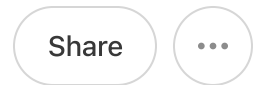


Talking Mutual Funds; Retail Investors Take Sudden Interest in SEC Activist Rule; Is Finra's Judicial System Unconstitutional?

Capitol Account: Free Weekly Version

JUL 15, 2023



There was a lot going on this week in financial regulation, especially at the SEC. The agency passed a controversial rule on money market funds, and was handed a partial defeat in its long-running legal battle with the crypto company Ripple. The digital asset industry was quick to crow, but the confusing district court ruling isn't likely to be the last word. We also revisited the SEC's push to put more limits on activist hedge funds, a policy effort that numerous retail investors are belatedly (and surprisingly) backing. Another interesting court decision caught our eye, as well. It indicates that at least some federal appellate judges in Washington have serious questions about the constitutionality of Finra's in-house court system. For our Friday interview, we spoke to the head of the primary mutual fund trade association. He's got a lot of issues with Gary Gensler's agenda.

Thanks for reading our free edition, a digest of articles we published throughout the week. Our paid newsletter had many more stories that you'd likely enjoy, including a [detailed review](#) of the new money fund rule and a look at the former Fed vice chair for supervision's surprising comments on stress tests. Click below to subscribe to our full offering.

Friday Q and A: Eric Pan, president of the Investment Company Institute, never thought he'd end up spending so much time battling the SEC. But Gensler's expansive regulatory push hits mutual funds pretty hard. Several of the regulations, the ICI argues, would fundamentally change the low-cost investment products – forcing firms to alter

the way they set share prices, accept orders from retirement plans and even name their funds.

We called up Pan this week to get his thoughts on what this all means, especially for the tens of millions of Americans who invest their savings with the industry. There was plenty to talk about, including the SEC approval this week of a new rule for money market funds. It was opposed by the two Republican commissioners.



Eric Pan

Pan joined ICI in November 2020. He's an attorney and has spent time in academia, including as a senior research fellow at the Center for Law & Economic Studies at Columbia University. Pan is also an alum of both the SEC and CFTC; he worked in their international offices. He got to know Gensler a bit when they both attended overseas regulatory meetings. Read on to learn Pan's take on the SEC chief and his huge to-do list. Outside of work, Pan seems to be a bit of a **Taylor Swift** fan. What follows is our (lightly edited and condensed) conversation.

Capitol Account: Some have been perplexed about Gensler's decision to target the mutual fund industry in so many rules. What do you think?

Eric Pan: Everybody who knew Gensler when he was on the CFTC knew that he would be coming in [to the SEC] wanting to do a lot. To your point, I think it's been very surprising – he's prioritized doing things in areas where it wasn't clear that there was a problem...He's proposed over 50 rules, maybe now past 55. If you look at everything he's

doing, there's a lot of rules where people are really scratching their heads and saying, 'Why?'

CA: ICI was opposed to a lot of dictates in the money fund rule. But not all of them.

EP: We're still analyzing what they put out, but there were some things which we completely agree with. I think these are going to be really helpful reforms. And there were other things that were added...where we're really puzzled. It wasn't clear in the proposal that [the SEC] was going to do some of the things it ended up finalizing.

CA: You're talking about the "liquidity fee," which the commission approved instead of a mandate that money funds use swing pricing during times of market stress. The SEC did mention the fee in the original proposal, and asked for comments about it. Isn't that enough?

EP: No. This is unusual...Asking a question is not the same thing as putting it in the proposal. My kids ask me questions all the time, that doesn't mean I've now given them permission to go off to Mexico and start drinking.

CA: You were aware, however, that this might be an option.

EP: There's a big gap between, 'what do you think about a fee?' versus 'here is this really complicated fee structure that [funds] now have to do.' A lot of conversations should have happened – in order to make sure that the end result was the right one. I can tell you we did not have conversations with the SEC about this. They did not seek our input.

CA: Stepping back a bit, what are money market funds and why are they important?

EP: Money market funds are used by lots of people, companies and individuals. They're a cash management tool...In the recent banking issues with Silicon Valley Bank, we've seen people use money market funds as a better place for them to keep their money.

CA: One of the reasons the SEC demanded these changes is because the Fed has been forced to backstop money funds when the markets went haywire. Gensler said he voted for the rule to stop bailouts.

EP: First, I don't agree with the term bailout because that implies that somehow there was a wealth transfer going on. Second, he's referring to what happened in March 2020... Everything was shutting down. This rescue of money market funds...came out on March 18th...March 13th is when we were sent home. The Fed was doing stuff to the markets as early as the 7th of March. So if Gensler wants to say March 2020 was all about saving money market funds, he's being very selective in his memory.

CA: The SEC meeting this week was pretty contentious.

EP: From my experience working at the SEC, every chair I've worked with, Republican and Democrat, attempts to build consensus. They want to get a 5-0 [vote]. Here we have a case of a 3-2 vote, with two [commissioners] expressing really, really serious concerns. That's unusual, and definitely I think, a break from past practice.

CA: Gensler has been asked about the need for some of this extra regulation and he's said that mutual funds can pose a risk to financial stability. Do you agree?

EP: He is echoing the talking points of the central bank community – talking points that have been developed since 2016. And are being stated by **Nellie Liang**, being stated by **Lael Brainard** and by **Janet Yellen**...They've identified a problem which they have developed through an echo chamber, and now we're going to make policy based upon it. At no point did anyone say, 'whoa, wait, a minute here, is this actually true?'

CA: Speaking of financial stability, we recently had a mini banking crisis. But bank regulators are pointing the finger at mutual funds?

EP: There are a lot of other issues in the financial system – liquidity at the Treasury market, for example. What happened with Silicon Valley Bank. What happened with Credit Suisse. We have all these real life problems. Why is the number one agenda item mutual funds? It doesn't make sense...(Friday)

Follow us on Twitter [@CapitolAccount](#) and on LinkedIn by clicking [here](#). We're always looking for stories, so if you have any suggestions on what we should cover (or comments about Capitol Account), shoot us a note. Jesse can be reached at: jwestbrook@capitolaccountdc.com, Rob at:

rschmidt@capitolaccountdc.com and Jessica at: jholzer@capitolaccountdc.com. If somebody forwarded this to you and you'd like to subscribe, hit the button below. Please email for our special rates for government employees and academics, and group discounts for businesses: subscriptions@capitolaccountdc.com.

Surprising New Opponents: The SEC's efforts to rein in activist investing has set off a bitter fight among powerful interests. Corporations that have long called for reforms to limit the ability of outsiders to meddle in their business decisions are strongly backing the regulator. On the other side are the hedge funds that quietly build up stakes in companies before going public with demands for board seats and changes in strategy. To many firms, the agency's push is existential – it could be a death knell for their business model.

One constituency has mainly stayed out of the fray: small investors. That, however, has changed dramatically in recent weeks as a flood of letters praising a proposal to speed up activist funds' public disclosures have landed at the SEC. While the outpouring has taken both the corporate supporters and hedge fund activists by surprise, it doesn't take much sleuthing to find the cause.

Much of the feedback (some 350 letters and counting) is stamped with the moniker We the Investors – an online advocacy organization that is better known for flexing its muscles in another contentious SEC battle, the market structure overhaul. The group has championed much of Gensler's plan, bolstering him against a sustained lobbying campaign by powerful Wall Street interests.

The move to weigh in on the activist rules brings We the Investors into the midst of another contentious debate. It also puts a spotlight on **Dave Lauer**, who founded the group after the 2021 meme stock frenzy. Despite being new to the Washington influence game, Lauer has made some important friends, including Gensler. The SEC chief has appeared at two We the Investors events.



Dave Lauer

Lauer's outspoken support of the market rules has also garnered him a fair share of critics in finance. Still, that hasn't deterred the former quant trader from urging his army of 150,000 Twitter followers, many with an interest in financial policy, to get more involved with SEC rules.

The story of We the Investors' entree into the activist wars, however, isn't simply happenstance. For one thing, Lauer jumped in late – only after the re-opening of the rulemaking in late April (the regulation was initially proposed in early 2022).

Among those who encouraged him to get involved was the office of a Democratic senator, who's long been demanding tougher regulation for activist hedge funds. Also notable, the group's form letter, now swelling the SEC comment file, has language that has been used almost verbatim by the Society for Corporate Governance, a pro-business group that has lobbied the SEC to tighten activist rules.

In an interview, Lauer says he's a strong supporter of the SEC's disclosure proposal, which calls for funds to report in five days (down from 10) when they own a 5 percent stake in a company. The rule, he notes, is designed to make markets more transparent and fair – a key tenet of We the Investors.

Activist funds, Lauer explains, are sitting on market moving information, and once their campaigns are disclosed, stock prices of the companies they target almost always go up. The longer the hedge funds can keep that information secret, the more they benefit – and the more his members lose.

“This proposal speaks to our core principals,” Lauer says. “The SEC’s economic analysis showed that retail investors are being disadvantaged by this.”

Lauer says he was motivated to focus on the issue partly because he was contacted by the office of Democratic Sen. **Tammy Baldwin**. The vocal critic of activists has been pushing Gensler to finish the rule for months, even bringing it up at a May meeting with the chair.

“A few people have reached out, just to turn us on to the issue,” Lauer notes. “Their view was that this is something that retail investors should care about. People are seeing the power of informed retail investors.”...(Thursday)

In-house Courts: A little-noticed order by the federal appeals court in Washington last week could have profound consequences for Finra’s policing efforts. The decision granted a brokerage firm’s emergency request to halt an enforcement action. But it has caused a stir among securities lawyers because it calls into question the constitutionality of the self-regulator’s entire adjudication system. And, depending on how the matter is ultimately decided, some think it could have even bigger implications.

The case involves Alpine Securities, a firm that a Finra hearing panel in 2022 kicked out of the industry and demanded it pay \$2.3 million in restitution to customers. Alpine’s litany of alleged wrongdoing included misusing client funds and securities, engaging in unauthorized trading and charging excess fees. As part of the ongoing legal battle, the firm sued to block its expulsion, arguing that Finra’s judicial officers are exercising government authority – thus, they should be appointed by the president (or a subordinate like an agency head) under the Appointments Clause of the Constitution.

“There is a serious argument that Finra hearing officers exercise significant executive power. And it is undisputed that they do not act under the president,” Judge **Justin**

Walker wrote in a lengthy concurrence to the order. “That may be a constitutional problem.”



Getty Images

The court’s injunction, granted 2-1, isn’t a ruling on Alpine’s constitutional claims – that will come later. Still, such orders are highly unusual and they indicate that the panel thinks there is a likelihood that the brokerage firm will win its case. “The fact that the court was persuaded enough to issue its ruling should give Finra pause,” says **Mike Piazza**, a former SEC trial attorney who is now a partner at the Ford O’Brien Landy law firm. “People should definitely not discount this decision.”

A lawyer for Alpine didn’t return a call seeking comment. A Finra spokesman said the self-regulator “is reviewing the decision and considering its options.”

While the case is far from being decided, attorneys say, it could pose some big – and thorny – questions. If Finra’s judicial system is found unconstitutional, does that unravel all the decisions its hearing officers have made? And is there an easy way to fix the system so that it complies with the law?

More broadly, some argue that depending on how the court looks at the issue, the entire system of self regulation could be imperiled — or look a lot different. Finra is a front-line regulator for brokers, run by industry members. But it enforces rules approved by its

federal overseer, the SEC. Is that really different than being a government agency? If its hearing officers are declared unconstitutional, would Finra's other employees, like examiners or enforcement lawyers, need to be installed under the Appointments Clause?

Cases against agency power have been percolating up through the courts, part of a movement among conservatives to challenge the administrative state. That's a subject, too, that the Supreme Court has seemed eager to address.

"We think this is a very important case for the brokerage industry to watch because it raises serious questions about the constitutionality of the entire self-regulatory apparatus under the Appointments Clause," says **Chris Iacovella**, president of the American Securities Association.

The SEC has been on the losing end of legal challenges to its own in-house court system. In 2018, the high court ruled that the agency's administrative law judges were improperly appointed – a case that Walker cited in the Finra order. Earlier this year, the agency took another hit when the high court gave defendants in SEC administrative proceedings a path to challenge them in federal court. And the justices recently agreed to hear another case next term that raises other constitutional questions about the process.

In the meantime, the D.C. Circuit Alpine ruling may sow some chaos even before the full case is decided. It is likely to spur similar suits, lawyers note, especially by firms that are facing big fines or at risk of getting kicked out of the industry. "This may well generate other cases," Piazza says. "If you are dealing with Finra enforcement and they're trying to give you the death penalty, what do you have to lose?"...(Wednesday)

It's always a good time to subscribe to *Capitol Account* — and get news like this every weekday.

© 2023 Capitol Account · [Privacy](#) · [Terms](#) · [Collection notice](#)
[Substack](#) is the home for great writing