive, I know you cannot shrink to greatness, and that is what people were trying to do at the SEC leading up to the subprime crisis.

There was some—I was asked to comment just briefly on PCAOB and some of the provisions on broker-dealer audits which the PCAOB is acting on today, very appropriately. We saw from Madoff that audits of these companies were very poor, the audit of the assets was very poor, and this provision of the law helps the PCAOB prevent those type of things, which I think will be very good as well as work much better with international regulators.

So I think with that, I will end my comments. But overall, I think this Title IX of Dodd was well done. Investors did not get everything they wanted, but, you know, I found that it would be nice if people in D.C., rather than thinking about being Democrats or Republicans, started thinking like being Americans, and I think in Title IX that is exactly what you did as a Congress and I think that is great. Thank you.

Chairman JOHNSON. Thank you, Mr. Turner.

I will ask the Clerk to put 5 minutes on the clock.

For any and all witnesses, reflecting on the financial crisis, what do each of you feel was the most serious harm it caused to retail and to institutional investors? In reflecting on the new law, what do you feel are the reforms that will be most helpful to investors? Mr. Massey.

Mr. MASSEY. Senator, in my opinion, the most injury from the perspective that we as State securities regulators see is with respect to what we call retail investors, also known as mom-and-pop investors, and these are the people that not only have taken big hits to their life savings, they have also suffered impacts on their financial planning that they were hoping to send their kids to college with. They have lost jobs. They have lost ownership of their small firms. The landscape is littered with victims of the financial crisis, and these are regular people who depended to a great extent for their future on the integrity of the financial system. Now, when it fell apart, they took the hit.

Chairman JOHNSON. Does anyone else care to respond?

Ms. ROPER. I would just like to add to that. I think, you know, there is no question, the financial losses that investors took were devastating. I think equally devastating is their loss of confidence in the integrity of the financial system, their loss of confidence that they can rely on this as a place to save for retirement, to save for their long-term goals.

And I think one thing that contributes to that is that sort of a peculiar characteristic of this crisis is that the harm that flowed to retail investors was not primarily as a result of anything that was done to them directly. They were not defrauded by a broker. They are the collateral damage of a regulatory system of a largely institutional market that simply did not function. And so they cannot even point to anything that they did. They followed the rules. They bought and held and diversified and suffered devastating consequences. So I think it is that sense in which it undermines their confidence that they know how to participate safely in these markets and that their regulators will protect them in the future.

Chairman JOHNSON. Ms. Simpson.

Ms. SIMPSON. I would like to answer that. This is Anne Simpson. In addition to regulators letting people down, let us shine a spotlight on the shareholder community. That is where we sit, as CalPERS. The question is, where were the owners? Why were we not able to see what the problems were as they were growing? Why were we not able or willing to intervene, to do something? And it is a simple corporate governance failure in the market which has left us powerless to behave as responsible owners.

Think about two parts of the story. The first is majority voting. This is something which we wanted to come out of Dodd-Frank and in the end did not survive passage from the early discussions. This is a situation where, without majority voting, we cannot remove directors. And second, without proxy access, we cannot put forward people who we think are better able to do the job that needs to be done. And if we are not able to hold boards of directors accountable and regulators are not in a position to intervene, then, really, this is how you can have rampant risk running through the system, executive pay that is out of control, and the situation which really took us to the brink of the abyss.

Our portfolio was hit to the tune of $70 billion and we are slowly but surely coming back. But it is extremely important that in capitalism, and that is the system we are all relying on, the owners have to be in a position to behave like owners, and that means being able to hold boards accountable. And if we are toothless, then I do not see who else can intervene to do the job.

Chairman JOHNSON. Mr. Pitt and anybody else on the panel, I want you to reflect on say-on-pay. In an interview, you were asked whether say-on-pay is going to be an effective tool to prevent excesses, to which you replied, “I think it will be. I think that this will have a very definite impact on how corporations and shareholders view these critical issues.”

In your testimony today, you note that say-on-pay would lead to increased shareholder litigation. Is some litigation, which you note is finally likely to fail, a necessary consequence of getting the benefits of say-on-pay? Mr. Pitt and other panelists, would you comment on this.

Mr. PITT. Yes. I believe that shareholders have the right to be fully informed about compensation, and they have the right to express their views. The difficulty that I see is that there has evolved a clear trend already on the part of some lawyers to sue anytime a corporation's shareholders express disagreement with the compensation levels. So what could have been an advisory kind of view, which is what the clear intent of Dodd-Frank was, has now been converted into a litigation tool, and that costs investors enormous expense. It also imposes on investors enormous burdens that I think are very difficult.

I am very much in favor of transparency and having shareholders have the ability to express whatever views they have. But I am not in favor of seeing this turned into a referendum and then a litigation exercise, which appears to be the direction in which this is headed.

Chairman JOHNSON. Does anyone else care to comment?

Ms. SIMPSON. Yes, thank you. CalPERS has voted on 4,000 say-on-pay votes in our U.S. portfolio this year, but we have been voting on this same issue in Australia, the United Kingdom, the Netherlands, and Norway for some time. We are a global player, and I would say that say-on-pay is simply bringing the United States in line with international best practice.

We have also found it extremely useful, and the reason is this: It has meant that companies want to pick up the phone or answer the phone and talk. They do not want to lose the vote, they do not want a high level of opposition, and they actually are being much more attentive to what the owners think, and this is only proper. Whatever pay is being paid, guess what? That money is being provided by the shareholders, and it is only good manners, surely, to be discussing the amounts and the performance targets.

So we have seen two good things come out of this:

One, the performance periods are getting longer. That is extremely important because we need to relieve the short-term pressure on companies, and that in part comes through having short-term targets for pay.

Second, we have seen a better alignment of pay and performance, and we have been delighted to see companies filing amendments to their plans all the way in the run-up to the AGM deadline. The result of that for CalPERS is that we voted against 7 percent of the plans that came forward. So we really see this as a good platform for dialogue, and thank you very much for the efforts in Dodd-Frank for doing that.

I also forgot to mention earlier the importance of the claw-back rule in Dodd-Frank. It is extremely important that we have now clearly got this ability to retrieve ill-gotten gains. If you know that you cannot get away with it and people will come after you to turn the money back that you have perhaps bet your company on a short-term bet and done well yourself personally, if you know people can come after you and ask for that money back, I think it concentrates the mind wonderfully. So thank you for that.

Mr. ATKINS. If I could interject one thing.

Chairman JOHNSON. Yes.

Mr. ATKINS. The United States is a lot different than other countries around the world. Our litigation system and the shareholder rights system is a lot different. And so I think the things that Chairman Pitt is pointing out ought to lead to some caution.

And the other thing that troubles me very much when we talk about "investor rights" is that some owners are treated differently than others, and the sense that some people can pick up the phone and talk to and cut back-room deals or influence things because of their special interest or size I think is very troubling. And so what we need is more transparency, and to the extent that these special rules give certain shareholders more clout than others have I think is a very troubling development.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Atkins, in the self-funding situation, some commentators, as you well know as a former Commissioner, have advocated self-funding for the Securities and Exchange Commission. Self-funding I believe would make the SEC less accountable to Congress, and as a former Commissioner, what is your view about how self-funding for the SEC would change the incentive perhaps for Commissioners to properly execute their duties? Would it make them less responsible obviously to Congress, you know, if they did not have to come before Congress for an appropriation?

Mr. ATKINS. Yes, sir, I think that is a very important point. I am not in favor of the idea of self-funding. If I were to put myself in the shoes of you all on the other side of the table and considering the responsibility to taxpayers, I think it is incumbent to try to exercise oversight and understand what is going on: To have various departments and agencies of the Government go through the normal appropriations process, to justify their budgets and then make decisions as to who is more deserving of the capital that is going to be allocated. So, I think that transparency is very important, and I think it has done the SEC well over the last decade. Accountability is crucial.

Senator SHELBY. Thank you.

I would like to address this question to the former Chairman, Mr. Pitt, and also to you, Mr. Atkins, as you both are former Commissioners of the SEC. Dodd-Frank enacted, as we all know, a number of changes. We have been talking about corporate governance. These changes give shareholders with 3-percent holdings I believe substantially more power than the average investors. Could these provisions cause companies to defer to the political or financial agendas of certain special interest shareholders at the expense of building the company's value for the benefit of all shareholders? And how do these changes benefit individual investors if they do? Mr. Pitt, former Chairman.

Mr. PITT. Thank you, Senator Shelby. I have a basic concern with any provision that holds a corporation's shareholders hostage to the views of special interests with respect to a company. The ultimate goal of accountability, which is what was behind these provisions, is a good one, but the solution was much simpler than the one that the SEC has come up with. The solution was simply to allow solicitations electronically so that there would not be the same fervor to make use of management's proxy materials; and, second, to rely on State law. The State law determines whether shareholders have the right to amend their by-laws, and if State law gives shareholders that right, then they ought to be able to exercise it subject to restraints on inundating the corporation with too many proposals and the like.

So I think there is a way to achieve the goal, but it is not necessarily the one that Dodd-Frank contemplated.

Senator SHELBY. Mr. Atkins.

Mr. ATKINS. Yes, sir. About 5 years ago, at an SEC roundtable, in response to a question that I asked, a couple of witnesses basically admitted that these sorts of provisions add more arrows to their quiver for them to be able to advance in smoke-filled rooms—out of sight of the public and without any transparency—to advance their ulterior motives and their special agendas. And in the past, State pension funds have also been basically in cahoots from time to time with some of these special interests.

So I think that lack of transparency is very troubling, and for an agency like the SEC, which stands for transparency in the marketplace, I think that is a troubling development.

Senator SHELBY. Mr. Massey, Dodd-Frank shifts the regulation of certain registered investment advisors from the SEC to State regulators. Will the State regulators have the resources and expertise necessary to properly oversee the investment advisors that would be moved to the States under their jurisdiction? And how would investors be helped by the change, if they will?

Mr. MASSEY. Senator, right now the estimate from the SEC is that approximately 3,200 investment advisor firms that are currently federally registered would be shifted over to State registration and regulation in the so-called investor advisor switch. NASAA has been preparing for this switch for more than a year now and has created a number of tools to make the State's role in regulating these investment advisors much more intelligent and much more efficient and much more responsive rather than a rubber stamp type of treatment of the examination requirement.

We have risk analysis software that is distributed to the States to let them adjudge the relative risk of the various firms so they can set their priorities of examination. We have uniform examination procedures so that every examination is going to ask the same question of every investment advisor out there. And, most importantly, the shift has motivated the States to have an outreach program by which road presentations are conducted in major cities for not only existing State registered investor advisors but also Federal advisors that are coming over, to let the Federal advisors know who the regulator is, to establish a positive working relationship with the State regulator, and to set up a good working relationship with what I refer to as the legitimate side of the industry so that the local cops on the beat can take their enforcement resources and put them against the Ponzi scheme operators.

Senator SHELBY. Ms. Roper, recently the National Association of Manufacturers estimated that the new Dodd-Frank disclosure requirement with respect to conflict minerals, such as the Congo and so forth, would cost between $9 billion and $16 billion—in other words, to the industry—rather than the $46 million that the SEC estimated. Are you concerned at all that this provision could end up costing investors more than the benefit that they will receive from disclosure? You know, we are all interested in doing the right thing, but we are also interested in some balance of cost here for our manufacturers.

Ms. ROPER. We did no work on that provision. I do not know anything about the provision. I have no basis for analyzing either of those cost estimates, so I just do not have a basis for commenting.

Senator SHELBY. OK. Ms. Simpson, do you have any knowledge base on this?

Ms. SIMPSON. Thank you. Yes, we actually are great fans of getting all relevant and material information properly provided to shareholders. But the root is going to be to ensure that, you know, the costs do not outweigh the benefits. That is a very sensible point of view.

I have not seen the underlying estimates that you are referring to, so I cannot comment on that, but it would seem to me quite extraordinary in this day and age of the Internet that a company could not find the relevant information in a cheap and affordable way.

Senator SHELBY. OK. Mr. Turner, one last question. In your testimony here today, among other things, you noted that in the lead-up to the financial crisis, and I quote, "most of the regulators were captured by industry." Your words. In your view, which regulators were captured by industry or are captured by industry? And if a regulator is captured by industry, isn't the solution to make the regulator more accountable to the American people by subjecting the regulators to more congressional oversight? That is one way, maybe not the only way. In other words, who was captured by industry?

Mr. TURNER. I certainly think the banking regulators were captured by industry. The Federal Reserve—I have dealt with the Fed for much of my career, and I think even Dr. Greenspan has acknowledged, I think, probably the best way to deal with it is through much greater transparency on the part of the Fed. I think the SEC in the mid-part of the last decade was extremely captured by industry, and contrary to what Paul said, the divisiveness at that point in time o the Commission was tremendous as well. In fact, I think the current Chairman, Chairman Schapiro, should be applauded for trying to dial the tone back a little bit.

But on your point about accountability, I do think both the Fed and the securities regulator, as well as the CFTC, all of them need to be subjected to much more rigorous oversight. I will tell you leading——

Senator SHELBY. Like right here.

Mr. TURNER. Like right here, Senator. You are absolutely right. And, in fact, I will tell you that myself and others—and I think Barb Roper was included in the group at the time. Just as we were getting into the subprime crisis, probably in about January of 2007, there was a group of us who came and met with the Banking Committee staff here as well as the House Financial Committee staff and members, and we urged at that point in time much greater, robust, in-depth oversight of the Commission. And, unfortunately, it did not happen in either institution.

I will say on the funding issue, I believe you have been one of the proponents—I have testified before you when you pleaded with the SEC Chairman to take more funding, and I greatly applaud you, Senator, for that. We probably disagree on the issue of self-funding. I am a strong proponent of self-funding. I think you can self-fund and still do the oversight hearing. I understand appropriators, people on the Appropriations Committee, like that oversight, so I understand where you are coming from.

Senator SHELBY. Like the two of us.

[Laughter.]

Mr. TURNER. Yes, and I think there is actually——

Senator SHELBY. He wants to give up his power. We do not.

Mr. TURNER. But I think you could have done it. But, you know, whether you self-fund or not, the most important thing is that the money that you scheduled out in Title IX get delivered to the SEC. And my problem and my concern is if you look at the first year, 2011, which is $1.3 billion, you are not even hitting that target. And if you are not even hitting that target, I have no expectation that you will get the SEC the funds that it needs. And I think the fact that you saw their staff cut by 10 percent from 2005 to 2007, $75 million cut in spending, the management was absolutely atrocious at the agency at the time, and I would have encouraged you to bring them up, as we did in January of 2007, and ask them what they were doing, because they did get the job done. And they did a great disservice to investors.

Senator SHELBY. You are not saying to us today here in the Banking Committee that the SEC's whole problem or the Federal Reserve's whole problem—of course, they have no funding problem.

Mr. TURNER. Certainly it was not the Fed because they got self-funded.

Senator SHELBY. It was a lack of money? Or was it a lack of will and a lack of action and a lack of diligence?

Mr. TURNER. I think first and foremost it was a lack of will and a lack of diligence.

Senator SHELBY. Thank you.

Mr. TURNER. I think in some cases funding contributed to that.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you, Mr. Chairman, and thank you for your testimony.

This issue of funding I think is central because Mr. Pitt expressed a concern I have, that we will give responsibilities to the SEC and not the resources to get them done, and that goes for the CFTC also. And so I was a strong proponent of self-funding even though I am also an appropriator.

I presume, Mr. Pitt, that ultimately you would be supportive of some type of self-funding mechanism?

Mr. PITT. Yes. I believe that there are a number of financial regulators who have the ability to self-fund, and the SEC should not be a stepchild. I think the concerns that have been expressed about accountability make it imperative that if self-funding is granted—and I believe it should be—that there be complete accountability before the appropriate committees, this Committee and others, so that you can assess where the SEC proposes to spend its money. But you would wind up saving taxpayers a billion plus dollars if the money did not come out of the Treasury, as it presently does.

Senator REED. Thank you, Mr. Pitt.

The back and forth has revealed the issue of accountability as well as funding, and there are ways for accountability. One is this Committee—in fact, probably a more effective way, if used correctly, than the Appropriations Committee. But also there is the issue of regulatory capture, and as you point out, every other regulatory agency, except the CFTC, financial agency, is self-funded. But there is still the issue of regulatory capture. But I think that has to be resolved probably in other forums. I do not see anyone here—if someone would like to put their hand up and say if the Fed should be subject to the appropriation process, do I have any takers? Barbara? Not even Consumer Federation of America.

[No response.]

Senator REED. So I think this issue of——

[Laughter.]

Senator REED. I think this issue of sort of, well, if they do not have appropriate oversight by the appropriators, they just will not be accountable to the American people defies the financial system we have in place today.

Ms. Simpson, you talked about majority voting, and I just want to clarify because the proposal that we had in the legislation I think is essential. It fell out, unfortunately. That would have required a director to receive the majority of the votes cast. Today, a director could be elected to a board with 10 percent of the votes or one vote if no one decides to cast votes. That happens sometimes and leads to anomalies. So effectively without this majority—without the ability to nominate directors and then without the ability to insist they at least get a majority vote, the leverage of shareholders is diminished.

Now, we have made some improvements, but you would suggest we should go further in terms of a majority vote. Is that correct?

Ms. SIMPSON. Yes, thank you. And the situation you describe is not that uncommon. We sort of had a look back last year. Just in the Russell 3000, there are over 100 directors who did not win a majority of the vote and who are still just quietly sitting on the board. So far this year, another 36. So this is an environment which is really very troubling. You know, this may be a democracy, but it is of a very peculiar sort if you do not have to win the election in order to keep yourself in place. And, of course, the comment that was made about special interests, I have to say with great respect to be rather like a politician saying we should not trust the electorate with something as important as the vote.

Senator REED. But let me follow up on that line of criticism that, well, this creates this lack of transparency because you might have big voting blocs doing things. Essentially whatever benefit you gain is equally shared by every other shareholder. Is that——

Ms. SIMPSON. Yes, that is absolutely right, and two points on that. First, CalPERS, being a great champion of transparency, thinks that has to apply to us as well. We put all of our votes on our Web site. Our policies are there for you to see. And I think that is very important, and I would encourage all investors to follow the same approach.

The other issue about the financial benefit is really important. So even though CalPERS is so big, typically we will hold about half a percent of a company, and if we want to do anything, first of all, we have to collaborate with others; and, second, you are quite right, the benefit is shared.

We had a report done for our board just before the end of last year looking at 10 years of our investor engagement to see what had happened at those companies, and sure enough, you went from a situation where that group of companies went from underperforming to producing excess returns. And, of course, that is not just going to help CalPERS; it is going to help every other shareholder. So there is a net-net gain in the market.

Senator REED. I think one of the dilemmas or sort of contradictions is that the presumption, of course, is that corporations are run for the benefit of shareholders, but I think particularly when you look at the companies that failed—Lehman Brothers, Bear Stearns—they were not being run for the benefit of shareholders at all. They were being run for the benefit of the management, with huge rewards to management. In fact, as I sort of look back, it was a public ownership model and a private compensation model, and it worked very well until, you know, the tide turned.

In many respects, shareholders are the least powerful people in corporations, and they are, according to corporate law—and I will defer to Mr. Pitt and others. They are the ultimate owners. They are the ones which every director has a fiduciary duty to and manager has a fiduciary duty to. But it appears from what has happened in the lead-up to this collapse that shareholders were sort of the last people being considered. Is that your view?

Ms. SIMPSON. Yes, I do agree with you. You know, we are the one-armed paper hanger. We need to have the tools to hold boards accountable, and I think what you will find, my conclusion is that if shareholders have votes that do not really matter and they do not have the ability to intervene in an effective way, they think, OK, the system is designed. Either you can sell or you can sue. Now, that is not going to work for CalPERS because we are too big and we are too long term. But we really do need the tools to be able to behave like owners, and that is why—and I know it has been said, well, we could go—Mr. Pitt has said we should go door to door with companies in different States filing resolutions to have amendments. But to be honest, we see this as a market fundamental. If capitalism cannot turn to the owners to hold companies accountable, then we should not be surprised when we have the problems that we do.

Senator REED. Thank you very much.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Well, thank you, Mr. Chairman. Thank you for holding the hearing.

I look at this issue, and I think about what is the market. The market is a series of investors seeking to invest in companies that hopefully will provide them a yield, a return on their investment so that they can personally prosper. And the flip side of that is a series of companies looking for investors so that they can grow their companies and prosper as well. And so there are two essential ingredients here, and one of them, but for their investments, would really not make the market what it is. Without them there is no market. And so investor protection seems to me to be incredibly important.

And I know that some say that the CalPERS of the world and the unions of the world are special interests. They happen to be the biggest singular investors along the way in this marketplace. So I do not look at them as a special interest. I look at them as a significant part of the marketplace, representing a broad universe of individuals at the end of the day who are taking their savings and making investments for them. And so ultimately it seems to me that investor protection in their respect as well is a very broad one because they represent a very large universe of people, and at the end of the day, more than ideological issues, I think they want to see their investments grow on behalf of the people who they invest in. So I have a little different view.

I have two sets of questions that I want to pursue. One is, Ms. Roper, with you. Soon after Dodd-Frank was signed into law, the SEC put out a study recommending a consistent best interest of the customer or fiduciary duty standard for broker-dealers and investor advisors, a priority that both Senator Akaka and I successfully fought for in the Wall Street reform with our honest broker amendment. And I know that the Certified Financial Planner Board of Standards recently sent a petition to the SEC with more than 5,000 signatures of financial planning professionals who favor fiduciary duties for all financial professionals giving investment advice.

Do you agree with having a high and consistent standard of the best interests of the customer for all stockbrokers and financial professionals? And if so, why?

Ms. ROPER. Absolutely, I agree, and any of you who are the recipients of my nearly daily letters on this subject during the legislative battle maybe remember that. This is in many ways the most important issue for retail investors. The last investment decision most people will make is who to rely on for recommendations. And the situation in the marketplace is this. Mr. Atkins says, you know, broker-dealers and investment advisors are doing two different things, so they should be subject to two standards. But let us review that. They call themselves by titles that are indistinguishable to the average investor. They both offer extensive personalized investment advice. And they both market their services primarily based on that advice. If they are doing two separately distinctly different things, why has the SEC allowed them to present themselves in a way that makes it impossible for the average investor to distinguish between them?

So if the investor cannot distinguish between them—and we know from survey research and focus group research that they cannot. In fact, the RAND study found that investors could not tell whether their personal advisor was a broker or an investment advisor, even after the differences had been explained to them. So they cannot go into the marketplace and make an informed decision based on an understanding of what services are being offered or what the standard of conduct is for those services.

So the reform that is needed is to ensure that when they are doing the same thing, when they are providing personalized investment advice to retail investors, they should be subject to the same standards.

Now, the brilliance of the proposal that the SEC has put out there is that it recognizes both the need to raise the standard and the need to preserve investor access to a transaction-based source of advice. Not every investor wants ongoing account management. Not every investor wants, you know, comprehensive financial planning. So investors benefit if there is a source of advice available that is compensated through commissions, that offers advice on a transaction basis. And the SEC uses the authority that Dodd-Frank gave it to put out a proposal that recognizes this. Brokers can still charge commissions. Brokers can still sell proprietary products. They can sell from a limited menu of products. And the SEC has said they will deal with the principal trading issue. They are making every effort to ensure that this advance in terms of the standard of conduct nonetheless retains investor choice.

Senator MENENDEZ. At the end of the day, they can make all of their commissions, but they have one standard. That would be the best interest of the investor.

Ms. ROPER. Absolutely.

Senator MENENDEZ. Otherwise, you could very well lead them to investments that would not necessarily be in their best interests, but for the standard——

Ms. ROPER. Absolutely. Absolutely. There is—you know, there is a difference between what you can do to satisfy a suitability standard and what you would have to do to satisfy a fiduciary duty. Now, they start from the same basis. You have to know the customer. You have to do that analysis to determine what is appropriate for that investor. The fiduciary duty requires the broker to take an additional step and have a reasonable basis for believing that what they are recommending is not just appropriate for the investor, but in the best interest of the investor within the limited menu of options that they have available to sell.

And where they have conflicts of interest, they are still able to operate, but they have to fully disclose those conflicts of interest to the investors. So they can no longer make recommendations based on their own financial interest because they get higher commission without disclosing that conflict to the investor and without then ensuring that that recommendation is also in the best interest of the investor, and not just their own bottom line.

Senator MENENDEZ. Thank you very much.

I have one other question. I want to turn to Mr. Turner. Mr. Turner, one of the provisions that I successfully included in Dodd-Frank would require publicly listed companies to disclose in their SEC filings the amount of CEO pay, the typical worker's pay at that company, and the ratio of the two. Now, over the last few decades, CEO pay has skyrocketed while the median family income has actually gone down.

There are those in the House that have opposed this because they say it is too burdensome for companies to disclose that, and second, that the information is not useful to investors. I find it hard to believe that companies that do all kinds of complicated calculations for everything else involving their revenues and expenses would find it difficult to take their 2,000 employees, figure out how much employee number 1,000 is paid, and report that one number to the SEC. It seems to me that it is much more about hiding the fact that, many times, CEOs have 400 times the pay of their typical employee.

Do you think it would be burdensome for companies to figure out how much their median worker is paid and report that number?

Mr. TURNER. Senator, as you know, I was an executive in a semiconductor company that was international. We were one of the larger importer-exporters at the time, in fact, in the country, and I do not think—in fact, I would be surprised if for most companies that was a difficult thing. First of all, it is something you ought to be managing, so you only manage what you measure in the first place. And if the compensation committee of a board, and I have sat on some of these boards, was not even looking at that ratio, I would probably be concerned. It would tell me there is a lack of management here, a degree of management that should exist.

But in terms of just getting the raw data, no, I think there are ways you can go about it. The SEC can implement some rules. I think they have been encouraged to implement some rules that are reasonable that would not have a great deal of cost. And again, let us keep in mind, when we talk about cost, this cost global markets $28 trillion. It cost U.S. investors $10 to $11 trillion. Much of that was due to very, very poor incentive packages. And in light of the fact that executive compensation this year—last year was up 23 percent while Main Street wages went up zero—zero—I think it is fair to turn around and start managing and taking a look at that issue, and I think compensation committees should. I think they can. I think CFOs in the same role I was in can get that number. And, no, I do not expect that to be a high-cost number. If it is a high-cost number, that company probably has some other management problems, as well.

Senator MENENDEZ. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman, and I welcome our witnesses here as we hear what is the latest that has been happening to the Dodd-Frank bill and how it has impacted our national community.

Ms. Roper, you have mentioned that the Dodd-Frank bill is a multi-protection framework and it provides tools that investors need to deal with, and I want to speak toward the Investor Advocate. In the Office of the Investor Advocate, which was created to empower retail investors and represent their interests with the SEC and SROs, there will now be an independent external check that investors did not have during the Madoff or Stanford Ponzi schemes or the financial crisis. My question to you is, how will the structure of the Investor Advocate affect its ability to achieve its purpose?

Ms. ROPER. I think we know from looking at how Inspector Generals function within agencies that if we want them to have any sort of ability to hold the agency accountable, they have to be independent and they have to have the ability to report out when they find problems. And the strength, I think, of the investor protection, the Office of Investor Advocate provision in this Act are precisely those, frankly, that former Chairman Pitt has criticized. They are the provisions that ensure that this office does not become just another weak and meaningless addition to the SEC bureaucracy.

You know, agencies do not like their IGs. They are uncomfortable with that function within the agencies. But I think we can all agree that they do perform a valuable function in terms of holding the agency accountable. The Office of Investor Advocate has exactly that same potential, to hold the agency accountable for being responsive to investor concerns.

Now, I find it interesting that people who say that the SEC's job to be the investor advocate are so threatened by the notion that it would be held accountable for listening to investor concerns. The Office of Investor Advocate cannot compel them to do anything. But they cannot be ignored, because they have to—the Commission has to respond. They cannot be denied access to the paperwork that they need to analyze proposals. They have to be built into the process of developing the Commission's rule proposals and agenda.

You know, I think that it is instructive that these same provisions that are designed to make the agency accountable to investors are viewed as so threatening by some. When I hear these words, the SEC, we do not need this because the SEC is the investor advocate, well, I have been an investor advocate for 25 years and, you know, I do not think you would find a single investor advocate who would agree with that statement. It is not the SEC's job to advocate on behalf of investors, and in the best of times, investors find it very difficult to have their voices heard.

So I think this is an important addition to the Act. I look forward to having the office established and up and running, and I think we can trust—the Chairman said, we will appoint this person. We will not put cowboys into that office who will behave recklessly. It is not in their interest.

And just one final note. This question of the—the threat is that the Investor Advocate can criticize the agency action. What we are talking about here is that they report to their oversight committee. Now, Members of this Committee just expressed a lot of concern about the ability of Congress to provide effective Congressional oversight. The fact that the Office of Investor Advocate will be reporting to the oversight committee should ensure that the committees can do a better job of providing oversight to ensure that the Commission is effectively protecting the interests of investors.

Senator AKAKA. Thank you.

Mr. Massey, you have mentioned that this bill should be implemented fully, and Mr. Turner also said that the law should be enforced. Mr. Massey, NASAA's statement on an SEC study on the obligations of broker-dealers and investment advisors said that a uniform fiduciary standard would have a, and I quote, "significant positive impact on investors." Do you have anything to add to Ms. Roper's comments about how investors would be positively impacted by a uniform fiduciary standard?

Mr. MASSEY. Senator, I agree substantially with what Ms. Roper said. I would add that I believe that it is appropriate to introduce a fiduciary standard on those brokers who are presenting themselves as purveyors of investment advice.

The brokerage industry has gone to a marketing mode in which it holds itself out to retail investors as being trusted advisors. Surveys have shown that regular retail investors do not know the difference between a stockbroker and an investment advisor, and they also believe that when they are sitting in front of a financial professional, that that financial professional is acting in their best interest, but that is not the situation.

The fiduciary duty that has been discussed would be imposed only on the brokers who are providing investment advice just like investment advisors provide investment advice. So if you are going to present yourself as a trusted advisor, you ought to be held to the standards of a trusted advisor and be responsible. The benefits to the investors would be a mandatory disclosure of any conflicts of interest that might show any kind of bias in that advice that is being communicated. The benefits would be to obtain full information about the—enabling the investor to choose the best performing product at the lowest expense to the investor. It makes sense to me and we fully support it.

Senator AKAKA. Thank you very much. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman, and thank you for holding this hearing on investor protection after the financial crisis.

I did want to welcome David Massey, who is from my State in North Carolina, and he has been a strong advocate for investors, especially those who lack the expertise or resources to protect themselves, so thank you for being here, too, and all of thee other panel members for being here.

I did want to ask Mr. Pitt, Mr. Atkins, and Mr. Turner a question concerning the Department of Labor. Right now—recently, the DOL has unilaterally proposed regulations under ERISA that would redefine the term "fiduciary," and many of my colleagues, I know, have expressed concerns about the coordination that is taking place, or the lack of coordination, too, between the SEC and the Department of Labor. In light of the SEC's recommendation that the Commission use its authority under Dodd-Frank to promulgate a uniform standard, and given you all's expertise at the SEC, I wanted to get your thoughts on this matter. Are you concerned that DOL's changes have not been made in coordination with the SEC, and what could some of the consequences of this coordination, if it does not take place, if we do not have the coordination?

Mr. PITT. I believe in requiring coordination between agencies of Government. It is one Government, and when Paul Atkins and I were there, when we would take enforcement actions that affected national banks or affected entities overseas, we would coordinate with the Federal Reserve Board or the State Department. I think there is no place for unilateral action when other agencies have a vested interest. And indeed, in the context of pension investments, the SEC has a lot of expertise to offer in that area.

Senator HAGAN. Mr. Atkins?

Mr. ATKINS. Yes, Senator. I agree with Chairman Pitt. Both SEC and the Department of Labor have overlapping jurisdiction with respect to these pension funds, 401(k) offerings, which touch just about everybody in the country. So, it is really vital that they coordinate, and as you are saying, the current situation has been characterized apparently by a lack of coordination. What is really important here are the consequences of unilateral action. It will raise costs and restrict choices that people have with respect to their 401(k) programs. The huge liability that will come down to peripheral actors will really discourage those people from being involved.

Senator HAGAN. I have heard that quite a bit.

Mr. Turner?

Mr. TURNER. Senator Hagan, the proposals that you refer to relate to a fiduciary standard that, as I recall, was adopted back at the time of ERISA, back in 1974. So things have dramatically changed since then. I think the Secretary over there is absolutely correct that they need to be updated. It has been, what, 35, 36, 37 years since those things were done, and investment funds like 401(k)s, IRAs, *et cetera,* have dramatically changed since then. I have served on the board of a mutual fund as a trustee. I currently am an independent member of the board of a $40 billion pension fund, as well, so have to deal with those fiduciary laws. And I do think that they need to be changed and updated.

The things she is changing to, in fact, are already in many instances incorporated into our contracts, so she is catching up the law to already what exists in many of our business contracts. So I do not think it is as dramatic a change as what some criticize her for. So I think they are good rules. I think she should move forward with them. But to the same point that Paul and Harvey say, though, in this city, it is always good to have people coordinate with one another and be talking with one another. I do not care whether it is the banking regulators, the SEC, CFTC. The more you can get in the room and hash over things, I think that is good.

But ultimately, the independence of any agency or any cabinet position, I think, is important. Ultimately, it is the Department of Labor Secretary that is responsible for those rules. So if she goes through consultation, including with the SEC, and then decides after that to go ahead and move, I do not have a problem with that because I think she is moving wisely in the right direction. But I would certainly encourage her to do that after consultation with the Commission.

Senator HAGAN. Well, it seems to me that it would be a problem if we have two different definitions of "fiduciary," one at the DOL and then one at the SEC.

Mr. TURNER. I would say this, that the things she is dealing with—there are two different things here. The fiduciary standard she is dealing with is dealing with what ultimately runs to the trustees on those funds. It will be applied broader, and I think to that extent, your concern has got some basis. But I do not think it is necessarily going to be the same fiduciary situation that the SEC necessarily has, so I do not know that, ultimately, at the end of the day, if they all talk to one another, I think you can have them talk to one another until they get blue in the face, and they may actually find that they do not have the same fiduciary standard at the end of the day.

Ms. ROPER. Yes. I think there is an issue here. I actually think if you look at it, you will find that the changes to the fiduciary definition under DOL actually bring it closer into alignment with the definition of fiduciary under securities laws. The problem is not so much with the definition, but then what flows from that definition under ERISA.

And when I first started looking at this issue, I assumed, oh, it is fiduciary duty. I am all for it. As we have looked at the issues more closely, there are issues with the ERISA proposal, I mean, with the DOL proposal on fiduciary duty and they are varied. One of them is that there is a conflict with the business conduct rules for swaps dealers. And I was involved working with the drafters in writing that section of the legislation and the clear intent was to avoid bringing the ERISA fiduciary duty into this interaction between swaps dealers and special entities because it then brings—you know, you cannot have an adverse interest. You basically cannot be a counterparty.

Now, members worked very hard to draft the legislation in a way that did not bring ERISA into play. Under the DOL fiduciary definition, there are things that swaps dealers that would have to do to satisfy the business conduct rules that would make them fiduciaries under the DOL definition and then would preclude them from acting as counterparties, precisely what Congress was trying to avoid.

There are other problems. I think a legitimate concern about what happens in, say, the individual retirement account context——

Senator HAGAN. I am hearing a lot of concerns on that.

Ms. ROPER. Right. If you bring into play the DOL, the ERISA restrictions on any third-party compensation, say, 12(b)(1) fees, they are not—these are not irresolvable problems. I mean, you can—but the real issue here is so DOL rolled out what I think is a very well intended definition and one that does, in fact, come closer to the SEC definition, but it rolled them out without putting out the prohibited transaction exemption explanations at the same time. So people do not know how it is going to work in the real world. And all of ERISA seems I am not an ERISA expert, but all of it seems to be devoted to figuring out what the prohibited transaction exemptions are.

And so you cannot sort of reasonably comment on the DOL proposal of the fiduciary definition unless you know how it is going to interact with those exemptions. So while we would very much like to see the agency move forward with a proposal that is designed to benefit investors, there are issues with that definition that need to be resolved before it is finalized.

Senator HAGAN. I see that my time has expired, but I do have other questions that I will submit to the record. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

Senator Shelby has one last question.

Senator SHELBY. Just a few observations. Thank you, Mr. Chairman, for calling this hearing. I think it is important.

One of my observations, and I have asked everybody that has come before this Committee for the last 25 years that were nominated for the Securities and Exchange Commission, a Commissioner and the Chairman, who owns a corporation? Who does? And what does a corporation exist for, for whom? The shareholder. Who owns it? The shareholder. Not management. Not special interests and so forth. In other words, shareholders, the investors, certainly not the directors or management.

I believe that we need to have—create conditions, that is, our regulators and so forth, where a corporation cannot be hijacked for financial reasons by management or by special interests also hoping to advance a political agenda, because why do you buy stock? To make money, for it to grow and so forth.

So our challenge, I believe, is how do we balance all of this without destroying something. We certainly do not want to give management a free pass. On the other hand, I do not think we ought to give special interests a free pass to hijack a company to advance something other than making money for me or my pension fund or my mutual fund or whatever. That is my observation. That is a challenge for us, as I know, and I do appreciate all of you coming here today. I think we had a lively discussion and a very important one.

Thank you, Mr. Chairman.

Chairman JOHNSON. I thank each witness for testifying and we appreciate your concern for the protection of investors in the United States securities markets.

I ask all the Members of the Committee to submit any questions for the record by close of business next Tuesday, and I ask the witnesses to submit your answers to us in a timely manner.

This hearing is adjourned.

[Whereupon, at 11:58 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF DAVID MASSEY

NASAA PRESIDENT AND NORTH CAROLINA DEPUTY SECURITIES ADMINISTRATOR

JULY 12, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I'm David Massey, Deputy Securities Administrator for North Carolina and President of the North American Securities Administrators Association, Inc. ("NASAA"). I am honored to be here today to discuss how the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is providing enhanced protection to investors, particularly Main Street Americans who are looking to lawmakers and State and Federal regulators to help them rebuild and safeguard their financial security.

The Wall Street reforms and investor protection provisions in the Dodd-Frank Act were born out of necessity. The financial crisis made it clear that the existing securities regulatory landscape required an overhaul. NASAA sincerely appreciates the work of Chairman Johnson and Members of this Committee to ensure that investor protection remained the foremost goal of the legislative effort to usher in the next generation of financial services regulation.

This comprehensive law was crafted to promote stronger investor protection and more effective oversight to help prevent another economic crisis and restore the confidence of Main Street investors. The Dodd-Frank Act addresses a number of critical issues for investors by incorporating disqualification provisions to prevent securities law violators from conducting securities offerings under SEC Regulation D, Rule 506; strengthening the accredited investor standard; and increasing State regulatory oversight of investment advisers. Dodd-Frank also includes a provision to safeguard senior investors from unqualified advisers and creates an investor advisory committee to advise the SEC on its regulatory priorities. In two other priority areas for investors, fiduciary duty and arbitration, the law authorizes the SEC to take action to provide enhanced protections and remedies for investors.

Role of State Securities Regulators

State securities regulators have protected Main Street investors from fraud for the past 100 years, longer than any other securities regulator. From the enactment of the first blue sky securities law in Kansas in 1911, State securities regulators continue, more so than any other kind of regulator, to focus on protecting retail investors. Our primary goal has been and remains to advocate and act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your States are responsible for enforcing State securities laws, the licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, pursuing cases of suspected investment fraud, and providing investor education programs and materials to your constituents. Like me, 10 of my colleagues are appointed by State Secretaries of State, five come under the jurisdiction of their States' Attorneys General, some are appointed by their Governors and Cabinet officials, and others work for independent commissions or boards. Many call us "local cops on the securities beat." I think of my State colleagues at NASAA as a national network of local crime fighters working to protect investors.

Securities regulation is a complementary regime of both State and Federal securities laws, and we work closely with our Federal counterparts to uncover and prosecute violators of those laws.

States have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious jail time for securities-related crimes. Over the past few years, ranging from 2004 through 2009, State securities regulators have conducted nearly 14,000 enforcement actions, which led to $8.4 billion ordered returned to investors. And, we have worked to secure convictions for securities laws violators resulting in more than 6,000 years in prison.

Traditionally, State securities regulators have pursued the perpetrators at the local level who are trying to defraud the "mom and pop" investors in your States. That allows the SEC to focus on the larger, more complex fraudulent activities involving the securities market at a national level.

Even so, States have successfully exposed and addressed the conflicts of interest among Wall Street stock analysts by requiring changed behavior. We led all regulators on late trading and market timing in mutual funds. And State securities regulators continue to lead the nationwide effort to address problems related to the offer and sale of auction rate securities, an effort that has resulted in the largest return of funds to investors in history. As regulators, we are convinced that every investor deserves protection and an even break.

Enhanced Investor Protections in Dodd-Frank

As we enter our second century of investor protection, State securities regulators are at the forefront of investor protection. By passing and signing the Dodd-Frank legislation into law, President Obama and Congress signaled the beginning of a new era of investor protection and financial market oversight. Reforms now taking shape at the national level are giving new authority to State securities regulators to address the challenges facing 21st century investors.

Trust in the markets must be restored if our system of capital formation is to thrive. The Dodd-Frank Act helps restore investor trust by enacting a number of much-needed investor protections that empower State securities regulators to protect citizens from fraud and abuse in the financial markets.

Reducing Investor Risk in Rule 506 Offerings

Section 926 of the Dodd-Frank Act took a necessary first step toward reducing risks for investors in private offerings by requiring the SEC to issue rulemaking excluding securities law violators from utilizing the Regulation D, Rule 506 exemption ("Rule 506") from securities regulation. In 1996, the National Securities Markets Improvement Act dramatically curtailed the authority of State securities regulators to oversee these unregistered private offerings. Rule 506 offerings are also exempted from Federal oversight and the SEC generally does not review them, so they receive virtually no regulatory pre-screening.

These unregistered private offerings naturally have become a favorite vehicle for unscrupulous promoters, who use the Rule 506 exemption to fly under the radar. In 2009, more than 26,000 of these offerings were filed with the SEC with an estimated offering total of $609 billion. Section 926 took the important step of ensuring that promoters and brokers who have a criminal or disciplinary history will no longer be able to prey on investors by using this exemption from registration.

We appreciate the inclusion in the Dodd-Frank Act of the so-called "bad actor" disqualifier language to prevent recidivist securities law violators from conducting securities offerings under Rule 506. However, we continue to believe the best way to deter fraud is to fully reinstate State authority over these unregistered offerings through the repeal of Subsection 18(b)(4)(D) of the Securities Act of 1933. Allowing State securities regulators to review these offerings provides regulators with a powerful weapon to detect and prevent fraud.

As required under Section 926, the SEC recently proposed rules mandated by the Dodd-Frank Act to disqualify known securities law violators from using the exemption contained in Regulation D, Rule 506. The proposed rules protect investors without hampering legitimate capital-raising by disqualifying felons and other "bad actors" from evading registration and review. Under the proposal, an offering would not qualify for the exemption from registration if the company issuing the securities or any other person covered by the rule had a specified "disqualifying event."

NASAA is a long-time supporter of the adoption of disqualification provisions for securities offerings under Rule 506. We commend the SEC for proposing disqualification provisions that are in line with many of our concerns and will continue to work with the SEC to strengthen the proposal.

Strengthening the "Accredited Investor" Standard

Private offerings were originally intended only for institutional investors and sophisticated individuals who were presumed capable of assessing risks and making investment decisions without the benefit of regulatory review and registration. The "accredited investor" standard, which sets out certain financial thresholds that must be met before an investor can purchase private offerings, was adopted as a means of assessing which investors could presumably fend for themselves. The standard as adopted by the SEC in 1982 has remained unchanged. Inflation has severely diminished the standard and eroded the investor protection goals it was meant to serve. To make matters worse, investors, and particularly retirees, with much of their net worth tied to their homes have been able to meet these diminished standards and purchase risky private placements that they may not fully understand.

NASAA has long advocated for adjusting the definition of "accredited investor" in light of inflation and has expressed concern at the length of time the thresholds contained in the definition have remained static.

Section 412 of the Dodd-Frank Act addressed this problem by adjusting the financial thresholds in the definition of an "accredited investor", and by removing the value of the investor's primary residence from the net worth calculation. Dodd-Frank also directs the SEC, 4 years after enactment, and once every 4 years thereafter, to review the definition of "accredited investor" to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy. Upon completion of the review, the SEC may adjust the other economic elements of "accredited investor".

Raising the standard for individual investors will provide greater protection for investors and will aid State regulators in enforcement activities by furthering more accurate suitability determinations for those individuals who choose to take greater risks by investing in unregistered securities.

Expanding State Oversight of Investment Advisers with the IA "Switch"

The oversight of investment advisers has always been a partnership between State and Federal regulators, both of which are directly accountable to the investing public. Congress recognized the strong record of the States in this area when it enacted Section 410 of Dodd-Frank to expand State authority to include mid-sized investment advisers with $25 million to $100 million in assets under management.

By the time this provision takes effect in mid-2012, State securities regulators will oversee the majority of all registered investment adviser firms. Having the States assume responsibility for mid-sized advisers will allow the SEC to focus on larger advisers. Investors will benefit from this change because it will enable the SEC to focus on the largest investment advisers, while mid-sized and smaller advisers will be subject to the strong State system of oversight and regulation.

States continue to prepare to receive oversight of approximately 3,200 mid-sized investment advisers from the SEC. Over the past year, NASAA members have been hosting a series of workshops for investment advisers in their jurisdictions. This outreach program is helping to educate federally regulated advisers about State registration and examination requirements. In addition, NASAA developed a memorandum of understanding calling for State securities agencies, when necessary, to assist one another with examinations of investment advisers. This MOU embodies the long-standing practice among NASAA members to work together to protect investors. NASAA members are actively engaged in sharing resources, including staff expertise, in an effort to bolster examination programs.

Last month, the SEC extended its timeline for this "investment adviser switch" from later this year into the middle of 2012 to accommodate the reprogramming of the Investment Adviser Registration Depository (IARD) system and to give investment advisers sufficient time to transition from SEC to State registration. NASAA remains committed to coordinating the actions of the States in response to the SEC's timetable and we will continue to work with the SEC, as well as industry, to see that the switch by investment advisers from SEC regulation to State regulation goes as efficiently and seamlessly as possible.

Extending the Fiduciary Duty

State securities regulators routinely see the financial devastation caused when the interests of investors do not come first. That is why NASAA has consistently urged policymakers to protect investors by requiring all who provide investment advice about securities to be held to the fiduciary duty currently applicable to investment advisers under the Investment Advisers Act of 1940.

Section 913 of the Dodd-Frank Act called for the SEC to examine the obligations of brokers, dealers, and investment advisers. We support the recommendations of the SEC staff report to apply a fiduciary duty to broker-dealers who provide personalized investment advice about securities to retail customers and believe it will have a significant positive impact on investors. NASAA looks forward to assisting the Commission as it develops rules to apply a fiduciary standard of care and loyalty to all who provide investment advice to ensure that this standard is as strong as the existing fiduciary duty of the Advisers Act.

Delays to Important Investor Protections

As with the fiduciary duty provision, Dodd-Frank shifts the ultimate responsibility to decide whether, and in what form, several important investor safeguards will be delivered. For example, the SEC and the Commodity Futures Trading Commission were given broad and sorely needed regulatory authority over certain segments of our marketplace, such as over-the-counter derivatives and private funds.

Yet in spite of their increased responsibility, the agencies are operating at inadequate funding levels. NASAA has consistently urged Congress to support funding the SEC at the level requested by the Administration so that the agency can fully implement its responsibilities mandated by Dodd-Frank. We support funding the SEC at the $1.3 billion level authorized by Dodd-Frank to carry out the functions, powers and duties of the Commission for FY 2011.

Giving Investors a Voice at the SEC

The SEC has already deferred action on a number of new activities, such as the creation of the Office of Investor Advocate and the Investor Advisory Committee. In

2009, the SEC established an Investor Advisory Committee to provide the Commission with a variety of viewpoints regarding its regulatory agenda. The committee included a State securities regulator, along with other investor advocates, to make certain that all SEC regulatory actions serve the best interests of investors.

This committee wound down in anticipation that legislation, ultimately the Dodd-Frank Act, would resurrect it under a statutory mandate. Indeed, Section 911 of the Dodd-Frank Act did require the SEC to establish and maintain a committee of investors to advise the SEC on its regulatory priorities and practices and also designated that a State securities regulator continue to serve as a member. SEC Commissioner Luis Aguilar recently said that this committee is of "critical importance to ensuring that the SEC is focused on the needs and the practical realities facing investors." Unfortunately, budget uncertainty has forced the SEC to defer the creation of the Investor Advisory Committee.

Providing Choice of Forum for Investors and Promoting Transparency

Every year thousands of investors file complaints against their stockbrokers. Almost every broker-dealer presently includes in their customer agreements a mandatory pre-dispute arbitration provision that forces those investors to submit all disputes that they may have with the brokerage firm or its associated persons to mandatory arbitration. If cases are not settled, the only alternative is arbitration. For all practical purposes, the only arbitration forum available to investors is one administered by the Financial Industry Regulatory Authority (FINRA).

Arbitration has been presented to the investing public as an inexpensive, informal, totally private process that results in a speedy resolution of cases. However, the mandatory arbitration provisions in contracts take away the ability of a harmed customer to "have their day in court" by forcing investors into a forum that limits discovery, reduces the pleading standards and allows decisions in which there is severely limited appeal. Arbitration as it exists does not treat the investing public fairly. If the system were a level playing field, arbitration probably would not be a universal requirement of the brokerage industry, and the investing public likely would embrace it voluntarily. Not surprisingly, studies have confirmed the belief that the securities arbitration forum is not perceived as fair to investors, and recovery rates in fact favor the securities industry.

In February, the SEC approved a FINRA rule proposal that would allow all investors filing arbitration claims the option of having an all-public panel, thus expanding a pilot program to all investor claims. Historically, the panels had been comprised of two public arbitrators and an arbitrator who had worked in the securities industry. The FINRA rule change was an important step toward leveling the playing field for investors and improving the integrity of the arbitration system. However, with the economy as it is today, investor confidence remains very low. Another major step in restoring investor confidence and industry integrity would be to restore investor choice in their agreements with their brokerage firm.

Section 921 of Dodd-Frank provides the SEC with rulemaking authority to prohibit, or impose conditions or limitations on the use of mandatory predispute arbitration agreements if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors. Pursuant to this provision, Congress should urge the SEC to use the authority provided the agency in Section 921 and impose rules prohibiting the mandatory nature of predispute securities arbitration. This would allow investors the choice they ought to have between arbitration and litigation in an independent judicial forum.

Funding the Grant Program to Safeguard Senior Investors from Unqualified Advisers

One of the highest priorities of NASAA's membership is to protect vulnerable senior investors from investment fraud. We have long been concerned with the use of misleading professional designations that convey an expertise in advising seniors on financial matters. Many of these designations in reality reflect no such expertise. Our concern led us to promulgate a model rule designed to curb abuses in this area, and 27 States have adopted rules or laws governing the use of these designations.

Section 989A of Dodd-Frank recognizes the harm to seniors posed by the use of such misleading activity and establishes a mechanism for providing grants to States as an incentive to adopting provisions meeting the minimum requirements of NASAA's model rule on the use of designations in the offer or sale of securities or investment advice. The law provides parallel incentives for States that have adopted provisions meeting the minimum requirements of the National Association of Insurance Commissioners' model rule on the use of senior designations in the sale of life insurance and annuities.

The grants are designed to give States the flexibility to use funds for a wide variety of senior investor protection efforts, such as hiring additional staff to investigate and prosecute cases; funding new technology, equipment, and training for regulators, prosecutors, and law enforcement; and providing educational materials to increase awareness and understanding of designations.

Unfortunately, disputes over the funding and leadership of the Consumer Financial Protection Bureau ("CFPB") not related to investor protection have indefinitely delayed the creation of the senior investor protection grant program under Section 989A. The CFPB Office of Financial Literacy must be fully funded and operational to begin issuing grants of up to $500,000 to States that have adopted the NASAA and NAIC model rules on misleading senior designations. These important senior investor protections should not be delayed because Congress has not provided sufficient funding for the Federal financial regulatory agencies.

Conclusion

As discussed above, the Dodd-Frank Act provides meaningful, tangible benefits to investors. It requires the SEC to raise standards that are long overdue and blocks fraudulent actors from taking advantage of exemptions that should be reserved for reputable issuers. The Dodd-Frank Act empowers the SEC to raise the standards under which broker-dealers provide investment advice to ensure that the interests of investors come first. The law also recognizes the investor protection contributions of State regulators by increasing our authority over the regulation of investment advisers and by ensuring we have a voice on both the SEC's investor advisory committee and the Financial Stability Oversight Council. I am honored to serve on the FSOC along with my State banking and insurance colleagues. State regulators bring to the FSOC the insights of "first responders" who see trends developing at the State level that have the potential to impact the larger financial system.

I want to thank Chairman Johnson for his consistent support for the important investor protections included in the Dodd-Frank Act. I appreciate your comments, Senator Johnson, that it "would be dangerous and irresponsible," to rollback these hard-won reforms.

Our message to Congress is simple and clear: Please continue your commitment to protecting investors and do not undermine the Dodd-Frank Act's regulatory authority either directly through legislative repeals or indirectly through a lack of appropriate funding or delayed execution.

We look forward to working cooperatively with the Senate Banking Committee, as well as all Members of Congress and fellow regulators to ensure full implementation of the investor protections included in the Dodd-Frank Act.

PREPARED STATEMENT OF LYNNETTE KELLY HOTCHKISS

EXECUTIVE DIRECTOR, MUNICIPAL SECURITIES RULEMAKING BOARD

JULY 12, 2011

Good morning Chairman Johnson, Ranking Member Shelby and Members of the Committee. I appreciate the invitation to testify today on behalf of the Municipal Securities Rulemaking Board.

Since the MSRB was created by Congress in 1975 as the principal regulator for the municipal securities market, the MSRB has placed investors front-and-center in all of our market initiatives. Through our rulemaking over municipal market intermediaries as well as our ground-breaking market information systems, we have put in place protections for the significant U.S. retail market for municipal securities.[1]

While the MSRB's original jurisdictional authority was limited to the regulation of broker-dealers and banks that buy, sell, trade and underwrite municipal bonds (referred to herein as "dealers") with the principal purpose of protecting investors, Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) greatly expanded our ability to protect investors and increased our responsibilities to the marketplace by vesting us with the duties of regulating municipal advisors and protecting State and local government issuers, public pension plans and obligated persons. Over the past year, the MSRB has undertaken substantial rulemaking and transparency efforts to promote high standards of professional conduct and market disclosure aimed at creating conditions for fair, well-informed financial decisions by all market participants.

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[1] The size of the municipal market is approximately $3.7 trillion. *See* Bloomberg L.P., *Municipal Market: Bloomberg Brief* (June 21, 2011). It is estimated that approximately two-thirds of the municipal market is comprised, directly or indirectly, of retail investors. *See* SIFMA Statistics, U.S. Municipal Securities Holders, Quarterly Data to Q1 2011.

The MSRB cannot act as a guarantor against poor decisions by either investors or issuers, or guard against the occurrence of adverse events in the market. However, we believe that a principles-based approach to regulating market intermediaries leads to the best possible outcome in terms of market fairness and efficiency. Key elements to ensuring such a fair and efficient market are such principles as suitability, disclosure, pricing and liquidity for investors. These elements also can have a substantial impact on the taxpayer's wallet and the public's confidence in the municipal market.

Since Dodd-Frank was signed into law, the MSRB has been operating under the leadership of its first majority-public Board of Directors, which represents the interests of the public and municipal market investors and issuers, in addition to regulated entities. This public Board has moved decisively but carefully to put in place safeguards that more fully protect the municipal market that is so fundamental to the public interest.

Since last October, MSRB rulemaking initiatives have addressed fiduciary duty, fair dealing, municipal advisor registration, pay-to-play, gift-giving and supervision. We are also developing municipal advisor professional qualifications requirements, including appropriate licensing examinations, and have enhanced our Electronic Municipal Market Access (EMMA) Web site to allow investors unprecedented access to market data and disclosures. These are the initiatives I would like to discuss with you today.

The Dodd-Frank Act and the Municipal Market

First, I would like to address the impact of the Dodd-Frank Act on the municipal market. This piece of legislation represents the most significant change affecting the municipal market since 1986—including key changes in the regulatory landscape for municipal advisors,[2] asset-backed securities,[3] credit rating agencies[4] and derivatives.[5] Furthermore, to our knowledge, this is the first time Congress has enacted a law to protect issuers of securities.[6]

The MSRB's expanded authority falls under Title IX of the Dodd-Frank Act, which covers investor protections and improvements to the regulation of securities intermediaries. The Dodd-Frank Act granted the MSRB regulatory jurisdiction over municipal advisors.[7] It also provides that MSRB rules for municipal advisors are to, among other things: (1) promote fair dealing, the prevention of fraudulent and manipulative acts and practices, and the protection of investors, municipal entities, and obligated persons; (2) prescribe means reasonably designed to prevent acts, practices, and courses of business that are not consistent with a municipal advisor's fiduciary duty to its municipal entity clients; (3) prescribe professional standards; (4) provide continuing education requirements; (5) provide for periodic examinations; (6) provide for recordkeeping and record retention; and (7) provide for reasonable fees and charges necessary or appropriate to defray the costs and expenses of operating and administering the Board.[8]

The establishment of a comprehensive set of rules for the activities of municipal advisors will provide significant protections to State and local governments and other municipal entities and will greatly enhance the existing protections afforded to investors beyond the protections already provided by the MSRB's longstanding investor protection rules covering broker-dealers and banks. By way of illustration, the MSRB has previously established a series of investor protection rules covering the activities of brokers marketing 529 college savings plans, which are investments sold exclusively to parents, grandparents and other retail investors, many of whom may have little or no prior experience as investors. With the enactment of Dodd-Frank, the MSRB now has authority to adopt a more comprehensive set of rules that go beyond the brokers marketing 529 plans to professionals that advise the States on the structure and related fundamental matters relating to the operation of such 529 plans that have a direct impact on investors and beneficiaries of the plans.

The MSRB has undertaken its Dodd-Frank responsibilities in a deliberate and thorough manner, recognizing that many of these financial professionals and products are falling under regulation for the first time. With respect to the Dodd-Frank provisions that affect the municipal market, but that come under the purview of other Federal regulators, the MSRB has provided input and coordinated with other

[2] Pub. L. No. 111–203 §975, 124 Stat. 1917 (2010).
[3] Pub. L. No. 111–203 §§942–943, 124 Stat. 1897 (2010).
[4] Pub. L. No. 111–203 §932, 124 Stat. 1872–1888 (2010).
[5] Pub. L. No. 111–203 §764, 124 Stat. 1785 (2010).
[6] Pub. L. No. 111–203 §975, 124 Stat. 1918 (2010).
[7] Pub. L. No. 111–203 §975, 124 Stat. 1917 (2010).
[8] Pub. L. No. 111–203 §975, 124 Stat. 1919 (2010).

municipal market authorities to create consistent and well thought-out regulatory decisions.[9] We would especially like to recognize the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority and the Commodity Futures Trading Commission in these coordination efforts.

Fiduciary Duty

I would now like to turn our attention to MSRB rulemaking efforts since the Dodd-Frank Act became effective. The Dodd-Frank Act has fundamentally altered the relationship of municipal advisors and municipal entities. As of October 1, 2010, municipal advisors owe a Federal fiduciary duty to their municipal entity clients under the Dodd-Frank Act. The MSRB has proposed a rule and interpretive guidance to provide the underpinning for this fiduciary duty.[10] The MSRB's interpretive guidance would provide that a municipal advisor has a duty of loyalty to its municipal entity client, which requires the municipal advisor to deal honestly and in good faith with the municipal entity and to act in the municipal entity's best interests. This duty of loyalty would also require municipal advisors to make clear, written disclosure of all material conflicts of interest and to receive written, informed consent from appropriate officials of the municipal entity.

The MSRB's interpretive guidance would also require municipal advisors to exercise due care in performing their responsibilities to municipal entity clients. That means that a municipal advisor should not undertake a municipal advisory engagement for which the advisor does not possess the degree of knowledge and expertise needed to provide the municipal entity with informed advice. For example, a municipal advisor should not undertake a swap advisory engagement or security-based swap engagement for a municipal entity unless it has sufficient knowledge to evaluate the transaction and its risks, as well as the pricing and appropriateness of the transaction.[11]

We believe investors will benefit from ensuring that municipal advisors act in their clients' best interest. Municipal securities offerings borne from self-interested advice or in the context of conflicting interests or undisclosed payments to third-parties are much more likely to be the issues that later experience financial or legal stress or otherwise perform poorly as investments, resulting in significant harm to investors and increased costs to taxpayers.

Importantly, under the Dodd-Frank Act, "municipal advisor" was defined to include guaranteed investment contract (GIC) brokers.[12] That means that GIC brokers now have a Federal fiduciary duty to their municipal entity clients and a duty of fair dealing to other clients, as described below. The proposed MSRB interpretive guidance on fiduciary duty would provide that they could not receive payments from other parties in return for giving them favorable treatment in what is supposed to be a competitive bidding process, even if they disclosed such payments. This is a major increase in the arsenal of enforcement agencies that, until now, have had to address this conduct through their anti-fraud jurisdiction.

We believe that the new Federal fiduciary duty, and the MSRB's proposed guidance with respect to that duty arising from our new grant of authority under Dodd-Frank, would have squarely addressed much of the wrongdoing uncovered by the SEC, Internal Revenue Service and Department of Justice in their major GIC bid rigging investigation[13] had this Dodd-Frank provision been in place when the wrongdoing occurred. In light of these allegations concerning the conduct of GIC brokers, the MSRB Board of Directors will discuss whether additional guidance specifically directed at such conduct is warranted.

[9] *See, e.g.,* MSRB Comment Letter Re: SEC Proposed Rules on Registration of Municipal Advisors, File No. S7–45–10 (February 22, 2011).

[10] MSRB Notice 2011–14 (February 14, 2011).

[11] Section 4s(h)(5) of the Commodity Exchange Act, as amended by the Dodd-Frank Act, requires that a swap dealer with a special entity client (including States, local governments and public pension funds) must have a reasonable basis to believe that the special entity has an independent representative that satisfies these criteria, among others. Section 15F(h)(5) of the Exchange Act, as amended by the Dodd-Frank Act, imposes the same requirements with respect to security-based swaps.

[12] Pub. L. No. 111–203 §975, 124 Stat. 1922 (2010).

[13] SEC Complaint ¶1, SEC v. J.P. Morgan Securities LLP, Case No. 2:11–cv–03877 (D.N.J. July 7, 2011) (alleging fraudulent bidding practices by J.P. Morgan Securities in at least 93 municipal bond reinvestment transactions); SEC Litigation Release No. 21956, Securities and Exchange Commission v. UBS Financial Services Inc. (May 4, 2011) (alleging fraudulent bidding practices by UBS Financial Services in at least 100 municipal bond reinvestment transactions); In the Matter of Banc of America Securities LLP, Exchange Act Release No. 63451 (December 7, 2010) (alleging fraudulent bidding practices by Banc of America Securities in at least three municipal bond reinvestment transactions) [hereinafter Bid Rigging Enforcement Actions].

Fair Dealing

MSRB Rule G–17 provides that, in the conduct of its municipal securities and municipal advisory activities, each dealer and municipal advisor must deal fairly with all persons and may not engage in any deceptive, dishonest or unfair practice. This "fair dealing" rule is key to defining the relationships of dealers and municipal advisors with investors and issuers, and has served as the basis for numerous enforcement actions.[14] The MSRB's rule goes further than SEC Rule 10b–5 [15] in that it imposes an affirmative duty to supply investors and issuers with disclosure about their transactions. This duty exists under the MSRB's rule even in the absence of fraud.

Last fall, the MSRB reminded dealers of their fair dealing obligations,[16] including their duty to disclose to customers all material facts known by the dealer and those reasonably accessible to the market prior to or at the time of sale of a municipal security. The MSRB also stated that firms must analyze and disclose credit risks and other material information about a bond, such as redemption options or features that would affects its tax status, in order to meet their fair dealing obligations. For example, if the credit rating of a municipal issuer was recently downgraded, the dealer must provide an investor with this information. The MSRB made clear to the dealer community the critical importance of sharing with investors such key information so they are able to make the best possible decision based on their individual circumstances and risk tolerance.

As I mentioned earlier, Congress expressly directed the MSRB in the Dodd-Frank Act to protect municipal entities.[17] As one of the MSRB's initial municipal advisor rules, the MSRB extended its fair dealing rule, MSRB Rule G–17, to cover the actions of municipal advisors.[18] The MSRB has proposed two pieces of interpretive guidance under Rule G–17, which apply this basic principle of fair dealing to municipal advisors and to underwriters of municipal securities in their interactions with municipal entities, as well as with organizations such as hospitals and colleges that borrow through municipal entities (referred to in the statute as "obligated persons").

The MSRB's proposed interpretive guidance on fair dealing obligations for underwriters [19] states that representations made by underwriters to issuers of municipal securities in connection with municipal securities underwritings must be truthful and accurate. It also requires an underwriter of a negotiated issue that recommends a complex municipal securities financing (*e.g.,* a financing involving a swap) to disclose all material risks and characteristics of the financing, as well as any incentives for the underwriter to recommend the financing and any other conflicts of interest. The guidance also contains pricing and compensation standards.

We note that, if true, the fraudulent and deceptive conduct of some major underwriters alleged to have occurred in actions brought by the SEC and Department of Justice as a result of their GIC bid rigging investigation [20] would be considered a clear violation of Rule G–17 under this proposed interpretive guidance.

The MSRB's proposed interpretive guidance on fair dealing obligations for municipal advisors [21] covers a municipal advisor's duties to obligated persons in a municipal securities or financial product transaction, as well as duties to municipal entities (such as public pension funds) when the advisor is soliciting business from a municipal entity on behalf of a third party. This guidance contains disclosure and competency requirements, as well as prohibitions on engaging in municipal advisory business in certain conflict of interest situations, such as those involving kickbacks. This interpretive guidance would offer protections to market participants when a stronger fiduciary duty does not exist.

A dealer's or municipal advisor's compliance with its fair dealing obligations to municipal entities creates uniform practices and fair pricing methods that improve market efficiency and have cascading benefits to investors in terms of receiving a fair return on their investment. We believe our revised fair dealing rule to be a pillar in investor protection.

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[14] *See, e.g.,* In the Matter of J.P. Morgan Securities Inc., SEC File No. 3–13673 (October 7, 2010) (providing a plan of final distribution for the disgorgement and civil penalty paid by J.P. Morgan Securities for violating MSRB Rule G–17 and other Federal securities laws).

[15] 17 C.F.R. § 240.10b–5, 15 U.S.C. 78j (2010).

[16] MSRB Notice 2010–37 (September 20, 2010).

[17] Pub. L. No. 111–203 §975, 124 Stat. 1918 (2010).

[18] MSRB Notice 2010–59 (December 23, 2010).

[19] MSRB Notice 2011–12 (February 14, 2011).

[20] Bid Rigging Enforcement Actions, supra note 12.

[21] MSRB Notice 2011–13 (February 14, 2011).

Pay to Play

As the first regulator to adopt a "pay to play" rule,[22] the MSRB recognized the potential for market abuse that can arise as a result of market professionals using political contributions to influence the award of business by public officials. The MSRB has curbed potential abuses by underwriters of municipal securities that made political contributions to win business and is seeking to do the same for municipal advisors.

Municipal advisors that seek to influence the award of business by Government officials by making or soliciting political contributions to those officials distort and undermine the fairness of the process by which Government business is awarded. These practices can harm municipal entities and their citizens by resulting in inferior services and higher fees, as well as contributing to the violation of the public trust of elected officials. The MSRB has proposed a rule that would, for the first time, regulate pay to play activities of firms and individuals that advise municipal entities, such as State and local governments and public pension plans, on municipal securities and municipal financial products, including derivatives.[23] The rule would also cover firms and individuals that solicit investment advisory business from municipal entities, such as public pension plans, on behalf of others.

Draft MSRB Rule G–42 would require quarterly disclosure of certain campaign contributions and would prohibit a municipal advisor from:

- Engaging in "municipal advisory business" with a municipal entity for compensation for a period of time beginning on the date of a non-*de minimis* political contribution to an "official of the municipal entity" and ending 2 years after all municipal advisory business with the municipal entity has been terminated; and
- Soliciting third-party business from a municipal entity for compensation, or receiving compensation for the solicitation of third-party business from a municipal entity, for 2 years after a non-*de minimis* political contribution to an "official of the municipal entity."

Furthermore, draft MSRB Rule G–42 would prohibit municipal advisors and municipal advisor professionals from:

- Soliciting contributions, or coordinating contributions, to officials of municipal entities with which the municipal advisor is engaging or seeking to engage in municipal advisory business or from which the municipal advisor is soliciting third-party business;
- Soliciting payments, or coordinating payments, to political parties of States or localities with which the municipal advisor is engaging in, or seeking to engage in, municipal advisory business or from which the municipal advisor is soliciting third-party business; and
- Committing indirect violations of Rule G–42.

MSRB pay to play restrictions have served as a model for Federal and State regulators imposing restrictions on pay to play activities in other areas and play a vital role in preserving market integrity. The MSRB has served as a key resource to such other regulators as they have developed and administered their rules.

Gifts

Gifts to employees controlling the award of municipal securities business by market professionals can similarly harm investors. The MSRB limits these gifts by dealers and recently proposed to extend the restrictions of MSRB Rule G–20 to municipal advisors.[24] Just as the existing rule helps to ensure that dealers' municipal securities activities are undertaken in arm's length, merit-based transactions in which conflicts of interest are minimized, amendments to Rule G–20 would help to ensure that engagements of municipal advisors, as well as engagements of dealers, municipal advisors, and investment advisers for which municipal advisors serve as solicitors, are awarded on the basis of merit and not as a result of gifts made to employees controlling the award of such business.

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[22] MSRB Rule G–37 was adopted by the MSRB in 1994 due to concerns about the opportunity for abuses and the problems associated with political contributions by dealers in connection with the award of municipal securities business, known as "pay to play." *See* MSRB Reports, Volume 14, Number 3 (June 1994).

[23] MSRB Notice 2011–04 (January 14, 2011).

[24] MSRB Notice 2011–16 (February 22, 2011).

Supervision

The establishment of a basic supervisory structure for municipal advisors is particularly important as the MSRB adopts new rules for municipal advisors that municipal advisors must understand and comply with in order to avoid possible enforcement actions and to effectively put in place practices that serve to protect investors. The MSRB recently requested comment on a supervisory rule, draft MSRB Rule G–44, to require that each municipal advisor firm establish a supervisory structure to oversee compliance with applicable MSRB and SEC rules.[25]

Draft Rule G–44 would require a municipal advisor to establish and maintain a system to supervise the municipal advisory activities of each associated person designed to achieve compliance with applicable rules. Draft Rule G–44 would also require municipal advisors to adopt, maintain and enforce written supervisory procedures designed to ensure that the conduct of the municipal advisory activities of the municipal advisor and its associated persons are in compliance with applicable rules.

Board of Directors

The new composition of the MSRB's Board of Directors has assisted us in carrying out our regulatory actions over the past year. The Dodd-Frank Act requires the MSRB's governing Board to be majority-public and to include municipal advisors.[26]

On October 1, 2011, the MSRB seated a 21-member Board with a majority of public members, including three municipal advisors.[27] The Board also includes representatives of issuers and investors, as well as members representing securities firms and banks. We have a newly structured majority-public Nominating Committee chaired by a public member.

We believe this Board of Directors reflects the benefits of a self-regulatory organization and, at the same time, the wisdom of increasingly diverse and public membership. Our rulemaking—and the public's interest—has benefited from the many perspectives offered by our Board members. The Board vigorously debates issues, carefully considers the experience and insight of each of its members and then proceeds with the best possible course of action. We believe the progress we have made over the last 9 months in further protecting the market has been unprecedented.

The rules I have mentioned are just a small part of the regulatory backbone that helps support a fair and efficient municipal market.

Professional Qualifications

It is vital to our mission that municipal market professionals can competently provide their services to investors and municipal entities. The MSRB Professional Qualification Program fosters competency of municipal professionals and compliance with MSRB rules through required examinations and continuing education. The Dodd-Frank Act requires the MSRB to set standards of professional qualification for municipal advisors.[28] The MSRB has been conducting outreach events and focus groups to gather input from municipal advisors and others about the development of a professional qualification examination to assess the competency of entry-level municipal advisors.

The MSRB recently organized a municipal advisor examination working group to consider all comments received by the MSRB, assess commonalities in municipal advisory activities and provide additional input. The working group expects to survey registered municipal advisors about the proposed examination content in late 2011 and use the results of the survey to prepare a draft examination content outline. We will continue to keep interested parties apprised of our progress in this area as we proceed.

EMMA and Market Transparency

I would now like to discuss another top priority of the MSRB—market transparency. Beginning as a pilot program in 2008, our EMMA system, at *www.emma.msrb.org,* has transformed the transparency of the municipal market. Any investor can now access from anywhere hundreds of thousands of disclosure documents and real-time trading information on 1.5 million outstanding municipal bonds. We provide all of this information to the public for free.

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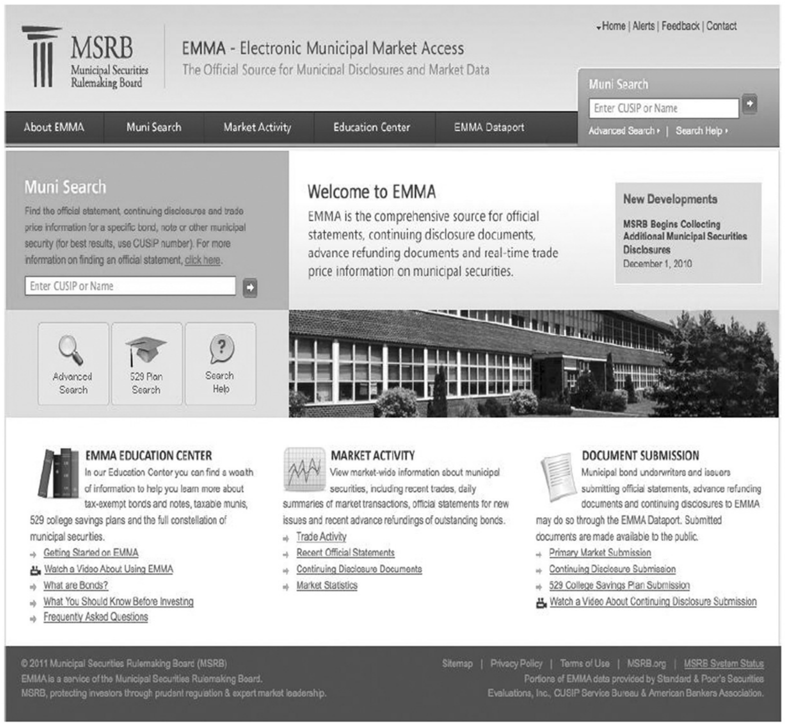
[25] MSRB Notice 2011–28 (May 25, 2011).
[26] Pub. L. No. 111–203 §975, 124 Stat. 1917 (2010).
[27] MSRB Press Release, MSRB Assumes Expanded Mission and Establishes Public Majority Board of Directors (October 1, 2010).
[28] Pub. L. No. 111–203 §975, 124 Stat. 1919 (2010).



www.emma.msrb.org

EMMA was created for the purpose of providing retail investors with easy access to key market information that was previously unavailable or difficult to find. Retail investors are heavily involved in the municipal market, with retail trades (generally viewed as trades of $100,000 or less) accounting for over 80 percent of the approximately 7.3 million customer transactions in municipal securities over the past year.[29] The MSRB's EMMA Web site supports well-informed decisionmaking by these investors.

Over the past year, the MSRB has greatly expanded the amount and type of information available to investors on EMMA. The MSRB began providing interest rate information on EMMA about auction rate securities (ARS) and variable rate demand obligations (VRDO) in 2009, after instability in these markets raised significant disclosure and market transparency concerns. Today EMMA remains the only source of current, market-wide interest rates for variable rate securities available to the general public. In May 2011, the MSRB enhanced EMMA to provide public access to key ARS auction and VRDO liquidity information, including actual copies of liquidity documents such as a letter of credit. Providing investors with easy access to these documents and data increases their ability to make informed decisions about investing. The MSRB testified before you in 2009 regarding our plans to increase the information and documents available about ARS and VRDOs[30] and I am happy to report that this increased transparency has been accomplished.

EMMA also is a tool for issuers to communicate important information about their bonds and their finances to investors. The MSRB received requests from State and local government issuers to provide the ability for issuers to voluntarily post pre-

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[29] This statistical information may be found by searching EMMA's Market Statistics tab at *http://emma.msrb.org/MarketActivity/ViewStatistics.aspx.*

[30] *Transparency and Regulation in the Municipal Securities Market Hearing Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs* (2009) (statement of Ronald A. Stack, Chair, Municipal Securities Rulemaking Board).

liminary official statements to EMMA. We are happy to announce that, as of May 2011, we have made this possible. Preliminary official statements can provide potential investors with the details of a new issue before it comes to market. Issuers in several States have already taken advantage of this new EMMA feature—including South Carolina, Utah, Kentucky, Florida and Wisconsin—and we expect its use to increase over time.

As part of its investor protection rules, the MSRB requires timely disclosure by our regulated entities and promotes good continuing disclosure practices by issuers. Issuers provide some types of continuing disclosure information under SEC Rule 15c2–12. The MSRB has added the ability for issuers to submit numerous voluntary disclosures that go beyond this SEC baseline. Most recently, the MSRB enhanced EMMA to allow issuers to submit information about the timing and accounting standard used to prepare annual financials. This helps investors acquire a more complete picture of the issuers and issues in which they are investing. As EMMA provides a centralized location for disclosures, investors and others interested in the disclosure practices of issuers and trading activity of bonds can easily use EMMA to access and compare the available information.

The MSRB will continue to improve EMMA. This fall, EMMA will display credit ratings from one or more of the Nationally Recognized Statistical Rating Organizations. These ratings will be available on the EMMA Web site, for free, and updated in real-time.

Conclusion

The municipal market funds much of this nation's health, education and transportation infrastructure. It is the MSRB's role to balance and protect the competing interests in this public-purpose market. Where we have the jurisdiction and ability to act, the MSRB has raised the bar on professional conduct by financial professionals and advanced market transparency in many significant ways. The benefits of these efforts ultimately flow to the investor and taxpayer.

The MSRB is dedicated to a thoughtful, thorough rulemaking process that involves significant input from municipal market participants. We depend on input from investors, issuers, industry members and others to ensure MSRB rules are timely and appropriate. We believe that this widespread participation in rulemaking makes both the process and the product at the MSRB as balanced as possible and in the best interests of investors and municipal entities.

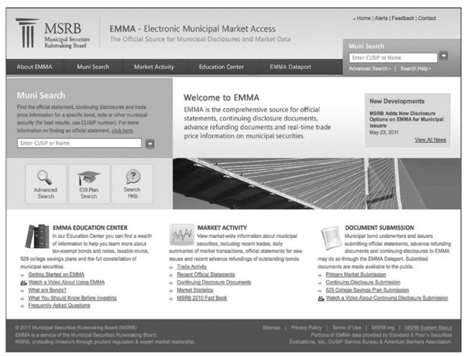
We believe we not only have a responsibility to write regulations and provide transparency, but also a corresponding responsibility to educate market participants on the progress of these efforts. Since the Dodd-Frank Act, the MSRB has conducted outreach events across the country to provide a forum for education and input regarding our new mission and jurisdiction. We appreciate the opportunities provided by the Dodd-Frank Act to improve the municipal market and look forward to continuing to work with Congress, industry members, issuers and investors with this goal in mind.

I thank you again for the invitation to speak today and will take any questions you may have.

MSRB
Municipal Securities Rulemaking Board

Municipal Market Transparency

By using our EMMA website, every investor can make an informed decision about buying municipal bonds — just as consumers use the Internet to determine the price and quality of other products.

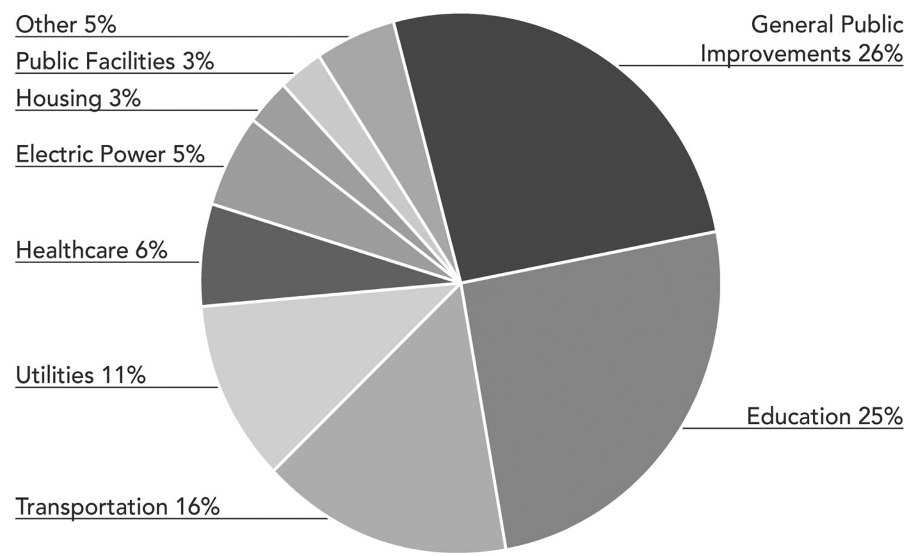


- Investors can read the terms and features of a bond to decide whether to make a purchase.
- State and local governments provide financial updates and other information that can affect their ability to repay bondholders.
- Investors can see bond prices and interest rates in real time to make trading decisions.

emma.msrb.org

MSRB Municipal Securities Rulemaking Board

How Do State and Local Governments Use Bond Proceeds?

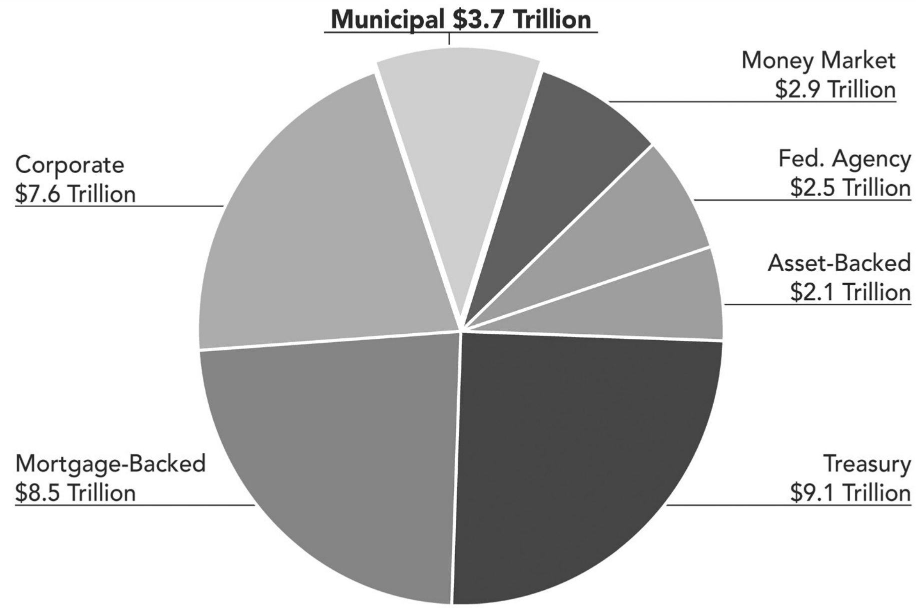


$342 Billion Issued Since Dodd-Frank Enacted

Source: Thomson Reuters

MSRB
Municipal Securities Rulemaking Board

Municipal Bonds Make Up a Significant Share of the US Bond Markets



$3.7 Trillion in Outstanding Municipal Bonds in 2011

Source: Federal Reserve, Bloomberg, US Treasury and US Agencies

PREPARED STATEMENT OF HARVEY L. PITT[1]

FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

JULY 12, 2011

Introduction

Chairman Johnson, Ranking Member Shelby, Members of the Committee:

I am pleased to appear before you today to respond to this Committee's invitation to testify about the critical issue of "Enhanced Investor Protection After the Financial Crisis." The financial crisis that began in 2007–2008 was, as we know only too well, one of the worst economic collapses this Country has experienced. The failures that led to that collapse are manifold, but principal among them, in my view, was the failure of our regulatory system (and financial regulators) to respond effectively, efficiently and with alacrity to both the warning signs that a crisis was imminent, and to cabin what eventually became a full-blown crisis.

Thus, I strongly believe this Country needed (and still needs) to reform its financial regulatory apparatus, and that was clearly the impetus behind the adoption and enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("D–F"). The Committee has specifically requested that testimony today focus on Titles IV and IX of D–F, which were intended, among other things, to enhance "investor protection." While Congress' intent in passing D–F was laudable, and while there was a compelling need to reform our financial regulatory system, D–F unfortunately did not provide the regulatory reform that our financial and capital markets, and those who invest, so urgently needed, and still require.

Notwithstanding my belief that D–F falls short of what we need, I believe the principal effort at this point should be to figure out what it will take to make the substance of D–F workable. Thus, my testimony is directed at the changes needed to enable D–F to fulfill its goals, without incurring many of the unintended consequences that I believe plague so much of this legislation. The views I set forth are solely my own, formed on the basis of an aggregate of over 43 years experience in the financial and capital markets, both as a regulator, as a counselor to those in the financial services industry and, for the past 8 years, as the Chief Executive Officer of Kalorama Partners, LLC and its law-firm affiliate, Kalorama Legal Services, PLLC.[2] My views do not reflect the views of any past or current clients of the Kalorama firms, and do not reflect the views of the SEC.

Summary

There is no question that, in the wake of the financial crisis that began in 2007–2008, financial regulatory reform was needed. We needed a more nimble regulatory regime. However, the legislation passed nearly 1 year ago did not provide the reform the Country needed. While this is not the forum in which to revisit all the problems with D–F, in brief, I believe the Country required that financial regulatory reform provide three critical elements:

- A steady flow of significant, current information on the activities of anyone playing a meaningful role in our financial and capital markets;
- The imposition on Government of a duty to analyze the information it receives to discern trends and developments, along with the obligation to publish, generically, the trends and developments Government discerns; and
- The grant to the Government of the ability to create so-called tripwires, so that as trends start to become apparent, Government can halt those trends until it determines (subject to appropriate Congressional oversight) whether these trends are potentially harmful and, if so, what steps should be taken to cabin their further development.

D–F did not achieve these goals. Worse, the Act is unduly complex, adds more layers of regulatory bureaucracy to an already over-bloated bureaucracy, makes financial regulation more cumbersome and less nimble than it already was, and contains the seeds for destroying the independence of three regulators whose independ-

[1] Mr. Pitt is the Chief Executive Officer of Kalorama Partners, LLC, and its law-firm affiliate, Kalorama Legal Services, PLLC. Prior to founding the Kalorama firms in 2003, Mr. Pitt served as Chairman of the U.S. Securities and Exchange Commission (2001–2003), was a senior corporate law firm partner (1978–2001), and served for over 10 years as a member of the Staff of the SEC (1968–1978), the last 3 years of which he served as the Agency's General Counsel.

[2] As a matter of policy, the Kalorama firms do not engage in adversarial efforts *vis-a-vis* the SEC; rather, they assist companies, firms, governmental entities and individuals that are committed to enhancing their fidelity to important fiduciary and governance principles, internal controls and compliance programs.

ence was always a strength of our existing regulatory system-the Federal Reserve Board, the SEC, and the CFTC.[3]

Notwithstanding these impediments, the SEC and other financial regulators have been working assiduously to adopt hundreds of new rules, and produce a plethora of written studies, often without being afforded the necessary time to achieve the demands imposed by D–F, including rules to implement provisions under Titles IV and IX of D–F—the Committee's current focus—as well as Title VII and other provisions of the Act, and many more rules are in process. While the SEC has valiantly attempted to address, through its rulemaking, many of the concerns that I and others have raised regarding the potential for mischief contained within the 2,300+ pages of D–F, there is only so much the Agency can, or should, do once Congress has expressed its judgment on important policy issues.

Without attempting to be exhaustive regarding the myriad problems I perceive in Titles IV and IX of D–F, there are four provisions that particularly deserve this Committee's attention if D–F is to serve its intended investor protection purposes:

- The expansion of the SEC's examination and regulatory responsibilities over hedge funds, private equity firms, and some venture capital firms (as well as enhanced obligations regarding credit ratings agencies) that the SEC cannot possibly fulfill given the current wording of D–F and the lack of appropriate resources;
- The establishment of a whistleblower "bounty" program that:
  - creates negative incentives that threaten to undermine corporate compliance programs;
  - threatens to make every "tip" of which both the SEC and private sector firms become aware a "Federal case"; and
  - sets the SEC up for failure by likely causing it to be inundated with a slew of "tips," without giving it the resources necessary to "separate the wheat from the chaff";
- Corporate governance provisions that:
  - intrude on the traditional province of State corporate law;
  - favor certain special interests at the expense of rank and file shareholders; and
  - impose significant unanticipated costs on corporations, and thus shareholders; and
- Provisions that establish a new Office of Investor Advocate that:
  - Undermine the authority not only of the Staff but of the Commission itself with respect to both enforcement and rulemaking decisions; and
  - Create a potentially divisive source of internal second-guessing that may actually slow down, rather than facilitate, regulatory reforms that protect retail investors.

Discussion

1. Increasing the SEC's Examination Responsibilities

As a result of Title IV of D–F, and especially D–F §§402 & 403, the SEC's jurisdiction over hedge funds, private equity funds and certain venture capital firms has increased exponentially. While there is a paucity of precise data, it appears that, as of the end of 2009, there were over 9,000 hedge funds in existence.[4] The Commission already oversees approximately 11,000 registered investment advisers and 6,000 registered securities broker-dealers, beyond which D–F imposes on the SEC new oversight responsibilities for credit ratings agencies, municipal securities dealers and a host of swaps professionals and participants.

Putting to one side the substance of D–F's creation of a new regulatory regime for hedge funds and other private fund investment advisers,[5] the grant of this au-

[3] Through the creation of the Financial Stability Oversight Council, which is led by the Treasury Secretary, the independent views of the Fed, the SEC and the CFTC, as well as their functions, can effectively be overridden.

[4] *See* IFSL Research, "Hedge Funds 2010" (Apr. 2010), *available at http://www.scribd.com/doc/36124567/Hedge-Funds-2010.*

[5] Because hedge funds were, initially, marketed only to highly sophisticated investors, in denominations that placed these funds beyond the reach of ordinary investors, it was not deemed sufficient to require detailed regulation of those who managed these funds. As hedge fund advisers have become publicly traded entities, and pension funds have turned more and more frequently to hedge funds to increase their returns, this justification for the absence of regulation

Continued

thority begs the question: How will the SEC exercise its oversight and compliance examination responsibilities once it has registered these new entities? It seems rather clear that the SEC's own compliance and examination efforts cannot match the number of entities requiring examination, or the sophistication and diversity of investment strategies with which the SEC's Staff will be confronted. Despite promises of new funding that were made when D–F was first enacted, the current budget crisis makes it impossible that the Commission will have sufficient resources to enable it to:

- Develop the necessary expertise to permit it to examine an additional 9–10,000 new entities subject to its jurisdiction;
- Deploy such expertise as it has to perform regular compliance examinations; or
- Provide investors with appropriate confidence that the funds in which they invest are subject to extensive compliance oversight by the Federal Government.

In February 2003, under my direction, the SEC proposed to require all investment advisers to undergo an exemption every year, or in the case of smaller advisers, every 2 years, by an independent, expert, private-sector entity that would perform a detailed compliance "audit" akin to the annual financial audits performed by independent outside public accounting firms.[6] The Commission would define requisite independence and expertise, and would dictate the substance of the annual (or biennial) compliance audit, and these audits would result in the preparation of a detailed report of findings that would be submitted both to the SEC and to the governing board of the funds whose advisers are examined.

Although this is a proposal that could address the serious problems that inhere in the SEC's existing compliance examination process, this proposal—or anything comparable—has not yet been adopted by the Commission. It is, in my view, long overdue, and should be mandated by Congress, to reduce the likelihood of future "Madoff-like" situations.[7]

2. Whistleblower Provisions

D–F §922 creates a new SEC whistleblower program that was intended to increase both the number and quality of "tips" received by the SEC from anyone who becomes aware of "possible" misconduct that could adversely affect our capital markets. It cannot be gainsaid that a well-designed whistleblower program that achieves the goal of providing the Commission with better access to quality indications of potential wrongdoing is a proposal that could benefit investors enormously. But, as D–F was enacted, this provision threatens to undermine corporate governance, internal compliance and the confidence of public investors in our heavily regulated capital markets.

a. Impact on Corporate Governance and Internal Compliance Programs

Over the last half-Century, great strides have been taken to provide investors with the most valuable first-line of defense against securities fraud and other forms of misconduct—internal corporate governance has been improved to ensure that corporate employees inculcate and adhere to proper values, while internal compliance processes at the firms of securities professionals have been strengthened and expanded to nip nascent potential frauds in the bud. While it is undoubtedly beneficial to encourage those who become aware of possible misconduct to report *to their firms and corporations* any perceived instances of misconduct, and to encourage those firms and corporations to inquire into perceived instances of misconduct, D–F and the rules it compelled the SEC to adopt threaten to have exactly the opposite effect.

D–F, and the SEC rules adopted under it on May 25, 2011, may incentivize tipsters to submit unsupported—and possibly speculative or even frivolous—"tips" directly to the SEC, rather than to the companies or firms to which their "tips" relate. More significantly, the system created threatens to divert the SEC Staff's attention away from more productive investigations. This is a logical outcome of the fact that the D–F whistleblower provisions give *formal* legal *rights* to those who claim their "tips" were significant factors in the SEC's ability to recover monetary payments in excess of $1 million, as a result of alleged securities-related misconduct. I believe

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disappeared. But, no nexus has ever been suggested between the economic crisis that began in 2007–2008 and the market/investment activities of hedge funds.

[6] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Rel. No. 25925, Investment Advisers Act Rel. No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003).

[7] "Enlisting" third-party expert examiners is not a guarantee against future Madoffs, but it will equalize the sophistication gap that exists between the young men and women who perform examinations for the SEC, on the one hand, and the experienced money managers whose operations the SEC Staff must examine.

that the potentially huge amounts at stake—a bounty ranging from between 10 and 30 percent of the monetary sanctions recovered in any successful enforcement action that resulted from the tip—and D–F's unfortunate premium for being "first in line," will at best undermine, and at worst *eviscerate,* companies' existing internal compliance programs.

Sound risk management practices as well as legal requirements, such as the Sarbanes-Oxley Act ("S–Ox"), place great emphasis on companies' implementation of robust compliance programs to help ensure that wrongdoing is prevented or detected, and if detected, stopped and remedied as quickly as possible. Companies with strong compliance programs may be able to detect and remedy misconduct more quickly *and* more effectively than the SEC can, given the Commission's many other responsibilities and its need to comply with the legal formalities required of Government actors. Public investigative and enforcement processes simply take more time than internal action.

However, D–F §922 and the SEC's implementing rules do not require an employee first to report internally the suspected wrongdoing. Instead, they create overwhelming financial incentives to bypass internal reporting mechanisms and requirements, and go directly to the SEC with their tips. As a result, they may effectively deny companies the opportunity to detect and take prompt remedial action in response to internally reported tips from employees. They also reduce the likely quality of any tips received by placing more importance on speed than factual support. By diverting tips and complaints from internal compliance and legal channels to the SEC, the whistleblower provisions paradoxically may result in violations continuing and becoming more serious. This is the very opposite of the result intended by Congress in enacting both S–Ox and D–F.

In response to comments prior to the promulgation of the final rules, the Commission acknowledged the potential of §922 to undermine internal compliance programs, and adopted certain measures that are intended to "encourage" employees to report wrongdoing to their compliance or legal departments, before or at the same time they report to the SEC. These are:

- A provision granting an employee whistleblower status as of the date the employee reports the information internally, if the employee provides the same information to the SEC within 120 days, thereby affording employees the ability to report the alleged wrongdoing internally first, without losing their "spot in line" for a possible award from the SEC.
- A provision that credits employees who report their suspicions internally first with information obtained from a company's internal investigation, that resulted (in whole or in part) from information that was reported internally by the whistleblower, even if the internal report, by itself, would not have been "sufficiently specific, credible, and timely" to "commence or reopen an [SEC] investigation . . . "
- A provision permitting the SEC to consider initial internal reporting as a factor weighing in favor of larger whistleblower awards. This provision, however, is permissive, not mandatory. Indeed, the failure to report suspicions internally will not necessarily result in a lower bounty, and whistleblowers who fail to report internally are still eligible to receive the highest possible bounty—30 percent.

I do not believe these measures, taken together, create sufficient affirmative incentives to ensure that employees will actually report their suspicions internally first. Tipsters who bypass internal compliance procedures and report to the SEC in the initial instance—even after they become aware of an internal investigation about the alleged wrongdoing—are still eligible for a 30 percent award, and tipsters who do report internally first are not assured of receiving the highest level award. Further, with the lure of million-dollar bounties, it is unlikely that potential whistleblowers will consider (assuming they understand) the prospect that they will be credited with the additional information generated by an internal investigation initiated as a result of an internal report. I believe that, notwithstanding the SEC's efforts to incentivize initial internal reporting, the overwhelming majority of tipsters will report directly to the SEC, bypassing their companies' internal reporting mechanisms and compliance departments.

Other provisions of the rules exacerbate the potential for damage to corporations' existing internal compliance programs. Specifically, the exclusion from eligible whistleblower status of internal compliance and internal audit personnel—including lawyers who receive tips in the context of a privileged attorney-client communication—is not meaningful. This is because the "exclusion" carves out, and thus makes eligible for whistleblower status, internal compliance, internal audit and legal personnel who claim "a reasonable basis to believe that disclosure of the privileged information is necessary to prevent substantial injury to the financial interest or property of investors."

As both Commissioners Casey and Paredes have observed, these exceptions effectively swallow the rule. Consequently, as a practical matter, such personnel are eligible to receive a bounty without taking any further internal action; like all other persons eligible for whistleblower status, these persons are not subject to a prior internal reporting requirement, despite being the very individuals directly charged with responsibility for the company's internal compliance, internal audit and legal functions.

By effectively negating the exemption of internal compliance and audit personnel from eligibility for whistleblower status, the rules: (1) create additional disincentives for both business heads and other employees to bring problems to the attention of internal compliance personnel, for fear that they will turn around and go directly to the SEC; (2) engender mistrust of internal compliance and audit personnel; and (3) otherwise create internal divisiveness between business lines and internal control support functions.

b. Transforming Every "Tip" into a Federal Case

Whether or not a tip is first reported to the tipster's employer, a likely consequence of this provision of D–F will be to convert every tip into a significant ordeal for those companies that learn of them. This is so for several reasons.

- Depending on the volume of tips received, but even if the Agency is not inundated with tips, it is in the SEC Staff's interest to refer every tip to the company or firm to which the tip relates, for initial review. In that way, the SEC Staff will not run the risk that they may mistake a valuable tip they receive for something of no real consequence.
- Once a tip is referred to a company—either by the tipster or by the SEC Staff—companies will have little choice but to elevate every tip to a higher level of attention than would otherwise be appropriate. After all, if a company investigating a tip wants to avoid having to go through at least *two* investigations—one by the company itself, and one by the SEC Staff—it will want to be able to document precisely how a spurious tip misses the mark in reality. This will add extensively to the cost of handling these kinds of tips, whether or not the tip has any merit at all.
- Because the tipster will have legal rights to recover money if it turns out the tip has merit and leads to a recovery in excess of $1 million, the company may feel the necessity of expending undue resources on even frivolous tips, since a company determination the tip is frivolous that persuades the SEC Staff may result in litigation brought to contest the company's bona fides in reaching it conclusion that the tip had no merit.

This is a hidden "cost" of this provision of D–F that will elevate the price extracted for those who seek, in good faith, to comply with the statute.

c. Impact on SEC Resources and Efficiency

In addition to the concerns I have about the whistleblower provisions' potentially devastating consequences for internal compliance programs, I am also concerned about the potentially impact of these provisions on the SEC itself. The prospect of huge bounties merely for reporting a "possible" violation will spur an excessive flow of whistleblowing claims to the SEC, with people reporting claims based on weak or speculative information or reporting wholly spurious claims "just in case." And, while responsible counsel for whistleblowers could serve as effective gatekeepers, there is no assurance they will do so. D–F §922 specifically provides that any whistleblower, who makes a claim, may be represented by counsel, and *must* be represented by counsel if he or she wishes to submit the claim anonymously.

It is therefore not surprising that the Commission, in its adopting release, estimated that it will receive approximately 30,000 tips, complaints and referral submissions *each year.* Further, despite the extraordinary *number* of tips expected, neither the statute nor the rules ensure that the *quality* of tips is commensurately high. To the contrary, as the adopting release acknowledges, the standards for qualifying for a bounty under the False Claims Act are much higher than those under D–F. Yet, the SEC has been given relatively few additional resources with which to "separate the wheat from the chaff," and has set aside $450 million to fund a pool from which rewards can be paid. D–F requires the SEC to establish a new, separate office within the agency to administer and enforce the whistleblower provisions. This new office will report annually to House and Senate committees on its activities, whistleblower complaints, and the SEC's response to such complaints.

However, due to funding constraints, that office is being staffed out of existing SEC personnel—diverting them from other responsibilities.

In short, the SEC is being set up for failure. That serves no one's interests, let alone that of investors. Somewhere, somebody should step back and say, "We are piling all these responsibilities on, creating all these new provisions, but how do we expect the agency to cope?" The SEC has been given more rulemaking, more studies *and* more demanding responsibilities under D–F than any other financial regulator, but was denied what many other financial regulators have—the ability to self-fund its operations (with accountability to Congress for the policy decisions it makes). The SEC should be given this authority, provided there is full and complete accountability to Congress on the uses to which the SEC proposes to put the funds available to it through this mechanism.

d. Proposed Amendment

On May 11, 2011, Rep. Michael Grimm of New York circulated draft legislation that would amend D–F to require a whistleblower to first report fraud through an internal compliance program before being eligible to receive an award under the program. I strongly support such an amendment. Indeed, I would go further and advocate that the "carve-out" from the exemption for whistleblower eligibility for internal compliance, audit and legal personnel be tightened, if not completely eliminated.

2. Corporate Governance

a. Proxy Access.

D–F's proxy access provisions are intended to promote shareholder democracy by requiring companies to include board candidates in management's proxy materials if nominated by shareholders holding at least 3 percent of the voting equity for at least 3 years. As a practical matter, however, the proxy access provisions, which have been stayed by the SEC pending the outcome of litigation over the validity of the Commission's rule, give disproportionate influence to certain shareholder constituencies—such as unions and pension funds—that have special interests that may be different from, or even adverse to, rank and file investors. Given that these special shareholder constituencies already usually possess significant leverage to affect corporate policy through the power of collective bargaining, it is not clear why providing them with an additional means of advancing their interests promotes shareholder democracy.

And, it follows that, if the benefits of the new rule were overstated, the likely costs of the rule were not properly considered. Contested elections are expensive, and shareholders ultimately bear their cost. While the SEC said in its adopting release that it expects about 51 proxy contests a year as a result of the new rule, that would mean a *drop* from the 57 contested corporate elections in 2009. It is not clear how a rule designed to facilitate shareholder nominees can lead to *fewer* contested elections?

While recognizing that some companies likely would oppose a particular shareholder nominee, and incur the consequent expenses, the Commission assumed that these costs would be limited because the directors' fiduciary duties would prevent them from using corporate funds to resist shareholder director nominations in the absence of any good-faith corporate purpose. Even if this assumption were true in an abstract sense, there is no way to quantify it sufficiently to support the Commission's estimates of the number of proxy contests likely to result from the new rule.

Quite apart from the flaws in the Commission's cost-benefit analysis, the new rules reflect an unnecessary and ill-advised change in shareholders' rights, by preempting State law—the traditional source of such rights—in favor of imposing a new, one-size-fits-all regime on corporations from which they cannot opt out, even if their shareholders would prefer to do so. In 1934, when this Committee's predecessors passed the Securities Exchange Act, power over proxy contests was divided between the Federal Government and the States. State law determines what substantive rights a corporate shareholder may claim, while Federal regulation was intended to govern the disclosure applicable to, and the mechanics of, shareholder votes.

In stark contrast, this provision of D–F turns the traditional *situs* of legal authority over shareholder voting power on its head. And, it ignores the most efficient ways to have resolved the thorny issue of proxy access:

- Given the current ubiquitous state of computer facilities, proxy materials should no longer be required to printed and mailed to corporate shareholders. Instead, the Commission should permit proxy solicitations to occur utilizing electronic communications. This change alone would diminish much of the effort on the part of corporate insurgents to utilize management's proxy materials to further their own policy choices.

- Even in the absence of a shift to electronic proxy solicitations, all the SEC need do is provide that shareholders have the right to amend their corporation's by-laws in whatever way State law permits, including an amendment to permit whatever form of proxy access the requisite number of shareholders approves. By dictating the mechanics of how this issue would be presented to shareholders (in particular, limiting the number of such proposals as well as the size and length of shareholdings entitling a shareholder to make such a proposal in management's proxy materials), the SEC has a relatively non-controversial way to resolve the thorny issue of proxy access without turning the supremacy of State law over shareholder voting rights on its head.
- This approach would take advantage of changes to State laws regarding proxy access. In 2007, the Commission considered amending Rule 14a–8(i)(8) to permit shareholders to propose binding shareholder resolutions to amend a company's by-laws to require the company to grant proxy access. Since 2007, the Delaware General Corporation Law and the ABA's Model Business Code have been amended to include provisions that explicitly permit proxy access bylaws and proxy reimbursement bylaws.
- This would have been (and still would be) an appropriate approach to proxy access. An enabling proxy access rule would avoid discriminatory distinctions among shareholders—potentially pitting self-interested groups, like unions and pension funds, against the average rank and file investor—in favor of true shareholder suffrage. Such an approach would facilitate companies' and shareholders' State-given rights to determine the processes that govern the nomination and election of directors, based on their unique circumstances. This approach would also, of course, facilitate shareholders' ability to avail themselves of the rights afforded by those processes.

b. Say-on-Pay

D–F §951 requires public companies to solicit non-binding shareholders' votes at least once every 3 years on the compensation of their highest paid executive officers. This new requirement has been referred to as say-on-pay. The first proxy season with say-on-pay votes has passed, and the overwhelming majority—88 percent—of these votes were positive, with more than 80 percent of these resolutions garnering at least 80 percent positive votes.

However, shareholders in at least 39 companies voted "no" on executive compensation. At least six of these "no" votes have been followed by derivative claims against those companies and their boards, claiming the pay packages awarded effectively breach the fiduciary duties owed to shareholders who have rejected the specific executive compensation involved, as well as corporate waste, in awarding the rejected pay packages. Other "investigations" have been announced into the approval of pay packages that presumably will lead to litigation.

The first wave of post-say-on-pay lawsuits lends credence to the warnings of those who predicted that the provision would lead to increased shareholder litigation, despite the express provision in D–F §951(c) that the results of a say-on-pay vote do not create or imply any additional fiduciary duties on the part of the company's board, nor change the scope of any existing fiduciary duties. While most legal commentators expect these suits to fail, given not only the language of §951(c) but also the high burden of proof set by the corporate law of most States with respect to breaches of fiduciary duty and corporate waste in the area of executive compensation, that only makes the litigation costs that say-on-pay is likely to impose on corporations—and thus their shareholders—even harder to justify.

3. Office of the Investor Advocate

Another example of D–F's unintended consequences is found in §915, its directive that the SEC establish an Office of the Investor Advocate. Putting to one side the fact that it is *the SEC as a whole* that is the "Investor's Advocate," this provision contains the seeds of unnecessary conflict and adversarial posturing that will, ultimately redound to the disadvantage of investors. The statute empowers the Investor Advocate publicly to criticize and challenge agency actions or inactions, without any obligation to seek the input of—or even give notice to—the agency officials whose judgments may be publicly challenged.

Moreover, at a time that the SEC's resources are strained to the limit (and beyond) by the imposition of D–F's other mandates, coupled with the denial to the SEC of the ability to self-fund (but with accountability to Congress), the Investor Advocate is expressly entitled to retain or employ independent counsel—that is, counsel not already a part of the SEC's staff—as well as its own research and service staff, as the Investor Advocate deems necessary to carry out the duties of the office. It is true that D–F §915 requires the Investor Advocate to "consult" with the SEC's Chairman before making any such expenditures, but there is no requirement that the SEC Chairman's views be given any deference whatsoever.

In short, the statute creates an independent bureaucracy within the SEC that is inherently adversarial to both the Commission and its other Staff, rather than collaborative. Indicative of the adversarial nature of this position is the requirement imposed on the Commission to establish procedures requiring a formal response to all recommendations submitted to the Commission by the Investor Advocate. Such responses must be received within 3 months, and then trigger the Investor Advocate's ability to criticize the Commission's or Staff's failure to implement the Investor Advocate's agenda of recommended action. This is the same obligation that is imposed upon the Commission in the face of any Inspector General ruling or criticism of the Agency or its Staff. The creation of this Office threatens to disrupt, rather than facilitate, the SEC's investigative, enforcement and rulemaking functions.

The ostensible purpose of creating the Office of Investor Advocate is to ensure that the interests of retail investors are built into rulemaking proposals from the outset and that agency priorities reflect the issues confronting investors. But, in order to achieve that objective, it was not necessary to create an entire new bureaucracy in order to achieve that end, nor was it necessary to give the Investor Advocate the effective ability to second-guess every judgment made by the Commission and its Staff as to how best to set priorities, balance competing interests and allocate scarce resources. The Office of Investor Advocate, far from being a resource to the Commission and its Staff in fulfilling the Agency's mission to protect investors, will be unnecessarily divisive.

Conclusion

The purposes behind D–F were surely laudable. But, in the critical area of investor protection, the provisions of the Act leave a great deal to be desired, and ultimately threaten to have adverse consequences on investor protection. It is possible to cure these problems, but that will require a determination by Congress, and resolve by the Agency, to implement that regulation which will indeed be likely to promote the needs of all investors.

I will be happy to respond to any questions the Members of the Committee may have.

PREPARED STATEMENT OF BARBARA ROPER

DIRECTOR OF INVESTOR PROTECTION FOR THE CONSUMER FEDERATION OF AMERICA

JULY 12, 2011

Chairman Johnson, Ranking Member Shelby and Members of the Committee:

My name is Barbara Roper, and I am Director of Investor Protection for the Consumer Federation of America (CFA), where I have been employed since 1986. CFA is a non-profit association of approximately 300 national, State and local pro-consumer organizations founded in 1968 to advance the consumer interest through research, advocacy, and education. I appreciate the invitation to appear before you today to discuss enhanced investor protection after the financial crisis.

Introduction

Improving protections for average investors has been a CFA priority for roughly a quarter century. During that time, experience has taught us that it often takes a crisis, or at least a scandal of major proportions, to highlight the need and provide the momentum for investor protection reforms. The recent financial crisis was traumatic event for U.S. investors that revealed serious shortcomings in the regulation of certain securities markets and market players. In particular, regulatory failures with regard to the market for asset-backed securities (ABS) and the credit ratings on which their sales depend were contributing causes of the crisis. Those regulatory shortcomings resulted in serious harm even to investors with no direct investments in ABS and no direct reliance on credit ratings. Indeed, many individuals with no investments at all nonetheless suffered devastating consequences in the form of lost jobs and lost homes.

The crisis and events that occurred in conjunction with the crisis—such as the exposure of the Madoff Ponzi scheme—also revealed more general short-comings in the quality of regulatory oversight provided by the Securities and Exchange Commission (SEC). In some cases, those regulatory shortcomings can be attributed to lack of needed enforcement tools or authority. In others, inadequate resources appear to be the cause. But recent events have also revealed regulatory stumbles at the SEC that cannot be blamed on either of these causes but must instead be acknowledged as operational failures of the agency staff or a failure of will to regulate on the part of its leaders.

Since Congress began consideration of financial regulatory reform legislation, a great deal of attention has been given to reforms designed to improve our ability to identify and address systemic threats, bring long-overdue regulatory oversight to the over-the-counter derivatives markets, and even to improve consumer financial protections by creating a new independent agency devoted to this task. Among the lesser known achievements of the Dodd-Frank Act is its creation of a framework that, if properly and effectively implemented, could significantly improve investor protections. Dodd-Frank takes a multi-faceted approach to bringing about this improvement in investor protections. Responding to abuses directly related to the crisis, it includes sweeping proposals to address flaws in both the asset-backed securitization process and in credit ratings, flaws that created incentives to write risky mortgages and helped mask those risks from investors. In addition:

- **Dodd-Frank includes a suite of provisions designed to improve the quality of regulatory oversight provided by the SEC.**

These include enhanced regulatory and enforcement tools and the potential for increased resources to enable the SEC to carry out its investor protection mission more effectively. Responding to recent problems in the operations of the SEC, the Dodd-Frank Act also includes provisions to improve outside oversight of the agency. And recognizing that investor voices are too often drowned out by industry in debates over agency policy, it includes mechanisms to increase investor input in the policymaking process.

- **Dodd-Frank includes another set of provisions designed to strengthen specific protections for average retail investors.**

Among these, the provision to raise the standard of conduct that applies to brokers when they give investment advice has received the most attention, both during the legislative debate and since. However, Title IX of Dodd-Frank also includes a number of other important investor protections, including provisions to strengthen the ability of defrauded investors to recover their losses, authority to address severe conflicts of interest in industry compensation practices, and provisions with the potential to dramatically improve the quality of disclosures investor receive regarding both investment products and services and the investment professionals who provide those services.

While Dodd-Frank creates a broad framework to improve investor protections, investors will only reap the benefits if the SEC uses its new tools and new authority effectively and if Congress provides it with the resources necessary to enable it to do so. It is too soon to tell whether that is likely to occur. To date, the SEC has appropriately focused its implementation efforts on those aspects of Dodd-Frank where it is required to act, leaving for another day areas where it has been given new authority but no such mandate. Many of the provisions in the Investor Protection Title fit in the latter category. Moreover, the agency's funding status is far from clear. While the Senate secured a welcome funding increase for the agency in 2011, the House has been reluctant to provide 2012 funding for the agency that is commensurate with its broadly expanded authority. Not only does this put at risk the high profile Dodd-Frank provisions related to derivatives, hedge funds, securitization, and credit ratings, but, if the agency is forced to rob Peter to pay Paul, the lower profile investor protection issues would also suffer. If that happens, average retail investors will not only fail to reap the strengthened investor protections promised by Dodd-Frank, they will see those basic protections diminished and will inevitably suffer the consequences.

The investor protection provisions of Dodd-Frank are too numerous to discuss each in detail here. Instead, my testimony will provide a broad overview of significant reforms and highlight a few areas of particular importance. My primary focus will be on topics of particular relevance to retail investors. Some issues with implications for retail investors, including municipal securities and whistleblower reforms, are not included in this testimony, not because they are not important, but because we lack the relevant expertise to provide informed commentary regarding the legislative provisions on these topics. Similarly, this testimony does not cover Dodd-Frank provisions to improve corporate governance. Although CFA strongly supported those reforms, others on the panel are better equipped to discuss their particulars. On the other hand, two other issues that aren't primarily retail investor issues—securitization reforms and credit rating agency reforms—are discussed briefly here because they so clearly illustrate the harm that can come to retail investors when institutional markets are not regulated effectively.

I. Improving the Quality of Regulatory Oversight

Dodd-Frank includes a suite of provisions intended to improve the overall quality of regulatory oversight provided by the SEC. These include general provisions to enhance the tools available to the agency to enforce the securities laws, provide better independent oversight of the agency, increase investor input into the agency's policymaking process, and authorize an increase in its funding. They also include a provision designed specifically to strengthen regulatory oversight of investment advisers, an area that has long been lacking. These provisions should help to improve the quality of regulatory oversight across the broad range of the SEC's responsibilities. The following section describes some of those provisions in greater detail.

A. Enhancing the SEC's Enforcement Tools (various sections from 925 through 929Z)

Title IX of the Dodd-Frank Act provides the SEC with a whole host of fairly technical but important enhancements to its enforcement tools. These include provisions that: give the SEC broader authority to bar bad actors from the industry (Section 925, collateral bars); ensure that the SEC has the ability to exercise its anti-fraud authority with regard to conduct that occurs overseas but significantly affects U.S. investors or conduct that occurs in the United States but involves transactions executed elsewhere (Section 929P, extraterritorial jurisdiction); enable the PCAOB to share information with foreign jurisdictions (Section 292J); clarify that the SEC's authority to act against those who aid and abet securities violations is satisfied by a showing of recklessness (Sections 929M–O); and allow for the ability to hire specialist personnel outside the usual hiring system (Section 929G). These are sensible reforms that should strengthen the SEC's ability to provide effective enforcement of the securities laws. Several of them deserve extra mention.

Expert Staff: The SEC's failure to uncover the Madoff fraud has been blamed in part on its lack of staff with the sophisticated financial knowledge needed to understand the mechanism of the fraud. The need to enhance the technical expertise of the staff, already great, takes on added urgency as the agency assumes responsibility for oversight of securities-based swaps, credit rating agencies, and hedge funds and private equity funds—all highly complex and technical areas that will demand staff with specialized expertise to enforce them effectively. Giving the agency the ability to hire specialist personnel outside the usual hiring system should assist the agency in building the technical expertise necessary to fulfill these functions and provide more effective regulatory oversight of an increasingly complex market.

Extraterritoriality: The Supreme Court decision in *Morrison v. National Australia Bank* left a gaping hole in SEC enforcement authority with its ruling that Section 10(b) of the Securities Exchange Act applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." Had this decision gone unaddressed, the SEC's ability to protect investors in an increasingly international marketplace would have been severely compromised. Moreover, the ability to evade U.S. fraud claims simply by moving transactions off-shore would have created a strong incentive for companies to avoid a U.S. listing and to execute transactions on foreign exchanges.

Unfortunately, Dodd-Frank did not provide the same fix for private actions under Section 10(b) and Rule 10b–5, deferring a decision until after an SEC study of the issue. That study is currently underway. We are hopeful that the SEC will recommend that Congress amend the Exchange Act to ensure that Section 10(b), and the rules thereunder, are applicable to all purchases and sales of securities by U.S. financial institutions and individual investors residing in the United States. This is an important addition to the authority already provided to the SEC in the Act, first because private actions serve as an important supplement to SEC actions, particularly in light of limited agency resources, and second because there will still be an incentive for companies to avoid a U.S. listing and execute transactions overseas until the protections of U.S. law are fully restored for U.S. investors.

PCAOB Sharing of Information with Foreign Authorities: Limits on the PCAOB's ability to share information with foreign regulators have been cited by some foreign jurisdictions as a reason not to permit PCAOB to inspect auditors within their jurisdiction. But the Sarbanes-Oxley Act requires PCAOB to inspect all auditors, including foreign auditors that play a significant role in the audits of U.S. listed companies. The PCAOB has sought to satisfy this requirement by developing a program of joint audits with foreign jurisdictions, with mixed results. While it is not likely to immediately remove all impediments, the provision in Dodd-Frank permitting this sharing of information should help open the way to greater cooperation in inspections of foreign auditors. Given the important role that foreign audit firms play in the audits of large multi-national companies as well as foreign companies listed in the United States, ensuring that these auditors comply with U.S. audit standards is an important investor protection priority. We are encouraged that the new leadership at the PCAOB has made this a priority and appears to be working effectively to make progress in this area.

B. Strengthening Oversight of the SEC (Subtitle F)

Dodd-Frank also includes a package of reforms designed to improve outside oversight of the SEC. It achieves this primarily through a series of Government Accountability Office (GAO) reviews and reports to Congress. These include an annual financial controls audit of the agency, a triennial report by GAO on the quality of the agency's personnel management, triennial GAO reports on the SEC's oversight of SROs, and a GAO study of the revolving door between the SEC and the securities industry it regulates. Perhaps most significantly, Section 961 of Dodd-Frank requires the SEC to report to Congress each year on its examinations of regulated entities and, in doing so, to certify the adequacy of its supervisory controls to carry out these exam functions. Effective exams are central to the agency's ability to detect and deter wrong-doing. This annual reporting requirement, subject to GAO and congressional review, should help to quickly identify any weaknesses in the exam program and focus agency attention on improving the quality of these examinations. That has the potential to significantly enhance investor protection.

An organizational study of the agency required by Dodd-Frank has already been completed.[1] The purpose of the study was to examine the internal operations, structure, and the need for reform at the SEC. In addition to praising recent initiatives undertaken by the agency to improve its efficiency and effectiveness,[2] the report suggests additional steps for the agency to take to improve efficiency. Among its more substantive recommendations are for the agency to play a more active role in overseeing the self-regulatory organizations (SROs) under its jurisdiction, to upgrade its information technology, and to hire staff with risk management and other high-priority skills. Ultimately, however, the report concludes that agency is unlikely to be able to fulfill even its high priority functions without additional resources. We share that conclusion, as we discuss in greater detail below.

C. Providing Investors with Greater Input into Agency Policy Decisions (Sections 911 and 915)

The SEC decides issues of enormous import to investors every day, often with little or no input from the investors affected by those decisions. This does not reflect any intent to shut investors out of the process. Rather, it reflects the simple fact that investors often lack the organization, manpower and resources to monitor agency actions and interact effectively with SEC leaders and staff as they set the agency's agenda and develop specific proposals to achieve that agenda. In contrast, industry is well funded and organized to perform this function, giving market participants an advantage in communicating with the agency that is further magnified by the revolving door that exists between the SEC and the securities industry. The inevitable result is that industry concerns tend to dominate the policy debate, while investor concerns can too easily be drowned out.

The Dodd-Frank Act includes two provisions specifically designed to increase investor input into the agency's policymaking process and ensure that investor concerns are heard. Section 915 creates a new Office of Investor Advocate within the agency, while Section 911 establishes a permanent Investor Advisory Committee. Properly implemented, these provisions have the potential to make the agency more aware of and thus more responsive to investor concerns and priorities. The result should be an agency that more effectively fulfills its mission to protect investors and promote the integrity of the capital markets.

The Office of Investor Advocate: The legislation seeks to ensure that this office will truly and effectively serve the interests of investors by requiring that the Investor Advocate be an individual with a background representing the interests of investors, by providing the office of the Investor Advocate with appropriate staffing and with unimpeded access to agency and SRO documents, by ensuring that the Investor Advocate reports directly to the Chairman, and by requiring that the Commission respond promptly to recommendations of the Investor Advocate.

Moreover, several important functions are entrusted to this office, including:

- Identifying areas in which investors would benefit from changes in the regulations of the Commission or industry self-regulatory organizations (SROs);

[1] "U.S. Securities and Exchange Commission Organizational Study and Reform," Boston Consulting Group, March 10, 2011.

[2] These include reorganization of the Division of Enforcement and the Office of Compliance Inspections and Examinations, the rollout of the new Tips, Complaints and Referrals program, and hiring of a Chief Operating Office and a new Chief Information Officer.

- Identifying problems investors have with financial service providers and investment products;
- Analyzing the potential impact on investors of proposed Commission and SRO rules and regulations; and
- Assisting retail investors in resolving problems with the SEC and SROs.

If the Commission follows through by appointing an energetic, effective and knowledgeable individual to this position and staffing the office appropriately, investors should benefit from an agency that is more attuned and responsive to their concerns.

This provision also has the potential to improve the quality of congressional oversight of the SEC. That is because Dodd-Frank requires the Investor Advocate to report directly to Congress without prior review or approval by the Commission or its staff. This should enhance Congress's ability to assess the effectiveness of the agency in serving the needs of investors, particularly in administrations that are less attuned to those concerns.

So far, however, this provision of the legislation has not been implemented. Implementation was delayed first by the hold-up in finalizing a 2011 budget. Now that the SEC's 2011 budget has been set, we understand that the Commission is awaiting approval by the House and Senate appropriations committees of its plan to reprogram funds for this purpose. We hope that any questions about this reprogramming plan can be resolved without difficulty so that this potentially powerful ally for investors can be put into place. The need for this investor input is particularly pressing given the importance of the issues currently being decided by the agency and the intensity of industry lobbying to weaken or water down many of those proposals.

The Investor Advisory Committee: When SEC Chairman Mary Schapiro took office, she made it an early priority to establish an Investor Advisory Committee to provide input on investor priorities to the Commission and its staff. Recognizing the potential benefits of this committee, the Dodd-Frank Act formalizes its existence as a permanent advisory committee to the Commission. As with the Office of Investor Advocate, however, implementation of this provision is awaiting approval of the Commission's funding reprogramming plan by congressional appropriators. Meanwhile, the existing committee has been disbanded in order to allow for changes in its makeup required by Dodd-Frank. Because this committee has the potential to enhance the agency's understanding of and responsiveness to investor protection concerns, we urge a speedy resolution to any remaining impediments to its implementation.

D. Increasing SEC Funding (Subtitle J)

Over the course of the past three decades, U.S. securities markets have exploded in size, complexity, international reach, and technological sophistication, all the while becoming the primary means by which Americans fund their retirement. Meanwhile, with the exception of a one-time major funding boost after the Enron and WorldCom accounting scandals, the staffing level of the SEC has grown slowly if at all. To be specific, staffing at the agency has grown roughly 85 percent from 2,050 FTEs in 1980 to 3,800 FTEs today, but the workload of the agency has grown many times faster. For example, based on my rough calculations, since 1980:

- the number of investment adviser firms overseen by the agency has grown by more than 150 percent, and the assets managed by these professionals has grown by roughly 7,400 percent;
- the number of mutual funds overseen by the agency has grown more than 430 percent; and
- while the number of broker-dealer firms has decreased by 20 percent, the number of registered representatives they employ and the number of branch offices from which they operate has skyrocketed, by roughly 225 percent and 2,100 percent respectively.[3]

The result is that the SEC today is critically under-staffed to carry out its existing responsibilities, let alone take on the vast new responsibilities entrusted to the agency in Dodd-Frank. And that doesn't take into account the woeful state of the agency's technology.

[3] These calculations are based in large part on numbers from a "Self-Funding Study," prepared by the Office of the Executive Director of the U.S. Securities and Exchange Commission and submitted in partial response to the request of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs S. Rpt. 100–105), December 20, 1988 as well as on more recent speeches by and testimony of SEC Chairman Mary Schapiro.

In Dodd-Frank, Congress recognized the need for increased SEC resources by authorizing funding increases that would roughly double the agency budget by 2015. Specifically, the bill authorizes funding of $1.3 billion in 2011, $1.5 billion in 2012, $1.75 billion in 2013, $2 billion in 2014, and $2.25 billion in 2015. We strongly support fully funding the agency at these levels as an essential component of any effort to increase investor protections, and we greatly appreciate the leadership that Chairman Johnson and Members of this Committee have shown in fighting for increased funding. Unfortunately, the debates over the FY 2011 and 2012 budget have already made clear that turning those authorizations into appropriations is going to be a tough fight. Some in Congress continue to resist these funding hikes, even though the agency's budget is fully offset by user fees and, since fees have to be adjusted to match the appropriation, there is no deficit reduction benefit from reduced funding. Indeed, even if the agency were fully funded at the authorized level for 2012, user fees would be reduced, since they currently bring in well over the authorized amount.

While we are sympathetic to those who argue that money alone cannot solve all of the agency's problems, we also believe that, without additional funding, the agency cannot reasonably be expected to effectively fulfill its investor protection mission. We urge Members of this Committee to continue to fight for full funding, and we offer our full support for those efforts.

E. Improving the Quality of Investment Adviser Oversight (Section 914)

One area where the funding shortfall is particularly critical is in the regulatory oversight of investment advisers. This issue received heightened attention as a result of the unraveling of the Madoff Ponzi scheme. This is ironic, since Madoff was a broker-dealer regulated exclusively as a broker-dealer up until just 2 years before his fraud was uncovered. If the Madoff scandal was an indictment of anything, therefore, it was an indictment of the effectiveness of broker-dealer oversight.[4] That said, the problem of inadequate investment adviser oversight is quite real. And it is first and foremost a resource problem, a problem that began to emerge in the late 1980s at a time when both mutual funds and investment advisers were growing at an extremely rapid pace and agency staffing to oversee these areas was growing slowly if at all. By the early 1990s, the problem had reached crisis proportions, with inspections so infrequent that a small adviser might reasonably expect to set up shop and reach retirement without ever seeing an SEC inspector.[5]

Over the years, CFA has supported a variety of approaches to solve this resource problem, including increased appropriations to the SEC, self-funding for the agency to free it from the appropriations process, and user fees on investment advisers to pay for increased oversight. None has been adopted. While the resource problem ultimately rests with Congress to resolve, Section 914 of the Dodd-Frank Act required the SEC to conduct a study assessing the need for additional resources for investment adviser examinations and options available to Congress to address this issue, including by delegating this responsibility to a self-regulatory organization (SRO).

Earlier this year, the SEC issued its Section 914 study.[6] In it, the staff documented a decline in the number and frequency of inspections of registered investment advisers over the past 6 years and described new challenges the Commission will face as it takes on responsibility for registration and oversight of private fund advisers. We share the study's conclusion that, "The Commission's examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers."

The study outlines three options for Congress to consider adopting to address this "capacity constraint:"

- imposing user fees on SEC-registered investment advisers to fund their examinations by SEC inspection staff;
- authorizing one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or

[4] A group of independent FINRA board members, led by Charles Bowsher, has since conducted a very credible examination of FINRA's failure to uncover both the Madoff and the Stanford frauds, and FINRA has reportedly begun to implement the recommendations of that study to improve the quality of its broker-dealer oversight.

[5] At the time, SEC staff members estimated that it small advisers were on a once every 40 years inspection cycle.

[6] "Study on Enhancing Investment Adviser Examinations," by the staff of the Division of Investment Management of the Securities and Exchange Commission, January 2011. The study is available here: *www.sec.gov/news/studies/2011/914studyfinal.pdf*.

- authorizing FINRA to examine dual registrants for compliance with the Advisers Act.

In the past, CFA has categorically opposed delegating investment adviser oversight to an SRO, particularly one dominated by broker-dealer interests and particularly if that SRO were given rulemaking authority. We continue to believe the user-fee approach outlined in the SEC report offers the best option for funding enhanced inspections in a way that promotes investor protection while minimizing added costs to industry.

However, having spent the better part of two decades arguing for various approaches to increase SEC resources for investment adviser oversight with nothing to show for our efforts, we have been forced to reassess our opposition to the SRO approach. Specifically, we have concluded that a properly structured SRO proposal would be a significant improvement over the status quo. Too often, however, the SRO approach is presented as an easy solution by individuals who have not adequately confronted the many thorny issues it presents. The SEC study does an excellent job, in our view, of laying out the issues that would need to be addressed if Congress were to pursue this approach. Only by answering the following questions can Congress develop an SRO proposal that adequately protects investor interests while avoiding imposing undue costs on small advisers.

- How should such an approach be structured in light of the diversity in the investment adviser community?
- How can the risks of industry capture be avoided?
- What are the implications of strong industry opposition to such an approach?
- What would the costs of effective SRO oversight be, and how would they be borne by the many small investment adviser firms?
- What resources would the SEC need in order to provide effective oversight of any such SRO or SROs to which this responsibility might be delegated?
- Should an SRO be an inspection-only SRO, or should it also have broader rulemaking authority?
- What entity (or entities) is best suited to this task?

Ultimately, whatever approach Congress chooses to take, we share the view expressed by SEC Commissioner Elisse Walter in her statement on the study, "that the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now." We urge you to act to resolve this problem sooner rather than later.

F. Improving Regulation of Financial Planners (Section 919C)

Section 919C of Dodd-Frank required a GAO study of the adequacy of financial planning regulation. Deferring to a study was a reasonable approach for Congress to take, since the crowded legislative calendar in the midst of the crisis did not allow for an adequate review of the issues or of various proposals that have been put forward to improve financial planning regulation. Unfortunately, the GAO study on financial planning regulation,[7] which was released in January, represents a real missed opportunity. While it correctly highlights problems with the weak conduct standards that apply to insurance agents, it fails to address the basic question of how best to regulate activity that cuts across a variety of regulatory domains.[8] This is an important question that deserves more thoughtful analysis than it received in the GAO study. Indeed, we would encourage this Committee to look into the issue once the press of overseeing implementation of Dodd-Frank has passed.

II. Strengthening Protections for Retail Investors

As the financial reform legislation worked its way through Congress, it became a vehicle for several specific measures to improve investor protections. These are not for the most part directly related to the causes of the crisis (though some are directly related to the Madoff scandal). Instead, they address long-standing weaknesses in protections for retail investors. The issues covered by these provisions range from the protections that apply to investors' interactions with those they rely on for investment advice, the quality of disclosures investors receive regarding in-

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[7] "Consumer Finance: Regulatory Coverage Generally Exists for Financial Planners, but Consumer Protection Issues Remain," Government Accountability Office, January 2011. The report is available here: *http://www.gao.gov/new.items/d11235.pdf.*

[8] The problems with the GAO study are summed up well in a Morningstar article by University of Mississippi Law Professor Mercer Bullard, "The Future of Financial Planning Regulation." The article is available here: *http://news.morningstar.com/articlenet/article.aspx?id=386262*

vestment products and services, and the ability of defrauded investors to recover their losses. For the most part, these Title IX provisions authorize rather than require the SEC to act. With the agency so far occupied primarily with Dodd-Frank mandates, and appropriately so, progress to date has been minimal. Once the agency has an opportunity to turn its attention to these issues, however, these provisions have the potential to dramatically improve protections for retail investors in areas long identified as high priorities by investor advocates.

A. Raising the Standard for Brokers' Investment Advice (Section 913)

Improving the protections that apply to investors' interactions with the financial intermediaries they rely on for investment advice and recommendations has long been a priority for CFA and other investor advocates. There are several reasons for this. Research suggests that investors are ill-equipped to make an informed choice among investment professionals, since they typically cannot distinguish between brokers and investment advisers, do not realize that their recommendations are subject to different legal standards, and do not understand the difference between those standards. Moreover, additional research has found that investors rely heavily, if not exclusively, on the recommendations they receive from investment professionals, typically doing little if any additional research on the investments recommended. This makes them extremely vulnerable to investment professionals who take advantage of that trust. That is why ensuring that these investment professionals act in their customers' best interests—both by raising the standard of conduct that applies to broker dealers when they give investment advice and by improving the quality of regulatory oversight for investment advisers—is such a high investor protection priority.

Section 913 of Dodd-Frank advances this goal by authorizing the Securities and Exchange Commission to impose a fiduciary duty on brokers when they give personalized investment advice to retail investors. In January, the Commission released the study required by the Act as a predicate to any regulatory action in this area.[9] In it, the Commission proposes to impose a uniform fiduciary duty on brokers and advisers through dual rules under the Securities Exchange Act and the Investment Advisers Act. This approach, which preserves the broker-dealer business model while raising the standard that applies to broker recommendations, has won enthusiastic praise not only from traditional proponents of a fiduciary duty, such as CFA, but also from the leading broker-dealer trade associations.[10]

The fact that the SEC has identified an approach to this issue that has won such broad support offers an opportunity for long-overdue progress on this key investor protection priority. SEC Chairman Mary Schapiro has indicated that the Commission is likely to move forward on rulemaking later this year. CFA strongly supports the Commission on this and urges Members of this Committee to do so as well.

B. Improving Disclosures (Sections 912, 917, 919, 919B)

In a number of areas and to a large extent, our system of investor protection is predicated on the notion that investors who are armed with complete and accurate information will be able to look out for their own interests. This concept, which predates the democratization of securities markets that has occurred over the past several decades, may be overly optimistic in its assumptions about the financial sophistication of average retail investors. At the very least, it puts a premium on our ability to deliver the information investors need, in a form they can access and understand, at a time when it is useful to them in making their investment decisions. I suspect that, if the SEC were to make extensive use of the disclosure testing authority provided to the agency in Dodd-Frank, it would find that few if any of the disclosures currently provided to investors satisfy this three-part test for effectiveness. In short, much can and should be done to improve the content, format and timing of disclosures, and the Dodd-Frank Act provides the SEC with a sound framework for making those improvements.

[9] "Study on Investment Advisers and Broker-Dealers," by the staff of the U.S. Securities and Exchange Commission, January 2011. The report is available here: *http://www.sec.gov/news/studies/2011/913studyfinal.pdf.*

[10] Unfortunately, a relatively small but vocal segment of the broker-dealer community, in particular those whose business model is dependent on the sale of high-cost variable annuities, has continued to oppose any Commission action to raise the standard of conduct for brokers. In voicing their opposition, they rely on arguments that are at best misinformed, at worst are outright deceptive, that requiring brokers to act in their customers' best interests would somehow harm middle income and rural investors. Contrary to the claims of these critics, the proposal put forward by the SEC offers middle income investors the best of both worlds, preserving their access to commission- and transaction-based services while simultaneously helping to ensure that those services are delivered with the investor's best interests in mind.

Section 917, for example, requires the SEC, as part of its study of financial literacy, to look at a variety of issues that are central to developing effective disclosures. These include identification of the key information investors need to make sound investment decisions as well as ways to improve the timing, content and format of disclosures. By requiring this analysis in the context of a study of financial literacy, this provision highlights the need to design disclosures with a realistic understanding of the financial sophistication of investors in mind. Section 912 builds on this study by authorizing the agency to engage in investor testing of disclosures. This authority can be used both to learn what methods and formats of disclosure generally are most effective in conveying information to investors and to test specific disclosure documents for clarity and effectiveness. It can and should be used both to help in the development of new disclosures and to improve existing disclosures. It is our understanding that the agency has begun to make at least limited use of this new authority, and we hope that is a trend that will continue and grow. For that to happen, however, the SEC must receive adequate funding for this purpose.

Timing of disclosures can determine whether or not they play a significant role in conveying important information to investors. Information received after the sale is of little if any use, but that is the current norm in all too many situations. Even information delivered at the point of sale may be of little value, if the investment decision has already been reached. To really benefit, investors must receive the key information when they are still evaluating their investment options. That argues for delivery at the point of recommendation, a goal that may be more easily achieved as we move toward greater use of the Internet to satisfy disclosure requirements. Section 919 of Dodd-Frank provides the SEC with tools to achieve this goal of timelier disclosures, by authorizing the agency to require pre-sale disclosures with regard to both investment products and services. We especially appreciate the decision to expand this provision beyond just mutual funds to include all investment products and services. This will give the agency the ability to take what it learns from its study on financial literacy and from any disclosure testing it conducts and use it to develop disclosure documents that are much more useful to retail investors.

C. Strengthening Protections for Defrauded Investors (Sections 921, 929B, 929H, 929Y, 929Z)

Title IX of Dodd-Frank also includes several provisions that could be used to improve, or at least protect, the ability of defrauded investors to recover their losses. These include provisions in Section 929B to expand the Fair Fund to include civil penalties, the Section 929Y study of extraterritoriality and private rights of action, and the Section 929Z study of private rights of action against those who aid and abet securities fraud. For investors to benefit from the latter two provisions, however, Congress will need to follow up on these studies and amend the Securities Exchange Act to provide U.S. investors with the ability to pursue private actions under Section 10(b) for foreign transactions and against those who aid and abet securities fraud. A series of recent court decisions have significantly limited defrauded investors' right to recovery. We urge Congress to redress that imbalance by restoring basic private rights of action in these areas.

Perhaps more significantly, Section 921 of Dodd-Frank authorizes the SEC to limit or restrict the use of forced arbitration clauses in brokerage contracts. CFA is a strong support of alternative dispute mechanisms. We believe it is absolutely essential the investors retain access to an arbitration system that is fair, efficient and affordable. It is precisely for this reason that we oppose pre-dispute binding arbitration clauses. Certain cases simply are not suited for resolution through arbitration, particularly complex fraud cases that require extensive discovery proceedings and a sophisticated reading of the applicable law. When forced into arbitration by pre-dispute binding arbitration clauses, these cases can both clog the arbitration system and increase its costs. Those operating the arbitration forum, in this case FINRA, come under pressure to adopt more formal, court-like proceedings to ensure that such cases can be dealt with fairly. And the goals of a fast, efficient, affordable system to resolve disputes end up being undermined. CFA therefore supports a careful approach to limiting the use of binding arbitration clauses that preserves investor access to arbitration but doesn't force cases into arbitration that don't belong there. So far, however, the SEC does not appear to have taken up this issue.

D. Strengthening Protections Regarding Custody of Client Assets (Section 411)

Responding at least in part to concerns raised by the Madoff scandal, Section 411 of the Dodd-Frank Act requires investment advisers to have appropriate protections in place to safeguard client assets held in custody, including by requiring an independent auditor to verify the assets. While we believe this is a useful requirement, it is worth noting that Madoff was a broker, not an investment adviser, for the bulk of the period covered by the scandal. Any Madoff-related reforms to address weaknesses in custody requirements would more appropriately focus on strengthening protections with regard to brokers who self-custody.

E. Adjusting the Definition of Accredited Investor (Section 413)

Several definitions in our securities laws seek to draw a line between sophisticated investors capable of looking out for their own interests and others who require the protection of the securities laws. One such is the accredited investor definition. While we question the validity of any definition based primarily on net worth or income, the validity of the definition is particularly questionable when it is not regularly adjusted to keep pace with inflation. Such has been the case with the accredited investor definition. Section 413 of Dodd-Frank significantly improves the definition by adjusting the net worth trigger upward, excluding the value of the primary residence from that calculation, and providing for periodic reviews and adjustments of the standard.

III. Addressing Securities Regulation Failures Related to the Crisis

While they fall somewhat outside the range of topics typically thought of as retail investor protection issues, two investor protection issues directly related to the financial crisis deserve at least a mention here—securitization reform and strengthened regulation of credit rating agencies. These issues perfectly illustrate how a failure to regulate effectively in largely institutional markets can have devastating consequences for retail investors.

A. Reforming the Asset-Backed Securitization Process

As the crisis unfolded, much attention was given to the way securitization had fundamentally changed incentives in the mortgage markets, making lenders far less concerned about ensuring the borrower's ability to repay. One reason this occurred was that the mortgage-backed securities (MBS) and collateralized debt obligations (CDOs) based on those securities were both incredibly complex and almost completely opaque, leaving investors in the securities with little or no information about the quality of underlying loans. As Penn State Visiting Law Professor Richard E. Mendales put it, "The many layers between debt instruments providing the underlying cash-flow for such instruments and the final instruments sold on world markets destroyed the transparency that the securities laws are designed to create . . . "[11]

The diligent investor who attempted to conduct due diligence on these securities got no assistance from securities regulations, which allowed the sale of MBS with minimal disclosures through the SEC's shelf-registration process. As a result, even those MBS that were registered with the SEC could be sold based "not upon a detailed prospectus but rather on a basic term sheet with limited information."[12] Regulation A/B also eliminated underwriters' obligation to perform due diligence to confirm adequate loan documentation. Bad as disclosures were for more traditional MBS, they were often even worse for CDOs, which were typically sold in private, 144A sales to Qualified Institutional Buyers (QIBs) with even less information on underlying assets.

Subtitle D of Title IX includes a broad set of provisions to reform the asset-backed securitization process. The legislation attempts to address the securitization's deleterious effect on incentives to ensure borrowers' ability to repay by requiring securitizers to have some "skin in the game" with regard to the asset-backed securities they issue. Just as important, Section 942 of Dodd-Frank requires more extensive disclosures of information necessary to permit investors to conduct a reasonable due diligence review of the securities. Section 945 requires issuers of asset-backed securities to perform a review of the assets underlying the security and to disclose the nature of that review to investors. Importantly, in issuing its rules implementing Section 945, the SEC appropriately specified that the due-diligence reviews must be adequate to provide reasonable assurance that the disclosures provided to investors are accurate. Meanwhile, the broader ABS disclosure rules required by the Act have been proposed but not yet adopted. When they are fully implemented, these provisions should go a long way toward making it possible for the institutional investors who participate in this market to make better informed investment deci-

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[11] Mendales, Richard E., "Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It," University of Illinois Law Review.

[12] Investors Working Group, *U.S. Financial Regulatory Reform: The Investors' Perspective,* July 2009. (The Investors Working Group is an Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors.) [Hereinafter, The Investors' Perspective]

sions, and that should benefit retail investors by reducing risks in the financial system.

B. Strengthening Regulation of Credit Rating Agencies

One justification given for allowing sale of MBS and CDOs without adequate disclosures was that they were highly rated by the credit rating agencies. In fact, the entire system of regulation for the securitization process was built on the assumption that ratings could reliably assess the risks associated with these investments. Special Purpose Vehicles set up to issue the securities were exempt from regulation under the Investment Company Act by virtue of their investment grade ratings. Eligibility for sale through the shelf registration system was also based on ratings, as was favorable treatment under financial institution capital standards. Mendales summed up our regulatory reliance on ratings this way: "Unregulated ratings for asset-backed securities became proxies for the full disclosure required by securities law. Thus, when they were repackaged into more complex CDOs or used indirectly to create derivative obligations such as default swaps, participants in transactions and institutions holding the securities as part of their required capitalization relied on the high ratings given to component asset-backed securities rather than looking at the assets underlying them."[13] As events later demonstrated, the reliance on ratings by investors and regulators alike proved to be disastrously misguided.

Subtitle C of the Dodd-Frank Act seeks to address this fundamental weakness in the system through a multi-faceted approach to credit rating agency reform. This includes: improving regulatory oversight of credit ratings agencies, strengthening internal controls over the rating process, making the assumptions behind the ratings more transparent to users of those ratings, making the ratings agencies more accountable for following sound procedures, and reducing regulatory reliance on ratings.

Implementation of the reforms is still very much a work in progress. Still awaiting approval by House and Senate appropriators of its funding reprogramming plan, the SEC has not yet been able to create the new Office of Credit Ratings required by Dodd-Frank. However, it has reportedly begun the stepped up inspections of rating agencies required under the Act. In addition, the SEC recently issued the rule proposals implementing the operational reforms required by the Act. Meanwhile, the agency has put on hold provisions designed to increase legal accountability of ratings agencies by subjecting them to the same expert liability that auditors and underwriters face when their ratings are used in prospectuses. Faced with a threatened boycott by ratings agencies and fearing a shut-down of the still struggling MBS market, the SEC has issued a no action letter permitting asset-backed securities to be issued without inclusion of a rating in the prospectus. While we believe ratings agencies ought to be held legally accountable for following reasonable ratings procedures, we understand the rationale behind the SEC action.

The SEC has also begun the difficult task of reducing regulatory reliance on credit ratings. CFA strongly supports the concept behind this proposal, but we preferred the more flexible approach contained in the original Senate bill. Had that approach prevailed, Federal financial regulators might not be in the situation in which they now find themselves—forced to remove regulatory references to credit ratings without having identified any acceptable alternative measures of creditworthiness to put in their place. We are deeply concerned that this well-intended provision of the legislation may end up increasing risks in the financial system. We strongly encourage this Committee to take a closer look at how this provision is being implemented and what the implications are for the safety and stability of the financial system.

Conclusion

With the exception of the September 11 terrorist attacks, I can think of no events in recent history that have been as frightening for, or as devastating to, investors as the recent financial crisis. For several months, the markets appeared to be in free-fall. As the Dow plunged ever lower, hard won retirement savings accumulated over many years were vaporized overnight. No one knew when, of where, the market would finally reach bottom. Some who had planned to retire had to put those plans on hold. The least fortunate lost their jobs and their homes as the credit markets froze and the economy tanked. With unemployment still topping 9 percent, many Americans are still feeling those ill effects today. In short, the financial crisis has left Americans feeling as fearful of financial disaster as the events of 9/11 left us fearful of another terrorist attack.

A peculiar characteristic of the crisis for retail investors is that they suffered these devastating effects despite the fact that they had never invested in the toxic

[13] Collateralized Explosive Devices. [footnotes omitted]

but nonetheless AAA-rated mortgage-backed securities that were a root cause of the crisis and had probably never even heard of the credit default swaps that helped spread that risk throughout the global economy. Instead, retail investors suffered the collateral damage of regulatory failures in markets to which they had no direct exposure. The bulk of Dodd-Frank is dedicated to rectifying those broader market failures, and appropriately so. Although most investors are unlikely to understand the cause and effect, reforms designed to improve the overall effectiveness of regulation in the financial markets should benefit these investors indirectly both by promoting the financial stability that is crucial to their financial security, but also by making the regulators (in this case the SEC) more effective in carrying out their basic investor protection functions. In addition, Dodd-Frank includes a number of provisions designed to address long-standing weaknesses in our system of protections for unsophisticated retail investors. If these provisions are implemented effectively, the SEC and our system of investor protection generally could emerge stronger than before.

The investor protection framework provided in Dodd-Frank is a sound one. But it only takes us so far. For it to succeed, regulators will have to demonstrate a willingness to use their authority aggressively and effectively, and Congress will have to provide them with both the resources and the backing to enable them to do so.

PREPARED STATEMENT OF ANNE SIMPSON

SENIOR PORTFOLIO MANAGER, GLOBAL EQUITIES
CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

JULY 12, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee:

Good morning. I am Anne Simpson, Senior Portfolio Manager, Global Equities at the California Public Employees' Retirement System (CalPERS). I am pleased to appear before you today on behalf of CalPERS and share our views on a number of important investor protections included in Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

My testimony includes a brief overview of CalPERS, including how we participate in corporate governance and make investment decisions. My testimony also includes a discussion of our views on those key provisions of the Dodd-Frank we believe significantly enhance corporate governance and thereby contribute to the quality of risk adjusted returns in our portfolio.

Some Background on CalPERS

CalPERS is the largest public pension fund in the United States with approximately $232 billion in global assets and equity holdings in over 9,000 companies worldwide. CalPERS provides retirement benefits to more than 1.6 million public workers, retirees, their families and beneficiaries. We payout some $15 billion in benefits a year, and 70 cents on the dollar comes from investments, a significant portion of which in internally managed.[1]

Those we support are on modest incomes: typically, $2,000 in benefits a month. For that reason, as a significant institutional investor with a long-term investment time horizon, CalPERS has a vested interest in maintaining the integrity and efficiency of the capital markets. Moreover, size and long term liabilities mean we have to look for market solutions. We cannot simply sell our shares when things go wrong. As a result, corporate governance issues are of great concern to us and those on whose behalf we are investing: the public servants such as the police officers, firefighters, school employees and others who rely on us for their retirement security.

Participation in Corporate Governance Decisions

CalPERS has been a long-time proponent of good corporate governance, which serves to protect, preserve and grow the assets of the fund, and we strongly support the corporate governance reforms found in Dodd-Frank. We have also strongly supported other measures which are vital to a coordinated and comprehensive reform effort. These are not the focus of today's discussion, but they are critical to the project: systemic risk oversight, proper funding and independence for regulators, derivatives reform, credit rating agency overhauls among them.

As a shareowner of each of the stocks held in its portfolios, CalPERS has developed, and periodically updates, a comprehensive set of corporate governance prin-

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[1] Approximately three-quarters of CalPERS global equities portfolio is managed by internal investment professionals.

ciples and detailed guidelines that govern the voting of the related proxies. These principles and guidelines focus on a broad range of issues including how we will vote on director nominees in uncontested elections and in proxy contests.

CalPERS votes its proxies in accordance with our guidelines. Both the CalPERS proxy policy and the actual proxy votes cast are published on our Web site, so that all constituents and interested parties can know our positions on these important issues. Moreover, as part of our proxy voting diligence process, we have detailed discussions with many companies in our portfolio. We engage underperforming companies in extensive dialogue through our Focus List program, which was found to produce superior returns over a 10-year period.[2]

Shareowner proxy voting rights are considered to be valuable assets of the fund. Attention to corporate governance promotes responsible business practices that serve as an integral component to a company's long-term value creation. In instances where guidelines are not dispositive on shareowner or management proposals, the Office of Corporate Governance, which I oversee, reviews and makes proxy voting recommendations that are consistent with the best interests of the fund and our fiduciary duties.

Investment Decision Making Process

As indicated above, CalPERS takes a long-term strategic approach to its investment decisionmaking process. Annually, a comprehensive "Strategic Investment Plan" is developed jointly by CalPERS' investment staff and its external consultants, with input from and subject to final approval of the 13-member board. The plan is based on careful analysis of the long-term outlook for the capital markets and major qualitative and quantitative factors including the unique needs, preferences, objectives and constraints of CalPERS. This detailed investment plan manifests itself in the development of an asset allocation framework designed to achieve the ongoing commitment to diversification and provide guidance in the investment decisionmaking process including advancing investment strategies, the hiring and monitoring of external investment advisors, portfolio rebalancing and meeting cash needs.

How Inadequate Corporate Governance Contributed to the 2008 Financial Meltdown

It is widely acknowledged that the 2008 financial crisis was fuelled by a toxic combination of lax oversight and misaligned incentives.[3] Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come.[4] Boards of directors were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind.[5] And too many boards approved executive compensation plans that rewarded excessive risk taking.[6] Others simply did not have robust risk management systems in place, or had these subservient to short term revenue chasing. The Dodd-Frank focus upon improving transparency around incentives and giving shareowners the tools to improve oversight of boards is therefore absolutely on target. We look forward to further improvements in disclosure also under discussion by financial regulators, for example to ensure that compensation below board level

[2] *See The CalPERS Effect on Targeted Company Share Prices,* Wilshire Associates, (November 2010). *http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201008/item05a-2-02-01.pdf.*

[3] *See* Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xviii* (Jan. 2011), *http://www.gpoaccess.gov/fcic/fcic.pdf* ("We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis") [hereinafter FCIC Report]; Investors' Working Group, *U.S. Financial Regulatory Reform, The Investors' Perspective* 22 (July 2009), *http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf* ("The global financial crisis represents a massive failure of oversight") [hereinafter IWG Report].

[4] IWG Report, *supra* note 1, at 22.

[5] *See* Staff of S. Permanent Subcomm. on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse 185–86 (Apr. 13, 2011), *http://hsgac.senate.gov/public/__files/Financial__Crisis/FinancialCrisisReport.pdf* (providing evidence that board oversight of Washington Mutual, Inc., including oversight of enterprise risk management, was "less than satisfactory"); IWG Report, *supra* note 1, at 22.

[6] FCIC Report, supra note 1, at *xix* ("Compensation systems-designed in an environment of cheap money, intense competition, and light regulation-too often rewarded the quick deal, the short-term gain-without proper consideration of long-term consequences); see also Deputy Secretary of the Treasury Neal Wolin, Remarks to the Council of Institutional Investors 4 (Apr. 12, 2010), *http://www.ustreas.gov/press/releases/tg636.htm* (noting that "irresponsible pay practices . . . led so many firms to act against the interests of their shareholders"); IWG Report *supra* note 1, at 22.

is disclosed for those who can have an impact upon the company's over risk profile, and also to improve understanding of pay equity across companies.

More specifically, a common element in the failure of Lehman Brothers, American International Group, Fannie Mae, Washington Mutual, and many other companies implicated in the 2008 financial meltdown, was that their boards of directors did not control excessive risk-taking, did not prevent compensation systems from encouraging a 'bet the ranch' mentality, and did not hold management sufficiently accountable.[7] As famed investor Warren Buffett observed in his 2009 letter to the shareowners of Berkshire Hathaway Inc.:

> In my view a board of directors of a huge financial institution is *derelict* if it does not insist that its CEO bear full responsibility for risk control. If he's incapable of handling that job, he should look for other employment. And if he fails at it—with the Government thereupon required to step in with funds or guarantees—the financial consequences for him and his board should be severe.
>
> It has not been shareholders who have botched the operations of some of our country's largest financial institutions. Yet they have borne the burden, with 90 percent or more of the value of their holdings wiped out in most cases of failure. Collectively, they have lost more than $500 billion in just the four largest financial fiascos of the last 2 years. To say these *owners* have been "bailed-out" is to make a mockery of the term.
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> The CEOs and directors of the failed companies, however, have largely gone unscathed. Their fortunes may have been diminished by the disasters they oversaw, but they still live in grand style. It is the behavior of these CEOs and directors that needs to be changed: If their institutions and the country are harmed by their recklessness, they should pay a heavy price—one not reimbursable by the companies they've damaged nor by insurance. CEOs and, in many cases, directors have long benefited from oversized financial carrots; some *meaningful* sticks now need to be part of their employment picture as well.[8]

Accountability is critical to motivating people to do a better job in any organization or activity.[9] An effective board of directors can help every business understand and control its risks, thereby encouraging safety and stability in our financial system and reducing the pressure on regulators, who, even if adequately funded, will be unlikely to find and correct every problem.[10] Unfortunately, long-standing inadequacies in corporate governance requirements and practices have limited shareowners' ability to hold boards accountable.[11]

Fortunately, Dodd-Frank contains a number of corporate governance reforms that when fully implemented and effectively enforced will reduce those inadequacies by providing long-term investors like with better tools, including better information, to hold directors more accountable going forward.[12]

The remainder of my testimony highlights some of the key corporate governance provisions of Dodd-Frank and why CalPERS believes those provisions are beneficial to investors in terms of improving the accountability of boards and enhancing investor protection.

Dodd-Frank Corporate Governance Provisions

SEC. 971 Proxy Access

The most fundamental of investor rights is the right to nominate, elect and remove directors.[13] Anything less provides a fundamental flaw in capitalism. The providers of capital need to be able to hold boards accountable, and boards in turn need

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[7] *See, e.g.* Press Release, CalPERS, *Investors Speak Out on Dodd's Financial Reform Bill—Offer Do's, Don'ts as Bill Reaches Critical Stage* 2 (Mar. 19, 2010), *http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2010/mar/investors-financial-reform-bill.xml.*

[8] Letter from Warren E. Buffett, Chairman of the Board, to the Shareholders of Berkshire Hathaway, Inc. 16 (Feb. 26, 2010), *http://www.berkshirehathaway.com/letters/2009ltr.pdf.*

[9] Press Release, *supra* note 5, at 2.

[10] *Id.*

[11] IWG Report, *supra* note 1, at 22 ("shareowners currently have few ways to hold directors' feet to the fire").

[12] S. Comm. On Banking, Housing, & Urban Affairs, Rep. On The Restoring American Financial Stability Act 30 (Mar. 22, 2010), *http://banking.senate.gov/public/__files/RAFSAPostedCommitteeReport.pdf.* (Noting that the Senate version of Dodd-Frank contained provisions designed to give investors "more protection" and shareholders "a greater voice in corporate governance") [hereinafter S. Rep.].

[13] *See* IWG Report, *supra* note 1, at 22.

to have effective oversight of management. The United States is virtually alone in world markets by not providing capital providers the ability to hold their stewards to account. Several roadblocks, however, have prevented this fundamental right from being an effective remedy for shareowners dissatisfied with the performance of their public companies.[14]

One of the most significant roadblocks is that Federal proxy rules have historically prohibited shareowners from placing the names of their own director candidates on public company proxy cards.[15] Thus, long-term shareowners who may have wanted the ability to run their own candidate for a board seat as a means of making the current directors more accountable have only had the option of pursuing a full-blown election contest—a prohibitively expensive action for most public pension funds like CalPERS.[16]

Fortunately, due to the extraordinary leadership of this Committee and the U.S. Securities and Exchange Commission ("Commission or SEC"), this roadblock—the inability for shareowners to place director nominees on the company's proxy card—we hope will soon be lifted.[17] As background, in June 2009, the Commission issued a thoughtful proposal providing for a uniform measured right for significant long-term investors to place a limited number of nominees for director on the company's proxy card.[18] Some opponents of the proposal subsequently raised questions about whether the Commission had the authority to issue a proxy access rule.[19] In response, Senator Schumer introduced, what would later become Section 971 of Dodd-Frank, removing any doubt that the Commission had the authority to issue a proxy access rule.[20]

After careful consideration of the input received in response to two separate comment periods on the proposal, the SEC issued a final rule on September 16, 2010.[21] The final rule provides the ability for CalPERS, as part of a larger group of long-term investors, to place a limited number of nominees for director on the company's proxy card and, thereby, effectively exercise its traditional right to nominate and elect directors to company boards.[22]

Unfortunately, despite Section 971 of Dodd-Frank, opponents of the Commission's final rule have chosen to sue the SEC to delay its implementation.[23] The legal challenge, based largely on Administrative Procedure Act grounds, is currently before the D.C. Circuit Court of Appeals ("Court") on an expedited review.[24] A decision is expected this summer.[25] Whatever the Court's decision, we fully expect that the Commission will, after curing any administrative deficiencies, promptly implement the final rule and remove this long-standing roadblock to the exercise of shareowners' fundamental right to nominate, elect, and remove directors.

SEC. 951 Shareholder Vote on Executive Compensation Disclosures

As described by the Financial Crisis Inquiry Commission, the financial crisis revealed compensation systems:

> [D]esigned in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often those systems encouraged the big bet—where the payoff on the upside could be huge

[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] We note that a second roadblock to the fundamental right of investors to nominate, elect, and remove directors—"plurality voting"—was not addressed by Dodd-Frank and remains a significant impediment to improving board accountability. More specifically, most companies elect directors in uncontested elections using a plurality standard, by which shareowners may vote for, but cannot vote against, a nominee. If shareowners oppose a particular nominee, they may only withhold their vote. As a consequence, a nominee only needs one "for" vote to be elected and, therefore, potentially unseating a director and imposing some accountability becomes virtually impossible. We would respectfully request that the Committee consider stand alone legislation to remove this roadblock. *Id.*
[18] Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (proposed rule June 18, 2009), *http://www.sec.gov/rules/proposed/2009/33-9046.pdf.*
[19] Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,674 (final rule Sept. 16, 2010), *http://www.gpo.gov/fdsys/pkg/FR-2010-09-16/pdf/2010-22218.pdf* ("Several commentators challenged our authority to adopt Rule 14a–11").
[20] *See id.*
[21] *Id.* at 56,668.
[22] *Id.*
[23] Ted Allen, U.S. Appeal Court to Hear Proxy Access Lawsuit, ISS (Apr. 6, 2011), *http://blog.riskmetrics.com/gov/2011/04/us-appeals-court-to-hear-proxy-access-lawsuit.html.*
[24] *Id.*
[25] *Id.*

> and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.[26]

During the development of Dodd-Frank, this Committee concluded that "shareholders, as the owners of the corporation had a right to express their opinion collectively on the appropriateness of executive pay."[27] The result was Section 951 of Dodd-Frank that provides that any proxy for an annual meeting of shareowners will include a separate resolution subject to shareowner advisory vote to approve the compensation of executives.[28]

We agree with the Council of Institutional Investors that Section 951 provides with:

> a tool . . . [to] effectively, efficiently and regularly provide boards with useful feedback about whether investors view the company's compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay offer a more targeted way to signal shareowner discontent than withholding votes from compensation committee members, and can serve as a helpful catalyst and starting point for dialogue on excessive or poorly structured executive pay. Also, the possibility of a majority "against" vote might serve as an additional deterrent against devising incentive plans that promote excessive risk-taking and/or enrichment.[29]

Section 951 became effective for the first time this proxy season. As recently discussed by SEC Commissioner Luis Aguilar, it appears that the new requirement is benefiting investors in at least three ways:

> First, say-on-pay seems to have resulted in increased communication between shareholders and corporate management. Reports seem to indicate that both shareholders and corporate management are pro-actively initiating discussions regarding executive compensation, which is far from the predictions that say-on-pay would lead to disrepair or at best be ineffective—this sounds like a positive development to me.
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> Second, the reports indicate that shareholders are making their voices heard. For example, as of this month, 31 public companies have failed to obtain majority support for their executive compensation packages.
>
> Lastly, some pay practices appear to be changing in deference to shareholders' views. Some companies have actually altered the pay and benefits of top executives. Many companies are putting in *more performance-based* compensation plans and they are addressing items that shareholders often criticized, such as: excessive severance; perks; Federal income tax payments; and pensions. For example, approximately 40 of the Fortune 100 companies have eliminated policies that had the company pay certain tax liabilities of executives. As another example, General Electric modified the pay of its CEO 2 weeks prior in anticipation of the shareholder vote, deferring the vesting of certain options and conditioning the vesting on whether the company meets certain performance targets. According to news reports, this was apparently done to avoid losing a say-on-pay vote.[30]

Section 954 Recovery of Erroneously Awarded Compensation

Another means identified by this Committee, the Investors Working Group, the Council of Institutional Investors, and many other parties to combat poorly structured executive pay plans that rewarded short term but unsustainable performance was to enhance current clawback provisions on unearned executive pay.[31] In response, Section 954 of Dodd-Frank strengthens the existing clawback provisions in three important ways: First, it expands the application of the existing clawback re-

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[26] FCIC Report, *supra* note 1, at *xix.*

[27] S. Rep., *supra* note 10, at 109.

[28] *Id.*

[29] Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors to Mr. Mike Duignan, Head of Market Supervision, Irish Stock Exchange 1–2 (Aug. 11, 2010), *http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/8-11-10CIILetter IrishCorpGovCode%20.pdf.*

[30] Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission, Speech at the Social Investment Forum 2011 Conference 3–4 (June 10, 2011), *http://www.sec.gov/news/speech/2011/spch061011laa.htm.*

[31] *See, e.g.,* Letter from Laurel Leitner, Senior Analyst, Council of Institutional Investors to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation 1–2 (May 19, 2011), *http://www.fdic.gov/regulations/laws/Federal/2011/11c07Ad73.PDF.*

quirements to any current or former executive officer (not just the CEO or CFO).[32] Second, it clarifies that a clawback is triggered by an accounting restatement due to material noncompliance without regard to the existence of misconduct.[33] Finally, it strengthens the existing clawback requirements by extending the clawback to 3 years from the existing 12-month period.[34]

CalPERS' support for Section 954 is based on our belief, shared by the Council of Institutional Investors, and many other corporate governance and compensation experts, that a tough clawback policy is an essential element of a meaningful pay for performance philosophy.[35] If executives are rewarded for hitting their performance metrics—and it later turns out that they failed to do so—they should return to shareowners the pay that they did not rightly earn.[36] We look forward to the Commission's proposed and final rules to implement Section 954 scheduled for later this year.

Section 973. Disclosures Regarding Chairman and CEO Structures

Finally, as indicated, the financial crisis represented an enormous failure of board oversight of management. We share the view of the Council of Institutional Investors, the Investor's Working Group and many others that board oversight may be weakened by forceful CEO's who also serve as a chair of the board.[37] In our view, Independent board chairs are a key component of robust boards that can effectively monitor and, when necessary, rein in management.[38] To have the CEO effectively running the board means the oversight process is fundamentally comprised. No one can grade their own performance objectively. Independent board oversight of the CEO is vital.

While not requiring the separation of the role of the chair and CEO, Section 973 of Dodd-Frank provides an important step forward by directing the SEC to issue rules, which are already in place, requiring those companies who have a Chairman/ CEO structure to disclose an explanation of the reasons that it has chosen that structure.[39] This is an important advancement in corporate governance disclosure that we continue to support.

That concludes my testimony. Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

PREPARED STATEMENT OF PAUL S. ATKINS *

VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

JULY 12, 2011

Thank you very much, Mr. Chairman, Ranking Member Shelby, and Members of the Committee, for inviting me to appear today at your hearing. It is an honor and privilege for me to provide information for your deliberations on Dodd-Frank and the SEC.

Dodd-Frank Overview

I come before you today not only as a former Commissioner of the Securities and Exchange Commission and member of the former Congressional Oversight Panel for the TARP, but also as a visiting scholar at the American Enterprise Institute for Public Policy Research. AEI has a long history of focus on the economic and psychological fundamentals of entrepreneurism, economic development, and the political economy. It is a privilege for me to be able to participate in the public discussion about the issues of the day in the context of my years of work in the public and private sector.

The news of this past week has highlighted the disappointing state of affairs in our economy. The data released by the Bureau of Labor Statistics show the unem-

[32] John E. McGrady, III, & Kristen R. Miller, Executive Compensation Clawbacks—Effective Deterrent or Effective Remedy?, BNA Insights, Daily Rep. Executives, at B–4 (July 7, 2011).

[33] *Id.*

[34] *Id.*

[35] Letter from Laurel Leitner, *supra* note 29, at 1.

[36] *Id.*

[37] Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors, to Jose Manuel Barroso, President, European Commission 1–2 (Aug. 31, 2010), *http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/CII%20Letter%20on%20EC%20Green%20Paper%20on%20Bank%20Governance%208-31-10%20final.pdf.*

[38] *Id.*

[39] S. Rep., *supra* note 10, at 119.

* The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

ployment rate increasing to 9.2 percent, while the labor force itself shrank by more than a quarter of a million people. Basically, unemployment has risen as the supply of available workers has shrunk. More than 14 million Americans are out of work—and almost half of those have been out of work for more than 6 months.

In a productive economy, jobs are normally created by people with entrepreneurial spirit—whether small businesses or large corporations. Starting with an idea for a product or service and the risk appetite to make it a reality, the entrepreneur will need to engage the help of others to make it a reality. To hire people and develop their product, entrepreneurs of course need money. The money has to come from somewhere, and with efficient financial markets, an entrepreneur should be able to borrow the money or find others willing to invest in the idea—risk their own capital for an interest in the potential profits.

We have a great debate in this country as to whether there is a shortage of credit supply or demand. Last year, as a member of the Congressional Oversight Panel, I had the privilege of testifying before the House Financial Services Committee regarding small business lending initiatives. The debate was then, as it is now, whether the issuance of credit is constrained because of a lack of demand or a shortage of supply. Regardless of the cause, in the current regulatory climate it is difficult for lenders to increase their small business lending. Small businesses produce most of the new jobs in the country. From my work on the Congressional Oversight Panel, we heard many anecdotal reports from our field hearings and elsewhere that bank examiners have become more conservative and have required increasing levels of capital since the advent of the financial crisis. The balance between sufficient regulation and over-regulation is often a fine one. We have to remember that it is the investors who pay for regulation—effective or otherwise—through higher prices, diminished returns, or restricted choices.

Why do I go through this description of how jobs are created? Because confidence and certainty are crucial to fostering a business climate that creates jobs. It is my belief that a major cause of the uncertainty handcuffing our economy today is in fact Government policy, particularly the sweeping new financial law enacted last year ostensibly for the sake of market stability and investor confidence. Because many of the provisions were not directly related to the underpinnings of the financial crisis, investors ultimately will pay for the increased costs associated with the mandates without receiving commensurate benefits.

That is the single tragedy of Dodd-Frank. It is a calamity—2,319 pages are aggravating uncertainty and undermining the climate necessary for economic growth. Yet considering its length and scope, the Dodd-Frank Act was passed with relatively few hearings and no real debate about provisions that now threaten economic growth. In contrast, following the market crash of 1929, Congress attempted comprehensive reform over a period of a decade, involving extensive hearings and public debate. Dodd-Frank calls for the creation of anywhere between 243 and 533 new rules, depending on how you count them, and 84 rules by 3 new agencies alone—the Consumer Financial Protection Bureau (CFPB), the Office of Financial Reporting (OFR), and the Financial Stability Oversight Council (FSOC). Each of these new agencies has far-reaching powers, and we will not know for years how they will develop. Legal challenges are inevitable, not just as to the technicalities of the rules and whether they have been properly promulgated, but also as to basic questions of jurisdiction and constitutionality.

As the past year has shown, Dodd-Frank also mandates very tight deadlines for Federal agencies to draft and implement these rules. In this quarter alone, Dodd-Frank mandates more than 100 rules to be finalized.[1] As some experts have noted previously,[2] this rate of rulemaking required by Dodd-Frank far outpaces the agencies' respective historical workloads. From 2005–2006 the SEC annually averaged 9.5 new substantive rules, while the CFTC averaged 5.5. Post-Dodd-Frank those numbers have soared to an average of 59 new rules for the SEC and 37 for the CFTC.[3] Members of this committee have previously expressed concern that Federal agencies are sacrificing quality for speed as they neglect to properly weigh the costs and benefits to the economy of their proposed rules. In these circumstances, something has to give, and so far we have seen very little in the way of cost benefit analysis (some agencies' inspectors general are investigating whether this lack of analysis may have violated the Administrative Procedure Act and other mandates), contracted timelines for the public to comment on proposed rulemakings (most com-

[1] *See Promoting Economic Recovery and Job Creation: Hearing before the H. Comm. on Financial Services,* 112th Cong., 1st Sess. (Jan. 25, 2011) (statement of Hal H. Scott, Professor, Harvard Law School).

[2] *Id.*

[3] *Id.*

ment periods are about 20 days shorter than usual), missed deadlines (right before the statutory effective date, registration requirements under Title IV had to be delayed by 8 months because the rules were finalized so late), and proposed rulemaking that is vague or overly broad. Taken together, the ability of stakeholders to provide input on matters directly impacting their business is severely impaired.

An example on the latter point can be found with the Financial Stability Oversight Council (FSOC), a new agency created by Title I to identify threats to the financial stability of the United States. While this seemed like an attractive idea to officials who wish never to relive the anxiety of the "Too Big to Fail" era, the realities and impracticalities of such a Council have already started to reveal themselves.

The principal new authority assigned to FSOC is to identify systemically important financial institutions. FSOC's proposed rulemaking in January 2011 regarding this process was roundly criticized by the public and bipartisan Members of Congress for merely parroting the broad statutory language. This lack of transparency—magnified by leaks to the media about the staff's methodology under consideration—has only compounded market uncertainty. FSOC recently announced plans to provide further guidance of this most important authority of the new systemic risk regulatory regime—although the form and extent of that guidance remains to be seen.

The activities of the Financial Stability Oversight Council (including OFR) and the Bureau of Consumer Financial Protection have received much scrutiny over the past year, and for good reason. They comprise just 2 of the Act's 16 Titles, however, and so I welcome today's hearing on the subject of the investor protection provisions. As I intend to make clear today, many of these provisions impose sweeping changes, yet received relatively little attention during consideration of last year's Dodd-Frank Act, which naturally raises the likelihood of unintended consequences.

Title IV: The Private Fund Investment Advisers Registration Act of 2010

Under Title IV of Dodd-Frank, investment advisers to hedge funds and private equity firms are required to comply with a set of registration rules, which hinders the success of both investors in the funds by adding administrative costs and potentially keeping competitors out of the market, and the SEC by spreading its resources too thinly and diverting its attention from protecting retail investors. This situation, together with the likely mistaken sense of security that investors might infer from SEC registration, endangers all investors.

By repealing the "15-client" exemption, Title IV effectively forces all investment advisers managing more than $150 million in assets to register with the SEC. The Commission estimates that this will bring 3,200 advisers under its supervision. The rules recently finalized by the SEC specify the exemptions provided by Dodd-Frank for advisers solely to venture capital funds, foreign private advisers, and family offices. The rulemaking was not completed until close to the deadline before which advisers were originally required to register. Prior to the adoption of the rule, the SEC allowed the affected entities to wonder for several months through rumor and staff statements if, when, and in what form the requirement might come into effect.

Why do we have this new registration process? One narrative has been that supposed "deregulation" during the past 6, 10, or 15 years—you pick the time period—led to the crisis. But, one can hardly say that the past 6–15 years have been deregulatory. In the United States we had Sarbanes-Oxley, new SEC rules, new stock exchange and NASD/FINRA rules, and new accounting rules. We saw the financial crisis hit regulated entities around the world, even in countries like Germany and France that one could hardly characterize as deregulatory.

Regulators and lawmakers abroad, especially in Europe, have tried to blame hedge funds and short selling. Hedge funds were supposedly over-leveraged and drove the demand for esoteric securities. This narrative claims they shorted all kinds of assets during the 2008 crisis, driving the market down and creating panic.

It will be surprising for subscribers to the popular narrative to learn that hedge funds overall had the least leverage, at 2:1.[4] Compare that to other financial institutions at the time, which had significantly higher leverage ratios. Taking short positions, in turn, is an important investment activity as it helps to provide liquidity and points out excessive valuations. I have yet to see a compelling argument for why the price declines and flagging investor confidence experienced in 2008 might be attributed to hedge funds' shorting activities rather than the obvious decline in economic and business fundamentals.

The costs borne by registering advisers, and in turn by their pension, institutional and private individual investors, are real and significant. Sending off the registra-

[4] *See* Andrew Ang, *et al.,* Hedge Fund Leverage 19 (Jan. 25, 2011) available at *http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf.*

tion form is the deceptively easy part. Registered advisers will have to bear numerous administrative, legal, and personnel costs.

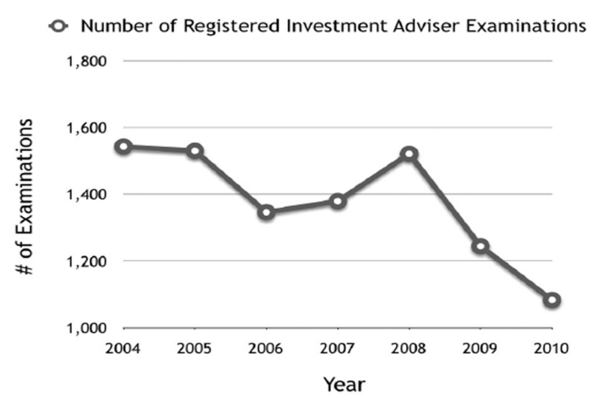
In the recently adopted rules, advisers exempted from registration requirements would still be required under Sections 407 and 408 to comply with some of the same reporting requirements as registered advisers. For example, venture capital advisers would be subject to examination and recordkeeping requirements. For venture capital firms especially, it is not clear what the investor protection rationale is. This construct seems to be contrary to the intent of Section 407; if so, this committee has an oversight interest in the new rules for exempt reporting advisers.

Obviously this shakeup will be particularly hard on smaller hedge funds and private equity firms, which have fewer resources all around. As some have already argued, this new regulatory structure has the potential to raise barriers to entry and drive segments of the industry overseas. In the end, all of this may add many more costs to an economy that can scarcely afford it.

Under proposed rulemaking passed earlier this year, a new reporting requirement will be imposed on all registered advisers known as Form PF. As proposed, Form PF is unprecedented in scope and detail: it is 44 pages long in its entirety. All registered private fund advisers would be required to file Form PF at least annually, and large advisers would be required to file quarterly. Advisers will be required to complete different sections based on their fund type and size, and the reporting burden increases exponentially for large firms. For example, advisers to private equity funds of at least $1 billion would have to file Form PF within 15 days of quarter's end, including possibly detailed information on their portfolio company holdings.

Requiring registered advisers to compile and report all this detailed information represents an enormous regulatory burden that provides no appreciable benefit to investors. Demonstrably, much like many other Federal agencies, in the SEC's rush to draft and implement rules in accordance with Dodd-Frank's statutory deadlines, it has not properly weighed the costs and benefits. The industry has raised numerous concerns with the draft rule, and I hope the SEC will consider the implications of Form PF carefully.

As the following chart [5] illustrates, since 2008 the number of examinations has actually been decreasing because of management priorities and allocation of resources. The flood of new registrants will only dilute the SEC's resources, and further reduce the frequency or scope of examinations. The allocation of resources in this area is critical—it should not be forgotten that in the case of the largest Ponzi scheme ever perpetrated, Bernard L. Madoff Investment Securities was both a registered broker-dealer and a registered adviser subject to regular SEC examinations.



Title IX: The Investor Protection and Securities Reform Act of 2010

Moving on to Title IX. Title IX encompasses a wide range of issues including credit rating agencies, whistleblowing, fiduciary duties, and SEC management.

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[5] *See* United States Securities and Exchange Commission, *Study on Enhancing Investment Adviser Examinations* 15 (Jan. 2011) *available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf.*

Credit Rating Agencies

This Committee took action with the *Credit Rating Agency Reform Act of 2006* to address the troubling oligopoly of credit rating agencies and the SEC's opaque method of designating nationally recognized statistical rating organizations (NRSROs). Unfortunately, the SEC had never addressed these issues in the 30 years after instituting the NRSRO designation. The framework adopted in 2006 (unfortunately too late to forestall the crisis) aimed to encourage transparency and competition among rating agencies. That approach, unfortunately, has been undermined by some provisions of Dodd-Frank that set up an expectation for ultimately unachievable regulatory control.

After the financial crisis, credit rating agencies were under fire for their faulty methodologies and conflicts of interest. To combat this, the SEC has requested comment for a study on the feasibility of standardizing credit ratings and has proposed hundreds of pages of new rules. Addressing problems of faulty methodologies and transparency, the SEC has proposed rules requiring internal controls for determining ratings, establishing professional standards for credit analysts, and providing for greater public disclosure about credit ratings.

Dodd-Frank also gives the SEC the power to penalize credit rating agencies for consistently inaccurate ratings. Further, Dodd-Frank also raises the dubious possibility that the SEC would assess the accuracy of ratings. It is unclear how that could ever be accomplished.

In an attempt to break up the oligopoly imposed by the three largest credit rating agencies, the SEC has proposed rules to remove references to credit ratings from regulations, pursuant to authority under Section 939. In addition, the SEC has alleviated the problem of conflicts of interest by precluding ratings from being influenced by sales and marketing and by enhancing a "look-back" review to determine whether any conflicts of interest influenced a rating.

Unfortunately, Dodd-Frank has taken an inconsistent approach with respect to credit rating agencies. With respect to sovereign debt, the threats currently being levied by government officials in Europe demonstrate that rating agencies are susceptible to political pressure as to the "correctness" of their ratings. Congress should consistently push transparency and competition so that investors get high-quality and objective advice from credit rating agencies.

Whistleblower Programs

Dodd-Frank provides that the SEC and the CFTC may award whistleblowers from 10 percent to 30 percent of monetary sanctions collected in enforcement actions.[6] Two special funds of $300 million and $100 million are set up for the SEC and CFTC, respectively, to ensure payment of whistleblowers. Dodd-Frank provides that whistleblowing employees can hire attorneys and that they *must* hire an attorney if they wish to remain anonymous. One can imagine what percentage of the 10 percent–30 percent take the lawyers will demand from the whistleblower.

Dodd-Frank clearly aims to encourage whistleblowers and ease their fears of retaliation, ostracism, and reputational damage for future employment-all authentic concerns for legitimate protesters. But it creates perverse incentives as well, and sets up a system that has many inherent problems. For example, if an employee approaches an attorney with a potential claim of less than $1 million, what will the attorney advise if the problem is ongoing and is likely to result in a settlement of more than $1 million at some time in the future? Will the attorney advise the employee to report it immediately, or to remain quiet until the problem crosses the compensation threshold? Moreover, the unintended consequences of unfounded charges from disgruntled employees with ulterior motives will be devastating for shareholders. Of course, this only considers the employee side of the system. From the SEC's side, how will it cope with effectively investigate the potentially overwhelming number of tips? The Bernie Madoff case is again an apt reminder.

Already, a company must hire attorneys and accountants to investigate almost any purported complaint, with strict policies and procedures to ensure due process. The injection of plaintiffs' attorneys into the mix increases the potential for specious claims to get traction and win a settlement, especially if the complainant is anonymous. Congress has skewed the delicate balance between good policy and over-indulgence of accusations.

Despite comments to the contrary, the SEC chose not to make mandatory internal reporting to a company's own compliance program. Because the bounties available to whistleblowers (and their attorneys) are so large, and because the SEC chose not to make internal reporting mandatory, whistleblowers are incentivized to "report

[6] Section 922 provides for the SEC's whistleblower program. Section 748 provides for the CFTC's whistleblower program.

out" directly to the SEC rather than to "report up" through their companies' compliance programs. Thus, the rule undermines internal compliance programs. Moreover, companies have no protection from disclosure of confidential information, and there is no real way to sanction a false whistleblower, absent "bad faith"—which is a tough standard to meet.

Fiduciary Duty

Under Section 913, the SEC was required to conduct a study on harmonizing the standard of care for investment advisers and broker-dealers. Under the Investment Advisers Act of 1940 and Supreme Court precedent, advisers have been deemed to owe a "fiduciary duty" to their clients whereas broker-dealers are subject to standards imposed by the Securities Exchange Act of 1934 and their self-regulatory organizations. The SEC has recommended to Congress that it harmonize these concepts into a uniform standard.

Under the 1934 Act and SRO rules, broker-dealers ultimately are held to a very high standard of care that has benefited investors for many years. With respect to an advisory relationship, any dispute ultimately will likely be judged through a lawsuit in State court under terms of the advisory contracts, which tend to be long and include many disclaimers of conflicts of interest. On the other hand, broker-dealers are subject to broad standards of practice that the SEC and FINRA have adopted and interpreted over the years, as well as a low-cost arbitration system.

It is important to remember that not all investors are the same. Some investors perhaps want and need a fiduciary who possesses intimate knowledge of their financial condition and can advise accordingly. On the other hand, some investors would prefer to have a true broker who is engaged on a transaction basis and is compensated accordingly. These two kinds of activities should have different standards of care attached to them. When the SEC turns to rulemaking later this year, as it has indicated it plans to do, it should respect the different needs of different investors.

At the same time, the Department of Labor is pursuing a separate rulemaking that aims to increase the ambit of fiduciary duty within the context of ERISA plans. Unfortunately, this Labor Department initiative does not seem to be coordinated with the SEC and carries potentially profound effects for the retirement plan market and the availability of product offerings.

SEC Management

Title IX contains many other provisions, most of which have nothing to do with the causes of the financial crisis. In my short window of time before you, I cannot discuss all of these sections. Suffice it to say that many sections respond to longstanding requests of special interest groups. The SEC's compliance with these provisions has been spotty: The ink was not even dry on Dodd-Frank when the SEC gave a new Federal right for some shareholders to be able to nominate corporate board members directly instead of going through the normal process by which directors are nominated. This rulemaking is being challenged in Federal court. Yet, the SEC has neglected Section 965, the intent of which was to direct the SEC to disband the Office of Compliance Inspections and Examinations and return the examiners to the Divisions of Investment Management and Trading and Markets.

Just last week the SEC chairman testified about the recent leasing decision and suggested that the SEC should no longer have leasing authority. In contrast, last year, some were suggesting the SEC should have a self-funding mechanism outside of the normal congressional appropriations process. In the meantime, the SEC has pursued an extremely divisive agenda, marked by more than a dozen 3–2 votes in the past 2 years alone. I have never witnessed such division—this record is in marked contrast to my experience of 10 years as staffer in two chairman's offices and as a commissioner under three chairmen. The dissenters are reasonable people and their dissents are not always fundamentally opposed to the rulemaking itself. The sad fact is that it appears that the leadership of the SEC does not engage effectively on the finer points of the policy issues. Thus, I encourage this Committee to continue to exercise oversight of SEC management.

Dodd-Frank attempted to focus on organizational and managerial issues at the SEC, but it wound up, in effect, micro-managing and making things more complicated. Section 911 codifies in statute the Investor Advisory Committee that the current chairman established, which itself was similar to the Consumer Affairs Advisory Committee that I helped Chairman Levitt establish when I worked in his office in the mid-1990s. This statutory provision etches in stone one way of doing things to the exclusion of others. We shall see how the Investor Advocate, an independent office established under Section 915, ultimately develops. The statute thus adds yet another direct report to the chairman, who already has more direct reports than is practicable.

Management philosophies like Total Quality Management and Six Sigma teach that in any organization, measurement drives human behavior because the incentive is to try to meet the measurement criteria ("You get what you measure").

For example, Enron was not reviewed for years because review personnel were judged by how many filings they reviewed, not necessarily by the quality of their review. The incentive was to postpone review of the complicated Enron filing because one could review many others in the time it would take to review Enron. By the late 1990s, this focus on numbers more than quality had decreased staff morale so much that employees began to organize to form a union. Despite management's campaign to thwart it, in July 2000, SEC employees voted overwhelmingly to unionize the workforce.

The emphasis on numbers over quality also affects behavior in the enforcement division and examination office. Every enforcement attorney knows that statistics (or "stats") help to determine perception and promotion potential. The statistics sought are cases either brought and settled or litigated to a successful conclusion, and amount of fines collected. These statistics do not necessarily measure quality (such as an investigation performed well and efficiently, but the evidence ultimately adduced did not indicate a securities violation). Thus, the stats system does not encourage sensitivity to due process.

In addition, the stats system tends to discourage the pursuit of penny stock manipulations and Ponzi schemes, which ravage mostly retail investors. These frauds generally take a long time and much effort to prove—the perpetrators tend to be true criminals who use every effort to fight, rather than the typical white-collar corporate violator of a relatively minor corporate reporting requirement who has an incentive to negotiate a settlement to put the matter behind him and preserve his reputation and career. Thus, over the years several staff attorneys have told me that their superiors "actively discourage" them from pursuing Ponzi schemes and stock manipulations, because of the difficulty in bringing the case to a successful conclusion and the lack of publicity in the press when these cases are brought (with the exception of Madoff, these sorts of cases tend to be small). Some senior enforcement officers openly refer to these sorts of cases as "slip-and-fall" cases, which disparages the real effect that these cases have on individuals, who can lose their life savings in them. Because of the interstate and international aspect of many of these cases, if the SEC does not go after them, no one can or will.

Sadly, this attitude is reflected even outside the SEC. Just last week, I saw a quotation in an article regarding the steps that the SEC needs to take to collect on the settlements that it has entered into. The sentiment expressed by the commenter was that many of the cases are very small, but that the agency is under political pressure to go after the smaller schemes. Not to discount the importance of combating any fraud, we need to remember that one individual losing his entire life's savings is extremely serious, even if it is "only" 5-digits in size.

During my tenure as commissioner, I emphasized the need to focus from an enforcement perspective on microcap fraud, including Ponzi schemes, pump-and-dump schemes, and other stock manipulations. I was a strong advocate for the formation of the Microcap Fraud Group in the Enforcement Division, which was finally formed in 2008. I had also strongly supported the good efforts of the Office of Internet Enforcement, established under Chairman Levitt in the late 1990s, which worked closely with other law enforcement agencies to tackle Internet and other electronic fraud. Unfortunately, it appears that while the administrative overhead functions within enforcement are gaining resources, insufficient attention is being paid to "boots-on-the-ground" investigative resources to combat the pernicious frauds that prey on individual investors.

There are many intelligent, competent, dedicated, hard-working people at the SEC. It is the management system and how it determined priorities over the past decade that has let them down. Three years ago, in an article published in the Fordham Journal of Corporate and Financial Law,[7] I called for the SEC to follow the example from 1972 of Chairman William Casey, who formed a committee to review the enforcement division—its strategy, priorities, organization, management, and due-process protections. Thirty-seven years later, and especially after the Madoff incident, this sort of review is long overdue.

[7] *See* Paul S. Atkins and Bradley J. Bondi, *"Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program,"* 8 Fordham Journal of Corp. & Fin. Law 367 (2008).

Conclusion

Dodd-Frank overall is a poorly drafted statute that drastically expands the power of the Federal Government, creates new bureaucracies staffed with thousands, and does little to help the struggling American citizen. Ambiguous language will result in frivolous and unnecessary litigation. Huge amounts of power and discretion have been ceded to regulators, who were given the impossible task of about a year or two to put things in place. All of these costs and distractions will further stifle economic growth. Consumers, investors, and workers will pay the price. That is certainly not the best way to get the economy up and running!

The Dodd-Frank Bill started out as a bill to "get" Wall Street and morphed into a bill that sticks it to everyone—Wall Street, Main Street, consumers, entrepreneurs, shareholders and taxpayers alike. The financial markets are critically important to America. They raise capital for businesses producing good and services. They create jobs, fund ideas and increase wealth for all Americans. When Americans save and invest, they are putting their capital to work, building their nest egg and that of others, too. We need a more thoughtful, balanced plan to make sure that the nest egg is as safe as it can be, but also to ensure the we are not killing the proverbial, golden egg-laying goose. The arguments over Dodd-Frank will continue. Regulators will continue to grind away at implementing its provisions. There will continue to be calls for repeal of all or parts of it. This will be a vital topic to follow for the foreseeable future.

Thank you again for the invitation to come here and testify before you today.

PREPARED STATEMENT OF LYNN E. TURNER

FORMER CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

JULY 12, 2011

Thank you Chairman Johnson and Ranking Member Shelby for holding this hearing and it is an honor to be invited to testify before you. Our capital markets in the United States have been the crown jewel of our economy for over two centuries. But in the last decade, they have been the source of great scandal, resulting in investors questioning whether they are on a level playing field or sitting across the table at a casino where the odds are greatly stacked against them. This along with a declining U.S. economy has led investors to invest increasing amounts of capital overseas, with less available here for jobs, investment in plant, and research and development. If that trend is to be reversed, investors must know they will be afforded reasonable protections and have regulators who serve as their advocates.

Background

Before I start, it might be worthwhile to provide some background on my experience. I have held various positions in the accounting profession for some 35 years. I started my career with one of the world's largest international accounting and auditing firms where I rose to become an audit and SEC consulting partner. I served as a CFO and vice president of an international semiconductor company as well as a business executive in a venture backed newly formed startup company. I have had the good fortune to be the Chief Accountant of the Securities and Exchange Commission ("SEC"). In addition, I have been: a member of and chaired audit committees of corporate boards of both large and small public companies; a trustee of a mutual fund and a public pension fund; and a professor of accounting. In 2007, Treasury Secretary Paulson appointed me to the U.S. Treasury Advisory Committee on the Auditing Profession ("ACAP"). I have also served on the Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG") of the Public Company Accounting Oversight Board ("PCAOB").

The Financial Crisis

It has now been over 4 years since the worst post Great Depression financial crisis imploded in this country and around the globe, resulting in the Great Recession. The financial damage to civilization was tremendous as Exhibit A illustrates; investors in the global markets lost over $28 trillion in the value of their holdings. In the United States, investors saw approximately $10–11 trillion in value disappear, not including the value of their homes which continue to depreciate. And consider the numbers: in 1930, 1.2 percent of the population owned stock; in 2008, the number invested in the markets through stock, mutual funds or retirement accounts approximated 110 million.

To put the damage to investors and the capital markets in greater perspective, the Dow Jones Industrial Average closed on October 9, 2007 at 14,164.53 but then proceeded to plunge as fear grasped investors to close at 6547.05 on March 9, 2009.

That represents a fall during the financial crisis of 7839.88 points or 54.9 percent. The S&P 500 closed on October 9, 2007 at 1565.15. On March 9, 2009, it would close at 676.53, representing a fall of 898.36 points or 57.4 percent. By this point in time, investors and the American public had lost confidence in the capital markets, no longer trusted business executives, and believed Wall Street had become a casino where the house odds were overwhelming in favor of Wall Street, not Main Street. Congress had to act.

Sound Financial Markets and Capitalism

My 35 years of experience as a businessman, regulator, and investor have taught me that sound financial markets and efficient capitalism, can only exist if built upon five fundamental bedrock pillars. These pillars are:

1. *Transparency*—Investors must receive unambiguous financial information that allows them to make fully informed decisions as to which companies they should invest in.
2. *Accountability*—Those entrusted with the money millions of Americans invest must be held accountable for how they use that money. Business executives should be rewarded for sound business decisions and long term performance. Their compensation should be cut or they should be replaced when underperforming. And investors must have redress when they have been recklessly or worse yet, fraudulently wronged, such as when credit rating agencies or public companies issue misleading reports.
3. *Independence*—A lack of conflicts and where conflicts do exist, clear and timely disclosure of those conflicts *prior to* solicitation of investor's money.
4. *Effective Regulators*—Independent, strategic and balanced regulators who understand their mission is necessary to protect investors, create confidence in the markets and attract capital. Effective regulation also requires that regulators be held accountable by Congress in a timely manner.
5. *Enforcement of the Laws*—In the past, the United States has prided itself as being a nation of laws. Those who break the laws, should be held accountable so that the markets and all market participants operate in a fair market place, and the playing field is not tilted to any one party's advantage.

Yet when we look back of the mayhem of the past decade, we see that:

- There was a dearth of transparency as investors and regulators alike could not decipher the financial statements and financial condition of institutions such as AIG, Lehman Brothers and many of the largest banks in the country. Assets and capital were inflated, liabilities understated and profits upon which huge compensation packages granted, a mirage.
- Regulation was most ineffective under the onslaught of those who mistakenly thought the markets and market participants could police themselves. These disciples of *laissez faire* failed to understand the culture of markets and power of greed and megalomania. At the same time, most of the regulators were captured by industry, lacked adequate funding and resources in the case of the SEC and CFTC, and lacked authority to regulate such markets as derivatives which had become increasingly toxic as they grew close to 10 times the GDP of the entire world.
- As the Senate's own investigations have illustrated, conflicts abounded as institutions collected fees for originating loans aptly named "Liars", "No Doc", or "NINJA", packaged them up for another fee, and then collected even greater fees when they sold them off to an unsuspecting, and poorly informed investing public. Conflicts were rampant among credit rating agencies, the lawyers who drafted and reviewed all these agreements, and auditors.
- Things falsely done in the name of capitalism or entrepreneurship, had nothing to do with them. As Charlie Munger, Vice Chairman of Berkshire Hathaway recently said: "None of us should fall for the idea that this was constructive capitalism. In the 1920s they called it bucket shops—just the name tells you it's bad—and they eventually made it illegal, and rightly so. They should do the same this time."
- And the public now questions whether the law enforcement agencies have created a two tier justice system; one for Wall Street and business executives and one for Main Street.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("The Act")

With that as a backdrop, Congress chose to act passing the Dodd-Frank Wall Street Reform and Consumer Protection Act. I believe doing nothing was not an option even though some have suggested that, or something akin to fringe changes, more intent on maintaining the status quo then protecting investors and consumers. And while I would have preferred a Pecora style investigation as Senator Shelby had urged, it is abundantly clear that was not going to happen in this city. Accordingly, I applaud Congress for acting.

Within the Act, are Title IV, *Private Fund Advisors* and Title XI, *Investor Protection and Securities Regulation.* I shall confine my remarks to Title XI and certain of the strong investor protections afforded within that section.

Whistle Blower Protection—Sections 922, 923, and 924

It is important the SEC become aware of securities law violations at the earliest possible date, so that it can act to stop the violation before further harm to investors and the markets occur, and it can hold people accountable. Obtaining credible information is vital to early action and successful prosecution by law enforcement agencies.

In its 2010 Global Fraud Study, The Association of Certified Fraud Examiners stated that on average, it took 27 months for companies to detect financial statement fraud. That's over 2 years investors would be unknowingly investing based on false and misleading financial information. The report also notes that the number one way in which frauds are detected is not a management review, internal audit or external auditors. Rather it is through tips.

Consistent with these findings, Dodd-Frank allows the SEC to reward those who provide it with a wide range of information of securities laws violations resulting in successful prosecutions. The SEC had very limited authority to do so before passage of the Act. In fact, since 1989 and prior to Dodd-Frank, the SEC had only made seven payouts to five whistleblowers for a total of $159,537.

The SEC adopted rules implementing the whistle blower sections of Dodd-Frank in May of this year, after soliciting and receiving public comments on the issue. While some from the business community feel the rules as proposed will encourage people to report to the SEC without going through the normal hot lines and compliance program a company sets up, others felt they would cause some to avoid providing useful tips to the SEC and result in tips showing up on the Internet at sites such as Wiki Leaks.

Having served on audit committees of public companies, I believe the SEC took a reasonable and balanced approach to the final rules it adopted. Hot lines will not work unless employees have confidence their identity will remain anonymous and protected, and the complaint will be addressed in an unbiased thorough manner. This is especially important as the business groups forming the Committee of Sponsoring Organizations of the Treadway Commission (COSO), noted in a May 2010 report that in the 347 cases of fraudulent reporting brought by the SEC from 1998 through 2007, the CEO and/or CFO were named in 89 percent of the cases, up from 83 percent in the prior decade. I believe Dodd-Frank and the new SEC rules will result in companies reexamining their hot lines and compliance programs, ensuring employees can put their faith in them.

The SEC provided reasonable protections for public companies. The SEC encouraged those who provide tips, to go through the normal company compliance channels. It did so stating that reporting internally will be considered when the size of an award is determined by the SEC. The Commission also provided individuals the opportunity to first report to the company, and then if they chose, reporting to the SEC. This is very beneficial from my perspective as it allows the company to act on the information and where appropriate, self report to the SEC. In addition, the SEC excluded payments to certain employees such as in house counsel, compliance personnel, internal auditors, certain executives and external auditors.

Enhanced Law Enforcement—Sections 925, 926, 929E, and 929KLMNOP

Dodd-Frank includes a number of beneficial provisions that will enhance law enforcement giving investors greater protections and ensuring fair markets. For example, under prior law, a securities professional who had been barred by the SEC as a result of serious misconduct as an investment advisor, could simply participate as a broker dealer, offering similar services. Dodd-Frank appropriately addressed this issue by giving the SEC the authority it sought to impose collateral bars against regulated persons. Likewise, Dodd-Frank prohibits someone already convicted of a felony in connection with a securities offering, from offering securities under Rule 506 of Regulation D. While the Act allows critical financing for startups, it keeps felons from gaining a foothold in the process, reducing the likelihood of fraud being perpetrated by repeat offenders.

Previously the SEC did not have the authority to bring claims and seek penalties against those who recklessly and knowingly aided or abetted others in a violation of the Securities Act of Investment Company Act. In essence, certain individuals could "drive the getaway car" when it came to a securities law violation and know they were beyond the reach of the regulator and law. Dodd-Frank addressed that problem. It also called for a study by the SEC on whether investors should be given redress against these individuals. Today, professionals including gatekeepers and investment bankers critical to a fair and orderly market, can assist an individual in the commission of a securities law violation. Such actions have contributed to great damage being inflicted on shareholders, but the person aiding or abetting the crime here in the United States knows the shareholder has no right to sue them, unless the person aiding and abetting the crime tells the public they are doing so. Such a ridiculous standard, which fails any test of common sense, needs to be corrected. And as is discussed later on, regulators often have not had the resources or the will to pursue such cases.

The Act further enhances investor protections by giving the SEC enforcement authority in key areas, and giving the SEC greater ability to hold market participants accountable for violations of the law. Under the Act, civil money penalties may now be imposed by the SEC in cease and desist proceedings. This should serve as a further deterrence to fraud. The SEC enforcement director has stated this will also enhance the effectiveness and efficiency of the Division's enforcement efforts, a view I agree with.

With the growing number of global markets, the legislation amends the 1933 Securities Act and 1934 Exchange Act to give U.S. district courts' jurisdiction over violations of the antifraud provisions when there is conduct in the United States that furthers the fraud, even if the securities transaction occurs outside the United States. Being able to have redress in these situations is critical to investor confidence and ability to invest safely. It is also important to ensure accountability on the part of those who engage in such unlawful behavior.

Dodd-Frank also requires the SEC to study the extraterritorial application of the securities laws to actions that would be brought by investors. This is in response to the U.S. Supreme Court ill advised opinion in the case of Morrison v. National Australia Bank, Ltd. In November, 2010, a number of public pensions, including one for which I serve as a trustee, wrote this Committee urging them to reverse this opinion. Investors must have an opportunity to obtain redress in the U.S. courts for fraud committed in the United States by foreign entities which seek capital from U.S. investors, and U.S. Federal securities laws should deter fraudulent statements by foreign entities to investors.

Improvements to the Management of the Securities and Exchange Commission—Sections 961, 962 963, 964, 966, 967, and 968

Leading up to and during the subprime financial crisis, the SEC has been the subject of much public criticism of its management. Most notably have been complaints for its failure to investigate whistleblower complaints on Madoff and the Stanford Group, a failure to adequately supervise market participants such as Bear Stearns, Lehman and Merrill Lynch, questionable investigations such as in the Aguirre matter, the leasing matter that has now been referred to the Department of Justice by the Inspector General, poor internal controls and lax enforcement actions such as the one against Bank of America which the judge was extremely critical of. I can't help but believe some of these criticisms are the result of very poor leadership and management of the agency during the later half of the past decade. Leadership that, in my opinion, failed to foster the right tone at the top, culture and investor advocate mission that had long been the mantra of a proud agency and its staff.

In the past, the SEC has had a reputation as the gold standard among regulators. But that image has been tarnished by the criticisms noted. Yet a well managed and run, independent SEC is vitally important to the capital markets. Investors over the years have had confidence in the markets, firmly believing the SEC ensured confidence could be placed in financial disclosures, that the markets were fair and the playing field level. I can tell you from personal experience, many an employee of the SEC has taken great pride in providing outstanding public service and their efforts to ensure the agency was indeed the public watchdog, the one true investors advocate.

There are a number of provisions in Dodd-Frank that I believe, as a former business executive, will contribute in a positive manner to the SEC restoring public confidence in the agency. I have found one manages what one measures, and does not manage what one does not measure. While the SEC has required public companies to increase their transparency, controls, monitoring and accountability, it has fallen short of adopting some of its own recommendations in a timely manner that could have been beneficial, such as reporting on internal controls. Accordingly, enhancements to the SEC's management and structure that will in the long run benefit it, include:

- An assessment of its overall structure and personnel;
- Enhanced monitoring, assessment and transparency of supervisory controls;
- Greater accountability for supervision through certification of the effectiveness of controls;
- Increased evaluation, monitoring and transparency of personnel management including actions taken with respect to those who have failed to perform their duties;
- A suggestion program and hotline for the employees of the agency; and
- Taking a long hard look at its "revolving door." Unfortunately, the study mandated by Dodd-Frank only requires a study of employees leaving the SEC for financial institutions and not the largest and fastest spinning revolving door—employees who leave the SEC bound for legal firms that represent individuals and public companies before the SEC.

Securities and Exchange Commission Funding—Section 991

The SEC has sought now for over two decades, the same types of self-funding mechanisms that banking regulators have. Unfortunately, Senate conferees rejected such a provision, which in June, 2010, the Federal Bar Associations securities law committee stated was "critical" to the "chronic underfunding" of the SEC.

Current and former SEC Chairmen such as Arthur Levitt and Richard Breeden have urged Congress to increase the SEC's funding so that it can do the job Congress and investors expect of it. Those who represent investors such as the Council of Institutional Investors have also called for increased funding of the SEC. Investors have always voiced support for adequate funding of the SEC and ultimately, the money comes out of their pockets.

As the GAO has noted in prior reports, the SEC was essentially starved by Congress of necessary resources during much of the 1990s. During this time period the markets experienced fast growth as millions of Americans invested through their retirement accounts. After this underfunding contributed to and played a role in the corporate scandals of a decade ago, Congress increased the funding of the agency. But during the period from 2005 to 2007, as the subprime market bubble was growing toward an implosion, the SEC staff was again reduced by over 10 percent and its spending reduced by some $75 million as a result of actions by Congress and management of the agency.

Despite the fact no taxpayer dollars are used to fund the SEC, but rather it is funded through user-based fees, it seems as if Congress has been bent and determined to somehow shrink the SEC to greatness. The fact of the matter is that congressional approach at times over the past two decades has been an absolute miserable failure.

Congress through Dodd-Frank, as well as the public has upped the bar for performance by the SEC and rightly so. The SEC is being asked to increase its inspections, its enforcement, the number of entities and the types of transactions it regulates. Dodd-Frank also requires the SEC to establish several new offices such as the office of the Investor Advocate and Ombudsman, the Office of Credit Ratings and the Whistle Blower office. I believe investors in general are strong proponents of these new functions at the SEC. At the same time, the SEC is being asked to do a much better job of market surveillance and take proactive steps to identify and address in a timely manner future market problems, before they become a crisis. To accomplish all of these tasks takes top notch people with the requisite experience, and very significant investment in technology, training and support services. And that takes money.

Dodd-Frank specified acceptable levels of funding, which have been applauded by many investors. Those levels are as follows:

- 2011—$1.3 billion
- 2012—$1.5 billion
- 2013—$1.75 billion
- 2014—$2 billion
- 2015—$2.25 billion

Unfortunately, Congress is already breaking its promise to investors and the SEC for the year 2011 as its funding is below the $1.3 billion level. If such funding is not forthcoming, and there are further crisis in the capital markets, such as has been seen with the flash crash, a good deal of the blame will rest squarely on the shoulders of Members of Congress.

Expansion of Audit Information to Be Produced and Sharing Privileged Information with Other Agencies—Section 929, and 929 K

The Act expands the power of the Public Company Accounting Oversight Board ("PCAOB") by:

1. Broadening the PCAOB's authority to include independent audits of broker dealers;
2. Enhancing the PCAOB's access to work papers of foreign auditors; and
3. Share information with foreign regulators.

The Madoff ponzi scheme brought to light a gaping hole in the regulation of independent audits investors rely upon. The PCAOB did not have the authority to inspect the audit of the Madoff fund, and the auditor was not subject to inspection by the accounting professions peer review program. To this day, the Madoff auditor would not be subject to inspection by the State regulator as he was a sole practitioner. Dodd-Frank rightly remedies this shortcoming by giving the PCAOB the right to inspect such audits and ensure the firms providing such audits have effective systems of quality controls.

More recently, scandals resulting from flawed audits of Chinese companies have also come to light, resulting in large losses for investors. Much of the audit work has been performed by Chinese auditors, although a U.S. audit firm may issue the audit report read and relied upon by investors. At the same time, with U.S. companies increasing their global operations, a growing portion of their audits are performed by foreign audit firms, many of which are affiliated with U.S. audit firms. If the PCAOB is to carry out its mandate of providing investor protections, it must be able to inspect the auditor work, and documentation of that work, regardless of where it is performed.

For example, frauds at such companies such as Satyam, Enron, Xerox, and the now infamous Lehman Repo 103 transactions involved transactions and related audit work executed in foreign countries. Without the access to audit work papers for this audit work, the PCAOB cannot ensure that the work supports the overall opinion the auditors are providing on the consolidated financial statements of the company. Nor can they inspect audit quality for a significant portion of the audit, leaving investors exposed to a portion of an audit where quality may be substandard at best.

Ensuring international audit quality, especially with respect to large international conglomerates that can attract hundreds of billions in capital from investors, is critical to confidence in financial disclosures that are the life blood of any capital market. It is important the PCAOB be able to share information, work and cooperate with its counterparts in carrying out this mandate. But I have talked to foreign regulators who expressed criticisms of the PCAOB, and a reluctance to work with it. That was because while they could share information with the PCAOB, it was a one way street because the prior law prevented the PCAOB from sharing information with them. The prior law had been adopted when the PCAOB was new and its counterparts in foreign jurisdictions did not exist. But that has changed and once again, to its credit, Dodd-Frank has updated the law and corrected this deficiency. It did so by giving the PCAOB the ability to share information with foreign regulators on a confidential basis. This was a badly needed reform to ensure regulatory cooperation on an international basis.

At the same time, the PCAOB has also called upon Congress to allow it to enhance the transparency of its enforcement program. It would do so by making its enforcement actions public, at an appropriate time, consistent with the way the SEC handles its 102(e) enforcement actions. Having been involved with the development of the current SEC 102(e) rule, I applaud the PCOAB for working to enhance its transparency. Without such a rule change, as evidence is now starting to show, audit firms will take every action available to them to seriously delay enforcement actions, during which time they continue to issue audit reports while their quality controls and audit work may suffer from serious deficiencies. This exposes investors and the capital markets to great risks which lack any transparency whatsoever.

Other Sections

There are many other important sections of Title IX of the Act which I also strongly support. The governance provisions granting investors the same access to the proxy for nominating directors as management has, is a great tool for establishing accountability over entrenched and underperforming boards. Creating independent compensation committees, enhancing the transparency of compensation and incentives, and giving shareholders an advisory vote on pay should all prove to be beneficial to ensure destructive risks taking is not rewarded, and executives compensation is based on performance. Already investors have shown they can use such rights in a wise and reasoned manner. And while investors did not get all that they wanted in this section of the bill, it was a very positive step forward.

The enhanced regulations of credit rating agencies should also improve the quality of credit ratings. Especially important is the private right of action granted investors, a useful mechanism to hold credit rating agencies accountable.

Closing

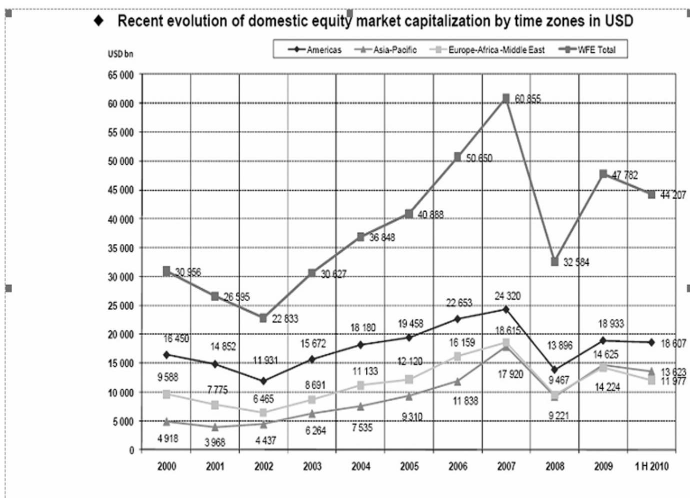
I believe the sections of Dodd-Frank I have discussed all help build and contribute to a stronger foundation upon which the capital markets can function more effectively. They increase transparency and accountability, they enhance independence including that of the regulator, they will improve the effectiveness of the SEC and PCAOB, and they certainly give these agencies greater authority necessary to enforce the laws and protect investors. That in turn should give a boost to investors confidence in the markets which is necessary if the capital markets are to continue to be the crown jewel of our economy.

Thank you and I would be happy to take any questions.

Exhibit A

World Federation of Exchanges

Markets capitalization



WFE total (USDbn)	30 956	26 595	22 833	30 627	36 848	40 888	50 650	60 855	32 584	47 782	47 207

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MORAN FROM DAVID MASSEY

Q.1. Mr. Massey, as you know Section 410 of the Dodd-Frank Act will shift between 3,000 and 4,000 registered investment advisors from SEC regulation to State regulation. However, this shift is coming at a time when States are struggling with major budget deficits and dwindling resources. How can we be certain that State regulators will have the resources necessary to properly regulate investment advisors and protect investors? How will States meet this challenge and increase their examination and regulatory resources?

A.1. Senator, the States have been presented with a unique regulatory challenge—an increase of approximately 25 percent in the number of investment advisers subject to State regulation that will result from the increase in the assets-under-management threshold from $25 million to $100 million, mandated under Section 410 of the Dodd-Frank Act ("Act"). Fortunately, the States and the North American Securities Administrators Association ("NASAA") have been preparing to meet the challenge of regulating an additional 3,200 investment advisers for over a year, and I am confident that these preparations will permit State regulators to implement intelligent, efficient and responsive regulation.

As I testified during the Senate Banking Committee hearing of July 12, the States have a proven track record in the area of investment adviser regulation. Further, NASAA is confident that State securities regulators will continue to marshal the examination and enforcement resources necessary to effectively regulate the investment adviser population subject to their oversight. While State investment adviser examination programs and resources are documented in significant detail in the comprehensive report that NASAA provided the Securities and Exchange Commission in support of the Act's Section 913 study,[1] some significant findings from that report include:

- States employ more than 400 experienced employees dedicated to the licensing and examination function, including field examiners, auditors, accountants, and attorneys. More than half of the States that reported qualitative staffing data indicate an average staff experience exceeding 10 years, with a heavy concentration of personnel in the 5- to 14-year range.
- State investment adviser examination totals have progressively increased each year for the past 5 years, resulting in a 20 percent increase in the total number performed through the first three quarters of 2010 as compared to 2006. As of August

[1] Available at *http://www.sec.gov/comments/4-606/4606-2789.pdf.*

2010, States had completed 2,463 onsite examinations of investment adviser registrants.

- The majority of State routine (non-cause) investment adviser examinations are performed on a formal cyclical basis. All States that adhere to a formal cycle audit their entire investment adviser registrant populations in 6 years or less. Half of the States complete the examinations on 3-year-or-less cycles.

Memorandum of Understanding (MOU) for the Sharing of Resources

Even a highly skilled workforce cannot succeed absent adequate resources, and the need for additional resources is a natural consequence of additional responsibility. To that end, the 50 States have agreed through a formal MOU to work together and share resources as needed to regulate the expanded State investment adviser population. Pursuant to this MOU, all States will work to ensure that examination resources are augmented, and that schedules are coordinated, to allow for maximum coverage and consistent audits. The MOU also provides for the possibility of joint exams funded by NASAA. The MOU will bridge the gap while and until State regulators acquire any necessary additional resources.

Frequency of Examinations

In recent years, the States have undertaken to increase the frequency of investment adviser examinations. In 2006, States reported 2,054 examinations of investment advisers, while in 2007 and 2008 that number increased to 2,136 and 2,389 examinations respectively. In 2009, State regulators performed 2,378 onsite examinations of investment advisers, not including the countless number of regular-desk, registration, and other abbreviated examinations that States perform every day. As of August, 2010, the States had performed 2,463 investment adviser audits, putting them on pace to again increase the total number of investment adviser examinations relative to the previous year. This trend constitutes a material and progressive increase, year over year, for five consecutive years.

The States stand ready and able to take on these new examination duties, and State securities administrators have been proactive in their preparation, as outlined below.

Development of Uniform Exam Procedures

Another important step that the States have recently undertaken to prepare for the switch-over has been to develop uniform examination procedures. These new procedures will promote and guarantee a consistent and high standard of examination at the State level, effectively ensuring that all State examinations—whether conducted in North Carolina, North Dakota, or Kansas—ask the same questions of investment advisers.

Utilization of New Risk Analysis Tools

NASAA has invested in new tools that will permit States to continue to do an even better job of leveraging their resources in the examination of investment advisers. Specifically, NASAA has acquired advanced risk-analysis software and has made this software available to all State regulators. The software will provide States a mechanism to rapidly review their investment adviser registrants, and rank the individual risk factors associated with each registrant. This tool will evolve as time goes on, but the bottom line is that the new software will permit States to better evaluate the risks associated with various firms and allocate their examination resources accordingly.

Industry Outreach Campaign

NASAA members have in the past year initiated an aggressive industry outreach campaign to prepare the industry for State oversight and to enable new registrants to set up their operations properly in order to avoid inadvertent noncompliance. The goal of this outreach campaign is to bring the legitimate investment advisers, the State regulators, and NASAA together, prior to the switch-over, so that all parties can establish a positive and constructive working relationship. By facilitating a partnership among the States and the many investment advisers who conduct their businesses in a legitimate and professional manner, this initiative will maximize the time and resources that State regulators can devote to protecting investors.

Senator, I would be pleased to answer any additional questions you may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM LYNNETTE HOTCHKISS

Q.1. Ms. Hotchkiss, the Board through the EMMA Web site makes a large amount of municipal bond market information freely and instantly available to investors. Do you feel that the availability and use of EMMA impacted the stability of the municipal market during the recent financial crisis and, if so, how? Does the Wall Street Reform Act impact the ability to operate and expand EMMA?

A.1. Of course it's impossible to know the precise effect that EMMA may have had in helping the municipal market weather the financial crisis, but I do know that it has had a considerable impact in raising the level of confidence in the municipal marketplace and giving all market participants equal access to the critical information needed to make informed investment decisions. EMMA came just when it was most needed, as the full impact was being felt of the municipal bond insurance downgrades resulting from the spreading financial devastation of the mortgage-backed securities collapse. We launched EMMA as a pilot disclosure utility in March 2008, for the first time making the full library of basic bond offering documents for most outstanding municipal securities issued since 1990, along with real-time trading information, available for all market participants at no cost. We have received highly complementary feedback from many retail investors attesting to the value of the information they find on EMMA and on their increased confidence in investing in the municipal securities market as a result of such availability.

As to the effect of the Dodd-Frank Act, we believe it was important to have our information dissemination function clearly delineated in our authorizing statute, and we look forward to working with other regulatory organizations in creating cross-market information systems as contemplated under Dodd-Frank. The ability to fully fund future enhancements to EMMA and to ensure secure and reliable operations of the system are the biggest barriers we see to realizing EMMA's full potential. Given that the information available through EMMA is a significant benefit to all market participants, we believe it is crucial that funding for the system be as broad-based as possible. We believe that Dodd-Frank struck the delicate—and right—balance of preserving free public access to EMMA's core collection while providing the MSRB with the ability to provide for the financial viability of our information systems through commercially reasonable fees for subscription or similar services as well as for customized data and document products and services. So long as we maintain the free core collection through EMMA, we think it is crucial for the health of the system and the benefit of marketplace that our ability to charge such commercially reasonable fees not be read too restrictively.

Q.2. Section 975(c)(8) of the new law created Section 15B(c)(9)(A) of the Exchange Act, which states that "Fines collected by the Commission for violations of the rules of the Board shall be equally divided between the Commission and the Board" and

> Fines collected by a registered securities association under section 15A(7) with respect to violations of the rules of the Board shall be accounted for such registered securities association separately from other fines collected under section 15A(7) and shall be allocated between such registered securities association and the Board, and such allocation shall require the registered securities association to pay the Board ⅓ of all fines collected by the registered securities association reasonably allocable to violations of the rules of the Board, or such other portion of such fines as may be directed by the Commission upon agreement between the registered securities association and the Board.

Have fines subject to this provision been collected thus far? If so, how have these fines been allocated? Please describe how this process will work going forward.

A.2. With respect to fine collections by a registered securities association—which means the Financial Industry Regulatory Authority, or FINRA—our two organizations have worked through an initial process for allocating fines and the MSRB began receiving monthly remittances earlier this year. The current allocation is based on the ⅓ apportionment formula set out in the statute and our two organizations continue to review how that apportionment is applied in situations where a broker-dealer may have violated both MSRB and FINRA rules, and we will make any adjustments that may be necessary if we find that some situations call for a different manner of application on overlapping violations. We are in the final stages of memorializing the allocation in a memorandum of understanding between our two organizations.

As of now, the Commission has not yet collected any fines since October 1, 2010, that it has attributed to a violation of MSRB rules, but we expect that the Commission will be stepping up its enforcement activities with respect to MSRB rules, particularly in light of the additional areas of MSRB rulemaking and the broader scope of the protections of those rules called for under the Dodd-Frank Act. One complicating factor that has delayed our establishment of a precise allocation process is that most fines levied by the Commission are paid directly to the U.S. Treasury, which could result in significant complications in having the MSRB allocable portion paid to us. It is our understanding that the Commission is considering providing for a separate levy of the MSRB allocable portion on any broker, dealer, municipal securities dealer or municipal advisor found to be in violation of MSRB rules, with payment of the MSRB allocable portion mandated under the Dodd-Frank Act to be made directly from such entity to the MSRB. We hope that the Commission is able to come to resolution on this process in the very near future so that we can proceed to document this allocation process.

Q.3. Earlier this month, the U.S. Securities and Exchange Commission (SEC) charged a division of JPMorgan Chase with fraud in connection with rigging of 93 municipal bond transactions in 31 States. What proactive steps has the MSRB taken to address conduct similar to that uncovered by the SEC?

A.3. The MSRB has been extremely active in undertaking rulemaking that covers the behavior of bond underwriters and municipal advisors to issuers in connection with questionable or illegal activities such as bid rigging. We proposed in February and are nearing the completion of the rulemaking process on guidance under both our general fair practice rule, Rule G–17, and a new Rule G–36, implementing the new Federal fiduciary duty of municipal advisors under the Dodd-Frank Act, that would squarely prohibit the key wrongful actions undertaken in this case. For example, under the Dodd-Frank Act, "municipal advisor" was defined to include guaranteed investment contract brokers, or GIC brokers, who now have a Federal fiduciary duty to the issuer. The MSRB guidance on fiduciary duty would prohibit receipt of payments from other parties in return for giving favorable treatment in what is supposed to be a competitive bidding process, even if they disclosed such payments. In addition, the proposed MSRB fair practice guidance for underwriters would establish significant new disclosure obligations to issuers, including specifically disclosures on conflicts of interest. That guidance would require that underwriters not charge excessive compensation. In determining whether compensation is excessive, underwriters would have to include payments from third parties, such as payments from swap providers or GIC brokers paid to the underwriters for recommending those parties to the municipal issuer.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM BARBARA ROPER

Q.1. In your written testimony, you state that credit rating agencies should be held to the same accountability standards faced by auditors and underwriters. Could you go into a little more detail about what you mean by this? What are the strengths and weaknesses of this approach? How should the SEC address the current state of relief (no-action letters) to issuers that do not disclose ratings in their prospectuses?

A.1. Much like auditors, credit rating agencies operate as private gatekeepers in our financial system. In fact, much as our system of financial disclosure rests on the assumption that auditors can provide reasonable assurance of the accuracy of those disclosures, the entire system of regulation for the securitization process was built on the assumption that ratings could reliably assess the risks associated with these investments.

- The special purpose vehicles that purchase the assets and issue the asset-backed securities (ABS) were exempted from the Investment Company Act based on credit ratings.
- ABS, including mortgage-backed securities (MBS), qualified for sale through shelf registration based on credit ratings.
- Under the Secondary Mortgage Market Enhancement Act, MBS that received ratings in one of the two highest categories were deemed acceptable investments for Federal savings and loan associations and credit unions and for State-regulated entities, such as insurance companies, unless the State opted out.
- Other Federal and State regulators of financial institutions counted asset-backed securities that received top ratings from an NRSRO at face value toward minimum capital requirements.

Just as auditors' failure to serve as effective gatekeepers was a key contributing cause of massive accounting scandals a decade ago, the rating agencies' failure to serve that gatekeeper function effectively was a key contributing cause of the 2008 financial crisis.

One way Dodd-Frank deals with that failure is by eliminating regulatory references to ratings. While this is an appropriate step, in our view, the regulators have struggled to find a way to implement it without inadvertently introducing new risks into the financial system. Even the harshest rating agency critics have failed to identify alternative measures of creditworthiness to serve as effective substitutes for credit ratings. As a result, for better or worse, credit rating agencies are likely to continue to play an important role in the financial system as arbiters of credit risk. Their gatekeeper function, while diminished, is therefore expected to continue. The clear implication is that it is not enough simply to reduce regulatory reliance on ratings, it is also essential to take steps to increase rating agency reliability.

In seeking an explanation for the rating agencies' failure to perform as effective gatekeepers, it quickly becomes apparent that they lack two of the most important characteristics we look for in a gatekeeper: independence and accountability. Their lack of independence is well documented in the recent bipartisan report on the causes of the financial crisis by the Senate Permanent Subcommittee on Investigations. With voluminous evidence taken from internal emails and witness testimony, the report shows rating agencies well aware of growing risks in the housing market but reluctant to reflect those risks in their ratings out of concern that it would cost them market share. In short, the major rating agencies prioritized profits over rating accuracy, and nearly brought down the financial system in the process.

The fundamental conflict at the heart of the credit rating agencies' issuer-pays business model creates a strong incentive for rating agencies to under-invest in analysis, to assign ratings even where the credit risks are unknown, and to inflate ratings in order to protect their market share and maximize profits. In the past, they have faced no comparable countervailing pressure to promote rating accuracy. Given the scale of the conflict, we share the view expressed by Columbia University law professor John Coffee in March 10, 2009 testimony before this Committee, that, "The only force that can feasibly induce" credit rating agencies to perform the kind of independent verification and analysis demanded of gatekeepers "is the threat of securities law liability." While enhanced regulatory oversight can help, past experience suggests that the SEC is likely to be too timid in exerting its authority to serve as an effective deterrent, particularly if Congress fails to come through with the increased funding the agency needs to implement the law effectively.

In order to strike the right balance, credit ratings should be liable not simply for getting it wrong but rather when they show a reckless disregard for the accuracy of their ratings. As noted above, the Permanent Subcommittee on Investigations Report is full of examples of these sorts of abuses, as is the early study by the staff of the Securities and Exchange Commission. That is the balance struck in Dodd-Frank, which establishes recklessness as the standard of proof in private actions. It remains to be seen, however, whether courts will accept that approach, or will continue to view ratings as protected by the First Amendment, even where the "opinion" in question does not reflect the actual views of the rating analyst of credit risk. If courts do begin to hold rating agencies liable, it should make the rating agencies less likely to assign ratings to securities (such as CDOs-squared) whose risks they do not understand and cannot calculate. Likewise, it should make them less willing to override their rating criteria to assign inflated ratings or to delay updating their rating criteria to reflect emerging risks out of a concern that it could cost them business.

The SEC no action position with regard to issuers who do not disclose ratings in their prospectuses raises a somewhat different set of issues. In keeping with its goal of reducing reliance on ratings, Dodd-Frank eliminated the special exemption from expert liability that was granted to rating agencies specifically to encourage the use of their ratings in prospectuses. When the provision took effect, however, the major rating agencies threatened to shut down the still fragile securitization market by refusing to allow their ratings to be published in prospectuses. Under pressure to revive securitization, the SEC issued a no action letter, later indefinitely extended, permitting issuers to forego disclosing ratings in the prospectus. Because of the separate Dodd-Frank provisions requiring financial regulators to eliminate all regulatory references to credit ratings, the requirement to disclose ratings was presumably on its way out anyway.

Under the circumstances, we did not come out in strong opposition to the SEC action, despite our support for making ratings agencies legally accountable for their actions. Once the regulatory requirement to disclose ratings in the prospectus is eliminated, however, the Commission should rescind its no action letter so that only the ratings of ratings agencies willing to stand behind their work would be disclosed in prospectuses. Under no circumstances should the special exemption from liability be reinstated. To do so would encourage reliance on ratings by encouraging their inclusion in prospectuses and would do so without subjecting them to appropriate legal accountability when they show reckless disregard for the accuracy of their ratings.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM BARBARA ROPER

Q.1. A provision that I successfully included in Dodd-Frank would require publicly listed companies to disclose in their SEC filings the amount of CEO pay, the typical workers' pay at that company and the ratio of the two. The past few decades, CEO pay has skyrocketed while the median family income has actually gone down. The House Financial Services Committee voted to repeal the provision last week under the guise of two arguments, first that it was "too burdensome" for companies to disclose that and second, that the information wasn't useful to investors.

I believe the real reason some companies don't want to reveal it is because they would find it embarrassing to reveal that they pay their CEO say 400 times what they pay their typical employee. And I find it very hard to believe that companies that do all kinds of complicated calculations for everything else involving their revenues and expenses would find it difficult to take their 2,000 employees, figure out how much employee number 1,000 is paid, and report that one number to the SEC. It seems to me that a company that can't manage to do that needs a new H.R. Department.

Do you believe such information would be useful to investors? These same investors are now often voting on an annual basis in say-on-pay votes. Would it be useful for them for example to know that in the past few years, a company has increased its CEO's pay by 50 percent while decreasing its typical worker's pay by 10 percent? Would it help investors to determine what a company's philosophy is, such as whether it is following Peter Drucker's theory that there should not be huge pay disparities between the executives and the typical worker for morale, inherent fairness, or other reasons?

A.1. Investors have an interest in CEO pay disclosures for a variety of reasons. First, excessive CEO compensation comes at the expense of shareholders of publicly traded companies. Second, excessive compensation may encourage executives to take undue risks. Ironically, existing compensation disclosures have been criticized for inadvertently promoting excessive compensation by encouraging competition among executives for more generous pay packages. In addition, while they provide a certain amount of data, existing disclosures fail to put that data in context. One of the best measures of executive compensation that is out of line can be found by comparing it to the pay of average workers, as your provision would require. Where CEO compensation is many times higher than that of the average worker, investors may reasonably conclude that the company is being run for the benefit of executives rather than for the benefit of shareholders. That may affect how they vote, not only on say-on-pay votes, but also how they vote in director elections.

That may help to encourage compensation committees to be more responsible when doling out CEO pay. The required disclosures also provide information about typical employee compensation packages, information investors are likely to find relevant in light of the fact that compensation is the biggest single expense at many public companies. For all these reasons, we oppose efforts to repeal the enhanced CEO compensation disclosures provided by Dodd-Frank.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ANNE SIMPSON

Q.1. Section 953 of Dodd-Frank requires companies to disclose the ratio between the compensation of the chief executive officer and that of the median employee. Are you aware of any evidence that links relative pay ratios to corporate performance? Is this ratio material for making investment decisions?

A.1. We are unaware of any research on this specific topic. However, this should not come as a surprise since issuers do not presently disclose these ratios. As far as whether an investor would find this information material, it probably depends on the investor. Similar to disclosures by an issuer's highest paid executives, the ratio between a company's CEO and a typical employee would be yet another metric for measuring assessing the reasonableness of executive compensation in the context of the company's performance.

Q.2. In your testimony, you observed that a "a common element in the failure of . . . many . . . companies implicated in the 2008 financial meltdown, was that their boards of directors did not control excessive risk taking, did not prevent compensation systems from encouraging a 'bet the ranch' mentality, and did not hold management sufficiently accountable." A recent European Corporate Governance Institute paper reported that financial firms with more independent boards and higher institutional ownership suffered larger losses during the crisis period and that these losses were related to executive compensation contracts that focused too much on short-term results. Why do institutional investors such as CALPERS endorse executive compensation contracts that focus on short-term results and encourage aggressive risk-taking?

A.2. Institutional investors such as CALPERS do NOT endorse executive compensation contracts that focus on short-term results and encourage aggressive risk-taking and we reject the conclusion in the referenced working paper. The fatal flaw of the paper is that it includes exactly one corporate governance factor—board independence. Although the independence of the board of directors is a key governance consideration, it is certainly not the only consideration. *See* CalPERS Principles of Accountable Corporate Governance (*http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf.* I also would refer you to an October 2010 report by Wilshire Associates (*http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf*) which concluded that engagement by institutional investors with corporate boards/management has resulted in long-term performance superior to market benchmarks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM ANNE SIMPSON

Q.1. Many witnesses addressed the fact that the Department of Labor ("DOL") recently proposed regulations under ERISA that would redefine the term "fiduciary". Many Members of the Committee have expressed concerns about the coordination that is taking place between the DOL and SEC.

As an investor at a large pension system, do you have concerns about the DOL's changes or concerns about the interaction that is taking place between the DOL and other agencies on this issue?

A.1. As a Government-sponsored plan, CalPERS is not governed by ERISA. Instead, CalPERS is regulated by State law. As such, CalPERS has no opinion as to DOL's definition of fiduciary duty.

Q.2. In your testimony you stated that "a tough clawback policy is an essential element of a meaningful pay for performance philosophy." It is my understanding that, in addition to internally managed equity investments, many State retirement systems such as CaIPERs, may allocate to external alternative investment managers.

Does your support for "tough clawbacks" extend to compensation arrangements with external managers?

A.2. Compensation arrangements between a corporation and its executives are quite different than those between an Institutional investor and its external money managers. However, in the spirit of protecting long-term shareowner value, CalPERS supports the notion of accountability by both corporate executives and its external money managers. Accountability for money managers comes in the form of agreements whereby contractual rights and obligations are imparted upon each party. Fortunately, CalPERS has not needed to seek judicial redress with any external manager.

Q.3. Is it common for pension funds to negotiate compensation arrangements with external managers that contain performance clawbacks as way deter managers from prioritizing short-term gains over long-term alignment? If not, what have been the hurdles?

A.3. CalPERS is unfamiliar with how other plans negotiation money management agreements, so we are unable to opine on whether a particular practice is common for public pension funds. However, when we negotiate such agreements, we insist that they include legal protections for the plan. We would expect other prudent fiduciaries would demand similar protections.

RESPONSE TO WRITTEN QUESTION OF CHAIRMAN JOHNSON FROM PAUL S. ATKINS

Q.1. Mr. Atkins, in your testimony you stated that, "Congress should consistently push transparency and competition so that investors get high-quality and objective advice from credit rating agencies."

Section 932 of the Dodd-Frank Act contains many provisions that promote transparency for the benefit of investors, including requirements that:

- NRSROs publish a form accompanying their ratings that will include the assumptions underlying the credit rating procedures and methodologies, the data that were relied on to determine the credit rating, and any problems or limitations with those data;
- NRSROs publish the initial credit ratings determined for each type of obligor, security and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs; and
- NRSROs publicly disclose the reasons when they make material changes to credit rating procedures and methodologies, and notify users of credit ratings of the version of a procedure or methodology used with respect to a particularly credit rating, when a material change is made to a procedure or methodology, and when a significant error is identified in a procedure or methodology that may result in credit rating actions.

Subtitle D of Title IX of the Act contains new disclosure requirements including Section 943, the requirement that each NRSRO include in any report accompanying a credit rating a description of the representations, warranties and enforcement mechanism available to investors.

Do you feel that such transparency requirements could be useful to investors?

A.1. Yes, Mr. Chairman, I agree that transparency requirements for credit ratings can be useful to investors, especially if they can help investors discern for themselves which ratings deserve more credence. Ratings, after all, are professional opinions, and the key to evaluating such an opinion is understanding the qualifications of the person propounding the opinion, the reasoning underlying the opinion, and any influences that might affect the opinion one way or another. But, we must recognize that any regulation can have unintended consequences and should be subjected to a cost-benefit analysis, since investors invariably pay for regulations one way or another, through higher prices or reduced choices. Because the credit-rating business has suffered from concentration and lack of competition, largely due to a non-transparent "no-action" process that the Commission permitted to exist for three decades, which this Committee in 2006 wisely prompted Congress to take strong steps to reform, the SEC must be very careful to ensure that regulations in this area do not further restrict competition or the ability of new entrants to compete against the more established firms.

For example, the burden and costs of required disclosure must be carefully weighed, as should the usefulness of the required disclosure to investors. Ironically, the more disclosure around ratings that make them seem more authoritative, the more investors (especially retail investors) may rely on them, discounting the fact that the ratings are opinions at the end of the day.

In addition, the SEC should be careful to avoid influencing the ratings themselves or consciously or inadvertently being a judge as to supposed "quality" of ratings. Those sorts of decisions are best left to the marketplace and investors themselves. Finally, the SEC also must be careful, through requirements that are one-size-fits-all, not to lead ratings into the same general mold, reducing diversity of opinion. The market thrives on diverse opinions—those who can warn of anomalies that they perceive versus the "group think" of consensus or conventional wisdom. Thus, in credit ratings, standardization may not be necessarily helpful to investors, although diversity of viewpoint is critical.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT FOR THE RECORD

PROTECTING AMERICANS' RETIREMENT SAVINGS

AMERICAN BANKERS ASSOCIATION
THE FINANCIAL SERVICES ROUNDTABLE
FINANCIAL SERVICES INSTITUTE
INSURED RETIREMENT INSTITUTE
NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

On

The U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on

Enhanced Investor Protection After the Financial Crisis

July 12, 2011

The American Bankers Association, The Financial Services Roundtable, the Financial Services Institute, the Insured Retirement Institute, and the National Association of Insurance and Financial Advisors

Respectfully Offer This

Statement for the Record

To the

The U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on

Enhanced Investor Protection After the Financial Crisis

I. We support retirement security.

The undersigned organizations[1] share the Congress' and the Obama Administration's goal of increasing opportunities for Americans to save and plan for their retirement. We support increased incentives and opportunities for Americans to save and invest. It is our belief that providing these opportunities for Americans is important because savings increase domestic investment, encourage economic growth, and result in higher wages, financial freedom, and a better standard of living. We believe that most Americans should approach retirement with a comprehensive strategy that incorporates a number of retirement vehicles. Consumer education about retirement savings products can help consumers make sound investment decisions and allow them to maximize their retirement savings.[2] Further gains can be achieved through better use of investment advice, and by promoting policies that provide for more diversified, dynamic asset allocation, and exploration of new and innovative methods to help individuals make better investment decisions.

As a partner with the Congress and the Obama Administration in our collective efforts to protect Americans' retirement security, we strongly believe that one of the largest challenges currently confronting pension plans, plan sponsors, small business owners, individual retirement account owners, employees, and retirees is the Department of Labor's (the "Department") proposed rule that would expand the definition of the term *fiduciary*[3] under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").[4] In our view, the Department's Proposal will negatively impact the ability of hard-working Americans to save and plan for their retirement. Moreover, the Department's Proposal would substantially increase the categories of service providers who would be deemed *fiduciaries* for purposes of ERISA,[5] and thereby decrease the availability of retirement planning options for all Americans.[6] We respectfully request the Department formally withdraw its proposed definition of *fiduciary*[7] and re-propose a more narrow definition of *fiduciary* that targets specific abuses.

II. WE BELIEVE THAT THE PROPOSED EXPANSION OF THE DEFINITION OF *FIDUCIARY* WOULD JEOPARDIZE THE RETIREMENT SECURITY OF MILLIONS OF AMERICANS.

Most Americans rely on retirement plans to supplement Social Security and private savings.[8] For instance, Americans have increased their participation in 401(k) plans by 250 percent over the last twenty-five years.[9] In addition, a 2009 study showed that over two-thirds of "U.S. households had retirement plans through their employers or individual retirement accounts ("IRAs")."[10]

IRAs are the fastest growing retirement savings accounts.[11] IRAs are widely held by small investors[12] who seek to maximize return by minimizing overhead on their accounts. According to the OLIVER WYMAN REPORT, smaller investors overwhelmingly prefer to use a brokerage account for their IRAs (rather than an advisory account)[13] because of the lower operating costs associated with brokerage accounts. In fact, 98% of IRAs with less than $25,000 in assets are serviced by securities brokers.[14]

We believe that the sheer breadth of the proposed expansion of the definition of *fiduciary* would have the unintended—but entirely foreseeable—consequence of reducing alternatives available to hard-working Americans to help them save for retirement, and increasing the costs of remaining retirement savings alternatives. The resulting increase in the number of persons who could be subject to fiduciary duties, increased costs, and increased uncertainty for retirement services providers will very likely reduce the level and types of services available to benefit plan participants and IRA investors by making benefit plans and IRAs more costly and less efficient.[15]

Thus, if the Department were to adopt the expanded definition of *fiduciary* in its present form,[16] we believe it is clear that fewer Americans would have access to the advice they need to help them make prudent investment decisions that reflect their financial goals and tolerance for risk as they prepare for their retirement because of their reluctance to pay the increased costs that will likely be associated with professional investment advice.[17]

We also are concerned that the Department's Proposal could lead to lower investment returns, and ultimately, a reduced amount of savings for retirement.[18] Moreover, if the Department were to adopt its expanded definition of *fiduciary* in its present form, millions of hard-working Americans are likely to have reduced access to meaningful investment services or help from an investment professional,[19] and likely would incur greater expense to access the broad range of product types associated with brokerage accounts.[20] We find the potentially adverse consequences that the Department's proposed expanded definition of *fiduciary* would have on our nation's retirement system and the retirement security of all Americans to be untenable.

In summary, our specific concerns with the Department's proposed expansion of the definition of *fiduciary* are:

- The Department has not demonstrated that the current definition needs to be completely re-written.
- The proposed expansion of the *fiduciary* definition to encompass IRAs is ineffective and counterproductive.
- The Department's rule could result in significantly fewer retirement accounts and less retirement savings.
- The Department has not evaluated the economic impact on small business owners.
- Consultation and coordination with each of the relevant regulatory authorities is needed, including without limitation the Securities and Exchange Commission and the Commodity Futures Trading Commission.
- The Department provided insufficient regulatory analyses.
- Given the substantive concerns raised in the public comment record concerning the adverse impact of the rule, the Department should publish notice of its proposed revisions to the definition of *fiduciary*, and solicit public comment on the proposed revisions.

1. The Department has not demonstrated that the current definition needs to be completely re-written.

- Despite 35 years of experience with the *current definition of fiduciary*,[21] the Department has not provided adequate justification for its wholesale revisions to the current definition.

- The Department's stated rationale is to pursue bad actors (*i.e.*, pension consultants and appraisers) who allegedly have provided substandard services and who failed to recognize or disclose conflicts of interest.[22] If this is the goal, then the Department should more narrowly tailor the proposed changes to reach those particular bad actors.

- The Department also should consider whether other regulations (including those enforced by other authorities) already provide adequate safeguards. For example, the Department's recent disclosure regulations will require pension consultants to disclose all direct and indirect compensation they receive before entering into a service arrangement with a plan.[23] This may address the Department's concerns.

2. **The proposed expansion of the *fiduciary* definition to encompass IRAs is ineffective and counterproductive.**

- The proposed expansion of the definition of *fiduciary* would constrain the availability of lower-cost commission-based IRAs, which would increase costs for IRA owners and reduce retirement savings.[24]

- The Department previously expressed the view that regulatory initiatives designed for ERISA employee benefit plans were neither necessary nor appropriate for IRAs.[25]

- Sales practices for IRAs currently are subject to oversight by the Securities and Exchange Commission and FINRA. If the Department is concerned about oversight of sales practices, it should work together with those regulators to address those concerns, as opposed to overhauling a much broader regulatory régime.

- Service providers to IRAs should be expressly excluded from any definition of *fiduciary* for purposes of Title I of ERISA.

3. **The Department's rule could result in significantly fewer retirement accounts and less retirement savings.**

- The Department issued the Proposal without having done any study or survey—or providing any data—on the Proposal's projected impact or effect on IRA owners or IRA service providers.[26]

- According to the OLIVER WYMAN REPORT, the effect of the Department's rule "could well result in hundreds of thousands of fewer IRAs opened per year."[27]

- "Nearly 90% of IRA investors will be impacted by the proposed rule."[28]

- The Department's Proposal would make service providers fiduciaries when merely providing a valuation of a security or other asset held in the account. This may lead service providers to withdraw from providing valuation services for real estate, venture capital interests, swaps, or other hard to value assets. As a consequence, investors will have far fewer investment choices available to diversify assets in their accounts as they seek to increase their retirement savings.

4. **The Department has not evaluated the economic impact on small business owners.**

- Small plan sponsors are not likely to be able to absorb the potentially substantial increase in costs arising from the expanded definition of *fiduciary*.[29]

- Small business owners are struggling to recover in the U.S. economy.[30]

- We urge the Department to ensure that its regulations not only protect retirement plan participants and beneficiaries, but also remove undue burdens that constrain the feasibility for small business owners to provide retirement plans for their employees.

5. **Consultation and coordination with each of the relevant regulatory authorities are needed, including without limitation the Securities and Exchange Commission,[31] FINRA, and the Commodity Futures Trading Commission.**

- Investors and retirement services providers need a regulatory régime that provides clarity and certainty.

- Regulations that establish conflicting rules create confusion, increase costs to service providers, and tend to lessen the availability of retirement services overall.

6. **The Department provided insufficient regulatory analyses.**

- The Department was obligated under Executive Order 12866[32] to determine whether its proposed expansion of the definition of *fiduciary* was a "significant" regulatory action.[33] Even though the Office of Management and Budget determined the Department's proposed definition was economically significant,[34] the Department performed an insufficient Regulatory Impact Analysis of the Proposal.[35]

- The Department stated "it is uncertain about the magnitude of [the] benefits and potential costs" of its regulatory action.[36] Yet, the Department failed to provide any data whatsoever in support of its Regulatory Impact Analysis, in which the Department "tentatively conclude[d] that the proposed regulation's benefits would justify its costs."[37]

- The Department's Initial Regulatory Flexibility Analysis failed to provide either an estimate of the number of affected small entities[38] or the increased business costs small entities would incur if they were determined to be fiduciaries under the proposal as required by the Regulatory Flexibility Act.[39] As a consequence, it appears that the Department of Labor performed an insufficient analysis under the Regulatory Flexibility Act when it estimated the impact of its rule proposal on small businesses, a segment of the market also impacted by the proposed expansion of the definition of *fiduciary*.

- On January 18, 2011, President Barack Obama issued Executive Order 13563 "Improving Regulation and Regulatory Review."[40] The Order explains the Administration's goal of creating a regulatory system that protects the "public health, welfare, safety, and our environment while promoting economic growth, innovation, competitiveness, and job creation,"[41] while using "the best, most innovative, and least burdensome tools for achieving regulatory ends."[42]

- The Department's Proposal contravenes the Obama Administration's publicly articulated goal to "identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public."[43]

7. **Given the substantive concerns raised in the public comment record concerning the adverse impact of the rule, the Department should publish notice of its proposed revisions to the definition of *fiduciary*, and solicit public comment on the proposed revisions.**

- The definition as proposed would require substantial changes to address concerns identified in the public comment file.[44]

- It is likely that class exemptions will be necessary and should be *part of the rule itself*, so that hard-working Americans do *not lose access* to investment products they need to fund their retirement *while the financial services markets wait for the Department* to adopt the required prohibited transaction class exemptions.

- The current definition of *fiduciary*[45] has informed almost 35 years of Department guidance on investment advice for ERISA retirement plans and IRAs. Revisions to such a mature rule ordinarily should not require ancillary exemptions in order for the final rule *to work in the real world.*

III. IN LIGHT OF THE SUBSTANTIVE CONCERNS RAISED BY THE PUBLIC, WE BELIEVE THE DEPARTMENT SHOULD WITHDRAW ITS PROPOSED EXPANSION OF THE DEFINITION OF *FIDUCIARY*, AND RE-PROPOSE A DEFINTION OF *FIDUCIARY* THAT ADDRESSES DEFICIENCES NOTED IN THE PUBLIC COMMENT FILE.

We and other parties have filed comments and supplemental materials with the Department that generally have raised these and other concerns about the adverse impact of the Proposal.[46] At present, it is our understanding that the Department is considering substantial revisions to its Proposal in response to the views expressed during the public comment period.[47]

It is in the interest of the millions of hard-working Americans who are saving for retirement that the Obama Administration and the Congress collaborate actively with the private sector—in particular, the small business community and the retirement security community—to develop a regulatory régime that will benefit consumers and expand Americans' retirement savings.

IV. CONCLUSION

In closing, strengthening the retirement security of all Americans is our priority. Strong and vibrant retirement programs benefit employees and their beneficiaries. As well, it strengthens the financial health and well-being of our nation. We, therefore, reiterate our request that the Department withdraw and re-propose a definition of the term *fiduciary*.

While we support policies that encourage safeguards in retirement savings programs to protect consumers and our markets from fraudulent practices, we vigorously oppose regulations that would discourage participation by employers and employees in retirement programs or would imperil retirement security for millions of hard-working Americans.

We urge policymakers to work with us to preserve a retirement system that helps strengthen retirement security for all Americans. We encourage the Congress to support policies that help promote retirement savings and enable the financial services industry to better meet the long-term retirement needs of hard-working Americans.

We stand ready to work with you and the Department on this important issue.

RESPECTFULLY SUBMITTED:

AMERICAN BANKERS ASSOCIATION **THE FINANCIAL SERVICES ROUNDTABLE**

FINANCIAL SERVICES INSTITUTE **THE INSURED RETIREMENT INSTITUTE**

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

END NOTES

[1] **The American Bankers Association** represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. Many of these banks are plan service providers, providing trust, custody, and other services for institutional clients, including employee benefit plans covered by the Employee Retirement Income Security Act of 1974. As of year-end 2010, banks held over $8 trillion in defined benefit, defined contribution, and retirement-related accounts (Source: FDIC Quarterly Banking Profile, Table VIII-A (Dec. 2010)).

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Among the Roundtable's Core Values are *fairness* ("We will engage in practices that provide a benefit and promote fairness to our customers, employees or other partners."); *integrity* ("[E]verything we do [as an industry] is built on trust. That trust is earned and renewed based on every customer relationship."); and *respect* ("We will treat the people on whom our businesses depend with the respect they deserve in each and every interaction."). *See Roundtable Statement of Core Values, available at* http://www.fsround.org/.

Roundtable member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

The Financial Services Institute, which was founded in 2004, is the only advocacy organization working on behalf of independent broker-dealers and independent financial advisors. **Our vision** is that all individuals have access to competent and affordable financial advice, products, and services delivered by a growing network of independent financial advisors affiliated with independent financial services firms. **Our mission** is to create a healthier regulatory environment for independent broker-dealers and their affiliated independent financial advisors through aggressive and effective advocacy, education, and public awareness. **Our strategy** supports our vision and mission through robust involvement in FINRA governance, constructive engagement in the regulatory process, and effective influence on the legislative process.

The Insured Retirement Institute has been called the "primary trade association for annuities" by *U.S. News and World Report* and is the only association that represents the entire supply chain of insured retirement strategies. Our members are the major insurers, asset managers, broker dealers and financial advisors. IRI is a not-for-profit organization that brings together the interests of the industry, financial advisors and consumers under one umbrella. Our official mission is to: encourage industry adherence to highest ethical principles; promote better understanding of the insured retirement value proposition; develop and promote best practice standards to improve value delivery; and to advocate before public policy makers on critical issues affecting insured retirement strategies. We currently have over 500 member companies which include more than 70,000 financial advisors and 10,000 home office financial professionals.

National Association of Insurance and Financial Advisors ("NAIFA") comprises more than 700 state and local associations representing the interests of approximately 200,000 agents and their associates nationwide. NAIFA is one of the only insurance organizations with members from every Congressional district in the United States. Members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. According to a Fall 2010 survey, nearly two-thirds of NAIFA members are licensed to sell securities, and 89% of NAIFA member clients are "main street" investors who have less than $250,000 in household income. The Association's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members.

[2] The financial services industry has developed numerous financial literacy initiatives, including initiatives directed toward elementary and high school students and programs presented to investors in the local community. *See* The Financial Services Roundtable, COMMUNITY SERVICE IMPACT REPORT at 64-69 (2010), *available at* http://www.fsround.org/publications/pdfs/CS10-ImpactReport.pdf; Insured Retirement Institute, *Retirement Planning Resources for Consumers*, *available at* http://www.irionline.org/consumers/retirementPlanningResources; Securities Industry and Financial Markets Association Foundation, *available at* http://www.sifma.org/Education/SIFMA-Foundation/About-the-SIFMA-Foundation/; Investment Company Institute, *available at* http://ici.org/#investor_education; and FINRA, *available at* http://www.finra.org/Investors/.

[3] Definition of the Term "Fiduciary" [RIN: 1210—AB32], 75 Fed. Reg. 65263 (Oct. 22, 2010) (the "Proposal").

[4] 29 U.S.C. § 1001, *et seq.*

[5] *See* Oliver Wyman, Inc., OLIVER WYMAN REPORT: ASSESSMENT OF THE IMPACT OF THE DEPARTMENT OF LABOR'S PROPOSED "FIDUCIARY" DEFINITION RULE ON IRA CONSUMERS at 13 (Apr. 12, 2011) (the "OLIVER WYMAN REPORT"), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-PH060.pdf (noting that "practically every investment-related conversation or interaction with a client [could become] subject to [a] fiduciary duty"). "Even . . . discussions with call center and branch staff[ ] could be curtailed (so as to avoid inadvertently establishing a fiduciary duty." *Id.* at 15. The OLIVER WYMAN REPORT is based on aggregate proprietary data furnished by "[twelve] financial services firms that offer services to retail investors." *Id.* at 1. These firms "represent over 19 million IRA holders who hold $1.79 trillion in assets through 25.3 million IRA accounts [or roughly forty percent (40%) of IRAs in the United States and forty percent (40%) of IRA assets]." *Id.*

[6] OLIVER WYMAN REPORT, *supra* note 5 at 19-20. If the Department were to adopt the Proposal, the likely result would be a "[r]educed choice of investment professional, level of investment guidance, and investment products," according to the OLIVER WYMAN REPORT. *Id.* at 19.

[7] It also would afford the Department an opportunity to receive further information and analyses from the public on the effectiveness of the proposed revisions. *See* Natural Resources Defense Council v. Environmental Protection Agency, 279 F.3d 1180, 1186 (9th Cir. 2002) (reviewing the "notice and comment" requirements, the court stated that "one of the salient questions is 'whether a new round of notice and comment would provide the first opportunity for interested parties to offer comments that could persuade the agency to modify its rule'").

[8] Insurance Information Institute and The Financial Services Roundtable, THE FINANCIAL SERVICES FACT BOOK at 37 (2011) ("THE FINANCIAL SERVICES FACT BOOK"), *available at* http://www.fsround.org/publications/pdfs/2011/Financial_Services_Factbook_2011[1].pdf.

[9] *Retirement Security: 401(k)s* (Sept. 23, 2010) ("*Retirement Security*"), *available at* http://www.fsround.org/fsr/pdfs/fast-facts/2010-09-23-RetirementSecurity.pdf. In 2009, $2,121 billion of retirement assets were held in defined benefit plans compared to $3,336 billion of assets in defined contribution plans. THE FINANCIAL SERVICES FACT BOOK, *supra* note 8 at 43 (2011) (Source: Securities Industry and Financial Markets Association).

[10] THE FINANCIAL SERVICES FACT BOOK, *supra* note 8 at 37.

[11] OLIVER WYMAN REPORT, *supra* note 5 at 4.

12 *Id.* at 10 ("[A]pproximately half of IRA investors in the report sample have less than $25,000 in IRA assets, and over a third have less than $10,000.").

13 *Id.* at 12. Investors who hold IRA assets in a brokerage account pay commissions to the brokers who buy or sell securities for their IRAs. In the alternative, investors can hold IRA assets in an "advisory" account and pay a fee that is a percentage of the assets held in the IRA. A study of 7,800 households conducted by Cerulli Associates found that more affluent investors also "prefer paying commissions." *See Fee vs. commission: No doubt which investors prefer*, BLOOMBERG (June 8, 2011), http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20110608/FREE/110609950 (reporting that the survey examined "households with more than $50,000 in annual income or more than $250,000 in . . . assets").

14 OLIVER WYMAN REPORT, *supra* note 5 at 2.

15 *Id.* at 19-22.

16 Proposal, *supra* note 3 at 65277-78.

17 *See* OLIVER WYMAN REPORT, *supra* note 5 at 2; *Fee vs. commission, supra* note 13.

18 OLIVER WYMAN REPORT, *supra* note 5 at 22 ("These increased investment costs would serve as a drag on long-term investment gains, and therefore on the ultimate retirement savings available to impacted [IRA] holders.").

19 *Id.* at 19.

20 *Id.* at 20.

21 40 Fed. Reg. 50842 (Oct. 31, 1975). *See also*, Mercer Bullard, *DOL's Fiduciary Proposal Misses the Mark* (June 14, 2011), *available at* http://news.morningstar.com/articlenet/article.aspx?id=384065 ("It is unfair to the industry because it disregards decades of administrative law and practice under ERISA. It is bad for investors because it strips them of fiduciary protections when they are needed most.").

22 Proposal, *supra* note 3 at 65271 (citing a Securities and Exchange Commission staff report that found a majority of the 24 pension consultants examined in 2002-2003 "had business relationships with broker-dealers that raised a number of concerns about potential harm to pension plans"); GAO, *Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO-09-503T, Testimony Before the Subcommittee on Health, Employment, Labor and Pensions, Education and Labor Committee, House of Representatives at 4 (Mar. 24, 2009), *available at* http://www.gao.gov/new.items/d09503t.pdf (noting that 13 of the 24 pension consultants examined by the Securities and Exchange Commission's staff "had failed to disclose significant ongoing conflicts of interest to their pension fund clients").

23 Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule [RIN: 1210—AB07], 75 Fed. Reg. 64910 at 64937 (Oct. 20, 2010).

24 OLIVER WYMAN REPORT, *supra* note 5 at 2 (noting that "estimated direct costs would increase by approximately 75% to 195% for these investors").

25 *See* Preamble to Interim Final 408(b)(2) Regulations, 75 Fed. Reg. 136 (July 16, 2010).

"The Department does not believe that IRAs should be subject to the final rule, which is designed with fiduciaries of employee benefit plans in mind. An IRA account-holder is responsible only for his or her own plan's security and asset accumulation. They should not be held to the same fiduciary duties to scrutinize and monitor plan service providers and their total compensation as are plan sponsors and other fiduciaries of pension plans under Title I of ERISA, who are responsible for protecting the retirement security of greater numbers of plan participants. Moreover, IRAs generally are marketed alongside other personal investment vehicles. Imposing the regulation's disclosure regime on IRAs could increase the costs associated with IRAs relative to similar vehicles that are not covered by the regulation. Therefore, although the final rule cross references the parallel provisions of section 4975 of the [Internal Revenue] Code, paragraph (c)(1)(ii) provides explicitly that IRAs and certain other accounts and plans are not covered plans for purposes of the rule." *Id.*

26 Proposal, *supra* note 3 at 65274-76.

27 OLIVER WYMAN REPORT, *supra* note 5 at 2.

28 *Id.* at 19-20 (IRA holders who cannot qualify for an "advisory account" would be "forced to migrate to a purely 'low support' brokerage model . . . and have little access to investment services, research and tools" to support their IRA savings goals.). *See also*, *Most Americans Haven't Planned for Retirement and Other Areas of Concern*, WALL ST. J., June 6, 2011, *available at* http://blogs.wsj.com/economics/2011/06/06/most-americans-havent-planned-for-retirement-and-other-areas-of-concern/ ("Efforts to make people essentially their own money managers may also be futile. Only 21% to 25% of respondents said they have used information sent to them from Social Security.")

29 While the costs associated with providing various employee benefits (including retirement plans) impact all employers, smaller companies typically are more sensitive to the costs associated with these programs. To the extent that service providers' expenses increase, those costs are passed through to their clientele. An example of expenses associated with the Department's Proposal is the legal cost associated with the initial "compliance review." According to the Department, the cost of legal review would average sixteen (16) hours of time at a rate of $119 per hour. Proposal, *supra* note 3 at 65274. This rate, however, is significantly lower than the average billing rate of $295 per hour for 10,913 lawyers surveyed by the *National Law Journal*. SURVEY OF LAW FIRM ECONOMICS, NAT'L L. J. (2010) ("LAW FIRM SURVEY"), *available at* http://www.alm.com/pressroom/2011/02/10/alm-legal-intelligence-releases-2011-survey-of-billing-and-practices-for-small-and-midsize-law-firms/.

30 *See*, Kelly Greene, *Retirement Plans Make Comeback, With Limits*, WALL ST. J., June 14, 2011, *available at* http://professional.wsj.com/article/SB10001424052702303714704576384072497942338.html (reporting that in the face of a "slowly improving job market, [many companies] seek to balance the need to retain highly skilled workers with the need to limit costs").

31 The Securities and Exchange Commission released a study evaluating the regulatory régimes applicable to investment advisers and broker-dealers who provide advice to retail customers, as required by section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act [Pub. L. No. 111-203, § 913, 124 Stat. 1824 (2010) (the "Dodd-Frank Act")]. STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (Jan. 21, 2011), *available at* http://sec.gov/news/studies/2011/913studyfinal.pdf. Section 913(f) authorized the Commission to engage in rulemaking to address the legal or regulatory standards of care applicable to investment professionals who provide "personalized investment advice about securities" to retail customers. Section 913(f) of the Dodd-Frank Act, 124 Stat.1827-28.

32 58 Fed. Reg. 51735.

33 75 Fed. Reg. at 65269.

34 *Id.* (According to the Office of Management and Budget, the Department's proposed rule "is likely to have an effect on the economy of $100 million in any one year.").

[35] For example, the Department estimated that service providers would incur about sixteen (16) hours of legal review at a rate of $119 per hour. While the complexity of the compliance review likely would far exceed the Department's estimate of sixteen (16) hours, an allocation of just $119 per hour for legal services vastly understates the cost of legal services in the United States. *See* LAW FIRM SURVEY, *supra* note 29 and accompanying text.

[36] 75 Fed. Reg. at 65275 ("[The Department's] estimates of the effects of this proposed rule are subject to uncertainty.").

[37] *Id.*

[38] *Id.* at 65276.

[39] *Id.*

[40] *Improving Regulation and Regulatory* Review—Executive Order 13563 (Jan. 18, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order.

[41] *Id.* at Section 1.

[42] *Id.*

[43] *Id.* at Section 4.

[44] *See infra* note 46.

[45] 29 C.F.R. § 2510.3-21(c).

[46] *See, e.g.*, Employee-Owned S Corporations of America (Jan. 12, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-040.pdf; American Council of Engineering Companies (Jan. 19, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-048.pdf; American Institute of CPAs (Jan. 19, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-050.pdf; National Association of Realtors (Jan. 20, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-052.pdf; Glass Lewis & Co. (Jan. 20, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-053.pdf; Securities Law Committee of Business Law Section of the State Bar of Texas (Jan. 11, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-039.pdf; Retirement Industry Trust Association (Jan. 26, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-064.pdf; International Corporate Governance Network (Jan. 21, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-065.pdf; New York City Bar Committee on Employee Benefits & Executive Compensation (Jan. 28, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-070.pdf; Investment Adviser Association (Feb. 2, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-082.pdf; International Data Pricing and Reference Data, Inc. (Feb. 2, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-082.pdf; The ERISA Industry Committee (Feb. 2, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-090.pdf; Institutional Shareholder Services Inc. (Feb. 2, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-104.pdf; U.S. Chamber of Commerce (Feb. 3, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-111.pdf; CFA Institute (Feb. 2, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-128.pdf; Business Roundtable (Feb. 3, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-139.pdf; and Committee of Federal Regulation of Securities of the Section of Business Law of the American Bar Association (Feb. 3, 2011), *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-152.pdf

[47] Definition of the term "Fiduciary" Proposed Rule Public Comments, *available at* http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html.

THE IMPACT OF EXECUTIVE COMPENSATION PROVISIONS IN TITLE IX OF THE DODD-FRANK ACT

AN ASSESSMENT OF SAY ON PAY, CLAWBACKS, PAY RATIO, PAY FOR PERFORMANCE AND INCENTIVE COMPENSATION

Hearing on Enhanced Investor Protection after the Financial Crisis

Senate Banking Committee

July 12, 2011

Statement Submitted for the Record

Center On Executive Compensation

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Chairman Johnson, Ranking Member Shelby and Members of the Senate Banking Committee:

The Center On Executive Compensation is pleased to submit testimony to the Senate Banking Committee providing its perspective on Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). For the most part, this title of the Dodd-Frank Act is unprecedented in its vagueness and breadth, and we urge the Senate to take a practical view of the implications of this law and identify areas that would benefit from a review, revision or repeal.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association and represents companies from a broad cross-section of industries. Because the senior human resource officers play a unique role in supporting the compensation committee chair, we believe that our Subscribers' views can be particularly helpful in understanding the complexities that would be required to implement the requirements set forth in Title IX of the Dodd-Frank Act.

I. Say on Pay

With over half of the first year of say on pay behind us, the Center has been closely tracking the recommendations and results of Fortune 500 companies. As of July 7, 2011, 384 Fortune 500 companies had reported results on their advisory votes on compensation. Of these companies, 378 received a majority of shareholder support (98.4 percent total shareholder approval). The mean shareholder approval percentage is 88.6 percent, and the median is slightly higher at 94.0 percent. The majority of companies (65.4 percent) received at least 90 percent approval from shareholders on their compensation programs.

The overwhelming approval demonstrates that shareholders are supportive of executive compensation arrangements, especially for large companies. The results are not surprising. They are consistent with the experiences in the United Kingdom, which has had say on pay since 2002, and with say on pay votes required of TARP companies.

Section 951 of the Dodd-Frank Act also mandated a periodic nonbinding shareholder vote on whether companies should hold a vote every one, two or three years. As of July 7, 2011, 394 Fortune 500 companies have submitted proxies to the Securities and Exchange Commission ("SEC" or "Commission") containing recommendations for say on pay frequency votes, with the majority (68.3 percent) recommending an annual say on pay vote. Of the 101 Fortune 500 companies that recommended a triennial frequency vote, only 29 have received a majority shareholder vote for a triennial frequency.

The irony in the overwhelming support for an annual frequency for say on pay votes is that the timing of the vote and the deadlines for company compensation decisions are out of sync. The vote is on the company's prior year's compensation, but for most companies, that vote typically occurs after the current year's compensation arrangements have already been set and communicated. For this reason, a company that receives a negative vote or a significant vote against it will take two years before shareholders will have a say on pay vote on any changes made to pay arrangements based on the prior say on pay vote. Accordingly, those changes will not be disclosed in the proxy for two years. This could have the effect of moving some companies and institutions to reconsider whether an annual say on pay vote makes the most sense.

II. Pay Ratio Disclosure

The pay ratio provision in Section 953(b) of the Dodd-Frank Act requires companies to disclose in their proxy statements the ratio of the median pay of all employees to the total pay of the chief executive officer. SEC officials from Chairman Mary Schapiro to the Director of the Division of Corporation Finance Meredith Cross, have indicated that due to the prescriptive nature of the provision, the SEC has very little interpretive authority with respect to this provision and thus would interpret it narrowly. For this reason, it is likely that companies would be required to calculate the pay of every employee globally, whether full- or part-time, in the same manner as compensation is calculated for the named executive officers. In comments to the SEC and the media, the author of this provision, Senator Menendez has insisted that this provision should not be modified, despite the considerable cost and burden imposed on the business community.

It is a common misperception that companies have this information readily available at the touch of a button. Most global companies do not have centralized payroll systems; therefore, generating the pay ratio information would be a considerably complex undertaking for large, multinational companies since it would require a company to gather and calculate compensation information for each employee, part-time and full-time, as required for senior executives under the SEC disclosure rules, determine the pay of each employee from highest to lowest, and then identify the employee whose pay is at the midpoint between the highest- and lowest-paid employee. No public company currently calculates each employee's total compensation as it calculates total pay for CEOs on the proxy statement; therefore, companies would be required to invest considerable resources to implement this mandate, which will not provide meaningful information to investors.

Under the pay ratio requirement, the scope of the information gathering requirement presents significant hurdles for most large companies. Accuracy is a significant concern, since compensation data is often housed in dozens of computer systems around the globe and subject to the compensation and benefits rules of different countries worldwide. Furthermore, these illustrations say nothing with respect to the impact that exchange rate fluctuations will have on the calculations. Companies would be required to develop and coordinate a consistent calculation across all countries and then ensure that the results were accurate since Section 302 of Sarbanes-Oxley requires the CEO and the CFO to sign the proxy statement certifying its accuracy.

The Center believes that pay ratio mandate is inconsistent with the purpose of the SEC disclosure rules. The SEC generally requires that companies disclose in the proxy statement all material information necessary to inform an investor of how and why a company compensates its named executive officers. Material information is that which would impact an investor's decision to invest in the company or its vote for directors. Therefore, the addition of nonmaterial information simply lengthens the disclosure and dilutes the impact of material information. Further, the inclusion of this ratio could mislead investors who seek to compare ratios between companies.

The ratio would not be comparable between companies as the pay of employees at all levels of an organization is subject to various forces in the market, such as competition, geography and job type. Companies employing more highly paid employees will likely have a smaller ratio due to the structure of their workforce as opposed to those employing a larger share of lower paid employees, such as retail clerks. However, the difference would not tell investors whether the company with the lower ratio is a better investment. Moreover, the ratio does not account for a company's global operational structure or business strategy, which would certainly have an impact. One company may rely on third parties for certain services like manufacturing or information processing whereas another company outsources it. Again, comparing the ratios between two such companies would provide little useful information.

Since 2006, the SEC has made significant changes to its executive compensation disclosure rules relating to executive compensation in an effort to expand the material information that is available to investors. Because of these rules, the average compensation disclosure in a proxy statement of Center Subscribers is now 26 pages. That is over a quarter of the length of proxy statements for large companies, which now are routinely 100 pages long. The addition of nonmaterial information in the form of the ratio and any narrative disclosure to explain the ratio would only add to the length and make it more difficult for investors to digest the material information

IV. No-Fault Clawback Policy

Section 954 of the Dodd-Frank Act requires the SEC to promulgate rules directing the securities exchanges and securities associations to develop listing standards requiring companies to adopt and disclose a no-fault clawback policy. Specifically, the policy to be disclosed must provide, in the event of a material restatement, for the recoupment of incentive compensation that is "based on financial information required to be reported under the securities laws" from current and former executive officers of the company, if such compensation is in excess of that which would have been paid in view of the restatement. This mandate raises a number of issues, including:

- Which compensation is "based on financial information required to be reported under the securities laws;"
- The mechanics of determining the amount to be recouped in the event of a material restatement;
- The role of board discretion in executing the recoupment policy, particularly where board discretion was applied in originally awarding the incentive compensation, where the cost of recoupment exceeds the amount to be clawed back, and in determining how to recoup the excess compensation over what would have been received; and
- The need to provide companies with sufficient lead time to implement a policy before the clawback mandate takes effect.

A. Clearly Delineate Compensation Subject to the No-Fault Clawback Policy

The linchpin of the requirement in section 954 of the Dodd-Frank Act is that companies are required to disclose and enforce a policy that provides for recoupment of incentive compensation that is "based on financial information that is required to be reported under the securities laws." Thus, if incentive compensation is "based on" financial results that are reported under the securities laws, it is potentially subject to recoupment. Consistent with principles-based disclosure and recognizing the complexity of issues that are created by the language of the statute, the Center believes that the SEC will need to differentiate incentive compensation that is subject to the recoupment requirement from compensation that is not subject to it. This will enable Boards of Directors and Compensation Committees charged with enforcing it to better understand their obligations.

Financial information that is required to be reported under the securities laws includes measures such as revenue, net income and earnings per share. It also may include non-GAAP measures such as earnings before interest, taxes, depreciation and amortization and return on net assets.

Incentive information that is not required to be disclosed under the securities laws includes stock price, total shareholder return (which is based on the change in share price plus dividends over a period of time) and operational performance measures specific to the business such as market share and customer satisfaction. Such measures are not financial information that is filed with the SEC and therefore would not be subject to clawback under section 954.

The Center believes that it is critical to understand how incentive plans are structured, so that the SEC may factor this information into its proposed regulations. Although compensation arrangements vary widely, depending upon the company, industry, competitive condition and global focus, below we present five hypotheticals, illustrating four common types of compensation arrangements:

(1) Purely formulaic incentive plans, based on financial metrics that pay out in cash;

(2) Formulaic incentive plans in which a pool is funded based on the achievement of objective financial measures, but the board has discretion whether to allocate the entire bonus pool toward incentives, where a recoupment would not be required;

(3) Identical to (2), except the facts change so that recoupment is required;

(4) Formulaic long-term incentive plans based upon financial performance with overlapping awards; and

(5) Nonqualified stock option grants, that are not granted or vested based upon performance.

<u>Annual and Long-Term Cash Incentive Measures Based Upon Financial Metrics</u>. The implementation of the recoupment policy is easiest when dealing with incentive plans that are purely formulaic, based exclusively on financial measures, and paid out in cash. In that situation, the clawback is the excess of what was actually received compared to the amount that would have been received under the formulaic plans had the financial statements been correct.

Example 1: Formulaic Incentive Plan With Incentives Based on Financial Metrics

- Annual bonus is based on achievement of targeted level of net income.
- The performance for 2009 equaled 105% of the targeted level of net income.
- The incentive formula increases payout by 3% for each 1% by which performance exceeds the target.
- The payout at 100% performance is 50% of salary.
- The payout based on the performance results would be 115% of the targeted payout.
- 115% of 50% of salary would produce an annual incentive payout of 57.5% of salary.
- Assume the performance results for 2009 had to be restated in 2011 and the impact was to reduce net income to 90% of the targeted level of performance.
- The incentive formula reduces payout by 3% for each 1% by which performance falls short of target.
- The incentive payout on the restated earnings would have been 70% of the targeted payout of 50% and would have produced an incentive payout of 35% of salary.
- The amount of annual incentive that would be clawed back would be the difference between what was paid (57.5% of salary) and that which would have been paid on the restated earnings (35%), which would equal 22.5% of salary.
- Assuming the executive had a salary of $500,000, the bonus amount to be clawed back would equal $112,500 (the difference between an incentive of $287,500 at 57.5% of salary and an incentive of $175,000 based on 35% of salary).

Formulaic Incentive Plans Where Financial Measures Fund a Bonus Pool. Where the financial measure funds a pool which is distributed based upon financial and non-financial measures, the application of the clawback policy will differ based upon whether the Board and/or the Compensation Committee had discretion in determining how much of the pool to allocate for incentives and whether the Board and/or the Compensation Committee has discretion in determining the individual awards.[1] Assuming the Board or Compensation Committee had discretion in determining the amount of the bonus pool to allocate to individual awards and the individual awards are determined based upon some measures that require the judgment of the board (rather than formulaic), a material restatement could require the Board to revisit its decisions. Examples 2 and 3 illustrate the pool concept and the role of Board discretion:

[1] If the Board does not have discretion (i.e., the bonus pool and the individual awards are formulaic), the clawback would be applied similar to Example 1 for the portion of the award based on the restated financial performance.

Example 2: Incentive Pool Approach With Restatement; Recoupment Not Required

- The annual incentive pool is generated based upon a percentage of net income, and at targeted level of net income for 2009 the pool would be sufficient to provide incentives equal to the sum of the incentive targets for the participating executives.
- The amount of incentive payout any individual would receive is based upon his or her individual performance against non-financial objectives in the areas of (1) talent development, (2) productivity and cost-savings, (3) operational performance measures and (4) modeling the desired company culture and promoting ethical behavior (weighted 25% each).
- In total the payouts to executives cannot exceed the incentive pool, but there is no requirement that the board allocate the entire pool to incentive payments.
- For 2009, the company hit 100% of the net earnings target, and the incentive pool was generated on that basis.
- The board allocated 95% of the pool for incentives.
- No executive received an incentive payment directly based upon the achievement of the net income target. Some executives received incentive payments above their targeted incentive; some received less than their targeted level of incentive and some received their targeted level of incentive. The amount received by an individual executive was based on the assessment of performance in the four areas listed above.
- Assume the performance results for 2009 had to be restated in 2011, and the impact was to reduce net income such that the incentive pool equaled 98% of the sum of the incentive targets for the participating executives.
- At this restated level of performance the bonus pool was sufficient to cover the actual amount of incentives paid (98% pool, 95% actually paid out).
- In this situation there does not appear to be a need to recoup any of the incentives paid unless the board determines it would have made different individual incentive decisions in view of the restated earnings.

Example 3: Incentive Pool Approach; Recoupment Required

- Same as Example 2 but the restated earnings would have produced an incentive pool equal to 90% of the sum of the incentive targets for the participating executives.
- The Board has three options regarding how to recoup the 5% that exceeded the amount allocated to the incentive pool.
  - Ratably reduce all executive incentives by 5% (non-discretionary recoupment although the incentive paid to each individual was based on board discretion);

- Discretionary recoupment on an individual-by-individual basis (the same way the bonus amounts were awarded) such that the total amount recouped equaled the 5% overpayment (discretionary recoupment);
- Recoupment is left to the discretion of the board, pursuant to the company's recoupment policy.

Recognition for Board discretion in such situations is absolutely critical. Thus, the Board should have the ability to decide to use any of the three options, so long as its rationale is explained in the company's next proxy statement.

<u>Overlapping Long-Term Awards and the Impact of a Material Restatement on Target Setting</u>. Long-term incentives are often three-year awards granted annually so that the awards are overlapping. In this situation a material restatement, and any required recoupment could affect up to four cycles of long-term incentive grants (the three outstanding performance cycles, plus the basis for setting the next award depending on whether the financial measures included in the restatement affect the long-term incentive program and also serve as the base year for setting performance targets for the next award). Example 4 illustrates the mechanics of this model:

Example 4: Overlapping Long-Term Incentive Awards

- Assume that Performance Unit Awards are granted annually and have the following design:
  - Units are denominated as a dollar amount (e.g., $100,000 value for achieving targeted performance).
  - Performance in excess of the targeted level of performance increases the payout by 3% for each 1% by which targeted performance is exceeded.
  - Performance that falls short of target reduces the payout by 3% for each 1% shortfall in performance versus targeted level of performance.
  - The performance metric is cumulative earnings per share (EPS) over the three-year performance period.
- Since the awards are granted annually, and given that the performance period is three years, a participant will have 3 overlapping awards outstanding at any given time.
- Therefore, a given year will be included in three separate award cycles and, depending how performance targets are set, may serve as the base year upon which the performance targets for a 4th award cycle are set.
- Outlined below is an example of the outstanding awards under a performance unit program:

	2007	**2008**	**2009**	**2010**	**2011**	**2012**
2007 Award:	2007-------	2008------	2009			
2008 Award:		2008------	2009-----	2010		

2009 Award:	2009-----2010---2011
2010 Award:	2010---2011-------2012

- Assume that in mid-2010 the company materially restates downward the earnings for 2009, thereby reducing 2009 EPS.
- The impact of the restatement would be to reduce the performance for the 2007, 2008 and 2009 award cycles.
- The restatement would also lower the base year upon which the board set the EPS targets for the three-year award cycle beginning in 2010.
- The 2007 awards would have been paid out to the participants and therefore the company would have to initiate recoupment for the excess payment that was based on the pre-restated 2009 EPS.
- The 2008 and 2009 award periods would not yet have been completed and therefore the potential payout of the performance units would be automatically reduced. No recoupment would be required.
- The board should also revisit the targeted cumulative EPS goals for the performance cycle beginning in 2010 to determine if the goals would have been set at a lower level had the board been aware of the restated EPS for 2009 at the time the goals were set.

Performance-Granted and Performance-Vested Equity Awards. Section 10D(b)(2) of the statute states that the clawback policy applies to "incentive-based compensation (including stock options awarded as compensation)." The Center believes this language should be read as requiring that the clawback policy applies to (1) incentive-based compensation as defined under the Commission's disclosure rules that is based upon information required to be reported under the securities laws; and (2) stock options that are awarded as compensation and that are incentive-based compensation as defined under the Commission's disclosure rules where the incentive is based on financial information required to be reported under the securities laws. This approach makes the clawback language in section (b)(2) consistent with the reporting language in (b)(1), which requires companies to disclose the policy of the company on recoupment of incentive-based compensation under the securities laws.

Applying this interpretation, the Center believes that performance-granted and performance-vested equity awards can be incentive compensation subject to the recoupment mandate, if the above definitions are met. Unlike nonqualified time-vested stock options, restricted stock or restricted stock units, which are not considered incentive compensation under the Commission's rules, performance-granted or performance-vested stock options, for example, are incentives that are often granted based on financial performance or other performance measures.

Time Vested Stock Options. Stock options generally take one of two forms: (1) performance-based stock options for which the granting or vesting of the award is based on the achievement of financial performance, as discussed above or, (2) time-vesting stock options for which the award is based on considerations other than financial performance and the vesting of such awards is based on the passage of time and is not contingent on achieving financial performance objectives. Stock options that vest merely on the basis of time are not considered incentive compensation under the SEC's disclosure rules and therefore should not be subject to a mandatory clawback. Many companies determine the level of stock options granted to an individual based on the executive's level, tenure and expected performance level, which are not linked to financial performance. In this case the following example should apply:

Example 5: Stock Option Awards

- Stock option awards are determined on an executive-by-executive basis.
- The actual award received is a function of salary grade, title, performance and potential.
- The determination of the performance of an individual executive for purposes of granting stock option awards is not tied directly to the financial results of the overall company.
- The option awards granted in 2006 have vested but the executives have not exercised the stock options.
- Assume the results for 2006 were restated in 2009 and the net income of the company was reduced by 1%.
- Correspondingly, the stock price dipped on the day of the restatement by 10% and has recovered over subsequent weeks but the recovery in stock price has trailed the overall movement of the market and the stock price appreciation of industry peers.
- In view of the fact that there has been no gain to the executives since the options have not been exercised, and in view of the fact that the size of the grant was not influenced by the net income of the company, no recoupment is warranted.
- An alternative stock option design would be a stock option that vests on the basis of achieving financial targets. In this case, the number of stock options that would not have vested based on the restated financial performance outlined above would be subjected to recoupment due to the material restatement.

In sum, the Center believes that the better way to interpret the clawback language in section 954(b)(2) is to consider any incentive compensation that is awarded, granted or vested based on financial measures required to be reported under the securities laws as subject to recoupment. Conversely, vehicles such as time vested stock options, restricted stock and restricted stock units should not be considered incentive compensation, and if the granting of such awards was not based on the restated financial performance, it is therefore not subject to the clawback requirement. However, if the granting of individual stock option awards is based on the restated financial performance, the number of shares awarded would be subject to the clawback based on the excess of the award over that which would have been awarded based on the restated financial performance.

B. Boards Should Have Discretion in Executing the Recoupment Policy

In implementing the clawback requirement, the role that Board or Compensation Committee discretion plays in setting executive compensation must be recognized, and any regulations should explicitly provide for Board and Compensation Committee discretion in the determination of the amount to be recouped and how that recoupment is to be executed. This interpretation recognizes that Board discretion often plays a role in how incentive compensation is awarded and allows the Board to make determinations to ensure that the recoupment is in the best interests of shareholders.

The Level of Discretion Used by the Board/Committee in Determining Amount to Be Clawed Back Should Be the Same as That Used in Making Original Grant. Boards should be given the same level of discretion to determine the amount to be clawed back as was used in making the initial compensation decision. As illustrated in the examples above, this may involve discretion under section 162(m) incentive plans in which financial performance funds a pool to be used for the distribution of compensation to NEOs or other executive officers. Committee discretion may also be used in applying other financial criteria used to make individual awards.

Board or Committee discretion is also increasingly an element of a company's risk mitigation system. Affording the Compensation Committee discretion allows it to reduce (or add) incentive payouts, when the committee takes the entirety of the circumstances into account. In addition, long-term incentive grants, whether granted on a value or a number of shares basis, are often made based on a formula, to which Committee discretion is applied in determining the actual grant.

Discretion Not to Claw Back Where the Cost of Executing the Clawback Would Outweigh the Benefits to Shareholders. The Center believes that in addition to discretion as discussed above, Boards should have discretion in determining not to execute a clawback against a current or former executive officer where, for example, the amount to be clawed back is de minimis or the Board believes that protracted litigation would be required to recoup the compensation. In cases such as this, the Center believes the Board's ability to decide not to claw back and to disclose that decision in the proxy should be recognized. This is especially important with respect to executive officers in certain countries or other jurisdictions that are extremely protective of employees, where it may not be possible to recoup the entire amount. Boards should be afforded the deference to settle a clawback for less than the full amount.

Discretion in Determining How to Recoup Compensation From a Current Or Former Executive Officer. The Center believes that since the statute is silent as to how clawbacks are to be executed, Board/Compensation Committee discretion should be explicitly recognized in executing recoupment by any method the Board deems to be appropriate (and discloses in the next proxy statement), including cancellation of unvested awards (equity and nonequity awards) and offsetting against amounts otherwise payable by the company to the executive (for example, deferred compensation) in place of having executives write a check, if the circumstances warrant. This flexibility helps to mitigate some of the procedural complexities involved in executing a clawback, including the need to file amended tax returns by both the company and the executives.

C. The Three-Year Recoupment Period Should Be Linked to the Restatement Filing Date

The Center also believes that the trigger for recoupment (i.e., when a company is "required to prepare an accounting restatement") should be when the company actually files an accounting restatement due to the material noncompliance of the company with a financial reporting requirement under the securities laws. This creates a verifiable date certain from which to determine the three-year period over which the recoupment applies. It also avoids speculation over when a company determined it should have known it was required to prepare a restatement.

The Center believes that restatements based on changes in Generally Accepted Accounting Principles should be excluded from the types of restatements that trigger a recoupment. These restatements are not based on oversights or deliberate errors by the company, but rather a change in the framework for reporting. Mandating a recoupment in such circumstances does not fulfill the policy objective sought by the clawback mandate: namely, if an executive did not earn incentive compensation based on financial results, he or she should be required to return it.

D. Include Sufficient Lead Time to Implement the New Clawback Requirements

The Center believes that the clawback policy will apply only to any new incentive compensation that is received after the effective date of the listing standards approved by the Commission. To apply the recoupment policy to compensation already granted would create excessive complexity in term of amendments required to outstanding compensation plans and executive contracts.

In addition, the Center stresses that companies need sufficient time to put such policies into place prior to the effective date of the listing standards incorporating the disclosure and recoupment obligation taking effect because of the considerable number of issues, such as plan amendments and contract renegotiation that must be addressed. We believe that a reasonable time would be 12 months after the Commission approves the listing standards.

III. Disclosure of Pay Versus Performance

Section 953 of the Dodd-Frank Act adds a new section 14(i)(a) to the Exchange Act, entitled Disclosure of Pay Versus Performance, which requires that public companies disclose in its annual proxy statement "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer." The Center believes there is a critical need for flexibility with respect to this disclosure in order to properly portray the unique aspects of individual company pay philosophies, programs and decisions. The statute requires companies to take "into account any change in the value of the shares of stock and dividends of the issuer and any distributions." We believe this disclosure should reinforce the purpose of the CD&A, namely to "put into context the compensation disclosure provided elsewhere."[2]

[2] U.S. Securities and Exchange Commission, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A, 34-54302A, 71 Fed. Reg. 53,157, 53,164 (September 8, 2006).

With this in mind, the Center believes this disclosure should reflect the Board's and Compensation Committee's perspectives on compensation and financial performance in making its compensation decisions. Rather than focus on uniform disclosure, the requirement in new section 10(i) should be interpreted to focus on explaining the link of compensation "actually paid" to performance, allowing companies the flexibility to explain the committee's decisions in the context of its overall pay philosophies.

Definition of Compensation "Actually Paid." We believe that the determination of "actually paid" will vary based on how the Compensation Committee and the Board structured the performance basis of incentive compensation granted to executives. This is consistent with the requirement that the CD&A "focus on the material principles underlying the registrant's executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions."[3]

Because much of the CD&A focuses on the amounts in the Summary Compensation Table, the intended performance linkage between pay and performance may not be clear from the amounts in that Table, depending upon the philosophy of the company, especially with respect to long-term incentives. The linkage between pay and performance is fairly consistent as it relates to salary and annual incentive because the amounts realized are reported in the same year as the corresponding performance. However, the design of long-term incentive plans can vary considerably among companies depending on the basis upon which awards are granted, performance periods, performance objectives and incentive vehicles used.

Long-term Incentives as Awards for Past Performance. For example, a Compensation Committee may grant long-term incentives as a reward for past performance. In this case, the grant date fair value estimate for long-term equity-based incentives in the Summary Compensation Table more appropriately reflects the decisions made by the Compensation Committee and the Board and thus the linkage between compensation "actually paid" and performance.

Example 1: The Company has a tremendous year in terms of financial performance and the senior executive team is granted above guideline stock option awards to reflect the accomplishments of the prior year in the total planned annual compensation value. In this case, the Compensation Committee and the Board would discuss the relationship between the financial results and the date of grant value of the stock option awards, as reported in the Summary Compensation Table, when combined with other forms of incentive compensation reported in the Summary Compensation Table, as reflecting the relationship of pay and performance. If performance had been below expectations, a lower planned grant value could result. This pay for performance philosophy is in large part backward looking in that long-term incentive grants are the result of past performance.

Alternative: Realized Compensation as "Actually Paid." By contrast, some companies are concerned that the long-term incentive estimates disclosed in the Summary Compensation Table do not completely reflect the pay for performance linkage underlying the committee's decisions. As a result, they may choose to put those amounts

[3] *Id.* at 53,242.

into context by discussing how compensation actually realized -- the compensation actually received by the executive at the end of the performance period based on the degree of achievement of the underlying performance objectives -- is the proper reflection of pay for performance rather than grant date value of the award.[4] This approach requires an explanation of how pay and performance were linked over the period the awards were outstanding and gives shareholders a sense for how such forward-looking incentive programs operate in practice.[5]

Example 2: The Company is in a turnaround situation and the Compensation Committee believes that it is important to grant a market-competitive level of long-term awards to the executive team to motivate them to improve the performance of the company. In this case, the philosophy of the company is that the link between pay and performance is best reflected based upon the pay that will be actually realized by the degree to which performance goals are achieved and the long-term awards create gains to the executives. This pay for performance philosophy is forward looking in that future performance will determine the pay received from the performance-contingent awards.

Some companies have begun disclosing the realized value of long-term incentive amounts in a table, similar to the following (which is separate from example 2):

Form of Compensation	**Total Received ($)**	**Annualized Amount**	**Performance Results Over Performance Period That Produced the Compensation**
• **2008-10 LTIP Payout**	$3,384,275	1,128,092	The total 2008-10 Long Term Incentive Plan award was $3,384,275. Performance criteria for this award were: (1) Total return to shareholders vs S&P Industrials Index companies, weighted 50%, for which the company ranked in the top 25 percent of companies, producing a near maximum payout for this component. (2) ROIC, weighted 25%, which exceeded the targeted level by 100%, resulting in maximum payout; and (3) Cash flow, weighted 25%, which exceeded the target by 15%, which resulted in a target payout. Overall the payout represented 150.25% of target.

[4] This approach is also reflective of the way the Commission has distinguished estimates of compensation included in the Summary Compensation Table and compensation earned and paid out in the preamble to its 2006 disclosure release. *See, e.g.,* U.S. Securities and Exchange Commission, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A, 34-54302A, 71 Fed. Reg. 53,157, 53,169 (September 8, 2006) ("This table, as amended, shows the named executive officers' compensation for each of the last three years, whether or not actually paid out.") *referring to the Summary Compensation Table*); *Id.* at 53,174("No further disclosure will be specifically required when payment is actually made to the named executive officer.") *discussing the treatment of equity awards on the Summary Compensation Table.*

[5] This approach may also be useful in turbulent economic times where the accounting estimate of long-term incentive awards included in the Summary Compensation Table may vary considerably from the amounts actually realized.

As the two examples above demonstrate, it is important that there is flexibility for the Compensation Committee and the Board to present the pay for performance relationship in a manner that is consistent with the company's pay philosophy.

Regardless of the approach used to describe the relationship between incentives and performance, the Center does not believe that the actuarial increase in defined benefit pension plans should be included in the calculation of compensation "actually paid" because the amounts are based on credited service, age, interest rates, and historical earnings, factors not generally related to financial performance, and given that pension estimates have not yet been received by the executive and thus should not be considered pay actually paid. The Center also believes that "other compensation," should be excluded as it is not related to financial performance.

Definition of Financial Performance Should Be Company-Specific. We believe that the definition of "financial performance" should link the compensation "actually paid" to the financial metrics the Compensation Committee and the Board have incorporated into the company's incentive plans. Companies choose these financial measures because they link to short-term and longer term financial objectives intended to drive long-term shareholder value that will ultimately be reflected in stock price. We suggest that a company be required to clearly state the extent to which financial performance measures are used in determining the incentive compensation "actually paid" to named executive officers and how those amounts relate to financial performance.

Example 3: For example, a company that links its long-term incentives to financial performance may state: "our company provides a long-term incentive program for senior executives that is paid out in shares of company stock at the end of the period, based on the achievement of certain financial results. A certain number of performance share units are granted at the beginning of the three-year performance period and adjusted based on performance at the end of the period. The financial performance on which the payout is based is:

- 60% Earnings per share;
- 20% Return on Invested capital; and
- 20% Cash flow."

The company would then provide the pay (either on an estimated basis or realized pay basis) that is linked to the financial performance.

Companies should be permitted to incorporate into this disclosure comparison of how other, nonfinancial measures compare with performance, consistent with the Commission's existing disclosure rules, so long as the link between financial performance and compensation actually paid is clear. This approach would allow companies to describe the link between pay and the performance on which it is based, whether financial, operational or strategic. Companies that base compensation decisions or measure performance based on financial and operational measures would report the compensation decisions or compare compensation received with the achievement of those objectives, while companies that base compensation actually paid on total shareholder return would measure performance on that basis.

Example 4: Company A determines a total long-term incentive value based on the committee's evaluation of the external market and allocates that total among two long-term incentive vehicles:

- 40% time-vested stock options, which vest after three years and provide value if the company's stock price exceeds the grant price; and
- 60% performance shares, which are based equally upon the achievement of earnings per share and total shareholder return measures.

In this case, only the performance shares are related to financial performance. However, rather than requiring a separate disclosure in which the company shows the link between the portion of the long-term incentive that was based on financial performance and compensation, the company should be able to disclose how each element of the long-term incentive produced or is expected to produce compensation based on performance (depending on the committee's philosophy in granting compensation as discussed above), and to highlight the elements that are based on financial performance.

Of course, as is the case under current SEC disclosure rules, companies would not be expected to disclose non-public performance metrics that would lead to competitive harm if disclosed to competitors.

In sum, compensation is not a one-size-fits-all exercise, and companies use different approaches that fit their size, industry, strategy, competitive outlook and talent retention and development needs. A principles-based approach should be implemented with respect to disclosure of the relationship between pay and performance in order to promote clearer shareholder understanding of the decisions made by a Compensation Committee and/or the Board.

V. Incentive Compensation at Covered Financial Institutions

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Agencies to promulgate regulations that prohibit incentive-based compensation that may encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. The Center is extremely concerned that the proposed rules are so prescriptive that they will effectively undermine the ability of covered financial institutions, especially those that are publicly held companies, to appropriately tailor compensation to performance for executives and other employees. The Center urged the Agencies to reconsider the prescriptive nature of these rules and to reshape these rules as guidelines to give the boards of directors of covered financial institutions the leeway and authority to govern a company effectively while accomplishing the statutory mandate of section 956. Allocating decision-making authority between the board, shareholders and the government as proposed will create disjointed programs that are likely to negatively affect company performance without adding measurably to the safety and soundness of the institutions.

While the guidelines required by the Dodd-Frank Act were mainly in practice at most financial institutions, the regulations that have been jointly proposed by the Securities and Exchange Commission, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration and the Federal Housing Finance Agency (collectively, the "Agencies") have exceeded that statutory mandate and could negatively affect the financial services industry at a time promoting the economy and ensuring stability in this industry is a principal focus.

The following summarize the Center's primary concerns with respect to the proposed regulations:

- Section 956 of the Dodd-Frank Act should be implemented in a Board-centric manner which draws on the informed judgment of the Board. Equipped with intimate knowledge of the company's business and talent strategy, the Board, is supported by the advice and council of independent expert advisors and is uniquely qualified to design and monitor incentive arrangements that are in the best long term interests of shareholders. Failing to maintain and reinforce the Board's unique role in managing compensation will create disjointed programs that are likely to negatively affect company performance without fulfilling the purpose of this rule – to improve the safety of financial institutions and mitigate unnecessary and excessive risk. This is especially the case with respect to executive compensation.
- Consistent with the duty to manage incentive arrangements in an informed and careful manner, Boards should continue to have responsibility for risk mitigation. Since the beginning of the economic downturn, companies took steps to minimize risk prior to government intervention. Accordingly, companies with strong corporate governance have involved the risk management function in discussions regarding compensation. The Center believes that the proposed regulations should recognize the initiatives Boards have undertaken to manage risk and adopt a flexible approach which allows Boards to adopt the most appropriate risk mitigation strategies for a company.
- Most companies seek to minimize risk in incentive compensation through multiple levels of review -- an appropriate and reasonable approach consistent with sound governance. These best practices should be recognized and accommodated in the rules. Requiring all companies to adopt a one-size-fits-all approach to risk mitigation is an overly broad reaction as most institutions already have in place a well-defined governance structure to assess risk in incentives. Additionally, companies should be free to allocate responsibility for risk management as appropriate for their business structure. The proposed regulations contemplate dictating a governance structure with respect to the compensation committee's responsibilities in reviewing, assessing and approving compensation for all individuals that have the ability to expose the institution to loss. Consistent with the oversight role of the Board, the responsibility for mitigation of risk in incentives below the executive level should be company management, and the Board should have responsibility to ensure processes are in place, and monitor such processes, to ensure risk mitigation is appropriate.
- The mandatory deferral provision in the proposed regulations exceeds the Agencies' statutory mandate and is contrary to a Board-centric approach to compensation. The Center is concerned that this requirement will lead to a "cookie-cutter" approach to executive compensation among large financial

institutions. Moreover, the requirement raises a number of questions with respect to how it will be interpreted and implemented, because it is drafted in such vague and ambiguous terms.

- The determination of what constitutes excessive compensation is best left to the judgment of the Board of directors. The Center believes that the Agencies should take a principles-based approach that would allow companies to develop compensation programs that are appropriately structured for the company and to discourage executives from taking excessive risk. Incorporating flexibility in these rules ensures that Boards can tailor the compensation programs – especially with respect to the competition for talent -- to reflect the unique company-specific facts and circumstances that surround each compensation decision.
- To the extent that the proposed regulations are duplicative of existing regulations, the Center requests that the Agencies consider removing the duplicative provisions. The annual report requirement is excessive, unclear and is redundant with many provisions that are already required to be filed under existing SEC disclosure rules and existing financial regulatory agency guidelines.
- As the proposed regulations are currently drafted, it is not always easy to determine which of the seven Agencies would be the appropriate regulating agency. This could lead to confusion in the future as each agency is permitted by the regulations to establish additional guidance. It is common for financial institutions to have two or more divisions that fall under a single corporate entity; therefore, it is possible that separate divisions could fall under the purview of different regulating Agencies with potentially inconsistent or contradictory requirements. The Center seeks clarification regarding the appropriate regulating agency rules.

Conclusion

The Center appreciates the opportunity to provide its views on this extremely important policy matter. We look forward to working with you and members of your staff to ensure that the Dodd-Frank Act will lead to the positive reform that was intended when it was enacted.