



Consumer Federation of America

**Testimony of Barbara Roper
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Consumer Federation of America**

Before The

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

Regarding

Enhanced Investor Protection after the Financial Crisis

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 policy-making 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 policy-making 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 U.S. 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 U.S., 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 wrongdoing. 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

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.

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 policy-making 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);
- 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 make-up 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

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.

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.

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 two 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

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.

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 six 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

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](#).

- 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 rule-making 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 rule-making 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 investment 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,

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](#).

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](#).

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

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](#).

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

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.

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

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*.

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

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*]

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 decisions, 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:

¹³ Collateralized Explosive Devices. [footnotes omitted]

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, or 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 nine 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 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.