Dodd-Frank's Title IX, Investor Protection, Professionalism and Reform

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Title IX of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") is now the primary and most critical legislation designed to protect investors, address systemic risk, prevent securities fraud and establish and enhance professional standards in our capital markets. The central themes of the specific statutory provisions of Title IX overlap in order to serve certain fundamental objectives, chief among which is enhancement of investor protection. Congress has stated its intent that Title IX of Dodd-Frank achieve substantial and significant regulatory reform to avoid a repeat of Enron, Madoff and other notorious Ponzi schemes, financial failures, and the accompanying catastrophic investor losses. Most especially, the Statute was intended to correct the organizational inefficiencies that have and will frustrate effective regulation, self-regulation, supervision within financial service firms, and overall compliance. Further if significant losses do occur, Title IX creates a remedial process to financially compensate the victims.

Title IX— "Investor Protections and Improvements to the Regulation of Securities" addresses the regulatory authority accorded to the financial regulators to protect investors from fraud and systemic risk. It provides for enhanced regulatory authority and more in depth regulation in a number of areas, including standards of competency and ethics for professionals; more effective disclosure, especially when the investor is receiving “personalized investment advice;” additional disclosure regarding executive compensation; fair risk retention and allocation of risk with respect to synthetic investment products; product suitability; heightened responsibility for gate keepers such as auditors and credit rating agencies; risk management; independent and objective review and testing; and above all greater overall transparency with respect to the capital markets. The statute also mandated various studies, further legislation, and rule-making that included the elimination of compulsory arbitration in a securities industry arbitration forum arising from the pre-dispute arbitration clause public customers have to agree to when opening a brokerage account.

Title IX of the statute is only the blueprint and not the building. This is why the statute must be analyzed and its purposes clearly understood.

I. Financial Regulatory Authority and Structure

Dodd-Frank changes the financial regulatory structure by enhancing and expanding regulatory authority, but the ultimate issue is whether Dodd-Frank facilitates investor protection. Let us look at the areas that Dodd-Frank focuses upon in order to make the financial regulatory scheme more effective and know what more needs to be done to achieve its laudable and primary objective of enhancing investor protection.

Section 911 establishes an Investment Advisory Committee (the "Committee") to assist the SEC by advising it on regulatory priorities and issues relating to securities, fee structures, effectiveness of disclosures, investor protection and initiatives to promote investor confidence. The Committee, which meets semi-annually, consists of between twelve (12) and twenty-two (22) members, each appointed for a three year term. The members are to represent the interests of individual investors, institutional investors, and pension fund investors. While the committee is independent of the SEC, the Commission is mandated to provide use of its staff to the Committee. One of the Committee members is the SEC's new Investor Advocate whose role and responsibilities are set forth in Section 915 and will be described in more detail in this article.

Section 912 amends Section 19 of the Securities Act of 1933 (the "33 Act") to authorize the SEC to gather information and engage in such temporary programs as the SEC determines are in the public interest for the purposes of evaluating any rule or program of the SEC. Previously there was a question of whether the SEC had authority to engage in consumer testing. Section 912 now "gives clear authority to the SEC for these activities." The statute recognizes "the very real potential to improve the clarity and usefulness of the disclosures… by meaningfully… [engaging in] consumer testing."[1] Just as suitability for individual investors is a function of the registered representative knowing his or her customer, collective suitability will be better achieved by the regulator having knowledge of the level of financial literacy and enhancing disclosure and other investor protections as a result.

Section 919 of Dodd-Frank amends Section 15 of the Exchange Act to grant the Commission authority to require investor disclosures of "any compensation or other financial incentive received by a broker, dealer, or other intermediary in connection with the purchase of a retail investment product" before the purchase of such investment product or service.

It is now hard to imagine that this requirement will have much of an impact on investor behavior given the findings of the SEC's study on the current level of financial literacy among "retail investors."[*]Section 917 of Dodd-Frank required the SEC to conduct a study to identify the

[*]To the authors one of the flaws of the existing system and culture is a sales mentality rather than a professional mind set, This is evident in how we and the regulators describe investors i.e. "retail investors; instead of "clients of the investment professional"

existing level of financial literacy among retail investors. To no one's surprise, that August 2012 study revealed that "U.S. retail investors lack basic financial literacy." Id. In light of this lack of financial literacy, will investors even read the disclosure put in front of them? Moreover will they understand it? An unsophisticated investor by way of example will not have any idea if the commissions they are being charged are high or low without meaningful disclosure of and an informed understanding of comparable industry numbers. Imposing a fiduciary duty or even a duty of good faith addresses this issue in a broad brush fashion. However, the rules must specifically require the investment professional to explain the disclosures to the client, especially where the investor is not sophisticated. This will result from textually clear professional standards set by the professional group whose practices are implicated and is a necessary means to facilitate informative disclosure.

There is enhanced authority with respect to investment companies including requiring broker-dealers to make disclosures regarding compensation with respect to transactions in open end and closed end mutual funds. Disclosures must now be pre-sale. The statute requires investors ". . . [to] be provided with relevant, meaningful, and timely disclosures about financial products and services from which . . . [investors] can make better informed decisions."[2] Further "[w]ithout slowing the pace of transactions in the modern capital markets, the SEC should require that adequate information is given to investors. . . ."

There is no longer any technological justification for not providing investors with adequate disclosure. If a fiduciary duty and/or higher standard of professional conduct is imposed on broker-dealers it will require that brokers also explain the implications of the disclosure to investors before they invest so there is genuine comprehension. If the broker does do this, this should be expressly acknowledged by the investor in a timely and regular manner. In the context where the investment professional is servicing the client, the "Be Speaks Caution Doctrine" should not be deemed an absolute defense and the registered representative should also provide the necessary explanations when the context requires it so there is reasonable assurance that the investor can make an informed investment decision.

Key to the Title IX intent is Section 915 which establishes within the SEC the Office of Investor Advocate [codified in Section 4(g) of the Exchange Act] to "strengthen the institution and insure that interests of retail investors are better represented." (Emphasis added) . Recognizing the real world difficulties presented by bureaucracy, the office is required to "assist retail investors to resolve significant problems with the SEC or . . . [SROs]."[3] A question arises as to whether investors should be perceived as "retail consumers" or as "clients of investment professionals " (i.e, their registered representatives) who are expected to give the investor professional and personalized advice. Given the current low level of financial literacy among public investors the latter is preferable.

The Office is mandated to analyze the potential impact on investors of proposed rules and regulations; identify problems that investors have with financial service providers and investment products; appoint an ombudsman to act as a liaison in resolving problems that retail investors may have with the Commission or an SRO; propose changes to

Congress and the Commission to mitigate these problems and to "promote the interests of investors." [www.sec.gov/investor ,SEC website]

Although the Office of Investor Advocate is modeled on the IRS Taxpayer Advocate, the Office of Investor Advocate is expected to help to "insure that the interests of retail investors are built into rule making proposals from the outset and that the agency's priorities reflect the issues that confront average investors."[4] Pragmatism and more effective representation and advocacy for groups traditionally without a voice (i.e. the "main street investor") are thus now emphasized as a key component to rule making implementing Dodd Frank reform.

Additionally, the Office of Investor Advocate is to increase transparency and accountability at the SEC and be more effectively equipped to act in response to feedback from investors so as to avoid mishandling of tips and other red flags (such as those presented in the Madoff case) that if identified early on could avoid or minimize the fraud. While some may view this as locking the barn door after the horse has been stolen, it should more favorably be viewed as learning from past mistakes. This will only be accomplished by heightened regulatory consciousness as to what is going on the industry and its impact on the main street investor. One of the best means of receiving this information and processing it , will come from a reformed arbitration and claim processes.

Congress also made specific reforms to the regulatory framework to address shortcomings in regulation that contributed to the financial meltdown in 2008. For starters, Section 931 recognizes that credit rating agencies perform the role of a "gatekeeper" in the debt markets and concludes that because they "perform evaluative and analytical services" which are "functionally similar" to those performed by securities analysts and auditors. They should be subject to the same coverage of oversight and liability. [Id.]Inaccurate ratings of structured financial products (notably pools of sub-prime mortgages) were a contributing factor in the financial market meltdown of 2008-2009. A clear conflict of interest arose when rating agencies were advising clients, for an additional fee, how pools of sub-prime mortgages could be structured to earn an investment grade rating. Accordingly, Dodd-Frank seeks to impose enhanced regulation, accountability, and transparency on rating agencies, to avoid such destructive conflicts but leaves the specifics to the regulators.

Sections 931 and 932 make Credit Rating Agencies serve in the same gatekeeper role in the financial markets as other SROs and subjects them to the level of oversight and accountability that applies to security analysts, auditors, and investment banks. Further Section 932 also gives the SEC authority to fine an NRSRO for violations of law or regulation. Under previous law, the SEC could <u>not</u> fine NRSROs, but could <u>only</u> "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve (12) months, or revoke the registration of any NRSRO. . . . <u>Under this provision the SEC retains these abilities . . . [however now] '. . . the SEC . . . [is] given the authority to fine the agencies or their employees who fail to adequately protect investors</u>."[5] (Emphasis added). Supervision and accountability of the SROs is as important in maintaining viable and sound financial markets as is supervision and accountability of broker –dealers, investment advisors, and public and private issuers.

Section 932 also attempts to eliminate the inherent conflict arising from an issuer pay model of the credit rating industry. The SEC was directed to write rules “preventing sales and marketing considerations from influencing the production of ratings” and “[v]iolation of these rules will lead to suspension or revocation of NRSRO status if the violation affects a rating.”

Section 932 directs the SEC to prescribe rules to require each NRSRO to consistently use procedures and methodologies approved by the NRSRO's Board of Directors or senior credit officer. NRSROs must also provide accurate and material disclosures regarding “qualitative and quantitative information that is intended to enable investors and users of credit ratings to better understanding of the main principles and assumptions that underlie the rating.” The intended greater transparency includes the NRSRO’s due diligence services. The findings and conclusions of any third party due diligence report obtained by issuers and underwriters of asset backed securities will be made public in a format approved by the SEC.

Section 932 seeks to enhance regulation and accountability of credit rating agencies. Section 932(a)(2)(B) requires Nationally Recognized Statistical Rating Organizations ("NRSROs") to have an effective internal control structure governing the way in which the NRSRO determines credit ratings. Dodd-Frank requires each NRSRO to submit an annual report to the SEC describing management's responsibility in establishing such internal controls and management's assessment of the effectiveness of such internal controls. This is similar to the requirement of Section 404 of Sarbanes-Oxley (“SOX”) that requires issuers to publish information in their annual reports concerning the scope and adequacy of a company’s internal control structure and procedures for financial reporting.

Section 932(a)(4) seeks to eliminate the conflict of interest discussed above by prohibiting a NRSRO from considering "sales and marketing" factors when assigning credit ratings. The SEC has adopted Rule 17g-5 which enumerates and prohibits certain conflicts of interest (Rule 17g-5(c)(1)-(7). Whether this will be sufficient given that the rating agencies are paid by the issuers remains to be seen.

The new regulatory framework gives the SEC authority to impose sanctions on NRSROs which have violated the conflict of interest rules including suspending or revoking their registration. Whether these sanctions will ever be invoked against major NRSROs remains an open question, but the clear intention of the statute and the Commission is to enhance regulatory and self-regulatory efficacy by establishing and maintaining more viable interconnections and accountability of the regulatory and self-regulatory organizations.

Section 932(a)(4) contains a look-back provision requiring each NRSRO to conduct a "look-back" review in cases where an employee of the NRSRO participated in assigning a rating to a product and went to work, within a year, for the issuer, underwriter or sponsor of the product that was rated.

Section 932 also requires each NRSRO's Compliance Officer to submit to the NRSRO an annual report on the NRSRO's compliance with securities laws and its own policies and procedures. Compensation of such officers may not be linked to the financial performance of the NRSRO and must be structured so as to insure that compliance officers are free to exercise independent judgment.

Further, compliance officers are prohibited from participating in the development of rating methodologies, the rating process, and setting of fees for the NRSRO’s. The statute establishes an Office of Credit Rating within the SEC in order to (i) protect "users of credit ratings and the public interest;" (ii) promote accuracy of credit ratings issued by NRSROs; and (iii) "ensure that such ratings are not unduly influenced by conflicts of interest."

Section 933 imposes professional liability standards (similar to those imposed on auditors) on the credit rating agencies. Building upon the principles of the Credit Rating Agency Reform Act of 2006, the SEC adopted rules removing references to credit ratings in order to "avoid using credit ratings in a manner that suggests in any way a 'seal of approval' on the quality of any particular credit rating or rating agency" and reduces reliance on credit ratings for regulatory purposes.[6]

The SEC has to inspect the NRSROs "at least annually" and make the reports of these inspections publicly available.

Other enhancements of the regulatory structure are found in Section 979 which creates an office of Municipal Securities within the Commission to administer the Commission's rules with respect to practices of municipal securities brokers and dealers, municipal securities advisors, municipal securities investors and municipal securities issuers; and work with and oversee the Municipal Securities Rule Making Board (“MSRB”) in the latter’s rulemaking and enforcement actions.

Finally, Section 981 authorizes the SEC to share information with foreign authorities and Section 982 amends Section 102 of Sarbanes-Oxley by giving the Public Accounting Oversight Board (“PCAOB”) oversight of broker-dealer audits and auditors in addition to authority over audits of public issuers.

II. Pragmatic Studies and Work-in-Progress

Key to Dodd-Frank’s goals and especially Title IX’s principal objective of protection for the “Main Street” Investor is the authorization and direction to perform pragmatic studies to facilitate more enlightened rule making.

Section 913 directs the SEC to conduct a study to evaluate the effectiveness of standards of care for broker-dealers and investment advisors and their associated persons in rendering personalized investment advice to the individual investor ; better described as the “main street investor”. In January 2011 the SEC's staff issued the report , “Study on Investment Advisers and Broker-Dealers”, (the "Report") which discussed the different standards of care required of investment advisors and broker-dealers. The Report cited several studies that found that retail investors do not understand the differences between investment advisers, broker-dealers and financial planners and are not knowledgeable about the different standards of conduct that apply to the roles they serve in and their advice and recommendations to their investor-clients. Since retail customers are relying on financial professionals "to assist them with some of the most important decisions of their lives" the Report concludes that "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations." (Emphasis added).[7] This is the case regardless of whether they are working with an investment advisor or a broker-dealer. Accordingly, the Report concludes by recommending that the Commission adopt in its rules a uniform fiduciary standard of conduct for broker-dealers and investment advisors. However there is a serious issue whether a uniform standard can apply in view of the fundamental nature and differences of their respective roles. This is not to say that higher standards of professionalism should not be imposed upon both broker-dealers and investment advisors.

Recently Chair Mary Jo White said that she is pushing the Commission to make a decision on whether to propose a regulation that would raise the professional standards of brokers who are providing investment advice. At the 2014 SEC Speaks conference in Washington sponsored by the Practicing Law Institute, Chair White stated the following: "We will intensify our consideration of the question of the role and duties of investment advisers and broker-dealers, with the goal of enhancing investor protection."[8]

Improvement of the respective professional standards of the different professional groups, whether uniform or not, is critical for protection of the individual and non-institutional investor . The lynchpin for the integrity and soundness of the capital market is professionalism at all levels and sectors .It will only come about by setting and implementing professional standards that come out of individual and collective experience.

Section 918 directed the Comptroller General of the United States to undertake a study (the “Study”) regarding mutual fund advertising in regard to open-end investment companies. The Study was delivered by the Government Accountability Office ("GAO") in July 2011. It addressed: (a) what is known about the impact of mutual fund advertisement on investors, (b) the regulatory requirements that exist for mutual fund advertisements, (c) the impact of advertising on consumers, and (d) in accordance with Dodd-Frank and 918(a)(4) it also discussed the extent to which performance information is included in mutual fund advertisements and/or administered and enforced "recommendations to improve investor protections in mutual fund advertising." The study concluded that "the evidence from existing academic research was mixed regarding the extent to which investors relied on performance information."[9]

It found that "[a]lthough the regulatory review process limits [the] potential for misleading advertisements, communication of role interpretation changes has been uneven." [Id. at p. 27] and recommended that the ". . . SEC , should take steps to ensure FINRA develops sufficient mechanisms to notify all fund companies of new interpretations of existing rules that arise during the course of FINRA’s regulatory reviews of advertisements.”

Section 919B requires the SEC to complete a study and make recommendations of ways to improve access by investors to registration information (including disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information) about registered and previously registered investment advisers, brokers and dealers and their respective associated persons. The study was released January 27, 2011 and recommended expanding the search functions of brokers check and IAPD.

Section 939 authorized a study by the GAO on the scope of federal and state securities laws and regulations with respect to the capital markets, banking, insurance and other areas impacted by credit ratings. Section 939A requires the SEC to study strengthening credit rating agency independence; evaluating management conflict of interests by the NRSROs including whether conflicts exist in providing other services. Section 939B requires a GAO study on alternative means of compensation for NRSROs to create incentives to provide more accurate ratings and to facilitate statutory change. Section 939C provides for a GAO study on the creation of an independent analyst organization *i.e.*, an NRSRO for credit rating analysts.

The Study which was released on January 18, 2012 examined alternative compensation models for NRSROs. As a result, the SEC has adopted rules which lay the development of a code of ethical conduct and means of oversight of the rating analysts. Until the enactment of Dodd-Frank there were no professional and independently set standards for rating analysts. The legislative history notes, "[c]reating one independent professional organization to which rating analysts from all rating agencies must belong that will ensure uniform standards especially ethical standards across all the rating agencies would also provide a forum external to the agencies where rating analysts might bring confidential complaints and ethical concerns." (Emphasis added.).[10]

Section 964 requires a report on oversight of national securities associations, especially with respect to their expertise in the area of regulation and the examination process, and consideration of conflicts which may arise when the Board of a National Securities Exchange consists of those subject to its regulation. This also raises the issue of whether the arbitration forum favors the industry in SRO arbitrations. So far, no measures to correct the deficiencies in the SRO dispute resolution processes have been adopted; let alone meaningfully and fully addressed.

Other aspects of the National Securities Association study is whether a separate SRO should be set up independent of FINRA comparable to the PCAOB for public company and broker-dealer auditors for '40 Act Investment Advisors.

Section 989 authorizes and directs a GAO study on proprietary trading and section 989A directs a study on investor protection for seniors.

The multiple studies mandated by the Statute show that regulatory reform is a work in progress and not a set of fixed rules at a given point in time. In respect to the above studies some of those that have been completed and are key are as follows:

I. Study As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumers Protection Act – January 2011.

II. Study Regarding Financial Literacy Among Investors As Required by Section 917 of Dodd-Frank, August 2012

III. Study on Enhancing Investment Advisers Examinations - January 2011.

IV. Report to Congress, Credit Rating Standardization Study As Required by Section 939(h) of Dodd-Frank, September 2012.

Proposed and Final Rules to consider are as follows:

1. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 1441 Offerings, 17 CFR Parts 230, 239,

and 242, Release No. 33-9415; No. 34-69959, No. IA-3624, File No. S7-07-12.

2. Investment Adviser Performance Compensation, 17 CFR Part 275, Release No. 1A-3372, File No. S7-17-11.

3. Disclosure for Asset-Backed Securities Required by Section 943 of Dodd-Frank, 17 CFR Part 240, Release Nos. 33-9175A, 34-63741A, File No. S7-24-10.

4. Security Ratings, 17 CFR Parts 200, 229, 230, 232, 239, 240 and 249, Release No. 33-9245, 34-64975, File No. S7-18-08.

5. Disclosure for Asset Backed Securities Required by Section 943 of Dodd-Frank, 17 CFR Parts 229, 232, 240 and 249, Release Nos. 33-9175, 34-63741, File No. S7-2410.

6. Net Worth Standard for Accredited Investors, 17 CFR Parts 230, 239, 270 and 275 Release Nos. 33-9287, 1A-3341, IC-29891, File No. S7-04-11.

7. Capital, Margin and Segregation Requirements For Security – Based Swap Dealers and Major Security – Based Swap Participants and Capital Requirements for Broker-Dealers. 17 CFR Part 240 Release No. 34-68660, File No. s7-08-12 [Proposed Rule].

8. Financial Responsibility Rules for Broker-Dealers; 17 CFR Part 240, Release No. 34-70012; File No. S7-08-07.

III. <u>Oversight, Rule Making, Application, And Coordination of Regulatory Regimes</u>

Regulatory gaps and previous lack of coordination of regulatory regimes have presented repeated systemic problems that Title IX seeks to address. Section 927 provides for equal treatment of SRO rules. Section 29(a) of the '34 Act, the non-waiver provision, does <u>not</u> allow for any private contract or transaction with an investor to effect an advance waiver of applicable rules and regulations, and that principle <u>now</u> applies <u>across the board</u> to all SRO rules.

In respect to Section 928, Section 205 of the Investment Advisors Act of 1940 that addresses performance fees and advisory contracts does <u>not</u> apply if the investment advisor is a state registered investment advisor, because it presumes state regulatory coverage. Section 929 that addresses unlawful margin trading is broadened. SOX Section 806, the anti-retaliation provision, applies not merely to issuers but subsidiaries and affiliate entities.

Section 922, the Whistleblower protection provision; provides a right to appeal an adverse decision of the SEC within thirty (30) days to the Court of Appeals. Section 925, Collateral Bars, provides for multiple bars for violations in <u>one</u> area. A securities broker barred from the securities industry should also be barred from becoming or continuing as a registered insurance agent. Section 926 authorizes state securities regulators to have regulatory jurisdiction over Regulation D offerings. The foregoing provisions make violations in one regulatory context have consequences in other regulatory contexts and shift regulatory responsibility to where it is more appropriate. Broader regulatory coverage is assured by jurisdictional assignments to the most appropriate regulator or self-regulator.

Section 929 (B), the Fair Fund Amendment provides that penalties imposed will be a source of financial recovery for victims, even if the disgorgement remedy is <u>not</u> obtained. Section 929c increases the limit on treasury loans to SIPIC to sustain its ability to provide recoveries for investors. The foregoing recognizes the limitations on the sources of investor compensation for losses and for this reason the arbitration process has to be reformed; mandatory professional liability insurance considered; and collective remediation more effectively put in place in cases of pervasive fraud and systemic failures.

Pursuant to Section 935 NRSROs have to consider information provided about issuers even from sources other than the issuer if the NRSRO finds the information credible. However, the NRSRO is <u>not</u> required to perform an audit function or act pursuant to a duty of due diligence or independent verification. The SEC was to issue, in accordance with Section 937, final regulations regarding rating agencies "within one (1) year of the date of other enactment of . . . [Dodd-Frank]." The absence of a role for an independent-compliance auditor with responsibility to undertake objective testing in this context needs to be addressed as it is a serious shortcoming.

Section 939C contemplates the establishment of "independent standards for governing the rating analyst profession establishing a code of ethical conduct, and overseeing the rating analyst profession." Section 941 directs the federal banking agencies and the SEC jointly to prescribe regulations to require any securities issuer to retain a material portion of the credit risk. Sections 942 and 943 require heightened disclosure and regulation of asset backed securities including prospectus disclosure <u>prior to</u> the investment being made. Material disclosure that affects the investor's decision to invest must always be made timely and prior to the investors decision to buy or sell .Section 944 rescinds the Securities Act of 1933 ('33 Act) exemption in respect to promissory notes secured by a first lien of a single parcel of real estate which is deemed "a dwelling or other residential or commercial structure."

Section 945 requires due diligence analysis to support disclosures in respect to asset backed securities.

Section 961 requires reporting to the House Financial Services and Senate Banking Committees regarding OCFI's inspections in material part motivated by "[t]he massive fraud perpetuated by Bernard L. Madoff through a Ponzi scheme . . . [that] cost investors a tremendous amount of money and went undetected through failures in SEC exams and investigations."[11] Pursuant to Section 962 the GAO is to submit an annual report on SEC personnel management. Section 963 requires the SEC to submit an annual report describing SEC personnel management and internal controls within the agency. Section 964 requires the GAO to report the SEC's oversight of national securities associations ("NSAs"). Section 965 requires the Division of Trading and Markets and Investment Management to conduct compliance inspections of entities under their jurisdiction and report to their respective Directors. Section 966 directs the SEC Inspector General to establish a <u>hotline</u> for SEC employees. All of the foregoing, while not directly impacting investors, gives greater depth to the regulatory structure. More responsibility and accountability at the different levels of supervisory responsibility within the SEC will allow the SEC to be more sensitive to its own processes as well as to the individual and small investors and the capital markets.

IV. Regulatory Enhancements for Investor Protection

As described above, Section 932 enhances regulation and accountability with regard to credit ratings in the capital market context. Section 938 prescribes uniform rating symbols precluding distinct symbols for different securities. It requires greater consistency and more meaningful disclosure in order to put investors in a better position to measure the ability of municipal and corporate obligors to meet the obligations represented by their bonds.

Section 945 mandates new SEC rules which will require more effective due diligence and meaningful disclosure in respect to asset backed securities. Section 951 requires shareholders to approve compensation of executives, including "golden parachute" arrangements, although the shareholder vote is a non-binding voting process. Section 952 requires in corporate contexts an independent compensation committee. Securities will not be listed that do not comply with the standards of the independent compensation committee.

Section 953 requires disclosure regarding executive compensation in annual proxy statements to show the relationship between compensation and performance. Section 954 provides for recovery of compensation paid or resulting from material non-compliance with accounting rules. Section 955 requires disclosure regarding employee and director hedging of the issuer's securities. Section 956 precludes as an unsafe and unsound practice, payment of excessive compensation by a bank holding company to executives, directors, and principal shareholders, or compensation, fees and benefits which could lead to material financial loss to the bank holding company.

Section 957 does not allow voting by brokers who have not been given instructions or who do not have a beneficial interest to vote in director elections or on matters of compensation. Also in furtherance of corporate democracy, Section 971 provides if a majority of a public company's shares are voted against or withheld from a nominee for a directorship who runs uncontested or without an opponent, he or she must resign unless the Board votes unanimously in favour of the nominee and it is in the best interest of the corporation for the nominee to serve. Section 972 allows shareholders to nominate Board members and put them on the company proxy. Section 973 authorizes the SEC to issue rules regarding issuer disclosure explaining why the same or different persons are chosen as CEO and Chairman of the Board.

V. Investor Loss and the Remedial Purposes of the Securities Laws

Loss prevention by rulemaking after pragmatic study, as well as the imposition of rational and not unduly harsh sanctions provided there is not actual fraud and genuine corrective measures are undertaken is consistent with the remedial purposes of the federal securities laws. However, it is not merely prevention of losses that serve the remedial purpose of the securities laws but compensating efficiently and fairly victims for their losses when those losses result from unlawful conduct. Accepting risk is a legitimate part of investment and trading activity but when the risk is created by fraud or systemic problems those responsible must indemnify the victims.

Since 1987 pre-dispute arbitration clauses, consistent with the Federal Arbitration Act's policy favouring arbitration, have been enforceable. However, Dodd-Frank has taken a different tack. Section 921 authorizes the SEC by rulemaking "to prohibit or impose constraints or limitations on the use of, agreements that require customers or clients of any broker to arbitrate any dispute between them." This statutory section recognizes that "[t]here have been concerns over the past several years that [the] mandatory pre-dispute arbitration" [clause] is unfair to the investors" and according to the North American Securities Administrators Association "a…major step toward improving the integrity of the arbitration systems is the removal of the mandatory industry arbitration."[12]. The perception of the statute is "`[the] mandatory industry arbitrator, with . . . ... industry ties, automatically puts the investor at unfair disadvantage." Investors should be able to make an informed and unbundled choice as to whether to go to court or arbitration. If the mediation-arbitration process were reformed and high standards of a fair and efficient process maintained, investors likely in the normal course opt for mediation-arbitration. Further, if the securities industry wants to have enforceable pre-dispute clauses in the operative contracts, at a minimum separate informed consent as well as express conditions of fairness for the investor, both in the choice for and in the arbitration process itself; are essential and should now be subject to and implemented by the rule making process..

The proposal to allow investors to choose arbitration or litigation is fraught with practical problems which may increase the burden on retail investors unless meaningful reforms to the mediation and arbitration process are put in place. There are calls for reform because the current system is seen as one sided and favoring the industry. Currently, arbitrators do not have to provide any rationale for or reasoning underlying their awards. Further there is no appeals process except limited challenges to the award through the courts if there is fraud, corruption, bias and/or manifest disregard of law by the arbitrators.

Evidentiary thresholds and principled application of the law do not have to take place for the award to be converted into a judgment.

In the authors' view, one possible approach to these concerns would be to require, if either of the parties elect; to have the arbitrators provide a reasoned award as to the underlying rationale for their decision and allow an appeal procedure to a disinterested tribunal within the SRO. This would be an appropriate resolution, especially to sustain the principled application of the law and regulations. Another would be to allow claimants to elect litigation or arbitration at the time a dispute arises so that smaller claims could be quickly resolved in mediation - arbitration, while large complex claims could be exposed to the light of the judicial process. This alternative would also allow the investor to make the more informed decision based on the specific facts in controversy. Moreover, the investor should have the option and <u>not</u> the industry.

In keeping with the legislative effort to not constrain investors to seeking redress in forums perceived to be dominated and disposed to the industry as well as to provide investor recovery for wrongful conduct that is not strictly fraud, actionable wrongs should exist where the actor "*knowingly or recklessly failed*" to comply with applicable laws, rules and regulations instead of merely "*knowingly or recklessly*" engaging in wrongful conduct.[13](Emphasis added). This subtle but very meaningful distinction is found in Section 933 of Title IX. This would signify a shift to hold the industry <u>not</u> just to an anti-fraud standard but to professional malpractice standards. If a breach of such standards results in a loss, investors should be entitled to compensation.

In order to enlarge recoveries for legitimate investor losses, Section 929c "updates the Securities Investor Protection Act by authorizing borrowing of funds from the Treasury, and reforms the treatment of securities, cash, portfolio margin and liquidation." The staff expressed the view that an increase in funding for SIPIC's insurance fund was warranted, along with an increase in coverage from $25,000,000 to $100,000,000. Section 988 in respect to the National Credit Share Insurance now deems a material loss to be in excess of $25,000,000.

VI. Questionable Reform and General Solicitation

Prior to the enactment of the Jumpstart Our Business Startups Act ("JOBS Act") private offerings of securities could be made to" retail investors" only if they were accredited investors and/or other specified conditions under Regulation D were met. Section 201(a)(1) of the JOBS Act directed the SEC to "remove the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506 provided that sales are limited to accredited investors and an issuer takes reasonable steps to verify that all purchasers of the securities are accredited investors."[14].

Currently Rule 506(b) allows for an unlimited number of accredited investors and no more than thirty-five (35) non-accredited investors; whereas now Rule 506(c) allows for general solicitation and advertising and notwithstanding the exemption from registration is still in place provided the only ones to purchase the investment are accredited investors

By providing for crowd funding and general solicitation and advertising, Congress sought to make it easier for a company to find investors and thereby raise capital. The fundamental issue, however; is whether this new ostensibly easier means of capital fund raising is properly balanced with investor protection or does it open the door to fraud? At a minimum there should be <u>independent</u> verification through an audit process.

Further, the fact someone is an accredited investor because he has a high income or substantial assets, does not mean they are qualified to evaluate investments. Being an accredited investor is not automatically equivalent to a sophisticated investor able to fend for oneself on a parity basis with insider or professional venture capitalists. Although the final Crowd Funding rules have not yet been adopted by the SEC, Crowd Funding is intended to go a step further by not even requiring investors to be accredited and allowing general solicitation absent required extensive disclosure.

Unlike a traditional private offering where the potential investor has an opportunity to meet the principals, ask questions, and examine the financial statements and business operations or proposed business operations <u>before</u> investing, a Crowd Funding offering does <u>not</u> afford these opportunities to the potential investor. This puts the investor at a serious disadvantage while opening the door to fraud, exactly the opposite of one of the most fundamental purposes of the Federal Securities Laws. Further an offering made by an entity which is not a broker dealer is not subject to the FINRA rules governing private offerings.

By way of example intermediaries that operate the portals of investment will not have to be registered broker-dealers or investment advisors and are prohibited from serving in that role so that the investors in this medium will not have access to personalized investment advice. Without personalized investment advice, does the average investor have the capacity to take financial risk or make an informed judgment as to the security and the transaction ? This is an issue that needs to be addressed.

The SEC's proposal to limit the amount that can be invested seems to send the message that a small investment only merits a small amount of investor protection and does a disservice to traditional and core securities law concepts.

The distinction between public and private offerings is solidly rooted in the Securities Act of 1933. The SEC Rules and Regulations only provide safe harbors by providing textual guidance and afford a comfort level if the rule or regulation is followed.. The safe harbor should not dislodge the distinction that can and should be maintained and the traditional statutory exemptions preserved, even without strict adherence to the safe harbor rule’s requirements. The statutory exemption should also be viewed as a safe harbor to the safe harbor.

The legislative rationale general solicitation and crowd funding is that individual investors should be afforded the same opportunity to get in on the ground floor as venture capital investors, in the next Google or Facebook. This, of course overlooks the reality that few new ventures succeed on that level. In fact many startups fail. It is one thing for a well-funded venture capitalist to lose money after thoroughly investigating a startup; it is another for an individual and/or small investor, who lacks the investigative ability of a professional venture capital firm, to lose money after investing in a Crowd Funded venture. While the sums involved may be small ,there is not an excuse for allowing publicly offered securities products to be sold without the necessary disclosures and other protections afforded by the Federal and State Securities Laws. Smaller dollar amount transactions are still subject to the same or greater fraud risk, whether it involves false financial statements, nominee accounts for insiders, and market manipulation.

VII. Investor Advocate's Agenda Report for Fiscal 2015

The Agenda report on Objectives ("the Agenda Report") for the fiscal year 2015 of the Office of Investor Advocate dated June 24, 2014 is topically focused upon (1) equity market structure; (2) investor flight; (3) municipal market reform; (4) cyber security; (5) effective disclosure; and (6) elder abuse. The first report on activities will be filed by the Office on December 31, 2014 identifying investor concerns and the problems investors have encountered during the period and the action taken by the SEC and SROs to address those problems.

In reference to equity market structure the June 2014 Report on objectives noted "market structure issues are complex" and there is "one overriding concern, is the equity market today fair for the investor?" The Investor Advocate's first recommendation is that Congress provides "sufficient resources to the SEC to conduct an adequate number of investment adviser examinations" as the "Commission examines only… ([nine percent] (9%) of its registrants each year."[15] It is the expressed belief of the Investor Advocate that investment adviser fraud, excessive fees, excessive trading and undisclosed conflicts of interest are problems that "more frequent compliance examinations will allow the SEC to halt and will provide a stronger deterrent to advisers who might otherwise succumb to the temptation to steal or engage in unethical practice." The SEC Chair on July 10, 2014 also declared the need for additional funds to increase the frequency and extent of investment advisor examinations and reiterated that this was an important priority for the SEC.

The Agenda Report goes on to identify the statutory objectives of the Office (a) assisting retail investors in reference to significant problems with the SEC and SROs; (b) identify areas in which investors would benefit from changes in SEC regulations or SRO rules; (c) identify problems investors have with financial services providers and investment products; (d) assess the impact on investors of Commission regulations and SRO rules; and (e) “to the greatest extent practicable” propose to the Commission and Congress securities law amendments, and SEC regulation and rule changes to mitigate problems identified, and to promote the interest of investors.

Essentially, the Investor Advocate’s Agenda Report states important objectives and outlines a pragmatic approach to the improvement of securities legislation and SEC regulations and rules placing special emphasis on investor interests and problems both with their interfacing with the SEC and SROs as well as in specific contexts such as municipal bonds, cyber security and recurring abuse of vulnerable investors such as those investors that fit within the senior category. As securities law practitioners, who have represented both the public customer and the industry in a number of different contexts, we are in full accord.

While we agree with the goals of the Investor Advocate, however, we think the process outlined can be made more informative and effective by some additional and different approaches. The Agenda

Report does not discuss the mediation, arbitration and claims processes. Securities arbitration needs to be reformed, not merely to give public customers the option to override the typical pre-dispute clause in the broker-customer agreement. Securities arbitration needs to be reformed to make it more time effective and cost efficient than litigation and above all be fair to public customers both in perception and in reality.

One Commissioner at SEC Speaks this year told one of the authors that he was in favor of allowing public customers as well as broker-dealers and securities industry personnel to opt out of arbitration. This would put public customers at a severe disadvantage since a broker-dealer could force a public customer to litigate a relatively small claim where any recovery might be less than legal fees. The answer is not to allow an opt out of either the customer or broker after an informed, separate , and truly voluntary consent is given. Further a better answer would be to improve the process so that either the customer or broker will, more often than not; opt for securities mediation and arbitration because of its time and cost efficiencies and its fairness to both the public customer and the industry. This is especially attractive for those brokers and broker-dealers who do not want their U-4s and U-5s unjustly marked. Further only the public investor should have the choice to opt out.

Arbitral awards receive limited court review and can only be challenged on grounds of bias, corruption, and manifest disregard of law; and only when the foregoing is apparent. Not only does this do a disservice to the public customer but also does a disservice to the principled development of the federal and state securities laws. SRO arbitrations are the context that can best measure the law's impact on individual investors and inform with greater insight the legislative and rule making process to achieve the necessary reform. Rather than further burden the courts, would it not be preferable to put into place an arbitration system which would provide awards that would recite the reasoning upon which the award is based ("reasoned awards").

Further we should put in place in the SRO arbitration forums an internal review and appeal process that will be as broad in scope as traditional judicial review for court cases and reasonably assure reasoned analysis of the underlying case. This also can be accomplished without materially altering the judicial review process presently in place in respect to securities arbitration in the state and federal courts. If this takes place the Courts will not sustain increased burdens. In fact, the new process may reduce the burdens of the Courts.

Reasoned awards and an internal review process will not only facilitate the fairness and the perceptions of fairness for both investors and industry professionals but will facilitate both enforcement and rule making because the arbitration panel will render an award which will be more transparent as a result of being required to expressly state the rational for any award. If the SEC and/or FINRA requires further information for enforcement and rule making before publication of the award, the exchange of information should be deemed privileged and confidential to third parties who are outside of the process and <u>only</u> subject to disclosure pursuant to SEC or Court Order.

The mediation, arbitration and claims processes should be strengthened to offer and reasonably assure investors greater protection and compensation for losses caused by wrongful conduct including professional malpractice in respect to industry set professional standards promulgated under SEC oversight. Professional liability insurance should be made mandatory for broker-dealers and investment advisors especially the smaller firms. Insurance underwriting (showing special sensitivity to professional standards) will also be an additional dimension of self-regulation and will facilitate greater compliance to sustain and achieve more effective risk management and insurability. SIPIC only protects investors for losses arising from misappropriation and custodial breaches. Professional liability insurance will afford greater coverage for investor losses as a result of wrongful conduct including compliance and supervisory failures and *non-scienter* and/or negligent conduct causing harm to the individual investor that is now consistent with Section 933 of Title IX.

In respect to enhancing broker-dealer and investment advisor examinations, greater examination coverage can and will also be achieved by developing independent and private sector compliance auditing comparable to financial statement audits. Both the compliance auditor as well as executive, supervisory and compliance personnel should be required to sign off on the audits, with exceptions being duly noted and reported as well as remedial measures promptly taken. Further those who act in good faith and do not directly or indirectly induce the wrongful conduct in issue will be able to more effectively establish their ’34 Act Section 20(a) defense by the audit report and its supporting evidence.

In reference to the Agenda Report’s identified critical issues, our comments are as follows: The process of legislation and rule making must be more informed. This will be so if more effective insight is provided by the mediation, arbitration, and claims process because in that context issues are presented in real life and not in the abstract. Investor flight may or may not be directly linked to a loss of confidence in the capital markets. After all, investors withdraw money from the market for a variety of reasons e.g., starting their own businesses and channeling their investments into privately held and close corporations, loss of employment, paying for their children’s education, health care needs, and a myriad number of other personal and business reasons. What is important is a focus on systemic problems and risk and drawing insight from forums such as the arbitration, mediation, and claims processes to achieve more comprehensive and better practices and greater regulatory reform. Investor confidence in our markets will only be restored by establishing and reinforcing a fundamentally sound regulatory structure and environment that places more emphasis on professionalism rather than a sales mentality.

In respect to municipal reform the concerns expressed in respect to riskless broker-dealer transactions and whether compensation is fair is a factor seemingly not considered. Firms need to be compensated for inventory risks as it represents a broker-dealer performing a vital function of facilitating market liquidity. The authors agree Data Tagging will make the market and its transactions more transparent as more meaningful information will be better able to be retrieved. This should be a point of focus for the Office of Investor Advocate as should be the Universal Proxy Ballot to enhance corporate democracy that will also address executive compensation and its attendant consequences including being a “turn off” to the market for “the main street investor.”

The elevation of professional standards for broker-dealers by deeming them to be fiduciaries may or may not be helpful. The duty already exists with Ezra Weiss' *Shingle Theory and Just and Equitable Principles of Trade* that already covers broker-dealer conduct, especially being operative in the interstices of law and regulation. Judge Benjamin Cardozo's definition of a fiduciary as one expected to adhere to "morals above the marketplace" is abstract and an aspiration. Intelligible and textually based professional standards are fundamental and more important than labels.

Both investment advisers and broker-dealers should be held to high professional standards set by their respective professional organizations in the first instance under SEC and SRO oversight and approval of their standards. This pragmatic approach has and will provide the informed and ongoing guidance of the distinct professional standards set by the different categories of financial service professionals that will be more intelligible and useful. It will provide a clearer standard of behavior for investment professionals, rather than an abstract standard not as firmly rooted in investor, broker- dealer , and investment advisor experiences.

In respect to Investment Advisors the time is now appropriate to create an Investment Advisor SRO that will facilitate improved standard setting for Investment Advisors and more exam coverage as well as a claims resolution forum focused on this professional group's standards and practices. It will perform a similar role to the recently formed PCAOB. Also critical is more fully utilizing the mediation, arbitration, and claims process to provide real world information which can be used for legislation, rulemaking and enforcement. Reasoned awards and an internal appeals process will aid the more principled development of the securities laws. Mandatory professional liability insurance, especially for smaller broker-dealers and investment advisers that do business with public investors will add to and facilitate risk management and just compensation when professional standards are breached

Above all, independent private sector compliance auditing, comparable to financial statement audits, will supplement the limitation of SRO and SEC resources. For a rule to provide that there be verification, such as what SEC Rule 506 requires with respect to "accredited investors" but not require reasonable audit procedures performed by an independent compliance auditor to test the verification makes the Rule not as effective as reality requires. Moreover as a base audit for every financial service firm every year the regulators will be able to make regulatory and self-regulatory examinations and investigations more selective and focused upon systemic problems that should be addressed.

CONCLUSION

A more fundamental and holistic approach to reform consisting of (1) heightened professional standards set by the industry and its distinct professional groups with SEC oversight and approval; (2) a claims and arbitration process that will be more informative to rulemaking and for enforcement by according any of the parties in the arbitration a right to have the arbitrators render a reasoned award and an internal appeal process within the forum to reasonably assure the principled application of the securities laws ; (3) mandatory professional liability insurance and collective remediation in cases of pervasive fraud and systemic wrong, (4) and independent private sector compliance auditing to cover regulatory gaps due to lack of funding or otherwise; are now the essential components to build a

better foundation for our capital markets and to enhance investor protection.

Woodrow Wilson in The New Freedom wrote, "the whole purpose of a democracy is that we may take counsel with one another so as not to depend upon the judgment of any one man but upon the common counsel of all" and, referring to Columbus; "a mere sea captain's desire to trace a new trade route led to a moral adventure for humanity." Dodd-Frank was and is only a start that should lead regulators (federal and state),self-regulatory organizations, the securities industry, and the professions that serve not only their clients but the public interest, to examine and re-examine in open meetings with informed discussion what is being done to enhance investor protection so that fraud and the systemic risks below the surface will be more effectively identified and eliminated both in terms of fair victim compensation as well as more effective rules and compliance with those rules.

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[1]The Restoring American Financial Stability Act of 2010, Senate Report No.111-176, April 30, 2010, Title IX, Investor Protection, Section 912-913, pages 73-111 (specifically 73-74).

[2]Senate Report No. 111-176, April 30, 2010, Title IX, Investor Protection, pages 74-76.

[3]Committee Reports, 111th Congress (2009-2010), Senate Report 111-176, Section 914, pages 74-75.

[4]Senate Report No. 111-176, April 30, 2010,Title IX, Investor Protection, pages 23 and 74-75

[5](Dodd-Frank Sec. 931, FINDINGS (1) – (5)). Senate Report No. 111-176, April 30, 2010, Pages 81-85

[6] Senate Report No. 111-176, April 30, 2010, pages 85-86.

[7] SEC Study on Investment Advisers and Broker Dealer, January 2011, pages 115; Senate Report No. 111-176, April 30, 2010, page 74.

[8] SEC speaks 2013 PLI Program.

[9]GAO Report to Congressional Committees, Mutual Fund Advertising, July 2011 , page 36.

[10] Senate Report No. 111-176, April 30, 2010, pages 84-85.

[11] Senate Report No. 111-176, April 30, pages 95-97.

[12] Senate Report No. 111-176, April 30, 2010, page 77.

[13] Senate Report No. 111-176, April 30, 2010, pages 85-86, Section 933.

[14] 17 CFR, Parts 230, 239 and 242, Release No. 33-9415, No 34-69959; No. IA3624, File No. 57-07-12. Eliminating the Prohibition Against General Solicitation and General Advertising in Certain Offerings , Rule 506 and Rule 144A, pages 13-14, Fact Sheet, SEC Open Meeting, July 10, 2013. See also: 2012 Columbia Business Law Review, Crowd Funding And The Federal Securities Law, by C. Steven Bradford.

[15] The SEC Investor Advocate's Agenda Report for Fiscal Year 2014, pages 16-18