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Investor Advocate Rebukes SEC, Calls for Rule Reversals and Legislation

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The US Securities and Exchange Commission (SEC) Investor Advocate¹ rebukes the SEC² for rulemaking actions and omissions and recommends that certain rules be overturned or reversed by new SEC leadership or Congress in his report³ to Congress for the year 2020 (Report).

He claims that the SEC violated the Securities Exchange Act of 1934 (Exchange Act), stating that “rulemaking was adopted in contravention of the Commission’s internal policies for full and objective economic analysis, Exchange Act Section 4(g)(5), and, at the very least, the spirit of the Administrative Procedure Act.”⁴

The Report has some scattered praise for the SEC, but, in the main:

- Finds that “the rulemaking agenda of the SEC was often disappointing for investor advocates” and, while “characterized as efforts to ‘modernize’ or ‘streamline’ regulations, they often had the effect of diminishing investor protections”;⁵
- Opposes certain SEC rulemaking as “flawed”⁶ and “troubling”⁷ and calls for certain rules to be “reversed” by Congress or “new leadership of the Commission”;⁸
- Claims that the basis for certain SEC rulemaking is “fundamentally flawed”⁹ and “inadequate”¹⁰ and that the SEC has “withheld” information from the public and the Investor Advocate for periods of time in “contravention

of the Commission’s internal policies”¹¹ and the Exchange Act;

- Complains that the SEC has failed to address “several modernizations sought by investors”¹² and identifies “near-term priorities that require legislative action or Commission rulemaking”;¹³ and
- Points out that the SEC and its Chairman can “impede [the Investor Advocate’s] ability to conduct independent research” and calls for legislation providing “enhanced protection of [the Investor Advocate’s] independence” from the SEC that is “necessary to safeguard our long-term mission to engage in evidence-based advocacy for the benefit of investors.”¹⁴

At the same time, the Report praises the SEC for other actions. Most prominently, the Investor Advocate “commend[s] the Commission for its response to the challenges of the pandemic.”¹⁵ He explains that the “Staff and leadership of the Commission reacted quickly to changing dynamics, and they demonstrated remarkable commitment and flexibility.”¹⁶ His assessment is that SEC action “alleviated many of the strains in the financial system that could have had devastating consequences for investors.”¹⁷

The Investor Advocate also praises the SEC for certain rulemaking. For example, he “recognize[s] the hard work the Commission and its [S]taff dedicated

to the Derivatives Rule, and . . . believe[s] that many aspects of the rule help modernize the regulation of funds' use of derivatives."¹⁸

The Report

The Investor Advocate, Rick Fleming, submitted his 88-page Report¹⁹ on December 29, 2020, to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives (House).²⁰

The Report addresses the activities of the Commission as chaired by Jay Clayton, an independent,²¹ and having two Republican Commissioners. The Report, submitted after the election of Joe Biden as President, anticipates the appointment of a Democratic chairman and a majority of Democratic Commissioners. It recommends²² that "Congress or *new leadership* of the Commission review this rule-making and reverse course."²³ In another instance, the Report identifies²⁴ "priorities that require legislative action or Commission rulemaking."²⁵ So, the Report could influence the Commission's agenda going forward.

The Investor Advocate enjoys important independence from the SEC in submitting his reports. Congress has required that his reports "be provided directly to the Committees . . . without any prior review or comment from the Commission, any Commissioner, any other officer or employee of the Commission, or the Office of Management and Budget."²⁶

The principal concerns of the Investor Advocate as they relate to investment management are set out below.

Shareholder Proposals

The Investor Advocate opposes Commission amendments²⁷ to Rule 14a-8 under the Exchange Act on both policy and procedural grounds.

The amendments raise ownership levels for investors to surpass for eligibility to submit a proposal for shareholder vote, add requirements for documentation from investors submitting proposals, impose

requirements on investors to specify when they can meet with management to discuss proposals, limit investors to one proposal per shareholder meeting, and raise the level of shareholder support that proposals must receive for eligibility for resubmission.

The Investor Advocate opposes the amendments on the "policy" ground that the amendments "significantly diminish the ability of shareholders with smaller investments to submit proposals."²⁸ He bases his opposition on the SEC's "comment file," which is "replete with evidence demonstrating that shareholders with smaller investments have played an important role in the shareholder-proposal process."²⁹

The Investor Advocate also opposes the amendments on the procedural ground that "the economic analysis in this rulemaking was fundamentally flawed."³⁰ He finds it "troubling" that the Commission "[a]stonishingly" limited its analysis to the effect of the amendments on just shareholders who "actually submitted shareholder proposals in 2018," while going "in the opposite direction" and counting "all companies that could potentially have received a proposal in 2018."³¹

In addition, he points to a "Staff analysis" estimating that "somewhere between half to three-quarters of the retail investor accounts that were eligible under the then-existing thresholds would lose eligibility to submit shareholder proposals."³² He complains that "the Staff analysis was withheld from public view" and "placed in the public comment file . . . six months after the deadline for public comments had expired."³³ He notes that "the SEC -- an agency that prides itself on its commitment to transparency -- issued no press release, no official statement, nor so much as a tweet to draw the public's attention to this new information."³⁴

Still further, the Investor Advocate accuses the Commission of withholding the Staff study from him "for more than nine months."³⁵ He claims that he "repeatedly requested copies of [the Staff's] written analysis to no avail."³⁶ He states that the Commission's conduct was "in contravention of . . . Exchange Act Section 4(g)(5)" that "directs the

Commission to ensure that the Investor Advocate has ‘full access’ to the documents of the Commission as necessary to carry out the functions of the Office.”³⁷

The Report concludes that “this particular rulemaking was adopted in contravention of the Commission’s internal policies for full and objective economic analysis, Exchange Act Section 4(g)(5), and, at the very least, the spirit of the Administrative Procedure Act.”³⁸ The Report calls for the rules to be “overturned or reversed.”³⁹

Proxy Advisory Firms

The Investor Advocate opposes amendments⁴⁰ to the proxy rules under the Exchange Act imposing requirements on proxy advisory firms on both policy and procedural grounds.

The amendments, among other things, require proxy advisory firms to provide enhanced disclosures regarding conflicts of interest, establish a mechanism by which a company that is the subject of advice may view the advice before dissemination, and establish a mechanism by which a client can reasonably be expected to become aware of a company’s additional soliciting material responding to the advice before voting.

As to policy concerns, the Report states the belief that “investors should be free to seek the services of a third party to provide independent, objective advice about voting their shares.”⁴¹ The Investor Advocate tells Congress that “investors should not be forced to pay for feedback mechanisms that subject them to further lobbying by corporate management.”⁴² He worries that “the newly mandated feedback mechanism enables undue interference in the voting process and will likely result in the suppression of dissenting views.”⁴³

The Report calls attention to “several troublesome [procedural] aspects of this rulemaking.”⁴⁴ These aspects relate to the Commission’s “implicit . . . finding that the existing system lacked ‘reliability and completeness.’”⁴⁵ The Investor Advocate claims that the finding “rested

on acceptance at face value of the claims of select market participants that proxy voting advice historically had not been transparent, accurate, and complex.”⁴⁶ He advises Congress that the “Commission did not evaluate the substance of these claims or distinguish biased opinion from fact, and these claims remain unsupported by empirical evidence.”⁴⁷

The Report “recommend[s] that Congress or new leadership of the Commission review this rule-making and reverse course.”⁴⁸

Derivatives Rule

The Investor Advocate finds both positive and negative aspects of the rule adopted⁴⁹ under the Investment Company Act of 1940 regulating derivatives. Essentially, the rule established “an outer limit on fund leverage based on value at risk”⁵⁰ (VaR).

On the positive side, the Report states that “many aspects of the rule help modernize the regulation of funds’ use of derivatives.”⁵¹ At the same time, the Investor Advocate is “deeply concerned that investor protection measures were significantly weakened—and in certain instances, entirely removed—from the rule as it progressed from proposal to adoption.”⁵²

The Investor Advocate quotes a dissenting⁵³ Commissioner’s statement that proposed limits “have now been converted to outer bounds calibrated specifically to ensure that they will have no impact on funds’ existing practices.”⁵⁴ Moreover, the dissenting Commissioner noted that “instead of a designated reference index,” the final rule “permits a fund to compare its risk to its own securities portfolio for purposes of the VaR test,” so that “a fund can simply change its own derivative risk limits by making changes in its non-derivatives portfolio”⁵⁵ Finally, the Investor Advocate points out that the final rule “does not require broker-dealers and investment advisers to exercise due diligence before approving retail investor accounts to invest in leveraged/inverse investment vehicles.”⁵⁶

The Report recommends “rescinding the Derivatives Rule,” and reconsidering the rule as proposed in order to provide “sensible protections of Main Street investors.”⁵⁷

ESG Disclosure Standards

The Investor Advocate finds fault with the Commission’s failure to adopt rules in certain areas, such as disclosure of environmental, social, and governance⁵⁸ (ESG) matters.

He agrees “with the many investors who assert that the principles-based disclosure requirements have failed to deliver important, decision-useful information.”⁵⁹ He cites two problems with continuing to rely on the traditional materiality text for ESG disclosure.

First, he advises Congress that the “information provided by companies tends to vary in quality, and it is not presented in a standard format that enables comparisons between companies.”⁶⁰

Second, he expresses concern about the practice of “greenwashing,” which is “the practice of making misleading claims regarding companies’ or funds’ ESG credentials in order to draw the interest of investors who place value in ESG matters.”⁶¹ He explains that “general, principles-based disclosures make it difficult to determine whether a company or fund is following its stated objectives” and “[i]n the absence of specific and comparable disclosures, even experienced investors and large financial institutions may struggle to discern meaningful differences in the practice of companies and funds.”⁶²

He tells Congress that he “would welcome legislative and budgetary support for the [disclosure] initiative.”⁶³

Investor Advocate Office

The Investor Advocate calls for “enhanced protection of our independence”⁶⁴ from the Commission. His belief is that “structural improvements are necessary to safeguard our long-term

mission to engage in evidence-based advocacy for the benefit of investors.”⁶⁵

He explained that the three factors described below can “impede [the Investor Advocate’s] ability to conduct independent research.”⁶⁶

First, the SEC Chairman’s office “controls the [Investor Advocate’s] budget,” including his “research function.”⁶⁷ The Investor Advocate risks “disfavor whenever we produce results that run counter to any of the Chairman’s preferred policy goals.”⁶⁸ So, the Investor Advocate requests legislation providing him “a specific budgetary authorization”—what the Investor Advocate calls a “ring-fenced budget.”⁶⁹

Moreover, the “data” that the Investor Advocate collects “is deemed to be the property of the SEC.”⁷⁰ The Investor Advocate’s experience has been that “[t]he Commission is reluctant to approve the release of the underlying data unless we first show them our analysis of that data,” and the Commission can “block the publication of research that may run counter to the Commission’s regulatory preferences.”⁷¹ So, the Investor Advocate requests “legislation that would grant the Investor Advocate the authority to release publicly the data we collect.”⁷²

Finally, the Securities Act of 1933 authorizes the Commission, but not the Investor Advocate, to “make a finding that investor testing and investor research are in the public interest.”⁷³ Such a finding is required for “obtaining an exception from the requirements of the Paperwork Reduction Act.”⁷⁴ This situation “gives the Commission the ability to veto certain [Investor Advocate] research projects at the outset.”⁷⁵ So, the Investor Advocate requests “legislation that gives the Investor Advocate the authority to make a finding that investor testing and investor research are in the public interest.”⁷⁶

The Investor Advocate insists that its call for “enhanced protection of our independence is in no way a reflection upon the incoming administration.”⁷⁷ Indeed, the Investor Advocate is “hopeful that new leadership of the Commission will support our efforts to conduct rigorous investor research.”⁷⁸

Conclusion

The Investor Advocate, as required by the Exchange Act, reported to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services proposed legislative and administrative changes and recommendations for administrative and legislative actions.

The author found nothing on the Website of either Committee that acknowledged receipt of the Investor Advocate's Report or announced any action in response to the Report. The author's email follow-up inquiry to the Chairman of the Senate Committee received no response.

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NOTES

¹ Congress established the Office of Investor Advocate within the SEC and required appointment of an Investor Advocate to lead the new office. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203 (July 21, 2010) (Dodd-Frank Act), Section 915 which became Section 4(g) of the Securities and Exchange Act of 1934. This article cites to Section 4(g) of that Act rather than to Section 915 of the Dodd-Frank Act. The SEC, pursuant to Section 4(g)(1), appointed Rick Fleming as the first Investor Advocate. Press Release, SEC, "SEC Names Rick Fleming as Investor

Advocate" (Feb. 12, 2014), available at <https://www.sec.gov/news/press-release/2014-27>. The almost three-and-a-half-year delay in the SEC's appointment of the Investor Advocate was due, at least in part, to the lack of required "reprogramming approval from the Committees on Appropriations of the House of Representatives and the Senate." See Letter from Mary L. Shapiro, SEC Chairman, to blacked out addressee (June 30, 2011), available at <https://www.sec.gov/spotlight/dodd-frank/investoradvocateletter063011.pdf>. Rick Fleming continues to serve as Investor Advocate.

² This article uses the Report's terminology, referring to the agency as a whole as the "US Securities and Exchange Commission" or "SEC," the five Commissioners as the "Commission," the SEC personnel as the "Staff," then Chairman Jay Clayton and his Republican majority Commissioners as "Commission leadership," and President Joe Biden's appointed Chairman and his Democrat majority Commissioners as "new leadership of the Commission."

³ Office of the Investor Advocate, US Securities and Exchange Commission, Report on Activities Fiscal Year 2020 at 3 [hereinafter Report], available at <https://www.sec.gov/files/sec-investor-advocate-report-on-activities-2020.pdf>. The Report identified "recent Commission rulemakings that, in our opinion, should be *overturned* under the Congressional Review Act or *reversed* by new leadership of the Commission." *Id.* at 3 (emphasis added). A footnote cites the "Congressional Review Act, 5 U.S.C. §801(b), providing for Congressional disapproval of rules and regulations by joint resolution." *Id.* at 72, n.7. For statutory requirements regarding the Report, see *infra* notes 20, 22, and 24.

⁴ *Id.* at 4. For information regarding the Commission's alleged violation of Section 4(g)(5) of the Exchange Act, see *infra* notes 35 through 37 and accompanying text.

⁵ *Id.* at 1.

⁶ *Id.* at 4.

⁷ *Id.* at 2.

8 *Id.* at 3.

9 *Id.*

10 *Id.* at 6.

11 *Id.* at 4.

12 *Id.* at 1.

13 *Id.* at 2.

14 *Id.* at 14.

15 *Id.* at 1.

16 *Id.*

17 *Id.*

18 *Id.* at 8.

19 This article does not cover the entire Report and, instead, focuses on certain Commission rulemaking.

20 Section 4(g)(6)(B)(i) of the Exchange Act provides that, not later than December 31 of each year, the Investor Advocate shall submit to the Committees “a report on the activities of the Investor Advocate during the immediately preceding fiscal year.” By way of supplemental information, Section 4(g)(6)(A)(i) of the Exchange Act provides that not later than June 30 of each year, the Investor Advocate shall submit to the Committees “a report on the objectives of the Investor Advocate for the following fiscal year.”

21 See Jay Clayton (attorney), Wikipedia (Political party Independent), available at <https://www.google.com/search?q=jay+clayton+wikipedia&oeq=jay+clayton+wikipedia&aqs=chrome..69i57.7414j1j7&sourceid=chrome&ie=UTF-8>.

22 Section 4(g)(6)(B)(ii)(V) of the Exchange Act requires the Investor Advocate’s report to contain “[r]ecommendations for such administrative and legislative actions as may be appropriate to resolve problems encountered by investors,” and Section 4(g)(4)(E) requires the Investor Advocate to “propose to the Commission changes in the regulations or orders of the Commission and to Congress any legislative, administrative, or personnel changes that may be appropriate to mitigate problems identified . . . and to promote the interests of investors.”

23 Report, *supra* n.3, at 6 (emphasis added).

24 Section 4(g)(4)(C) requires the Investor Advocate to “[i]dentify problems that investors have with financial service providers and investment products.”

25 Report, *supra* n.3, at 2.

26 Section 4(g)(6)(B)(iii) of the Exchange Act.

27 See *Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8*, Exchange Act Release No. 89964 (Nov. 4, 2020) (adopting release), available at <https://www.federalregister.gov/documents/2020/11/04/2020-21580/procedural-requirements-and-resubmission-thresholds-under-exchange-act-rule-14a-8>.

28 Report, *supra* n.3, at 3.

29 *Id.* (footnote omitted).

30 *Id.*

31 *Id.* at 4 (footnote omitted).

32 *Id.* (footnote omitted).

33 *Id.*

34 *Id.*

35 *Id.*

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.* at 3.

40 *Exemptions from the Proxy Rules for Proxy Voting Advice*, Exchange Act Release No. 89372 (Sept. 3, 2020), available at <https://www.sec.gov/rules/final/2020/34-89372.pdf>.

41 Report, *supra* n.3, at 5.

42 *Id.*

43 *Id.* (footnote omitted).

44 *Id.*

45 *Id.*

46 *Id.* (footnote omitted).

47 *Id.*

48 *Id.* at 6.

49 *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Investment Company Act Release No. 34084 (Oct. 28, 2020), available at <https://www.sec.gov/rules/final/2020/ic-34084.pdf>.

50 Report, *supra* n.3 at 8.

51 *Id.*

52 *Id.*

53 The Report notes that two Commissioners had voiced “forceful dissents,” *id.* at 7, footnote omitted,

to adoption of the rule, which was “along strict partisan lines,” *id.* at 8.

⁵⁴ *Id.* (footnote omitted).

⁵⁵ *Id.* (footnote omitted).

⁵⁶ *Id.* (footnote omitted).

⁵⁷ *Id.*

⁵⁸ Environmental, Social and Governance, or ESG, factors have increasingly figured into asset management and investment. “References to ‘ESG’ principles doubled last quarter and a full 35 percent of S&P constituents talked about injustice and equality on their earnings call.” Scott Martin, “ESG Takes Over Wall Street: But What Do Those Letters Mean?,” *Wealth Advisor* (Sept. 22, 2020), available at *thewealthadvisor.com*. For a comprehensive discussion of the substantive ESG issues raised, see Jennifer L. Klass, Amy J. Greer, and Jonathan E. Hoffman, “ESG Investing Faces Changing Regulatory Landscape,” *The Investment Lawyer*, Vol. 28, No. 3 at p.7 (Mar., 2021).

⁵⁹ Report, *supra* n.3, at 9.

⁶⁰ *Id.* (footnote omitted).

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.* at 14.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

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