Remarks at The SEC Speaks in 2015

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I. Introduction

Thank you, Keith [Higgins], for your kind introduction. It's hard for me to believe that this is my fourth SEC Speaks speech. A lot has changed over the course of those years, but one thing has remained constant - the remarkable talent and dedication of the SEC staff. Before I continue, I want to take this opportunity to thank the entire staff for all that they do for the markets and investors.

In preparation for my speech today, I took a trip down memory lane - conveniently located under the "Speeches" tab on the SEC website — to revisit my comments from previous SEC Speaks conferences. Depressingly, many of the calls to action I've issued over the years are, at best, only partially answered.

In 2012, for example, I discussed failure-to-supervise liability for legal and compliance officers in the hopes of establishing some clarity in this traditionally murky area.[1] I argued that the Commission and – in the case of broker-dealers – the SROs, need to provide a framework that encourages in-house legal and compliance officers to depart, when necessary, from the safety of black and white categorizations of who is and who is not a supervisor. Noting the importance of encouraging such personnel to wade into thorny regulatory matters, I stated that our understanding of the issue must begin with the premise that broker-dealer or investment adviser compliance and legal personnel are, by default, not supervisors, but rather providers of support for the firm's other employees. While I was glad to see the excellent FAQs on the subject issued in 2013 by the Division of Trading and Markets,[2] there is much more that can and should be done at the Commission to provide the clarity so desperately sought by our regulated entities.

Instead, we've spent much of the past several years chipping away at the one hundred or so mandates imposed upon the Commission by the Dodd-Frank Act. At last year's Speaks conference, I delivered an "open letter" to the SEC staff. Reiterating a theme to which I've referred throughout my tenure as a Commissioner, I stated that the Dodd-Frank Act is "a 2,319 page monstrosity that is in substantial part untethered to the causes of the crisis."[3] Some have objected to this and the many related pronouncements I've made regarding the Dodd-Frank Act over the years. To them I say: You should have seen the first drafts!

Now it's 2015, and we are not even halfway done implementing our Dodd-Frank mandates. What's worse, some of the mandates we have implemented are more likely to exacerbate than solve the true causes of the financial crisis. Most notably is the Section 941 credit risk retention joint rulemaking, which made the Commission complicit in the ongoing effort by some policymakers to restore the standards-free mortgage lending practices that created the housing bubble that, in turn, caused the financial crisis.[4]

But despite my long-held and loudly-articulated concerns about the failings of Dodd-Frank and the distractions it has created from dealing with important issues like failure-to-supervise liability, today I find myself confident that the Commission will be able to correct course and focus on the real issues of capital markets regulation. Last June, Chair White announced a holistic equity market

structure review, something for which I have long advocated, while also noting that we will be studying and seeking appropriate reforms in our long-neglected and woefully under-staff-resourced fixed income market oversight regime. I am confident that TM Director Steve Luparello, a good friend and a an excellent Director – and the fine staff of my old Division – are up to these challenges. Meanwhile, Keith Higgins and his excellent staff in in the Division of Corporation Finance have initiated a desperately-needed, comprehensive review of our issuer disclosure regime. And, Chair White recently announced new initiatives for oversight of the asset management industry that could, if done properly, revolutionize the Commission's program for oversight of these advisers. It is my hope that these incredibly important initiatives will be at the center of the Commission's agenda for the next couple of years. And if this happens at the expense of purely political wish-list items like the pay ratio and clawback rulemakings, then all the better!

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Speaking of distractions and rulemaking untethered to identifiable problems, I'd like to turn now to a long-anticipated re-proposal, a sequel of sorts – but, probably more like Goonies 2 than Godfather 2. This rulemaking is based on the premise that an entire SEC-regulated industry is plagued by conflicts of interest. This is a premise that, despite the white-hot intensity with which it is posited by its proponents, has nowhere been proven. This rulemaking would attempt to fix this putatively systemic issue by effectively overhauling the entire regulatory regime. In so doing, it would ignore eight decades of securities laws and regulations. The real kicker, however, is that this is not a Commission rulemaking.

II. Department of Labor Fiduciary Rule

In October 2010, the Department of Labor issued a proposal that would have broadly defined the term "fiduciary" for purposes of the DOL-administered Employee Retirement Security Act of 1974, or ERISA, as a person who provides investment advice to plans for a fee or other compensation.[5] That proposal, which would have radically altered well –established law, was based on DOL's desire to take action against investment professionals who DOL believes provide inaccurate, misleading, or biased advice.

The proposal generated much comment, most of it negative. One of the main criticisms of the proposal is that it would have severely limited investor access to qualified investment advice and investment products. DOL withdrew the proposal in 2011, but like so many bureaucratic dreams, it was only deferred, not denied. Based on recent reports, the re-proposal will be published soon.

Now, I have not seen the re-proposal. And given the SEC's comprehensive oversight authority with respect to the investment advisers and broker-dealers who would be impacted by it, you might find that curious. It's even more curious given that Section 913 of Dodd-Frank mandated that the SEC study the effectiveness of the existing regulatory standards of care for brokers and advisers, a study that was in progress when DOL first published its proposed rule in 2010.

The SEC staff published the Section 913 Study in January 2011. The study recommended a uniform fiduciary standard for investment advisers and broker-dealers who provide investment advice about securities to retail customers. The standard recommended would be no less stringent than the current fiduciary standard for investment advisers.[6] Then-Commissioners Casey and Paredes issued a statement of opposition to the study, reasoning – very persuasively, I would add -- that the Study did not adequately articulate or substantiate the problems that would purportedly be addressed through additional regulation.[7] They also pointed out another fundamental flaw in the study – that it did not consider whether its recommendations could adversely impact investors. Last year, my friend and colleague, Commissioner Piwowar, similarly noted that a uniform fiduciary duty

could actually harm retail investors and expressed his concern that it could limit financial advisory options or preclude investors from receiving investment advice altogether.[8]

Since the publication of the Section 913 Study, the Commission has formally requested information, in particular quantitative data and economic analysis, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers.[9]

Yet, despite all the work the SEC Staff has undertaken on the subject, not to mention the Commission's decades of history in regulating broker-dealers and investment advisers and overseeing their disclosures relating to conflicts of interest, DOL has not formally engaged the Commissioners, at least not this Commissioner, on its fiduciary rulemaking process and the impact it may have on investors. And despite public reports of close coordination between the DOL and SEC staff, I believe this coordination has been nothing more than a "check the box" exercise by DOL designed to legitimize the runaway train that is their fiduciary rulemaking. Unfortunately, this is par for the course in Washington these days - take, for example, the Financial Stability Oversight Council SIFI designation process for non-banks, where everyone's an expert except for the actual experts.

Although, as I noted, I haven't seen the DOL's re-proposal, thanks to a White House "memo" shockingly "leaked" to the press earlier this year,[10] I can make an educated guess at what might be included. Although nominally focused on the subject of DOL's draft rule, this memo took aim at every professional engaged in selling securities to investors.

Let's start with some of the claims the White House memo makes. First, the memo states that "consumer protections for investment advice in the retail and small plan markets are inadequate." This overarching statement is not accompanied by any analysis or study of the current protections investors receive from the regulatory oversight of brokers and investment advisers by the SEC and the SROs - in fact, it blatantly ignores this comprehensive regulatory oversight. Indeed, the memo manages to avoid any mention of either the SEC or FINRA!

Second, the memo states that "the current regulatory environment creates perverse incentives that ultimately cost savers billions of dollars a year." I am not going to be drawn into a debate about the studies the memo selectively cites to support this conclusion. But I will point out that there are SEC and SRO rules directly addressing the so-called perverse incentives referenced to in the memo. Among other things, these rules require clear disclosure to investors about payments and fees – including incentive fees – prohibit the use of manipulative, deceptive or fraudulent practices, and require significant diligence about investors and their needs. These rules also limit performance fees and regulate advertising.

Third, the memo states that "the current regulatory environment allows fund sponsors and advisory service firms to create incentives for their advisors to recommend excessive churning . . . of retirement assets and to steer savers into higher cost products with financial payoffs for the advisor." Far be it from me, as a mere SEC Commissioner, to second guess the White House securities law experts, but I do feel obligated to point out that our rules expressly prohibit brokers from churning client accounts, and the SEC and SROs have sophisticated tools designed to monitor for such activity.

Finally, the memo states "academic research has clearly established that conflicts of interest affect financial advisors' behavior and that advisors often act opportunistically to the detriment of their clients because of payments they receive from product providers." This statement, like the others, ignores the existence of the comprehensive oversight and disclosure regime specifically designed to

address these underlying conflicts of interest.

Taking a step back, there are two general approaches to regulating conflicts of interest. The first is simply to ban them or, as the DOL may attempt, to effectively ban them by issuing rules full of so many ill-defined hoops and hurdles that any reasonable regulated entities would throw their hands up in defeat. The second is to mitigate potential risks associated with conflicts through market rules, disclosure, compliance and enforcement—the approach taken by the securities laws now.

The White House memo is clearly premised on a belief that the status quo is deficient. But, it ignores the main reason for the mitigation-based approach to conflicts and related disclosures: Investors benefit from choice; choice of products, and choice in advice providers. This is something the nanny state has a hard time comprehending. If the DOL sticks with its approach to ban or effectively ban conflicts, entire categories of products and services that are now available to investors could disappear. And, tragically, some commenters say the negative impact of this loss will be borne by low and moderate-income workers.[11]

To be blunt, the White House memo is thinly-veiled propaganda designed to generate support for a widely unpopular rulemaking. Seven years after the height of the financial crisis, it is obvious that some remain intent on not letting it go to waste. Perhaps it's time to acknowledge a little nuance.[12]

It's easy to shout about conflicts of interest and vilify any potential practices that involve them, even if it means taking entire swathes of investment products off the table. It's a lot harder to establish a regulatory system that balances mitigating conflicts and effective disclosures with expanding investment opportunities for the good of individual investors and the economy as a whole, as the Commission has done for decades. In a matter of this import, we should not shirk from our path simply because it is difficult.

III. Fiduciaries the Commission Regulates

To be clear, I do not mean to imply that the SEC's regulation of investment professionals is perfect. But, I believe that the model is not fundamentally broken. And I am greatly concerned that much of the debate on these issues seems to assume that the "fiduciary duty" is some sort of talismanic protection that can overcome any competing regulatory concerns. All too often, this is the approach taken by those who simply do not know how the fiduciary duty works in practice. They do not understand or choose to ignore the limitations of the fiduciary duty. As I have said before, despite the fine work of our OCIE and IM staff in the area, even the SEC has much to learn about the real world application of the fiduciary duty – an area that receives far less attention than it should.

A.Commission oversight of fiduciary duties

As everyone should be aware by now, the extent of the Commission's investment adviser examinations is unacceptably narrow. There are nearly three times as many investment advisers registered with the SEC than there are broker-dealers, and there is no SRO interposed between the adviser industry and the SEC like there is for broker-dealers. As a result, we are only able to examine 10 percent of advisers annually, whereas on the broker-dealer side, between us and the SROs, we examine 49 percent annually.[13]

I worry that this abysmally low rate of examinations has resulted in a lack of nuanced understanding of the adviser industry by the SEC and the general public. People often forget that the principal – and historical – purpose of an active and well-resourced examination program is an informed policymaking function, not a large, attention-grabbing number of enforcement referrals.

Our limited resources and narrow focus on traditional registrants has also caused us to large ignore, from a policy perspective, the roles of lesser-known investment advisers[14] and other fiduciaries operating in the securities markets. So when the Commission does bring cases involving breaches of fiduciary duties, those cases are rarely against non-advisers breaching their obligations in securities-related matters. Rather than pursuing an action against the fiduciary, the Commission often takes the path of least resistance and brings an action against the intermediary, oftentimes a broker-dealer.

An encouraging departure from this norm occurred in 2012 when the Commission brought a case against trustees of the Detroit public employee pension funds.[15] Those trustees happened to be the Mayor and City Treasurer. Citing breaches of their fiduciary duties and duty to disclose conflicts of interests to the pension fund, including the lavish gifts they received from the pension fund's investment adviser, the Commission charged these individuals with antifraud violations. This case came out of our Municipal Securities and Public Pensions Unit, a group that has been doing excellent work for the Commission and investors. I hope and expect that this unit will continue its focus on similarly situated fiduciaries.

Many such fiduciaries present their own unique form of potential conflicts, but the SEC does not have a particularly good track record of staying current on their businesses and what their practices mean for investors.[16] Despite our limited resources, we must evolve with the markets and market participants. We should not be resigned to *ex post facto* reactions to new, undisclosed conflicts arising from changes in business models or markets. Rather, we should be watching as these changes develop, learning what new conflicts they could generate, and ensuring appropriate disclosures are made.

IV. Conclusion

In closing, while being a "fiduciary" means acting in the best interest of the client, it does not mean that all models where financial professionals are not fiduciaries are flawed. It also does not mean that labeling a financial professional as a fiduciary will solve the problem, especially when those problems have not been sufficiently identified and their causes studied. One size fits all regulation, in practice, tends to end up as one size fits none. And when all is said and done, it means investors are presented with fewer choices and higher prices. Conflicts exist, that we cannot deny. But, investors and our markets are better off when we seek to manage those conflicts, through disclosures or otherwise, rather than eviscerating entire business models and the benefits they provide. This is the approach the Commission has taken for over eight decades. It should remain our approach for the next eight decades and beyond.

[1] *See* Gallagher, Daniel, Remarks at The SEC Speaks in 2012 (Feb. 24, 2012); available at http://www.sec.gov/News/Speech/Detail/Speech/1365171489872.

[2] *See* Division of Trading of Markets, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Section 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.

[3] *See* Gallagher, Daniel, An Open Letter to the SEC Staff (Feb. 21, 2014); available at http://www.sec.gov/News/Speech/Detail/Speech/1370540834506.

[4] *See* Gallagher, Daniel, Dissenting Statement Concerning Adoption of Rule Implementing the Credit Risk Retention Provisions of the Dodd-Frank Act (Oct. 22, 2014); available at http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543240793.

[5] *See* Definition of the Term "Fiduciary," 75 F.R. 65263 (Oct. 22, 2010), *available at* http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=24328&AgencyId=8&DocumentType=1.After receiving numerous comment letters objecting to the proposal, the Department of Labor announced in September 2011 that it would re-propose the rule. *See* US Labor Department's EBSA to Re-Propose Rule on Definition of a Fiduciary, Release No. 11-1382-NAT (Sept. 19, 2011), *available at* http://www.dol.gov/ebsa/newsroom/2011/11-1382-NAT.html.

[6] *See* Study on Investment Advisers and Broker-Dealers (Jan. 2011); available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[7] *See* Casey, Kathleen L. and Paredes, Troy A., Statement Regarding Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011); available at http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

[8] *See* Piwowar, Michael S., Remarks at the National Association of Plan Advisors D.C. Fly-In Form (Sept. 30, 2015); available at http://www.sec.gov/News/Speech/Detail/Speech/1370543077131.

[9] *See* SEC Release No. 34-69013, Duties of Brokers, Dealers, and Investment Advisers (Mar. 1, 2013); available at http://www.sec.gov/rules/other/2013/34-69013.pdf. And, of course, all of this study follows on numerous other studies that the Commission has commissioned over the years. *See e.g.*, Angela A. Hung, et. al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008) available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf and Daniel P. Tully, et. al., Report on the Committee of Compensation Practices (Apr. 10, 1995); available at https://www.sec.gov/news/studies/bkrcomp.txt.

[10] *See* Furman, Jason and Stevenson, Betsey, Memorandum for Senior Advisors Regarding Draft Conflict of Interest Rule for Retirement Savings (Jan. 13, 2015); available at http://www.scribd.com/doc/253449711/WH-DOL-memo.

[11] *See* Debevoise & Plimpton, Memorandum Concerning Expected Department of Labor Conflict of Interest Rule (Feb. 17, 2015); available at http://fsroundtable.org/debevoise-memo-fsr-dol-fiduciary-duty/.

[12] To help make this point, here is a quote from a recent review of my friend Peter Wallison's excellent new book "Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again":

> On the one hand, we have the likes of Barack Obama, Elizabeth Warren, Barney Frank, the Occ clown show, etc., doing a sort of John Adams chorus: "Greed! Greed! Billionaires! Greed! Greec Wall Street Greed!" And the response from the responsible Right is: "Because most PMBS held financial institutions were rated AAA, they were used by many banks and other financial firms f short-term collateralized borrowing through repurchase agreements," a sentence that appears introduction (!) to Wallison's book.

See Williamson, Kevin D., Government Sponsored Meltdowns, National Review (Feb. 23, 2015); available at https://www.nationalreview.com/nrd/articles/397937/government-sponsored-meltdowns.

[13] *See* United States Securities and Exchange Commission, Agency Financial Report for Fiscal Year 2014 SEC Annual Financial Report (Nov. 14, 2014); available at http://www.sec.gov/about/secpar/secafr2014.pdf#financial. Indeed, I have stated that one way to address this imbalance would be to provide for third party examiners of investment advisors—including, potentially, defining the term "third party" to include SROs in order to allow the SROs currently involved in broker-dealer oversight

to conduct examinations of "dual hatted" investment advisors as well. *See* Gallagher, Daniel, Remarks at the 46th Annual Rocky Mountain Securities Conference (May 9, 2014); available at http://www.sec.gov/News/Speech/Detail/Speech/1370541779229.

[14] The lesser known investment advisers are namely proxy advisory and pension consultant firms.

[15] *See* United States Securities and Exchange Commission v. Kwame M. Kilpatrick et. al., Case No. 12-cv-12109 (filed E.D. Mich. May 9, 2012); complaint available at http://www.sec.gov/litigation/complaints/2012/comp-pr2012-88.pdf. *See also* S.E.C. vs. Larry P. Langford et. al., Case No. CV-08-B-0761-S (filed N.D. Ala. Apr. 30, 2008); and In the Matter of J.P. Morgan Securities Inc., File No. 3-13673 (Nov. 4, 2009); available at http://www.sec.gov/litigation/admin/2009/33-9078.pdf.

[16] Take, for example, proxy advisory firms. Although there are proxy advisory firms that are registered investment advisers, they operate in materially different ways than traditional investment advisers. This is eerily similar to the various credit rating agencies that also were registered with the SEC as investment advisers before the Credit Rating Agency Reform Act of 2006. They often provide corporate governance consulting services to issuers and then turn around and provide recommendations to investment advisers on how to vote on corporate governance proposals from those very same companies. This often places the proxy advisory firm in the position of telling investment advisers how to vote their proxies on the proxy advisory firm's own proposals – an obvious and overwhelming conflict of interest. More subtly, the tremendously concentrated nature of the proxy advisory industry means that such firms have a number of clients, both large and small, with often incompatible or even contradictory goals. The extent to which the priorities of their larger clients' determine the proxy advisory firms' advice to all of their clients on certain matters, and the extent to which adequate disclosure is made to smaller clients of this potential conflict of interest, are unclear. They shouldn't be.

In addition, the clients of the proxy advisory firms—investment advisers—are themselves fiduciaries to their clients, which means that investment advisers owe their investors adequate oversight of the proxy advisor as well. It is my hope that the Commission will continue to make progress on these issues, building on recent staff guidance requiring robust conflicts disclosure and OCIE's inclusion of these relationships in its list of inspections priorities for 2015. *See* Staff Legal Bulletin No. 20 (IM/CF), 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.

Another prime example of an all-too-often ignored conflict of interest arises in the case of pension consultants. These entities often provide services both to pension plans who are their advisory clients and to money managers, which could lead pension consultants to steer their pension plan clients to certain money managers and other vendors. Additionally, many such consultants have affiliated broker-dealers. As with other arrangements where those directing trades to brokers receive compensation for doing so, this scenario raises best execution concerns. The Commission last conducted a sweep exam of pension consultants almost a decade ago in response to complaints regarding their conflicts of interest. I hope we continue to stay on top of these advisers in light of the growing problems many pension funds now face. *See* United States Securities and Exchange Commission Staff Report Concerning Examinations of Select Pension Consultants (May 16, 2005); available at https://www.sec.gov/news/studies/pensionexamstudy.pdf.

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