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and

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to

The U.S. House of Representatives; Committee on Financial Services;

Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets.

"Putting Investors First: Reviewing Proposals to Hold Executives Accountable."

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I. Introduction:

Good morning Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee. Thank you for the opportunity to testify today. My name is Melanie Lubin. For the past 33 years, I have worked in the Securities Division in the Office of the Attorney General of Maryland, serving since 1998 as the Maryland Securities Commissioner. I also represent Maryland within the North American Securities Administrators Association ("NASAA"),[1] where I currently serve as a Board member and a member of NASAA's Committee on Federal Legislation. Since 2015, I have also served as NASAA's representative to the Financial Stability Oversight Council ("FSOC").

NASAA members include state securities regulators who, for more than 100 years, have served on the frontlines of investor protection, safeguarding the financial futures of hardworking Americans and assisting local businesses and entrepreneurs in raising investment capital. My NASAA colleagues and I enforce state securities laws by investigating complaints, examining broker-dealers and investment advisers, registering certain securities offerings, and providing investor education programs. Our position as the regulators closest to the investing public provides us with a unique window into the concerns of Main Street investors and small businesses.

State securities regulators bring civil and administrative enforcement actions and may bring criminal prosecutions or provide substantial assistance with those cases. Our most recently compiled enforcement statistics reflect that in 2017 alone, state securities regulators conducted nearly 4,790 investigations, leading to more than 2,000 enforcement actions (including 255 criminal prosecutions). Of these enforcement actions, 150 involved broker-dealer agents, 187 involved investment adviser representatives, 120 involved broker-dealers, and 190 involved investment advisers.

II. Summary:

As a preliminary matter, NASAA applauds the Subcommittee on its decision to hold its first several hearings of the 116th Congress on policy questions that explicitly aim to place the interest of Main Street investors first. Main Street investors are an engine of prosperity helping to drive our nation forward; when we put their interests first, our capital markets, our economy and our country all win.

NASAA is very supportive of the ***"Investor Choice Act of 2019"*** introduced by Representative Foster. The bill is a modernized and expanded version of legislation that NASAA supported when it was introduced in 2013. The 2013 bill would have prohibited broker-dealers and investment advisers from mandating arbitration of disagreements with customers by including binding pre-dispute arbitration clauses in customer account agreements. The current

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[1] The oldest international organization devoted to investor protection, NASAA was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

bill goes further by applying this prohibition not only to customer account agreements but also to governing corporate documents. We strongly support the current bill, and we look forward to working with the Chairwoman and the Committee in passing the legislation this year.

NASAA also shares the Committee's interest in defining "insider trading" for purposes of clarifying the types of activities that are prohibited. We support the goal of the ***"Insider Trading Prohibition Act of 2019,"*** sponsored by Rep. Himes (D-CT), which seeks to codify in federal statutes the insider trading standards that exist today as a result of case law. Defining the standards for insider trading liability by statute would add greater clarity and consistency to this important area of the law.

NASAA welcomes the introduction of ***"The 8-K Trading Gap Act of 2019"*** by Chairwoman Maloney. This bill aims to close the so-called "8-K trading gap." We agree that there appears to be compelling evidence that this trading gap does exist and that it unfairly advantages corporate insiders by enabling them to enter into securities transactions before the public release of market moving information.[2] Closing this gap is a basic issue of fairness for retail investors.

NASAA is similarly supportive of draft legislation sponsored by Rep. Green (D-TX) entitled ***"A bill to amend the Securities Exchange Act of 1934 to amend the definition of whistleblower,"*** which would revise Section 922 of the Dodd-Frank Act of 2010 to clarify that whistleblowers who report alleged misconduct to their employers but not also to the U.S. Securities and Exchange Commission ("SEC") are protected by the anti-retaliation provisions in Section 922. The bill is a necessary response to the U.S. Supreme Court's 2018 holding in *Digital Realty Trust, Inc. v. Somers* that only reports made directly to the SEC are protected.

Finally, several of the legislative proposals before the Committee concern outstanding rulemakings to address executive compensation that arose during Congress's consideration of the Dodd-Frank Act. Specifically, the Committee is considering draft legislation entitled ***"A bill to require the SEC to complete rulemaking required by section 10D of the Securities Exchange Act of 1934,"*** and ***"A bill to require the SEC to complete rulemaking required by section 14(i) of the Securities Exchange Act of 1934."*** These bills seek to compel the SEC to complete rulemakings mandated by Dodd-Frank Sections 954 and 953(a), respectively.

NASAA strongly supported the Dodd-Frank Act.[3] The preceding financial crisis had made it plainly evident that the existing regulatory landscape required an overhaul to prevent another economic crisis and to restore the confidence of Main Street investors. The Dodd-Frank Act has largely achieved its goals, and where appropriate Congress has taken steps to adjust certain of its provisions. Further, just as the 111th Congress was correct to reform our financial

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[2] Cohen, Alma, et al., *The 8-K Trading Gap*, Columbia Law and Economics Working Paper No. 524 (2015).

[3] *See* NASAA Letter to House Speaker Nancy Pelosi (D-CA), House Minority Leader John Boehner (R-0H), Senate Majority Leader Harry Reid (D-NV), and Senate Minority Leader Mitch McConnell (R-KY) urging support for the Dodd-Frank Wall Street Reform and Consumer Protection Act Conference Report (June 29, 2010), http://www.nasaa.org/wp-content/uploads/2011/07/6-29-11-NASAA_Supports_Conference_Report062910.pdf.

system in 2010, the 116th Congress is correct to insist that the SEC fully implement the law, including by completing rulemakings mandated therein.

III. Analysis of Certain Legislative Proposals:

(1) The Investor Choice Act of 2019

The Investor Choice Act of 2019 would amend the Securities Exchange Act of 1934 ("Exchange Act"), the Securities Act of 1933 ("Securities Act"), and the Investment Advisers Act of 1940 ("Advisers Act") to prohibit mandatory pre-dispute arbitration agreements in a variety of contexts related to the offer and sale of securities.

Specifically, the Investor Choice Act would amend the Exchange Act to specify that "Notwithstanding any other provision of law, it shall be unlawful for any broker, dealer, funding portal, or municipal securities dealer to enter into, modify, or extend an agreement with customers or clients of such entity with respect to a future dispute between the parties that: (1) mandates arbitration for such dispute; or (2) restricts, limits, or conditions the ability of a customer or client of such entity to select or designate a forum for resolution of such dispute." The bill would make analogous amendments for investment advisers in the Advisers Act.

In addition, the Investor Choice Act of 2019 would prohibit public companies from including mandatory arbitration clauses in their bylaws or other corporate governance documents. The extension of the bill's prohibition on forced arbitration contracts in such corporate documents and bylaws is essential to counter recent efforts by some parties to reverse decades of SEC opposition to such provisions.[4]

Mandatory Arbitration in Customer Agreements

Customer disputes are oftentimes resolved in court or through alternative dispute resolution processes (*i.e.*, negotiation, mediation or arbitration). Before 1987, securities investors' claims against stockbrokers were, similarly, generally pursued as either lawsuits or through arbitration. However, in 1987, the Supreme Court upheld the enforceability of agreements to arbitrate investors' claims arising under the Exchange Act,[5] and since then, the use of mandatory pre-dispute arbitration clauses have become commonplace in agreements between broker-dealer and their customers.

Today, the rules of the Financial Industry Regulatory Authority ("FINRA") permit broker-dealers to include mandatory pre-dispute arbitration provisions in their customer account agreements and virtually all FINRA members have incorporated such provisions into their customer account agreements. The effect of the proliferation of such clauses has served to practically eliminate investor choice regarding the forum for dispute resolution.

[4] *See*, *e.g.*, David Michaels and Gabriel Rubin, *SEC Allows Rejection of Mandatory Shareholder Arbitration*, Wall Street Journal (Feb. 12, 2019).

[5] *See* Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220 (1987).

NASAA has long been concerned with the use of mandatory pre-dispute arbitration clauses in customer contracts, whether by broker-dealers or by investment advisers. Such provisions deprive investors of a choice when it comes to selecting a forum for resolving disputes with their investment professionals. Such provisions stand in contrast to the preference of most investors, who place a premium on having a choice when it comes to selecting a dispute resolution forum. In fact, national polling conducted on behalf of NASAA reflects that 83 percent of respondents agreed that they want a choice on whether to pursue their dispute in court or in arbitration rather than being forced into arbitration.[6]

Investor confidence in fair and equitable recourse is critical to the stability of the securities markets and long-term investments by "mom and pop" investors. Retail participation in our capital markets and by extension, job growth, is directly tied to investors' trust in having reasonable avenues through which to seek recovery if they are victimized by securities fraud or other unethical conduct.

Section 921 of the Dodd-Frank Act was included in response to congressional concern that mandatory pre-dispute arbitration agreements were unfair to investors.[7] Specifically, Section 921 granted the SEC explicit rulemaking authority to "prohibit, condition or limit the use of mandatory pre-dispute arbitration agreements" if it finds that doing so protects investors and is in the public interest." Unfortunately, although Congress gave the SEC an important tool to act in this area, in the nearly nine years since the Dodd-Frank Act was enacted, the SEC has not exercised its authority to conduct rulemaking. In light of continued inaction on Section 921 by the SEC, NASAA strongly supports the Investor Choice Act's statutory resolution of this issue.

Mandatory Arbitration in Corporate Governance or Offering Documents

The Investor Choice Act would extend the prohibition against mandatory arbitration to securities issuers. NASAA supports this as well. Forcing investors into mandatory arbitration or otherwise precluding investors from joining class actions is bad policy, as this would harm retail investors and be disruptive to the marketplace. The SEC and state securities regulators have limited resources and cannot combat all securities frauds entirely on their own. The Supreme

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[6] A national opinion poll of investors was conducted on behalf of NASAA by Engine, a national opinion firm based in New York. The telephone survey of 1,000 investors was conducted between February 7, 2019 and March 3, 2019.)

[7] As the Committee Report accompanying the Dodd-Frank Act noted:

> "For too long, securities industry practices have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress. Brokerage firms [hold] powerful advantages over investors. Brokerages often hide mandatory arbitration clauses in dense contract language. Moreover, arbitration settlements generally remain secret, preventing other investors from learning about the performance of a particular brokerage firm. If arbitration truly offers investors the opportunity to efficiently and fairly settle disputes, then investors will choose that option. But investors should also have the choice to pursue remedies in court." *See* H. Rep. No. 111-687, Part 1, at 50.

Court has long recognized that securities class actions are "an essential supplement" to government enforcement powers,[8] which is a point that Congress has also recognized.[9]

Securities class actions serve as a deterrent to violative conduct and a primary mechanism by which investors are compensated for the misconduct of fraudsters. While funds recovered by federal and state regulators can be returned to investors, such as through an SEC Fair Fund or a court appointed receiver, these amounts have historically paled in comparison to the amounts recovered directly by investors.[10]

Shareholder class actions also serve an important role in maintaining investor confidence and supporting an efficient capital market system. Class actions are the primary means of upholding securities disclosure standards and contribute materially to the development of the common law. In contrast, arbitrators can deviate from the law, their opinions may be unexplained, and their decisions are essentially unreviewable.[11]

Basic questions of shareholder rights are foundational "rules of the game" issues that should be kept uniform across publicly traded companies. To require that investors research every issuer's articles of incorporation and bylaws to know what their rights are vis-à-vis the company would be grossly inefficient and contrary to their reasonable expectations when making investment decisions.

(2) The Insider Trading Prohibition Act of 2019

State securities regulators combat securities violations on a daily basis. These violations encompass a dizzying array of bad behavior – including fraud, Ponzi schemes, theft or conversion, and breach of a fiduciary or other duty by a securities professional. These nefarious activities, which can include insider trading, erode retail investor confidence in the markets and market participants and keep much needed investment capital on the sidelines. Therefore, NASAA supports codification of a clear, appropriate and effective insider trading definition in the federal statutes.

Insider trading generally refers to buying or selling a security in breach of a fiduciary duty or other relationship of trust and confidence based on material, nonpublic information about the security. Often, it is corporate insiders and the individuals whom they have tipped that commit illegal insider trading. Insider trading also may be done by others such as corporate outsiders who misappropriate information they have otherwise legitimately acquired through the services they perform for the company.

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[8] Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007).

[9] *See, e.g.,* S. Rep. No. 104-98 (June 19, 1995), reprinted at 1995 U.S.C.C.A.N. 679.

[10] *See* John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and its Implementation, 106 Colum. L. Rev. 1534, 1542-43 (2006).

[11] *See* AT&T Mobility LLC v. Concepcion, 563 U.S. 333, 350 (2011).

Currently, no statute or SEC rule explicitly prohibits insider trading. Rather, insider trading is considered fraud within the broad contours of Exchange Act Section 10(b) and SEC Rule 10b-5.[12] Under either the classical or misappropriation theories, this conduct "satisfies § 10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities."[13] The deceptive device in insider trading is feigning fidelity to the source of the information. Case law has attempted to define the precise boundaries of insider trading over the past four decades; however, meaningful disputes persist as to what is/is not unlawful.[14]

The Insider Trading Prohibition Act would formally codify much of the existing case law on insider trading and outlaw by statute what has to date been illegal only because of judicial applications of the Exchange Act's general antifraud provisions. Specifically, the bill would amend the Exchange Act to prohibit any person from trading securities while in possession of related material, nonpublic information: by knowingly or recklessly disregarding that the information has been obtained wrongfully; or by engaging in transactions that would constitute a wrongful use of such information.

NASAA supports codification of a clear, appropriate and effective insider trading definition for both courts and market participants. By proposing to codify much of the existing case law surrounding insider trading, the Insider Trading Prohibition Act is a major step forward.

(3) The 8-K Trading Gap Act of 2019

The 8-K Trading Gap Act seeks to prohibit officers and directors of SEC-registered issuers from trading their companies' securities during the so-called "8-K trading gap." This gap refers to the period (currently set by SEC regulation at four days) between when an issuer determines a material event has occurred that requires disclosure on Form 8-K and the time when disclosure is actually made through a public SEC filing.[15] Notably, all prohibitions on insider trading apply during this period, but research has indicated that insiders tend to trade more profitably during this gap than at other points in time.[16] The unfairness of such trading is patently clear.

The SEC instituted the current four-day filing deadline for Form 8-Ks in 2004. The SEC had wanted a two-day filing deadline, but issuers and their legal counsel objected that this was

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[12] Dirks v. SEC, 463 U.S. 646 (1983).

[13] United States v. O'Hagan, 521 U.S. 642, 653 (1997).

[14] *See, e.g.*, Salman v. United States, 137 S. Ct. 420 (2016).

[15] SEC registrants must file Form 8-K whenever a specific category of information changes in between filing of their periodic reports (the 10-Qs and 10-Ks). Form 8-K lists nine categories of material information for which the registrant must file the form to disclose the changes. For a quick overview of these categories of information, see: https://www.sec.gov/fast-answers/answersform8khtm.html.

[16] *See* Cohen, Alma, et al., *The 8-K Trading Gap*, Columbia Law and Economics Working Paper No. 524 (2015).

too onerous, and the SEC assented.[17] In retrospect, the issuer's objections seem unreasonable and excessive. Although the SEC may have felt compelled by corporate issuers and their counsel to permit a 4-day filing period, Congress is not so constrained. Congress should close the Form 8-K trading gap because doing so will help ensure the playing field is level between corporate insiders and retail investors.

(4) A Bill to Amend the Securities Exchange Act of 1934 to Amend the Definition of Whistleblower

The SEC's Whistleblower Program, instituted under the Dodd-Frank Act, is an extremely effective tool for uncovering corporate wrongdoing. The program has led to SEC enforcement actions requiring over $1.7 billion in monetary sanctions, including more than $901 million in disgorgement of ill-gotten gains and interest, half of which has been (or is being) returned to investors.[18] According to the SEC, the agency received over 5,200 whistleblower tips in FY 2018, and whistleblowers have alerted it to numerous securities frauds, supplying information and documentation that the SEC's investigators otherwise may never have uncovered.[19]

Section 922 of the Dodd-Frank Act sought to protect whistleblowers from retaliation by their employers if they make a whistleblower report.[20] Unfortunately, imprecision in the drafting of Section 922 resulted in competing interpretations as to the scope of whistleblowers protected by it. The SEC interpreted Section 922 broadly to include whistleblowers who report to the agency as well as whistleblowers who report internally to their corporations (such as through a corporate whistleblower hotline). But in 2018, the U.S. Supreme Court disagreed by finding that the plain text of Section 922 affords protection only to whistleblowers who report directly to SEC.[21] The Court's decision therefore opens the door to corporate retaliation against whistleblowers who seek to do the right thing by reporting misconduct to their employers. The SEC's whistleblower program has proven effective in efforts to address fraud and misconduct in the securities markets, and whistleblowers should be protected from retaliation regardless of how they report misconduct.

In addition to the reforms currently envisioned by the legislation, NASAA urges the Subcommittee to examine whether the bill should also amend Section 922 of the Dodd-Frank Act to clarify that workplace and confidentiality provisions apply to reports made to state

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[17] *See* https://www.sec.gov/rules/final/33-8400.htm#P98_9054.

[18] *See* https://www.sec.gov/sec-2018-annual-report-whistleblower-program.pdf

[19] Ibid.

[20] In 2014, the SEC for the first time used its authority under Dodd-Frank to take enforcement action against employers who retaliate against whistleblowers. Specifically, the SEC took action against hedge fund advisory firm Paradigm Capital Management Inc. for retaliating against an employee who reported violations to the SEC.

[21] *See* Digital Realty Trust, Inc. v. Somers, 138 S. Ct. 767 (2018).

securities regulators, including where such reports lead to referrals to the SEC whistleblower program.

IV. **Conclusion**:

NASAA applauds the Subcommittee for holding this important hearing and for this Subcommittee's ongoing efforts *to assert and reassert* the importance of investor rights in the modern securities marketplace. The financial crisis that struck our country a decade ago is not a distant memory in the minds of hard-working Americans, but rather very much a reminder of lost opportunities. The adverse financial effects, and the distress that comes with the loss of retirement savings built up over many years, was devastating. Many Americans are still working to recover from these losses. It is incumbent upon Congress and regulators to demonstrate an unwavering commitment to Main Street investors and to continue taking the steps necessary to protect them. In this regard, NASAA and its members look forward to working closely with the Committee and Subcommittee on these important issues.

Thank you again for the opportunity to testify. I will be pleased to answer any questions.