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On Enhancing Investor Protection After The Financial Crisis

Statement of Paul S. Atkins

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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 unemployment 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 six 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 comment 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 eight 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 U.S. While this seemed like an attractive idea to officials who wish never

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[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.*

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 two of the Act's sixteen 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

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[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.

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

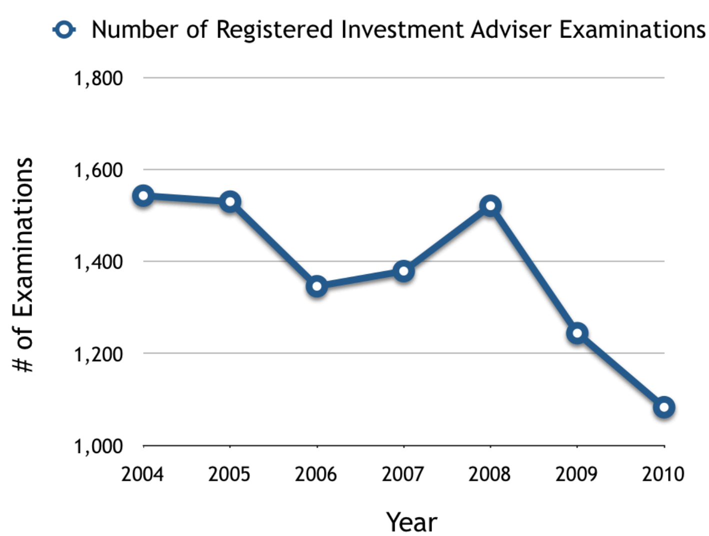
In the recently adopted rules, advisers exempted from registration requirements would still be required under Sections 407 and 408 to comply with some of the same reporting requirements as registered advisers. For example, venture capital advisers would be subject to examination and recordkeeping requirements. 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.



[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

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.

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 thirty 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% to 30% 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 <u>must</u> hire an attorney if they wish to remain anonymous. One can imagine what percentage of the 10%-30% 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

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

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 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 law suit 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 long-standing 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 two years alone. I have never witnessed such division - this record is in marked contrast to my experience of ten 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.

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[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.