# The Importance of the SEC's Rulemaking Agenda — You Are What You Prioritize:
# Remarks at the 47th Annual Securities Regulation Seminar of the Los Angeles County Bar Association


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Thank you, John [Hartigan], for that kind introduction. I am honored to be a part of this venerable conference, which is one of the longest-running of its kind, spanning 47 of the 80 years that the SEC has been in existence. The Los Angeles County Bar Association has always been a leader in addressing the legal and policy issues that impact our capital markets, and I am pleased to be able to join you today to continue that tradition.

I always look forward to my trips to the West Coast, in large part because they give me the opportunity to visit our regional offices here that are so programmatically important to the agency. Earlier this week, I visited with our dedicated staff both here in Los Angeles and up the coast in San Francisco, and I am proud to report that the SEC's California regional offices are firing on all cylinders and performing at the top of their game.

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I am going to speak to you this afternoon about the Commission's agenda — not only the current agenda, but also our agenda over the past several years. After all, what we did or didn't do in the recent past has a tremendous effect on our current — and future — agenda.

Never in the Commission's history has it been so important to be at the top of our game. In many ways, however, never before have we been so hampered and distracted by external factors. The incredible burden imposed on the Commission by Congress through the Dodd-Frank Act[1] has handcuffed and politicized what is supposed to be — indeed, must be — an independent agency. The Commission is at a precipice, teetering on the edge of irrelevancy as we devote a wildly disproportionate amount of resources to implementing an agenda that is no less political than other, more widely discussed pieces of single party legislation. The Affordable Care Act[2] may get more attention, but Dodd-Frank is just as radical, passed in a similarly hasty, sloppy process motivated by the desire not to allow "a serious crisis to go to waste."[3]

Since the passage of Dodd-Frank in July 2010, the agency has lost its way, as well as a significant part of its independence. The never-ending effort to appease the "Dodd-Frank coalition" of politicians and special interest groups has caused the Commission to veer towards the political whims of the day and away from its core, tri-partite mission of protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets. Meanwhile, other regulators, particularly the prudential regulators, have unleashed a torrent of rules that hugely impact the markets overseen by the SEC. As I noted in a speech last week, the move to impose prudential regulation on our capital markets, in particular by applying a one-size-fits-all approach to capital requirements, is nothing short of an existential threat to those markets — and to the SEC itself.[4]

Dodd-Frank is no ordinary piece of legislation. It is a 2,319 page Frankenstein's monster, cobbled together out of a hodgepodge of provisions advanced by special interests, very few of which have any nexus with the actual causes of the financial crisis or the SEC's core mission. It was natural and expected that Congress would respond to the tragic financial crisis of 2007-2009, just as it did in response to the 1929 stock market crash. However, unlike its measured response to the 1929 crash, Congress rushed to judgment in responding to the recent financial crisis, passing Dodd-Frank even before its own commissioned report on the causes of the crisis was finished.[5] Just as Dr. Frankenstein implanted the "abnormal" brain into his monster, the animating principles of Dodd-Frank are based on abnormal narratives — that is, narratives that bear no relation to the actual causes of the financial crisis. And the resulting monster — which in honor of Halloween I will call "Dodd-Frankenstein" — has been unleashed for years, wreaking havoc on the country and its financial markets.

Policymakers who played a role in the irrational exuberance of the housing markets in the years leading up to the financial crisis understandably were not interested in revisiting and shining a light on their pre-crisis actions when they drafted the legislative response to the crisis. Accordingly, Dodd-Frank was built on a narrative of Wall Street greed and regulatory failures. While these two factors certainly played a role in the crisis, they were not fundamental, underlying causes of the crisis so much as symptoms of a much larger illness — failed federal housing policy.

Once it was clear that Dodd-Frank would be a single party, runaway train of legislation, it became a convenient vehicle for every orphaned wish list item of policymakers and special interest groups. Take, for example, the sociopolitical conflict minerals and extractive resources mandates the SEC spent the better part of two years implementing between 2010 and 2012.[6] While the elimination of gang violence in the Congo is a laudable goal, I am one hundred percent sure that a lack of corporate disclosures about humanitarian issues did not bring down Lehman Brothers or AIG. Funny, though, that the words "Fannie" and "Freddie" don't feature in Dodd-Frank, yet these two taxpayer-owned Zombie banks continue to be the nerve center of the U.S. housing markets. Not so funny is the fact that these sociopolitical mandates have done far more harm than good to the people they were meant to protect, causing at least a million subsistence miners to lose their jobs.[7]

Dozens of SEC staff members spent thousands of hours working on these two rules alone, which our economists estimated would cost issuers an astonishing $4 billion — that's right, billion.[8] All too predictably, this colossal waste of the Commission's resources resulted in two severely flawed rules that were challenged and fully or partially vacated by the federal courts,[9] and which continue to drain precious Commission resources. Unfortunately, the portion of the conflict minerals rule that did take effect cost issuers an astonishing $700 million in the first year alone.[10]

While I often point to conflict minerals and extractive resources as Exhibits 1 & 2 of the Commission's misguided rulemaking agenda, they are just the tip of the iceberg. Take, for example, the Commission's rush to pass the proxy access rule just weeks after Dodd-Frank was enacted.[11] While the ruins of the financial crisis were still smoldering, a majority of the Commission thought it was a good idea to prioritize a longtime wish list item of unions and other special interests that lacked any connection whatsoever to the turmoil that brought down the financial markets. And let's not forget about the time and resources the agency wasted on the Volcker Rule, despite the fact that the rule's namesake as well as the then-Secretary of the Treasury who presided over the creation of Dodd-Frank both publicly stated that proprietary trading had nothing to do with the financial crisis.[12] The Commission created an entirely new regulatory regime for municipal securities advisors and rushed to push out rules under Title IV of Dodd-Frank to regulate hedge funds, despite the lack of any evidence that either group contributed to the crisis. And, maddeningly, earlier this week a majority of the Commission, together with other federal agencies, passed an utterly impotent Dodd-Frank mandated rule on credit risk retention that codifies the worst features of the failed federal housing policy that led to the crisis.[13]

I often tell people that the SEC won the Dodd-Frank "booby prize," and we are still paying the price over four years later. The Act was packed with roughly 400 mandated rulemakings and studies for the federal regulatory agencies, with approximately 100 assigned to the SEC — far and away the most of any of the

agencies involved. Rather than tending our regulatory garden, so to speak, by focusing on policy issues that are core to our mission, the Commission has spent much, if not most, of its time and resources for nearly half a decade shoveling manure, in some cases for no discernable purpose whatsoever. Even after all this effort, of the 100 rulemakings mandated to the SEC by Dodd-Frank, we still have more than half left to finalize.[14]

Notwithstanding my outspoken criticism, I recognize that Dodd-Frank is the law of the land and that the Commission must implement it. However, we cannot allow it to get a stranglehold on our agenda at the expense of the Commission and its staff doing our "day jobs". As I stated in a speech last year,[15] it is absolutely critical that we apply a reasoned framework in deciding which of the remaining Commission Dodd-Frank mandates to prioritize. After all, *one* of the hundred mandates has to be the last one implemented. Sadly, no such framework has been applied during my tenure as a Commissioner.

To be fair, there have been some flashes of hope showing that the agency still has a rudder, most notably in the form of non-Dodd Frank mandated initiatives. Examples include such projects as Staff Legal Bulletin 20, issued to provide guidance on the use of proxy advisors;[16] last year's release of FAQs on the supervisory liability of compliance and legal personnel;[17] and the Commission's critically important Consolidated Audit Trail rulemaking.[18] In addition, I'm hopeful that notwithstanding recent media speculation of delay and discord, we'll be able to complete a rational Regulation SCI final rule in the near future. At a more macro level, the entire Commission has expressed an interest in a holistic review of equity market structure — an idea I have advocated throughout my tenure[19] — which I hope will start soon. I am also encouraged by the initiative undertaken by Keith Higgins and the Division of Corporation Finance to comprehensively review corporate disclosure.[20]

But what other initiatives ought to be at the top of the SEC's agenda? What issues should the Commission be prioritizing, both now and over the long term? Let me outline for you a few of the items that I consider "mission critical" for the agency.

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Topping the list of issues in need of our immediate attention are the fixed income markets. Over the past six months, since the release of a certain book, the impact of high frequency trading on our equity markets has been the topic *du jour*. However, as I have stated before, if we are setting our regulatory agenda based on Michael Lewis books, we need to address *Liar's Poker* before *Flash Boys*. Twenty-five years after the publication of the former, our fixed income markets are shockingly similar to — and include many elements unchanged from — those described by Lewis in 1989.

There are two things about the debt markets that should concern us all. The first is the heavy exposure of retail investors to products and trading practices that are little understood by and all too opaque to the average investor. Including asset backed securities, there is approximately $11.3 trillion of debt outstanding in the corporate bond markets.[21] Approximately 45% of that is held by retail customers, and nearly a quarter of that is held directly. Retail participation is even more pronounced in the municipal debt markets, where nearly 75% of the $3.7 trillion in outstanding debt is held by retail investors. It should be a wakeup call to us all that such a staggering percentage of our fixed income markets rests in the hands of ordinary investors who often do not understand the product they hold or the accompanying risks, including the devastating effect an inevitable interest rate hike could have on their investment.

Which brings me to my second major concern — the clear and present danger of a liquidity cliff in the debt markets. Over the past few years, these markets have witnessed historic growth due to a zero percent interest rate environment. While investors have been flocking to bonds at a record pace, dealer inventories have shrunk by nearly 75% since 2008 as financial institutions have been forced to deleverage in the wake of Basel III, the Volcker Rule, and other constraints introduced by prudential regulators ostensibly in response to the crisis.[22] This has set the stage for a potentially dire liquidity crisis. When interest rates rise — which the Fed has indicated could happen as early as next summer[23] — outflows from high yielding and less liquid debt could drive bond prices down. Which raises the question of the hour — where is the necessary liquidity going to come from?

As the primary regulator of the non-government fixed income markets, the SEC needs to champion the tough reforms that are needed to modernize the fixed income markets. First and foremost, we need to bring transparency to the markets for retail investors by requiring bond traders to disclose markups to customers of "riskless principal" trades, most of which are really just agency transactions in sheep's clothing. We also need to ensure that there are no regulatory impediments to the development of electronic fixed income trading platforms, and we should work to reduce the number of bespoke bond offerings in favor of encouraging more standardized offerings if that would result in more liquidity. I recently came across a statistic that was shocking to me — General Electric has over 900 bond issuances, but fewer than 50 of them trade on a regular basis.[24] The SEC needs to take steps to facilitate bond market liquidity, ideally by working with the industry and investors to create workable, market-based solutions. The last thing we need is a Dodd-Frank Title VII-like regime in which an equity market structure is overlaid on a market that operates in a fundamentally different manner.

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Another critically important area that we need to address is capital formation for small businesses. In early 2012, Congress passed with overwhelming bipartisan support an incredibly impactful piece of legislation — the JOBS Act.[25] The JOBS Act was all about capital formation and job growth for Main Street, not Wall Street.

Just imagine if Bill Gates had decided to sell his fledgling technology company to a competitor in the late 1970s rather than allowing it to grow and become a public company through the IPO process. Many growing businesses have consciously avoided the IPO markets over the past decade because of the burdensome regulatory baggage that accompanies the offering regime. Instead, they've taken the far simpler option of selling their business outright to a larger entity, or they simply stayed private and never gained access to the capital they needed to take their business to the next level. If Bill Gates had faced such a mountain of impediments to publicly listing his company, he may very well have sold out early too, and the innovation and jobs spawned by an independent Microsoft never would have happened. As the primary regulator of the capital markets, the SEC has a duty — indeed, a defined mission — to facilitate capital formation for small businesses. The JOBS Act reminded us of that duty by streamlining the IPO process for emerging growth companies, eliminating the ban on general solicitation for private offerings, creating a crowdfunding capital formation regime, and mandating that the SEC modernize Regulation A.

We have made some progress, finalizing a rule on general solicitation and issuing a proposed rule on crowdfunding. I am committed to finalizing our rulemaking on crowdfunding in a workable fashion. If that isn't possible under the JOBS Act as enacted, then the Commission should be loudly telling Congress that we need a legislative fix, and that we need it now.

We took a big step forward by issuing proposed rules to amend Regulation A in December of last year, but we have to finish the job as soon as possible. Regulation A+, as our proposed rules have come to be called, would democratize capital formation, allowing equity in small, pre-IPO companies to be sold to the ordinary investor — the woman who lives down the street from the brewery that needs to raise capital to grow. She knows the owner, she knows the beer, she *likes* the beer, and she should be able to buy equity in the business, but she can't do so under the current regulatory paradigm because she is not an accredited investor and the brewery cannot afford a traditional IPO. With Regulation A+, we are on the cusp of breaking down the barriers of entry into the capital markets for small businesses and ordinary investors.

But Regulation A+ is only half of the equation. We also need to facilitate the development of a secondary market for small businesses on which equities can be traded after an initial offering. To this end, I have been an outspoken advocate for the creation of "Venture Exchanges": national equities exchanges with rules tailored for smaller businesses, including those engaging in issuances under Regulation A. Shares traded on these exchanges would be exempt from state blue sky registration, and the exchanges themselves would be exempt from the Commission's national market structure and unlisted trading

privileges rules. This new regulatory framework would attract market makers and analysts to these exchanges, fostering the rebirth of a secondary market for small business equity that has been suffocated by layer upon layer of regulatory burdens.

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These are just a few examples of the vital initiatives the Commission needs to prioritize, but there are certainly others. We need to finish removing references to credit rating agencies from our rule book — one of the few Dodd-Frank mandates that was germane to the financial crisis — and we need to revise the long-outdated transfer agent rules, which have not been amended in decades. We also should consider revisiting the Securities Investor Protection Act in light of the shortcomings that became evident following the collapse of Lehman Brothers and the Madoff Ponzi scheme, among other failures. And we also need to finalize rules for the Commission's 17(h) broker-dealer risk assessment program.

But beyond these discrete items, we must take a step back and realize where we are today as a regulator and where we have been for the past five years. We need to set a course to once again being a preeminent federal agency and thought leader in the policy debates that have been for too long happening around us.

Once again, thank you for this opportunity to share my thoughts with you, and I wish you an enjoyable and productive conference.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

[2] *See, e.g.*, The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010).

[3] *In Crisis, Opportunity for Obama*, Wall St. Jrnl. (Nov. 21, 2008) (quoting statement by Rahm Emmanuel at Wall Street Journal Forum: "You never want a serious crisis to go to waste… This crisis provides the opportunity for us to do things that you could not do before.").

[4] Commissioner Daniel M. Gallagher, "The Securities and Exchange Commission — The Next 80 Years: The 15th Annual A.A. Sommer Jr. Lecture on Corporate, Securities and Financial Law" (Oct. 16, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543190122.

[5] The congressional response to the 1929 stock market crash post-dated and built upon the extensive investigations and hearings into the causes of the crisis headed by former Manhattan district attorney and future SEC Commissioner Ferdinand Pecora. The Dodd-Frank Act, in contrast, *pre*-dated the findings of both the Congressionally-mandated Financial Crisis Inquiry Commission and the Senate's Permanent Subcommittee on Investigations. In short, Dodd-Frank was an almost purely political response to a real world crisis. Not surprisingly, then, Dodd-Frank is premised primarily on largely false but highly convenient narratives about regulatory failures, including those of the SEC, without any reference whatsoever to the *policy* failures behind the crisis.

[6] The Commission adopted Form SD (17 CFR 249.448), in conjunction with adopting its rule to implement Section 1502 of the Dodd-Frank Act ("Conflict Minerals") (Rel. No. 34-67716 (Aug. 22, 2012)). That same day, the Commission also adopted a rule to implement Section 1504 of the Dodd-Frank Act ("Disclosure of Payments by Resource Extraction Issuers"), to which Form SD would also apply (Rel. No. 34-67717 (Aug. 22, 2012)).

[7] *Well Intentioned 'Blood Mineral' Provision Backfires*, UPI (May 24, 2013) (reporting trend of issuers moving operations — and thus mining jobs — out of Congo to avoid costs of compliance with conflict minerals and extractive resources disclosure requirements), available at http://www.upi.com/Top_News/World-News/2013/05/24/Well-intentioned-blood-mineral-provision-backfires/2971369424824/.

[8] *See* SEC Conflict Minerals Release at 24 ("After analyzing the comments and taking into account additional data and information, we believe it is likely that the initial cost of compliance is approximately $3 billion to $4 billion, while the annual cost of ongoing compliance will be between $207 million and $609 million.").

[9] *See Am. Petroleum Inst. v. SEC*, No. 12-1668 (D.D.C. Jul. 2, 2013) (vacating extractive resources disclosure rule on grounds that SEC misinterpreted Section 1504 of Dodd-Frank to mandate public disclosure of the reports required by the rule, and finding the SEC's decision to deny any exemption to the disclosure requirements of the rule arbitrary and capricious); *Nat'l Ass'n of Mfgrs v. SEC*, No. 13-5252 (D.C. Cir. Apr. 14, 2014) (finding requirement that issuers describe certain of their products as not DRC conflict free to be a violation of the First Amendment and remanding to district court to determine what provisions of the rule are unconstitutional).

[10] Payson Ctr. for Int'l Dev., Tulane University, "Dodd-Frank Section 1502: Post-Filing Survey 2014" (Oct. 1, 2014) (projecting first year costs of $709 million for issuers to comply with conflict minerals disclosure requirements), available at http://www.payson.tulane.edu/sites/default/files/content/files/TulanePaysonS1502PostFilingSurvey.pdf. While that is less than the SEC's $4 billion cost estimate, issuers have been making robust use of the rule's phase-in exemptions for "conflict undeterminable" and the independent private sector audit. When those exemptions expire, the full cost of the rule will finally become apparent.

[11] U.S. Securities and Exchange Commission, Final Rule, Facilitating Shareholder Director Nominations, Release Nos. 33-9136; 34-62764; IC-29384 (Aug. 25, 2010), available at http://www.sec.gov/rules/final/2010/33-9136.pdf.

[12] *See, e.g.*, *Proprietary Trading Not Central to Crisis*, Reuters (March 30, 2010) (quoting Paul Volcker: "proprietary trading in commercial banks was there but not central" to the financial crisis), available at http://www.reuters.com/article/2010/03/30/us-financial-regulation-volcker-idUSTRE62T56420100330; *Volcker Rule is the Wrong Response to the Financial Crisis,* Financial Services Forum ForumBlog (Sept. 19, 2009) (quoting Treasury Secretary Geithner: "If you look at the crisis, most of the losses that were material for the weak institutions — and the strong, relative to capital — did not come from [proprietary trading] activities. They came overwhelmingly from what I think you can describe as classic extensions of credit.").

[13] U.S. Securities and Exchange Commission et al., Final Rule, *Credit Risk Retention*, Release No. 34-73407 (Oct. 22, 2014), available at http://www.sec.gov/rules/final/2014/34-73407.pdf.

[14] In this day and age of highly technical, 1000+ page rulemakings requiring the time and attention of scores of staffers across the SEC's divisions and offices, and collaboration with other federal agencies, completing a dozen major rulemakings a year would be a herculean task. Even at that highly ambitious pace, if we focused our entire rulemaking agenda exclusively on implementing the remaining Dodd-Frank mandates, it would take five years for the agency to reach the finish line. And there would be no time or bandwidth for the Commission to work on any other initiatives.

[15] Commissioner Daniel M. Gallagher, "A Renewed Focus on SEC Priorities" (Oct. 25, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370540102737.

[16] U.S. Securities and Exchange Commission, Division of Investment Management, Staff Legal Bulletin 20, "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms" (June 30, 2014), available at http://www.sec.gov/interps/legal/cfslb20.htm.

[17] U.S. Securities and Exchange Commission, Division of Trading and Markets, "Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act" (Sept. 30, 2013), available at http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

[18] U.S. Securities and Exchange Commission, Final Rule, Consolidated Audit Trail, Release No. 34-67457 (July 11, 2012), available at http://www.sec.gov/rules/final/2012/34-67457.pdf.

[19] *See, e.g.*, Commissioner Daniel M. Gallagher, "Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation, Remarks Before SIFMA's 15th Annual Market Structure Conference" (Oct. 4, 2012) ("It is my hope, therefore, that the Commission not only pursue a new comprehensive study that addresses both market structure and self-regulation, but does so under the stipulation that there are no sacred cows."); "A Renewed Focus on SEC Priorities, Remarks at AICPA/SIFMA Financial Management Society Conference on the Securities Industry" (Oct. 25, 2013) ("As I've noted in the past, our securities markets and trading practices did not develop in a vacuum but instead have been shaped by our rules. It is long past time to conduct a serious, thorough, holistic review of our current market structure with no 'sacred cows,' and I was very pleased earlier this month to hear Chair White express her agreement that we need to rethink our assumptions in that manner."); "Remarks to the Georgetown University Center for Financial Markets and Policy Conference on Financial Markets Quality" (Sept. 16, 2014) ("It is critically important that we begin the holistic review, in earnest, as soon as possible. Markets and market participants want and need clarity and, more importantly, investors deserve it.").

[20] Keith Higgins, Director of Division of Corporation Finance, U.S. Securities and Exchange Commission, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting" (April 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370541479332.

[21] Data derived from Federal Reserve Board, "Flow of Funds Accounts of the U.S." at Table L.211 (municipal) and Table L.212 (corporate), available at http://www.federalreserve.gov/releases/z1/current/z1.pdf.

[22] *See, e.g.*, *Banks Consider New Corporate-Bond Trading Network*, Wall St. Jrnl. (Nov. 22, 2013), available at http://online.wsj.com/news/articles/SB10001424052702304337404579214092115777898; *Global Risk Reappears, Bonds Benefit*, *Barron's* (July 19, 2014); available at http://online.barrons.com/news/articles/SB50001424053111904255004580029312208066450.

[23] *Fed's Dudley Says Bets on Mid-2015 Rate Increases Look Reasonable*, Wall St. Jrnl. (Oct. 7, 2014).

[24] Blackrock, *Corporate Bond Market Structure: The Time for Reform is Now* (Sept. 2014), available at http://www.blackrock.com/corporate/en-gb/literature/whitepaper/viewpoint-corporate-bond-market-structure-september-2014.pdf.

[25] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (Apr. 5, 2012).

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