Commentary: The Investor's Advocate

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At the end of 2008, I wrote a column for Traders Magazine entitled "Regulatory Capture," which argued the need for an investor advocate. An investor advocate is necessary to ameliorate the problem of undue industry influence on regulatory decisions, a disease known as "regulatory capture" that afflicts many government agencies. I am pleased to report that there has been a great deal of progress since that time.

The problem of regulatory capture was described in detail in the 2008 column. In brief, to do its job, the SEC must obtain information from the broker-dealers, exchanges, issuers and investment advisers that it regulates. In turn, the business of these regulated entities will be directly affected by the decisions the SEC makes. As regulated entities feed information to the regulator, they gain access—the regulated have many opportunities to complain about "unnecessary" and "burdensome" regulations, request special rules and exceptions, and influence the course of rulemaking.

The industry's influence over the SEC's decisionmaking is exacerbated because the SEC, like most other government agencies, routinely hires staff from law and accounting firms, and many staffers expect that upon leaving government service, the most promising employment opportunities will be at law and accounting firms whose clients are regulated by the SEC.

I have the greatest respect for professionals who decide to take a severe cut in income to devote years of their career to government service. But it is also true that, while these professionals make every effort to represent their new government client wholeheartedly, their views and perspectives are influenced by their experiences representing regulated entities, and they tend to lean in favor of their former clients or employers, consciously or unconsciously. Similarly, I don't think there is anything wrong with SEC staffers finding jobs in the securities industry. They need to support their families, like everyone else. But, these future employment prospects undoubtedly limit the zeal of staffers to provoke the industry's ire by aggressive efforts to institute or enforce costly regulations.

Our culture and system of laws recognize that conflicts of interest will always be with us. Rather than trying to abolish them, we usually address conflicts of interest by providing a counterbalance. We try to expose the existence of the conflict of interest; then we try to make sure that there is an unbiased arbiter and, at the very least, provide an opportunity for each party to have an unbiased advocate who will tell their story in a light most favorable to their cause. The idea is that the truth lies somewhere in the middle.

Unfortunately, investors generally don't hire advocates to represent their positions to the SEC. The big pension funds and other large institutional investors retain lawyers to advocate their views on a handful of issues, such as proxy voting. And retail investors sometimes call the SEC to complain about their brokers or some industry miscreant. But in the process of rulemaking, most rules that may have an enormous impact on investors are promulgated without any input from advocates for investor interests.

Of course, the SEC is charged with protecting the interests of investors, and I believe they try to consider these interests when rules are promulgated. However, the information used to make any particular regulatory decision is almost always generated by the securities industry. There has been no counterbalance on the investors' side, until recently.

In 2009, the SEC organized an "Investor Advisory Committee." It is composed of people who represent a broad spectrum of investor interests, as well as some members of the securities industry. The Committee includes some law professors and representatives of organizations that advocate the interests of institutional investors and individual investors. Some members represent labor organizations, which have a great interest in seeing that the retirement funds of their members are invested properly. There are also some members who are employees of exchanges and broker-dealers.

When this group was first assembled, I wondered whether it would actually try to accomplish any useful purpose, or whether its role would consist of simply applying lipstick to a pig. A recent webcast of the Committee's latest meeting left me guardedly optimistic.

The meeting began with a presentation by Dan Ariely, a behavioral economist and author of the best selling book "Predictably Irrational." Dr. Ariely challenged the most basic propositions of the securities laws. Disclosure, in his view, merely confuses investors and recent behavioral studies suggest that the person making disclosure feels liberated to make outrageous claims on the theory that the disclosure has sanctified the process. He also pointed to recent experiments showing that conflicts of interest cannot be cured by disclosure.

Dr. Ariely's research takes aim at some highly venerated sacred cows that serve as the foundations of our securities laws. It will be interesting to see how far the

Committee goes in its recommendations to the SEC. There seem to be some fairly simple alternative ways to protect investors that are suggested by Dr. Ariely's research, and these may well find their way into the Committee's recommendations to the SEC. Others of his suggestions would require us to abandon the notion that "sunlight is the best of disinfectants." An entirely new theory of investor protection would have to be developed to take its place.

Another panel got into a thorough and balanced discussion of the pros and cons of securities arbitration. My experience representing clients in securities arbitration has caused me to loathe the process. Nonetheless, I came away from the panel discussion thinking that doing away with it altogether would probably do more harm than good. A more nuanced approach that improves the fairness of the process is probably the most practical alternative.

The Committee's discussion of money market funds was particularly interesting. The Committee is generally opposed to the SEC's recent rule-making proposal, which, among other things, considers whether to do away with a stable net asset value. This proposal would cause the value of a share to vary each day, much like a traditional mutual fund. The Committee thoroughly grilled Robert Plaze from the Division of Investment Management, who provided a lot of information about the thinking of the President's Working Group on this issue. This discussion demonstrated the Committee's independence from the SEC and the current administration on a very controversial issue.

The SEC from time to time organizes "blue ribbon" commissions and other committees to focus on certain issues. They generally make some recommendations, which may lead to rulemaking, and then they go away. In this case, however, it appears that we can be reasonably optimistic that the Investor Advisory Committee will be with us for the long haul. Both the Senate and House version of the recently passed financial service regulatory reform bills require the SEC to establish an Investor Advisory Committee. It would have to be funded and meet at least twice each year. The SEC would be required to consider the Committee's recommendations, but would not be required to do anything about them.

The Senate bill would go one step further. It would establish an "Investor Advocate," who would be a member of the Investor Advisory Committee. This would be a paid position. The Investor Advocate also would be entitled to retain or employ independent counsel – that is, counsel who would not be part of the SEC Office of General Counsel – and its own research and service staff, as the Investor Advocate deems necessary to carry out the duties of the office.

The Senate bill's Investor Advocate would have the duties of an ombudsman, assisting retail investors to resolve significant problems with the SEC or FINRA. It would identify areas where investors would benefit from rule changes and problems with financial service providers and investment products, and propose changes to rules and orders that would be helpful to investors. Most importantly, the Investor Advocate would be charged with analyzing the proposed impact on investors of proposed regulations, including changes in FINRA's rules, and with suggesting changes to the SEC and Congress, including legislation, that would be appropriate to address adverse impact to investors. The SEC would be required to respond to the Investor Advocate's suggestions. One would expect the "Investor Advocate's Statement" to become an important part of rule-making proposals.

The Investor Advocate would also be required to make an annual report to Congress on its success in achieving its objectives. Among other things, this report would describe the quality of the SEC's cooperation and would not be reviewed by the SEC prior to its submission. The Senate clearly intends that the Investor Advocate will be independent of the SEC and provide an independent assessment of the SEC's effectiveness as a regulatory agency.

A lot depends on who gets appointed Investor Advocate and how seriously they take their responsibilities. But this proposal has a lot of potential. If it survives in conference and becomes law, and the Investor Advocate competently performs its assigned tasks – both very big ifs -- the SEC's decision-making process will never be the same. I would expect the Investor Advocate and the Investor Advisory Committee to provide a strong counterbalance to the influence of industry advocates.

The days of regulatory capture are numbered.

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