Written Testimony of Harvey L. Pitt[1]
Before the United States Senate Banking Committee on
"Enhanced Investor Protection After the Financial Crisis"

(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.

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[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 ten years as a member of the Staff of the SEC (1968-1978), the last three years of which he served as the Agency's General Counsel.

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 forty-three 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 eight 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 one 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**

[2] As a matter of policy, the Kalorama firms do not engage in adversarial efforts vis-à-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.

- **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 independence 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:

[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.

- **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 authority 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

[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 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.

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 two 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]

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[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.

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. <u>Impact on Corporate Governance and Internal Compliance Programs</u>

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 that the potentially huge amounts at stake — a bounty ranging from between ten and thirty 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—thirty 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 thirty 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. <u>Transforming Every "Tip" into a Federal Case</u>

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 three percent of the voting equity for at least three 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 fifty-one proxy contests a year as a result of the new rule, that would mean a *drop* from the fifty-seven 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 pre-empting 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 three 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% — of these votes were positive, with more than 80% of these resolutions garnering at least 80% positive votes.

However, shareholders in at least thirty-nine 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 three 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.