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Getting Specific About the Policy and Tools of Securities Regulation: A Limited Response to *Diversifying to Mitigate Risk: Can Dodd–Frank Section 342 Help Stabilize the Financial Sector?*

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"Historically, the great strength of the U.S. economic and political system has been its ability, in the face of scandal, to reform and heal itself. Indeed, we have often needed scandals to trigger reform."[1]

"Regulators have power to reduce excessive risk taking and broad powers to order remedies concerning risk-taking innovation. Financial regulators hold broad power to determine legal violations in the financial sector."[2]

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1. Harvey J. Goldschmid, *The SEC at 70: Let's Celebrate Its Reinvigorated Golden Years*, 80 NOTRE DAME L. REV. 825, 825 (2005).

2. Kristin Johnson et al., *Diversifying to Mitigate Risk: Can Dodd–Frank Section 342 Help Stabilize the Financial Sector?*, 73 WASH. & LEE L. REV. 1795,

"[T]he SEC routinely exercises its regulatory power to achieve superior compliance, risk management, and corporate governance in wayward registrants and regulated entities."[3]

I. Diversity in Governance Matters: A Herculean and Worthy Undertaking

The global financial crisis of 2007–2009 predictably catalyzed a federal legislative and regulatory response.[4] In some respects, that response afforded federal agencies new regulatory authority; in other respects, that response employed existing agency authority in new ways. Regardless, the regulatory process may have frustrated—or at least not have given full effect to—congressional intent or authorization, with the possible result that (for this and other reasons) the causes of the financial crisis may not have been completely addressed. However, financial regulators may yet pave the way forward.

In *Diversifying to Mitigate Risk*,[5] Professors Kristin Johnson, Steven A. Ramirez, and Cary Martin Shelby suggest a non-obvious path to a more stable national financial future. The article takes on an enormous task relevant to financial regulatory reform arising out of the financial crisis. That task ultimately involves harnessing and channeling federal financial regulatory authority to manage financial market risk. The issue and line of attack are well known. Yet, comprehensive, realizable solutions have been elusive.

The approach of these authors is innovative and focuses on integrating issues of market risk with literature promoting diversity in firm governance. In *Diversifying to Mitigate Risk*, the authors first demonstrate that diversity in financial firm governance is important as a risk management device.[6] That, in and of itself, is a tall order. However, the authors do not stop there. They then proceed to contend that Congress intended in passing the Dodd–Frank Wall Street Reform and Consumer

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1851 (2016).

3. *See id.* at 1865 (describing the response).

4. *Id.* at 1796.

5. *Id.* at 1795.

6. *Id.* at 1840–51.

Protection Act of 2010 (Dodd–Frank)[7] to delegate to financial regulators the task of employing diversity as a risk management device through the mandate in Section 342(b)(2)(C) of Dodd-Frank (Section 342).[8] More specifically, they argue that Section 342 requires financial regulators to evaluate "the diversity policies and practices"[9] of regulated entities rather than allowing firms to self-assess these policies and practices under regulatory guidelines. Because federal financial regulators chose the self-regulation route, the authors conclude that federal regulators have not complied adequately with Congress's Section 342 mandate.

> [T]he diversity initiative embodied in Section 342 . . . holds the promise of enhanced financial performance as well as risk mitigation. In fact . . . powerful evidence suggests that diversity particularly leads to superior risk management during periods of financial turbulence such as the financial crisis. . . . Unfortunately, . . . the financial regulators ignored this lesson and materially diluted the impact of the statutory provision.[10]

As the authors note in the article, a former commissioner of the U.S. Securities and Exchange Commission (SEC), Louis Aguilar, shares their concern.[11]

Overall, the argument in *Diversifying to Mitigate Risk* is well-documented (offering valuable citations to supporting literature) and thorough. As someone who has written about the merits of gender and other diversity based on matters of trust[12] and crowd theory,[13] much of what the article says about the value of diversity in business governance decision-making resonates

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7. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. §§ 5301–03), https://www.sec.gov/about/laws/wallstreet reform-cpa.pdf.

8. *See id.* § 342(b)(2)(C).

9. Johnson et al., *supra* note 2, at 1803.

10. *Id.* at 1838–39 (footnotes omitted).

11. *See id.* at 1839 n.219.

12. *See generally*, *e.g.*, Joan MacLeod Heminway, *Sex, Trust, and Corporate Boards*, 18 HASTINGS WOMEN'S L.J. 173 (2007).

13. *See generally* Joan MacLeod Heminway, *Women in the Crowd of Corporate Directors: Following, Walking Alone, and Meaningfully Contributing*, 21 WM. & MARY J. WOMEN & L. 59 (2014) (explaining crowd theory particularly as it relates to women in corporate governance).

with me. Moreover, I find the article's linkage of diversity and market risk to Section 342's mandate both creative and provocative, even if the authors' precise expressed prescription as to the use of the SEC's regulatory authority is, as yet, only generally articulated in the article.

I do, however, have several relatively narrowly drawn critiques of the portion of the article in which the authors make assertions about the broad scope of financial regulatory authority that enables financial regulators to use diversity more directly as a risk-management tool. As a general matter, the authors argue that "[r]egulators have power to reduce excessive risk taking and broad powers to order remedies concerning risk-taking innovation. Financial regulators hold broad power to determine legal violations in the financial sector."[14] I agree with the general contention, but in general, I am concerned that it is not effectively defended. Specifically, the article offers supportive examples from banking and securities regulation. Securities regulation is my primary area of practice and a body of rules about which I frequently write. Accordingly, my comments relate to the observations made in the article about the regulatory authority of the SEC under U.S. federal securities regulation.

My appraisal of the authors' treatment of SEC authority in *Diversifying to Mitigate Risk* proceeds in two principal substantive parts. First, in Part II, I address the absence of clear articulations in the article of the policies underlying and tools of regulation under the two most salient federal securities laws. Then, in Part III, I note that one of the examples provided by the authors in the prescriptive part of *Diversifying to Mitigate Risk* invokes two additional federal securities laws with different underlying policies and operative regulatory tools that also should be, but have not been, explored by the authors. Finally, I offer a brief conclusion.

To be clear at the outset, none of the critique offered in this response to *Diversifying to Mitigate Risk* goes to the heart of the authors' thesis. Moreover, their work in this article is both important and useful. My ultimate objective in undertaking this commentary is to offer additional support for the authors' argument.

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14. Johnson et al., *supra* note 2, at 1851.

II. Missed Opportunities: Policies and Tools under the 1933 Act and the 1934 Act

As a securities lawyer and erstwhile student of institutional reform at the SEC,[15] I admit to some disappointment with the level of analysis afforded to policy and related regulatory tools in the article's suggested securities regulation response. That response comes late in the piece (in the last eight pages of the article, under the subsection heading "The SEC and the Securities Industry")[16] and fails to sufficiently address what I consider to be the core values—policies and regulatory tools—of securities regulation under the two key federal laws governing securities offerings and trading: the Securities Act of 1933, as amended (the 1933 Act),[17] and the Securities Exchange Act of 1934, as amended (the 1934 Act).[18] "These acts and the Commission itself remain the fundamental foundations that make our securities regulation system work today."[19]

The authors begin this important part of their article—concluding with prescriptions for the use of the SEC's vast regulatory authority—with a weak premise. Specifically, they assert that "[t]he SEC's main concern is legal compliance and regulatory risk."[20] The limited support provided for this statement in the appended footnote, which refers to a "Fast Answers" page from the SEC's website that addresses only the 1933 Act (from which no examples are drawn in this part of the article), is inadequate to the introductory function it is intended to serve.

It would be appropriate to begin this portion of the article with a brief recitation of the nature and broad-based statutory

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15. *See generally, e.g.*, Joan MacLeod Heminway, *Sustaining Reform Efforts at the SEC: A Progress Report*, 30 BANKING & FIN. SVCS. POL'Y REP. 1 (Apr. 2011) (describing and evaluating the progress of SEC reforms efforts); Joan MacLeod Heminway, *Reframing and Reforming the Securities and Exchange Commission: Lessons from Literature on Change Leadership*, 55 VILLANOVA L. REV. 627 (2010) (assessing SEC reform efforts through the lens of change leadership).

16. Johnson et al., *supra* note 2, at 1860–67.

17. 15 U.S.C. §§ 77a–77z-3 (2012).

18. *Id.* §§ 78a–78qq.

19. Goldschmid, *supra* note 1, at 826.

20. Johnson et al., *supra* note 2, at 1860.

authority of the SEC. The SEC was established in Section 4 of the 1934 Act as an independent federal agency.[21] The broad scope of the SEC's authority over federal securities regulation is evidenced by the many congressional enactments that reference the obligations or permissive powers. These include, for example, the general

> power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter [the 1934 Act] for which they are responsible or for the execution of the functions vested in them by this chapter, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof.[22]

This general statutory foundation for the SEC's authority to regulate establish provides a strong underpinning for the argument in *Diversifying to Mitigate Risk* that the SEC can police board diversity in regulated entities.

Other relevant general manifestations in the 1934 Act of the wide-ranging authority of the SEC include those in Sections 21 and 22 regarding the conduct of investigations, enforcement actions, and hearings.[23] Although perhaps less relevant to this article, the SEC's general authority to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter [the 1934 Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors"[24] is a further indication of the breadth and depth of its statutory powers. The SEC has similarly broad authority to regulate offers and sales of securities under the 1933 Act.[25] Successful challenges to the

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21. 15 U.S.C. § 78d.

22. *Id.* § 78w.

23. *See id.* §§ 78u & 78v.

24. *Id.* § 78mm.

25. *See, e.g.*, *id.* § 77s (general rulemaking authority); *id.* § 77t (investigations, injunctions, prosecutions, and other enforcement authority); *id.* § 77u (authority to hold hearings); *id.* § 77z-3 (general authority over exemptions).

SEC's authority under these provisions have been relatively rare.[26]

The authors also could have laid a more robust foundation for their recommendations by establishing and offering citational support for the general tools of federal securities regulation under the 1933 Act and the 1934 Act and the regulatory policies these tools serve. I have collected and acknowledged these tools and policies in prior work:

> [M]andatory disclosure has been and continues to be a key regulatory tool in U.S. securities regulation. Along with the prevention of fraud and other misleading conduct and the substantive regulation of market participants, disclosure mandates under securities laws and rules . . . serve to protect investors, maintain the integrity of securities markets, and encourage capital formation. These are the core policy objectives of securities regulation.[27]

As *Diversifying to Mitigate Risk* argues, direct SEC efforts to ensure diversity in financial firm governance constitute substantive regulation geared to safeguard investors, ensure fair markets, and foster the development of capital.

The breadth and depth of the SEC's authority to regulate broker-dealers and other financial intermediaries, the central examples used by the authors in this part of the article, are amply supported by the general and specific statements of statutory authority in the 1933 Act and the 1934 Act and the three articulated core policy objectives underlying U.S. federal securities regulation. Moreover, the SEC's authority to revoke the registration of broker-dealers is a specific manifestation of substantive regulation. From a stronger statutory, regulatory, and policy foundation, the article can better proceed with its examples of the SEC's exceptional power to both "give" and "take

26. *See, e.g.*, Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 167 (D.C. Cir. 2010); Chamber of Commerce of U.S. v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005); Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

27. Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the "Crowd"*, 38 VT. L. REV. 827, 828 (2014) (footnotes omitted); *see also* Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREP. BUS. L.J. 335, 337–41, 345 (2012) (offering a general overview of the purposes of security regulation in the United States).

away" as gatekeepers of the very existence and scope of activities of regulated financial firms and its specific illustrations of "the power of the federal financial regulators over the internal governance of firms they regulate."[28]

III. Distinctions with a Difference: The Regulation of Investment Advisers and Investment Companies

The 1933 Act and the 1934 Act are only two of the six federal securities laws adopted in response to the 1929 stock market crash.[29] A seventh act was enacted in 1970.[30] The SEC enjoys regulatory authority under all seven federal securities laws.[31] The 1933 Act and 1934 Act, taken alone, do not provide a sufficient foundation for all of the examples offered by the authors as illustrations of the breadth and depth of the SEC's regulatory authority. But the seven acts taken as a whole support the authors' contentions.

Specifically, the Putnam Investment Management LLC settlement referenced in *Diversifying to Mitigate Risk* exemplifies the SEC's authority under the Investment Advisers Act of 1940, as amended (the Investment Advisers Act),[32] and the Investment Company Act of 1940, as amended (the Investment Company Act).[33] As with the 1933 Act and the 1934 Act, the Investment Advisers Act and the Investment Company Act establish the scope of the SEC's overall authority in multiple sections.[34] Moreover, these two additional securities laws have, their own, unique policy underpinnings and use distinctive regulatory tools

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28. Johnson et al., *supra* note 2, at 1862.

29. *See* Joel Seligman, *Key Implications of the Dodd-Frank Act for Independent Regulatory Agencies*, 89 WASH. U.L. REV. 1, 7 (2011) ("The New Deal's six federal securities laws were a response to the 1929-1933 stock market crash.").

30. Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 450 n.2 (2002).

31. *Id.*

32. 15 U.S.C. §§ 80b-1–80b-21 (2012).

33. *Id.* §§ 80a-1–80a-64.

34. *See, e.g.*, *id.* § 80b-9 (enforcement authority); *id.* § 80b-11 (rulemaking authority); *id.* § 80a-37 (rulemaking authority); *id.* § 80a-41 (enforcement authority).

that are largely unexplored in *Diversifying to Mitigate Risk* as foundations for the authors arguments about the scope of the SEC's authority to regulate the internal governance of financial institutions.

For example, "[t]he policy of the Investment Advisers Act is to protect investors from potential 'malpractices' on the part of investment advisers."[35] More expansively:

> The Investment Advisers Act essentially reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as an intent to eliminate, or at least to expose, all conflicts of interest that might induce investment advisers, consciously or unconsciously, to render advice that was not disinterested. The Investment Advisers Act clearly was enacted for the protection of investors and was intended to promote full and accurate disclosure of all material facts by investment advisers. In summary, the Investment Advisers Act imposes a fiduciary duty upon investment advisers when dealing with their clients and prohibits them from violating this duty by engaging in fraudulent and deceitful practices.[36]

This investor protection focus, implemented primarily through disclosure, is shared with securities regulation under the 1933 Act and the 1934 Act. Yet, other policies and tools of regulation under the Investment Advisers Act, enacted more than six years after adoption of the 1933 Act and the 1934 Act, emanate from perceived gaps in the then existing regulatory framework and rely on distinct observations about the role of investment advisers in financial markets and the economy as a whole.[37] The contextual origins of and policies underlying the

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35. Dean L. Bussey, *Securities Regulation-Performance Fees Under the Investment Advisers Act: The Inadequacy of Disclosure Provisions*, 11 J. CORP. L. 457, 459 (1986).

36. *Id.* at 460 (footnotes omitted); *see also* 15 U.S.C. §§ 80b-4 (setting forth reporting responsibilities); *id.* § 80b-4a (requiring policies and procedures to prevent the misuse of nonpublic information); *id.* § 80b-7 (making willful material misstatements and willful misleading material omissions unlawful).

37. *See, e.g.*, Steven L. Jones, *Custodial Collies of Transparency—the Competitive Advantage of Protecting Investing Lamm(Bs) from Advising Wolves:* Lamm v. State Street Bank & Trust, 66 MERCER L. REV. 1119, 1128 (2015) ("The Investment Advisers Act of 1940 . . . was a Congressional effort . . . to prevent and eradicate fraudulent, deceptive, and manipulative practices by investment advisers."); Elliot J. Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087, 1098

Investment Advisers Act, as well as its disclosure mandates and additional regulatory tools, may or may not ultimately impact the authors' argument about the SEC's authority to regulate the internal governance of investment advisers. Regardless, the absence of any analysis is conspicuous.

Similarly, the Investment Company Act occupies an overlapping, yet distinct, regulatory space as among the U.S. federal securities laws. The distinctions provide an opportunity for significantly clearer and more pointed observations than one can easily make with respect to the Investment Advisers Act. The Investment Company Act "regulates the activities of investment companies both in offering securities to investors and in its governance and investment activities."[38] The act itself expressly regulates the internal governance of registered investment companies in a number of ways.[39]

> [T]he Investment Company Act places its principal reliance on independent directors, rather than on direct shareholder democracy or administrative agency oversight. Not only does the Act require that forty percent of a fund's board be composed of independent outside directors (and in some circumstances dictate that a majority be independent), but it assigns specific duties to these independent directors and thus takes them away from the discretion of the board as a whole.[40]

Arguably, the Investment Company Act's policy underpinnings and its express statutory regulation of investment company internal governance provide more direct support for the authors' contention in *Diversifying to Mitigate Risk* that the

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n.69 (1982) ("[T]he Investment Advisers Act . . . establishes a fiduciary relationship between investment advisers and their clients").

38. Joseph A. Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, 7 STAN. J.L. BUS. & FIN. 1, 37 (2001).

39. *See, e.g.*, 15 U.S.C. §§ 80a-10 (addressing director independence); *id.* § 80a-16 (setting forth requirements for the election of investment company directors); *id.* § 80a-55 (regulating board composition based on affiliation and other interests).

40. John C. Coffee, Jr., *The Survival of the Derivative Suit: An Evaluation and A Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 288 (1981) (footnotes omitted); *see also* 15 U.S.C. §§ 80a-1(b) (offering an express, relatively detailed, general statutory statement of policy listing adverse effects on "the national public interest and the interest of investors"); *id.* 80a-10 (addressing, as indicated by its title, "[a]ffiliations or interest of directors, officers, and employees").

SEC's overall regulatory authority permits it to control the internal affairs of the firms it regulates. "[T]he Investment Company Act of 1940 established a strong corporate governance framework for investment companies from the very beginning."[41] On the other hand, one might be able to argue that the *express* statutory provision of internal governance rules in the Investment Company Act militates against the *implied* existence of broad SEC regulatory authority over matters of internal governance elsewhere in the Investment Company Act or under other federal securities laws.

These matters under the Investment Advisers Act and the Investment Company Act beg for analysis. The Investment Advisers Act and the Investment Company Act have distinct statutory provisions, and they were proposed for adoption to address concerns different from those to which the provisions of 1933 Act and the 1934 Act are directed. The statutes rest on different policy foundations and use different regulatory tools. While the existence of differences in regulatory authority over different financial intermediaries is explicitly recognized in *Diversifying to Mitigate Risk*,[42] the implications of those differences are not fully addressed. At a minimum, the unique position of Investment Company Act regulation merits special treatment as a statutory basis for regulatory incursions into firm governance.

IV. Conclusion

In sum, I have significant praise for the scope and overall argument of *Diversifying to Mitigate Risk*. However, I find the article's analysis of the SEC's capacity to regulate internal governance to be lacking in depth and specificity. Optimally, the authors of *Diversifying to Mitigate Risk* would have more clearly

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41. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (Mar. 29, 2016), https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html (last visited May 1, 2017) (on file with the Washington and Lee Law Review).

42. *See* Johnson et al., *supra* note 2, at 1863 ("The SEC regulatory scheme with respect to each of these different types of financial institutions differs in important ways.").

and individually articulated the statutory bases for the SEC's authority to regulate financial services firms under relevant statutes, the policies underlying the SEC's regulation of specific financial institutions, and the tools employed in those regulatory schemes. Clear, individual articulations would provide more concrete support for the authors' claim that the SEC's authority is broad enough to encompass the management of the internal governance structures and attributes of regulated entities

Nevertheless, my criticisms regarding the substantiation of broad-based SEC authority in *Diversifying to Mitigate Risk* do not take away in any substantial respect from the general point made by the authors that the SEC's broad authority to register and revoke the registration of financial intermediaries, read together with Section 342, affords the SEC the power to engage in assessments of the diversity policies and practices of the firms it regulates. They argue from this point and from the literature on governance diversity that, in the wake of a global financial crisis in which non-diverse financial institutions played leading roles, the authority of financial regulators, including the SEC, should be used to manage risk by managing diversity in the governance of regulated entities. They are motivated in large part by their conclusion that "[a] more diverse financial sector is bound to allocate capital better, achieve greater systemic stability, and meet the public's expectations of the financial sector."[43] That conclusion is supported by the overall weight of authority presented in the article and provides a basis for hope that financial regulators can help the U.S. economic system reform itself by better mitigating risk. Let's hope that the regulators accept the challenge and that these authors are correct.

43. *Id.* at 1868.