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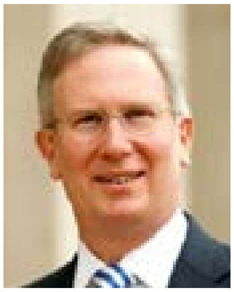
Q&A with an Expert: Insights into the SEC's Investor Advisory Committee



Paul G. Mahoney is a member of the SEC's Investor Advisory Committee (IAC). He is a professor at the University of Virginia School of Law, where he also served as the dean from 2008 to 2016. Professor Mahoney's teaching and research interests include securities regulation, law and economic development, corporate finance, and financial derivatives and contracts. He is the author of *Wasting a Crisis: Why Securities Regulation Fails* (University of Chicago Press, 2015) and has served on the IAC since mid-2018.

Dimensions interviewed Professor Mahoney on how the IAC operates and how its recommendations influence the SEC's disclosure rulemaking, as well as other securities disclosure topics.

This interview expresses the views of Professor Mahoney and does not necessarily reflect the views of the IAC, the SEC, the University of Virginia, or any other organization.

What is the SEC's Investor Advisory Committee?

The current IAC is actually its second incarnation. The SEC chartered an earlier Investor Advisory Committee in 2009 in accordance with the Federal Advisory Committee Act. The mission of that committee was to advise the SEC on matters of concern to investors and provide information and recommendations on regulatory programs from the point of view of investors. Subsequently, Section 911 of the Dodd-Frank Act established the current Investor Advisory Committee to advise and consult with the SEC on regulatory issues, including initiatives to protect investor interests and promote investor confidence in the markets. The statute directs the current IAC to submit its findings and recommendations to the SEC.

What is the background of the committee members on the IAC?

The statute itself imposes certain requirements on the composition of the IAC's membership. It must include a representative of state securities commissions and a representative of the interests of senior citizens; as well as the general membership, who should represent the interests of individual investors, including mutual-fund investors, and the interests of institutional investors. Dodd-Frank also established an Office of the Investor Advocate within the SEC, and the Investor Advocate (currently Rick Fleming) is designated in the statute as a member of the IAC.

If you look at the current membership of the IAC, it is quite well suited to satisfy those requirements. Our chair, Anne Sheehan, was formerly the director of corporate governance of the California State Teachers' Retirement System. The committee also has members from the private and public institutional investor communities; members affiliated with the Consumer Federation of America and the AFL-CIO; and members like me, who come from more of an academic or research background. So the membership represents a nice cross-section of backgrounds and perspectives.

Why should securities lawyers and financial-reporting professionals follow what the IAC finds and recommends?

The statute mandates that the SEC review any findings or recommendations that the IAC brings it. Moreover, the SEC must respond publicly to those findings and recommendations and disclose what action, if any, it intends to take in response. So, of course, securities lawyers and financial-reporting professionals should want to know what the IAC is doing because we have, at a minimum, the power to draw the SEC's attention to an issue.

Beyond that, the IAC has a statutorily mandated consultative role in the SEC's ongoing work to modernize and simplify the ongoing disclosure requirements for public companies under Regulations S-K and S-X, which the SEC calls the Disclosure Effectiveness Project.

What do you see as your role on the IAC?

As an academic, I do not have the depth of practical day-to-day experience in the markets that many of my IAC colleagues have. What I bring is the perspective of someone external to the securities markets who has nevertheless thought about, taught, researched, and written about securities regulation for nearly 30 years. In my opinion, it is important for the SEC to hear both the practical, internal perspectives and the theoretical, external perspectives to adopt good policies.

IAC meetings often feature spirited discussions among its diverse members. How do the IAC's meetings compare to law-school debates?

Academics tend to be drawn to ideas that have interesting theoretical underpinnings and potential applications across many different problems. Industry participants tend to be more interested in the immediate problem at hand and in solutions that are pragmatic. The IAC has more practitioners than academics, so its discussions, I think, tend to veer in a more concrete and pragmatic direction than a typical academic discussion would.

Does the SEC have an obligation to consult with or provide updates to the IAC?

I covered the formal obligations earlier. The structural setup of the IAC essentially ensures a good flow of information between it and the SEC. The

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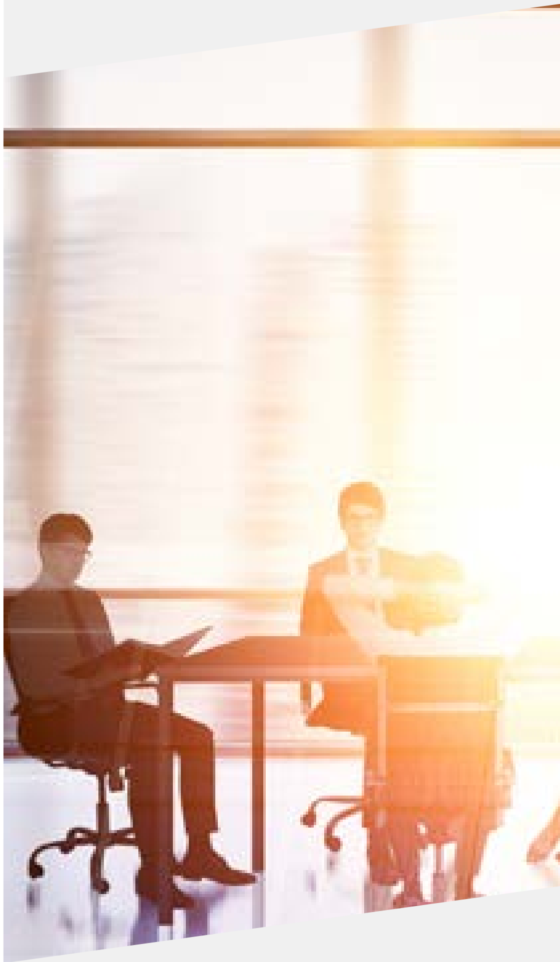

THE IAC HAS MORE PRACTITIONERS THAN ACADEMICS, SO ITS DISCUSSIONS TEND TO VEER IN A MORE CONCRETE AND PRAGMATIC DIRECTION THAN A TYPICAL ACADEMIC DISCUSSION WOULD

presence of the Investor Advocate, who is a senior SEC official on the IAC, helps facilitate our understanding of the SEC's priorities. The statutory requirement I mentioned—that the SEC respond to IAC findings and recommendations—ensures that the IAC gets feedback on its proposals.

Probably more important than the structure provided by the statute is the fact that the SEC commissioners themselves have clearly taken a deep interest in the IAC's work. They routinely appear at the IAC's public meetings. SEC Chair Jay Clayton has been particularly generous with his time, giving opening remarks at every public meeting since I joined the IAC in mid-2018.

The IAC discusses timely topics in the market, from cybersecurity to proxy infrastructure to investor protections. How are the meeting agendas determined?

The IAC's chair, in consultation with the subcommittee chairs and the full membership, to the extent they want to weigh in, sets the meeting agendas. In my experience, the chair has been eager to get suggestions from the entire membership about timely topics.

How does the IAC develop its recommendations and its priorities for recommendations?

Much of the work of developing ideas and proposals takes place in the IAC's three subcommittees. They are the Investor as Owner Subcommittee, the Investor as Purchaser Subcommittee, and the Market Structure Subcommittee. They meet telephonically to discuss and gather information regarding issues that members think are worth the full IAC's attention. Not surprisingly, if an individual member feels strongly about an issue, he or she can take the lead by doing some preliminary analysis and information-gathering to show the other subcommittee members that this is indeed an important issue.

It seems that the SEC is listening to the IAC's recommendations?

Without question. The SEC commissioners and staff have been very generous with their time, which I think indicates the importance they attach to our work. Since I joined the IAC, it has made three formal recommendations, each of which in substantial part related to an existing rulemaking proceeding. In fact, the SEC recently adopted revisions to Rule 15c2-12 regarding municipal securities disclosures, which was the subject of one of our recommendations. The SEC's adopting release discussed the IAC's recommendations and, indeed, slightly narrowed the definition of the term financial obligation in the final rule in response to the concerns of the IAC and other commentators.

The IAC has long supported structured data, including XBRL. In 2013, the IAC published recommendations on the use of structured data. In 2016, the IAC's comment letter on the Disclosure Effectiveness Project included an entire section on structured data. Why do you think the IAC supports structured data in SEC filings?

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THERE HAS LONG BEEN A CONCERN IN THE ACADEMIC COMMUNITY THAT THE CURRENT DISCLOSURE SYSTEM MAY PRODUCE INFORMATION OVERLOAD FOR RETAIL INVESTORS

The 2016 letter actually gives the logic behind the IAC's stance on structured data. It provides a statement of overarching principles that should guide disclosure. The first of these is that disclosure requirements should be guided by the needs of the investor community. This community includes both institutional and retail investors. To underscore that, the second overarching principle states that the disclosure system should serve the needs of retail investors, not just institutions.

Different types of investors differ in their ability to process large quantities of information. There has long been a concern in the academic community that the current disclosure system may produce information overload for retail investors. One possible solution to the problem of having sufficiently detailed disclosures to satisfy institutional investors without overwhelming retail investors is to use technology to leverage retail investors' ability to analyze information. The IAC letter argued that serving the interests of retail investors does not necessarily imply reducing the complexity or completeness of the existing system but instead implies structuring the disclosures to facilitate easy access by retail investors to the information they find most relevant.

Do you feel the SEC has been moving forward with securities-disclosure recommendations made by the IAC?

The comment period for the first piece of the Disclosure Effectiveness Project ended in November 2016, right around the time of the last presidential election. Not a single current SEC commissioner was in office at that time, so the current commissioners had to study what was done before they arrived and assess it. Against that backdrop, I find it impressive that the SEC was able to finalize a fairly substantial package of disclosure updates and simplifications last year.

Part of the purpose of that package of rules was to eliminate duplicative disclosure requirements. Sometimes Regulation S-K or S-X requires disclosures that partly overlap with GAAP requirements but are nevertheless broader. In some cases, the SEC has maintained the current S-K or S-X requirement but referred the issue to FASB for possible expansion of the GAAP requirements to incorporate the S-K or S-X approach. Examples of that include discounts on shares, income-tax disclosures, and disclosures about major customers. To the extent those disclosures migrate fully to GAAP, the XBRL tagging requirements for financial statements will ensure easier access to the disclosed information.

In its 2016 comment letter, the IAC recommended a complete revision of the approach to filing and retrieving information and advocated the layered presentation of disclosures. What is layered disclosure, and is the SEC moving in that direction?

The idea behind layering is that, whenever possible, information should be initially presented in a summary format with cross-references to detailed disclosures for those investors who want to look into a particular area in more detail. The SEC has taken a step in that direction in its adoption of a rule requiring hyperlinks to exhibits in registration statements and reports.

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IF YOU SIMPLY COUNT THE NUMBER OF COMMANDS TO WHICH BANKS AND BANK HOLDING COMPANIES ARE SUBJECT IN THE RULES OF THE PRINCIPAL BANK REGULATORS, THE TOTAL HAS INCREASED BY NEARLY A FACTOR OF 10 SINCE 2008.

Let's turn to the book you wrote, *Wasting a Crisis: Why Securities Regulation Fails*. In it, you reexamined the commonly accepted viewpoints of what caused the financial crisis of 2008. Do you believe the changes and additions to the laws and regulations since then have made it more or less likely that another financial crisis will occur?

Regulated financial institutions, both the traditional commercial banks and the large investment banks that converted to commercial bank holding companies, are better capitalized than they were before the financial crisis. To that extent, the post-crisis regulatory changes have made the financial system more stable.

But when you look at the regulatory system more broadly, there are some counterproductive elements there. If you simply count the number of commands to which banks and bank holding companies are subject in the rules of the principal bank regulators, the total has increased by nearly a factor of 10 since 2008. Not surprisingly, then, a substantial amount of lending has migrated out of the regulated system. So banks may be safer, but that is not necessarily a guarantee that the financial system as a whole is safer.

To take another example, the orderly liquidation authority contained in Dodd-Frank tries to ensure that the systemically important institutions will be resolved quickly, so that their funds will not be tied up during lengthy and contentious bankruptcy proceedings. It also tries to assure taxpayers that those institutions will not receive government bailouts.

But the system gives the FDIC considerable discretion in the resolution process, and the FDIC has a statutory mandate to protect the financial system as a whole. And that may encourage creditors to run for the exits at the first sign of trouble to avoid the possibility that this discretion will be used in ways that are adverse to them. This would be quite counterproductive, given that the withdrawal of wholesale funding from financial institutions—the modern equivalent of a bank run—was one of the key mechanisms that produced a full-scale crisis in 2007–2008.

Can securities and financial disclosures prevent financial crises?

Financial crises are a fact of life. We in the United States did not have one from the 1930s until 2007, so it came as a great shock to learn that we are not in fact immune. But as Carmen Reinhart and Kenneth Rogoff's excellent book [*This Time Is Different: Eight Centuries of Financial Folly,* Princeton University Press, 2009] points out, financial crises are a common phenomenon. So I think that it is not realistic to believe that better disclosure can prevent crises.

Certainly, better economic and financial policies can help make financial crises more infrequent. Crises have their roots in excessive debt. Empirically, two forms of excessive debt pop up time and again. The most common is excessive government borrowing or money-printing as a substitute for borrowing. The second is excessive mortgage debt. Both of those, in principle, can be addressed through public policies, but they involve unpalatable political tradeoffs.

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I THINK WE HAVE A LOT TO LEARN ABOUT SPOTTING A FINANCIAL CRISIS BEFORE IT ARRIVES.

What is the role of structured data, technology, and artificial intelligence in financial-crisis prevention or early warning?

I think we have a lot to learn about spotting a financial crisis before it arrives. Financial economists are doing a lot of work on measuring phenomena in the financial system that might give early warning of a coming crisis. Better data produces better analysis, all other things being equal. I think that to the extent we know more, particularly about the buildup of leverage and interconnection within the corporate sector and within the financial sector, the better we will do at developing early warning systems for the types of risks that produce financial crises.

The SEC uses statistical data, often derived from XBRL financials, extensively in its assessments of proposed rules. This is often compiled by the Division of Economic Risk Analysis (DERA). How does data such as that assist the IAC members?

It just so happens that the issues which we have dealt with thus far in my limited time on the IAC have not really been ones that require the data. So we will have to see how that goes in the future.

One of the issues that we are working on is the plumbing of the proxy system. It is possible that as the discussion goes forward, we will be interested in knowing, for example, how effectively investors are using tagged data.

Do you have an interest in the technology side of SEC filings?

I certainly have a long history of observing that technology. I was in private practice when EDGAR first got under way and was a bit player at my law firm in one of the first EDGAR filings that the SEC accepted. It seems to me that, initially, the system was designed with the idea of making it easy to transmit the whole document and read it on a screen. There was not a notion that investors would be able to reach into an electronic document and extract data. Obviously, the vision has changed quite a bit over the years. It will be really interesting to see how that evolution continues.

As a lawyer, you understand the complexities of disclosure rules. How do companies balance being compliant with the need to inform investors?

I think compliance was easier when I was in practice. A company could mostly limit its public disclosures to backward-looking factual information that it could verify. Since then, the SEC has recognized that investors are interested in forward-looking and evaluative statements. This raises the risk that a company will say something that it later has to walk back and face criticism or even litigation. In my opinion, anyone speaking on behalf of a public company should always ask herself the question "How do I know this?" or "Why do I believe this?" before making a public statement. Just going through that exercise in your own mind can cause you to formulate the statement with more precision and reduce the likelihood of misunderstandings.

When in-house counsel decides to blow the whistle on corporate fraud

Abstracted from: *The Dilemma Of In-House Counsel As Whistleblower: When And Where To Blow The Whistle?*
By: Gerardo Adrian Galvan and Kelly Crawford
SMU Dedman School of Law (GAG); Scheef & Stone, Dallas TX (KC)
Securities Regulation Law Journal
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Guarding a whistleblower's back. In the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, Congress encouraged employees—including in-house lawyers—to report corporate fraud by shielding them from retaliation. Only Dodd-Frank offers a bounty: 10%-30% of sanctions over $1 million obtained in an enforcement action based on "original information" given to the SEC. The whistleblower must file a complaint with the Secretary of Labor not more than 180 days after facing retaliation and must exhaust administrative remedies before suing the employer under Sarbanes-Oxley. Under Dodd-Frank, explain attorney Kelly Crawford and law student Gerardo Adrian Galvan, the whistleblower may sue the employer first—and within six years.

The statutes overlap in naming the circumstances to which the anti-retaliation shield applies. A whistleblower under Dodd-Frank is an employee who reports to the SEC, while a whistleblower under Sarbanes-Oxley is anyone who reports to the SEC, another federal agency, Congress, or the person's in-house supervisor. The Supreme Court reaffirmed this Dodd-Frank limitation in *Digital Realty Trust Inc. v. Somers* (2018), so in-house lawyers who are fired after reporting suspected corporate fraud must proceed under Sarbanes-Oxley.

Can counsel shoulder the ethical burden? SEC regulations seem to respect the attorney/client privilege by barring in-house counsel from disclosing to the SEC information that is subject to the privilege or that was discovered while representing the client. Significant exceptions, the authors point out, cover disclosures made to protect the company or the shareholders from serious financial harm, to remedy such harm, or to keep the company from committing perjury or fraud in front of the SEC. Dodd-Frank also incorporates SEC regulations that allow lawyers who practice before the SEC to report directly to it if a specified chain of in-house attempts to report "up the ladder" fails.

Does US law gut fiduciary duties? SEC regulations say they supersede lawyers' fiduciary duties under state law, creating a safe harbor from state-law violations for compliance in good faith with the regulations. In-house counsel's duties of confidentiality vary by state, the authors note. In most states, the duty covers all information needed to represent the company. Some states have adopted the ABA Model Rules' exceptions, but the federal exceptions—particularly the Dodd-Frank whistleblower's bounty—are broader and therefore are troubling for companies. The states impose a uniform duty of loyalty on in-house counsel, all of whose actions must benefit the company; but under the Model Rules, loyalty bans any conflict of interest, which a bounty might create.

Two factors lessen the threat that bounties might pose to both fiduciary duties. First, the evidentiary burden is greater for permitted external disclosures than for the SEC's required internal disclosures. Second, the SEC may withhold a bounty from counsel whose information breaches the attorney/client privilege or falls outside the SEC's exceptions to confidentiality. Furthermore, whistleblowing could be consistent with the duty of loyalty, since counsel owes it to the company, not to management.

Will federal courts flesh out the legal skeleton? Federal courts have begun considering how Dodd-Frank and Sarbanes-Oxley interact with state ethics rules. A California federal court held that in-house counsel could be a whistleblower under the federal statutes because the SEC rules preempt the state's very strict duty of confidentiality. The case is on appeal* and, the authors surmise, the holding will be limited because counsel reported internally, not to the SEC, before being fired (and thus falling outside the Dodd-Frank definition of a whistleblower).

Timing is also key to a case now pending in the Eastern District of Pennsylvania. In-house counsel seeks Dodd-Frank protection from retaliation for reporting to the SEC while still an employee. The company has counterargued that, prior to the report, it gave notice that counsel would be fired. A decision in the District of New Jersey denied Dodd-Frank protection to an attorney fired for reporting to FINRA, rejecting the argument that this was tantamount to reporting to the SEC, which supervises FINRA, while still employed.

**Editor's Note: The Ninth Circuit remanded the case on February 26, 2019, affirming in part and vacating in part. See also commentary on the remand from Sheppard Mullin lawyers.*

Abstracted from ***Securities Regulation Law Journal***, published by Thomson Reuters, 610 Opperman Drive, Eagan MN 55123. To subscribe, call (800) 328-4880; or visit *https://store.legal.thomsonreuters.com/law-products/c/Securities-Regulation-Law-Journal/p/100029157*. For more on the SEC's response to the Supreme Court's Digital Realty holding, see *What Do The SEC's Proposed Whistleblower Rule Amendments Mean For Business?* by attorneys Masha Trainor and Laurel Gift, ***ACC Docket***, Jan/Feb 2019.

RECENT DEVELOPMENTS

Making financial data standardization a top priority

By *Dimensions* staff

The XBRL tagging requirement in SEC filings is part of a broader trend in financial regulation, domestically and globally, toward standardizing the data used by investors, analysts, regulators, and others in the capital markets. Like barcoding in the retail, shipping, and related industries, standardization of financial information involves the use of machine-readable structured data such as XBRL, as well as related technologies. This consistency makes it easier to convey, extract, and consume vast amounts of financial data swiftly and accurately. Data standards benefit not only investors making market decisions but also companies that need to tell their financial stories clearly to investors and market analysts.

The efficiencies of XBRL-tagged data have led to increasing use of standardized data. Major data providers are incorporating XBRL-tagged disclosures into their feeds, while product innovators have developed XBRL-based platforms that efficiently deliver financial data to companies for their strategic research. XBRL is also a crucial tool for the SEC's review of company disclosures in the Corporation Finance and Enforcement divisions.

Another example of standardization is the Legal Entity Identifier (LEI), discussed in a recent issue of *Dimensions.* The LEI is a universal alpha-numeric code that identifies legal entities across markets, products, and regions. In addition to facilitating financial transactions, the LEI is a significant factor in creating market transparency.

Despite the benefits of standardization, researchers find obstacles remain

Yet despite its universal benefits, data standardization has not progressed quickly, according to researchers Richard Berner (Executive-In-Residence at NYU Stern School of Business) and Kathryn Judge (Professor of Law at Columbia Law School). Their paper (*The Data Standardization Challenge*) explains what the benefits of standardization are, what obstacles it faces, why it should be a high priority for regulators, and how to facilitate its implementation. The research is also summarized in a commentary published by Columbia Law School's CLS Blue Sky Blog (*When Good Incentives Are Not Enough: The Quest for Financial Data Standardization*).

"Data standardization offers significant benefits for industry and regulators alike, suggesting that it should be easy," observe the researchers. "In practice, however, the process has been hard and slow moving." If the advantages of data standardization are universal and obvious, why has it proved so difficult to establish?

The study reveals a few major reasons for the slow adoption of standardized data. First, companies bear the costs of implementing specific standards at the outset, while the benefits take time to become visible. As the researchers observe:

> Standardizing data is not a free good. The costs of developing standards, testing them, retooling firm and regulatory systems to use them, and working out the kinks in implementation are considerable, and the costs of these investments are incurred early on. The benefits follow with a lag, and the benefits aren't restricted to those who incur the bulk of the costs.

Compounding these issues are cultural obstacles, since data standardization needs coordinated action from many different groups in the public and private sectors.

Moreover, companies may lack "the technology and enterprise-wide data management and governance practices that are needed to allow them to use the data to better identify and manage their risks." In other words, for many companies, data standardization seems to fail a cost/benefit analysis.

The US regulatory structure also makes standardization more complex than it should be. Individual regulatory agencies can specify any data standards or none at all. "Adding to the challenge," the researchers note, "no higher authority can compel agencies to use a particular standard."

Government leadership: good, but can do better

Berner and Judge look to government for leadership in these matters.

> Designing and implementing appropriate data standards is an important mechanism through which the government can fulfill these dual roles of enhancing the efficiency of private activity and obtaining the high-quality information necessary to better serve the public at large. Standardization is essential to compare and aggregate data and can enable firms and regulators to produce more accurate and timely information about a host of issues at lower expense.

Companies can understand their customers' needs better and can manage risk more efficiently; regulators can identify trends better and assess local and systemic risks.

The researchers indicate that US federal regulatory agencies generally take a similar viewpoint. For example, since it was created in 2010 by the Dodd-Frank Act, the US Treasury Department's Office of Financial Research has advocated data standardization, including the Legal Entity Identifier. The Commodity Futures Trading Commission was quick to adopt the LEI in swap reporting following the 2008 financial crisis and is working toward further data standardization in financial instruments.

Government impetus is supported by the efforts of lobbying groups such as The Data Coalition, which promotes the benefits of standardized data across the federal government, not just in financial regulation. Passage of the Data Act (HR 4174, Foundations for Evidence-Based Policymaking Act of 2017) suggests that "even in divided government, persistence can persuade the authorities to do the right thing," according to the researchers' blog commentary. They conclude that leadership, creativity, and collegiality are crucial to keep up with the "dizzying speeds" of the financial markets. "More is needed, and we think possible. Only vision and leadership are the missing ingredients."

Equal data access for all investors

Jennifer Froberg, EDGAR Specialist at Toppan Merrill, affirmed the researchers' observations to *Dimensions:* "This paper illustrates the critical importance of extending data standards across financial regulation and markets. Standardized, high-quality data, such as XBRL-tagged financials, provides all investors with a level playing field and access to the same information."

About *Dimensions*

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