Speech

Getting Back to Basics: Protecting, Serving, and Empowering Investors

Remarks before the Investment Adviser Association Compliance Conference 2020

Commissioner Allison Herren Lee

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Introduction

Thank you Karen [Barr] and thank you all for hosting me today. I appreciate IAA's engagement on the issues important to its members and to the broader markets, and I'm honored to have the opportunity to speak to this audience today.

I want to start by saying that the views I express today are my own and may not represent the views of my fellow Commissioners or the staff. What are those views? Well, I've now been on the Commission for approximately eight months, and in nearly every meeting I have, I am asked the same question: What are my priorities for my time as a Commissioner?

Obviously, I've thought a great deal about this. In fact, over the past twenty years, in private practice, on the staff of the Commission, as an international instructor in financial regulation, and now as a Commissioner, my career has focused on the SEC and its mission, and I have considered and analyzed our role from each of these vantage points.

A lot has changed in twenty years. We've seen the integration of the internet into securities markets, which has transformed the way businesses raise capital. A boom in investment advisory businesses—including the introduction of robo-advisers—has brought many first-time investors into the markets. At the same time, a seismic shift in investor preferences toward passive investing has led to the exponential growth of ETFs and index funds. Decimalization and the computerization of the stock markets has transformed the way that people (and now also machines) buy and sell stock; and flash events and other consequences of the current market structure have led us to reevaluate how the national market system has developed. And, of course, a devastating financial crisis

caused us to step back and reorient much of the Commission's work toward addressing the types of risks that gave rise to market failures in the mid-to-late 2000s.

I, just as many of you, have experienced these pivotal changes in real time. Just to give you some context on the extent of changes since I first came to the Commission, when I arrived, the Enforcement division had what we informally referred to as the "Internet Group." It was a handful of enforcement attorneys tucked away in a back room surfing the World Wide Web just in case, you know, any fraud should happen over the internet.

So yes, a lot has changed in our space. But, as the adage goes, the more things change, the more they stay the same. Throughout these changes, I've come to conclude that the SEC is wise to focus its resources on its core mission—to protect, serve, and empower investors. If we do this job well, everything else follows. Maintaining fair markets and facilitating capital formation follow as natural consequences of focusing on what investors need and expect from the SEC.

In that vein, I want to touch on three areas where we can and should do just that—endeavor to protect, serve, and empower investors. While these concepts overlap, there are nuances to each that bear discussion.

Investment Adviser Advertising

First, protection. Our investment adviser advertising rules are designed generally to protect investors from false and misleading marketing. Marketing materials provide useful information to investors as they select or retain an investment adviser, but, given the complexity of an adviser's services, the Commission's rules must ensure that such materials are accurate, contain appropriate content for the intended audience, and provide investors with sufficient information and context to make an informed decision.

The current proposal is the first real update to these rules since 1961, and I applaud Director Blass our Division of Investment Management for undertaking this important effort.[1] In general, the proposal would modernize much of the existing framework for adviser advertisements and, importantly, address the presentation of adviser performance in a more holistic fashion than the piecemeal approach derived from existing staff guidance. I supported the proposal and I think it represents a meaningful improvement over the existing framework.

It includes protective measures designed to ensure that investors are not misled;[2] it updates and modernizes the regulatory regime to reflect the changing ways in which investors receive and review information;[3] and it requires advisers, in certain contexts, to provide specific information to facilitate more informed decision-making.[4] Updating our rules in this manner—by trying to meet investors where they are—is wholly consistent with our mission to protect investors.

Let me drill down on a couple of specifics with respect to the proposal. First, one area that I believe merits significant thought and debate is the emphasis on a principles-based approach to certain of the rule's requirements. This creates flexibility, but that can come at the cost of certainty around compliance, something I know compliance professionals are rightly focused on. I know from prior experience working as in-house counsel (on loan from my law firm) how difficult it can be to translate sometimes broad legal principles into straightforward answers to everyday questions from the business side. For the most part, they need yes or no answers, and, absent more substantive guidelines in the rule text, a risk-averse compliance professional may default to a conservative approach that unduly restricts the substance of an adviser's advertisements.

If rules are too broad or vague, we may end up circumscribing conduct that we would not intend to capture. Let's take for example, the proposal's approach to whether a performance presentation or the presentation of specific investment advice is "fair and balanced."[5] I think we can all agree that either type of presentation should be fair and balanced, but is that guideline alone enough information from the Commission for you to apply that standard on a daily basis? Another example is the prohibition of testimonials that are "reasonably likely to cause an untrue or misleading inference to be drawn."[6] Again, does this aspect of the proposal provide sufficient guidance to facilitate compliance?

I know there are concerns expressed by many about what is often referred to as "regulation by enforcement." If the rule's requirements are too vague, how can the Commission ensure compliance without raising those sorts of concerns? If it's not enforceable, responsible advisers like the people in this room may find themselves competing against advisers who use performance information that is not "fair and balanced" at all. I believe that the current proposal may rely too heavily on high-level principles, which can certainly exacerbate that issue. But I'd really like to hear from you all on how to get this balance right.

Second, I support the effort in the proposal to specifically engage with and receive input from both investors and small investment advisers through the use of questionnaires.[7] Many retail investors and small advisers may not have the ability or resources to provide meaningful responses to the numerous requests for comment. The questionnaire approach provides the opportunity to respond to discrete questions that are relevant to them. I would support refining this approach and the use of investor testing for future rulemakings.[8] I hope those of you in this room will encourage your clients to engage with the Commission to help us protect investors and ensure their voices are heard in our rulemaking.

Climate risk disclosure

Next, in addition to protecting investors, is the vital role that the Commission plays in serving investors. Serving investors starts with listening to them, and investors have been clear about their need for climate risk disclosure. We must not only seek to prevent false or misleading disclosure, but also to ensure that investors receive the material information that they need to pursue their investment goals, either on their own or through their investment advisers.

As most of you know, the Commission continues apace with its "Disclosure Effectiveness Initiative," an overhaul of the disclosure requirements for public companies and funds in an effort to improve and modernize the disclosure regime for both investors and registrants.

Unfortunately, however, that modernization effort has thus far declined to address what has been called "one of the defining challenges of the 21st century marketplace"[9]—climate change and its attendant risks. There is overwhelming investor demand for consistent, reliable, and comparable disclosure around climate risk, demand that I know many of the people in this room see from your clients on a daily basis. The lack of consistent, reliable, and comparable disclosure in this area undermines investors' and investment professionals' ability to evaluate the relevant risks when making investment decisions, and thus undermines efficient capital allocation.[10]

A growing body of evidence demonstrates the importance of this information to investors and its relationship to financial performance.[11] That's why we're seeing some of the largest asset managers in the world join the chorus of voices affirming the critical importance of this information to the assessment of risk and long-term performance.[12] In response, most large public companies supply some form of sustainability disclosure, much of it outside of reporting mandated by the Commission.[13] But investors have been clear that the existing, largely voluntary disclosures are insufficient to meet their needs. Without even a standardized taxonomy, much less uniform disclosure requirements, not all companies will disclose and the disclosure will vary from company to company, meaning it will lack the comparability necessary for meaningful investment analysis.[14]

Going forward, I will continue to advocate that the Commission address climate change risk through both rulemakings and guidance in order to better serve investors. I hope everyone here today will help us in those efforts as you continue to look out for your clients and respond to their needs.

Proxy reform

And finally, empowerment. Investors must be empowered to hold the stewards of their capital accountable for the decisions they make and the strategies they pursue. The proxy process provides the mechanism for this, and it is the Commission's role to ensure this process runs fairly and efficiently.

Unfortunately, each of the two proxy proposals released in November of last year would operate to disempower investors. One of the proposals will, among other things, restrict the ability of some shareholders to submit

proposals for a vote at a company's annual meeting.[15] Which shareholders? *Only* small retail investors—exactly those whose interests the Commission otherwise purports to elevate.[16]

I have numerous additional concerns with this proposal, but I will focus more today on the second of the two proposals related to proxy advisors[17] because I know that is one about which IAA cares deeply. And you are not alone. The Commission has received hundreds of comment letters on this proposal representing trillions of investor dollars. There appears to be a strong consensus of opinion among those who rely on proxy advisors that the rule as proposed would operate to increase costs, reduce reliability, and potentially reduce overall shareholder voting.[18]

Let's start with what is conspicuously absent from the proposal: concrete evidence of a real problem. The proposal rests on the premise that proxy advisor recommendations contain errors sufficient in number and scope to warrant a rulemaking. No objective evidence is offered for this anywhere in the release. Instead, the proposal uncritically reproduces allegations of error.[19] Allegations which, by the way, would still show an extremely low error rate.[20] But the proposal does nothing to examine the validity of the allegations, despite the fact that we have access to the relevant filings and could (and should) easily do so. Examining the factual basis for these allegations is particularly important where they represent the primary policy justification for the proposal.

The proposal also cites no evidence that investment advisers who utilize the services of proxy advisors have failed to uphold their fiduciary duties in voting proxies, nor evidence from examinations of proxy advisors or investment advisers that could support the rulemaking. I've often heard the claim that "you can't prove a negative," but it seems as though that is what we are expecting of proxy advisors. The burden ought not to be on proxy advisors to prove a lack of evidence. Rather, the Commission is required to set out a record to support its rulemakings with evidence.

Next, from this unsupported premise, the proposal proceeds to the even more implausible premise that these alleged errors would be reduced by mandating greater influence from a plainly conflicted party—the issuer.[21] This defies common sense, and thus predictably runs counter to the approach we take in other areas, such as in protecting the independence of analyst research.[22] As I have said before, issuers have deep expertise and insight on proxy ballot issues, but they also have a clear stake in the outcome.[23] They can and do offer opposing viewpoints when they disagree with a proxy advisor's recommendations or the factual bases underlying them. These valuable viewpoints should be presented entirely separately from the work of proxy advisors, and investors and/or their advisers can evaluate them accordingly..

Finally, and importantly, the proposal presents risks to the exercise of shareholders' voting rights. Most investors rely heavily on investment advisers and asset managers, like those here today, to vote on their behalf at annual meetings. I know that you take that responsibility seriously, and that many of you depend on proxy advisors to help you make informed decisions about how to cast those votes in your clients' best interest. Because the proposal introduces costs, delays, and unreliability into the proxy voting process, advisers may feel compelled to abstain from voting altogether, thus stifling investors voices in corporate democracy. Such an outcome—a reduction of investor engagement with the companies that they own—is clearly not in the best interest of investors. This is the opposite of investor empowerment.

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And that brings me full circle to my original point, which is that, in every endeavor we undertake at the SEC, we should focus on whether we are protecting, serving and empowering investors. I appreciate the role that you all play in helping us do that every day. Thank you for having me today, and I look forward to answering your questions.

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[1] *See* Proposed Rule: Investment Adviser Advertisements; Compensation for Solicitations, Investment Advisers Act Rel. No. 5407 (Nov. 4, 2019), https://www.sec.gov/rules/proposed/2019/ia-5407.pdf.

[2] For example, the proposal includes restrictions on the use and distribution of hypothetical performance in advertisements, as well as required contextual information for when that type of performance is included. *See id.* at 158-180.

[3] The proposal broadens the definition of advertisement to include a communication disseminated by any means, not just in written form or on radio or television. *See id.* at 22-23.

[4] For example, the proposal would require that any performance presentation provided to retail investors show performance net of all fees and expenses and include 1-, 5-, and 10-year performance figures. *See id.* at 120-130.

[5] *See id.* at 62-71.

[6] *See id.* at 57-59.

[7] *See id.* at Appendix B: Investor Feedback Flyer and Appendix C: Smaller Adviser Feedback Flyer.

[8] Investor testing is a critical tool that should play a prominent role in all of the Commission's rulemakings relating to disclosure that is intended for retail investors. Comments from the industry and the public provide helpful information for our consideration in the rulemaking process, but hard data on whether and how disclosure works in the real world is essential to designing effective disclosures.

[9] *See* Graham Steele, The Great Democracy Initiative, A Regulatory Green Light: How Dodd-Frank Can Address Wall Street's Role in the Climate Crisis at 3 (Jan. 2020), https://greatdemocracyinitiative.org/wp-content/uploads/2020/01/Final_Greenlight_Steele.pdf.

[10] *See, e.g.*, State Street Global Advisors, The ESG Data Challenge at 1 (Mar. 2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/03/esg-data-challenge.pdf ("Asset owners and their investment managers seek solutions to the challenges posed by a lack of consistent, comparable, and material information. Investors increasingly view material ESG factors as being critical drivers of a company's ability to generate sustainable long-term performance. In turn, ESG data has increasing importance for investors' ability to allocate capital most effectively.").

[11] *See* Emirhan Ilhan et. al., Swiss Finance Institute Research Paper Series N. 19-66, Institutional Investors' Views and Preferences on Climate Risk Disclosure at 4 (last revised Jan. 7, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3437178 ("We find that the survey respondents share a strong general belief that climate disclosure is important. In fact, 51% of respondents believe that climate risk reporting is as important as traditional financial reporting, and almost one-third considers it to be more important."); State Street Global Advisors, The ESG Data Challenge, *supra* note 10, at 1.

[12] *See, e.g.*, State Street Global Advisors, The ESG Data Challenge, *supra* note 10, at 1; Letter from Larry Fink, Chairman & CEO, BlackRock to CEOs (Jan. 14, 2020), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter ("Investors are increasingly reckoning with these questions and recognizing that climate risk is investment risk. Indeed, climate change is almost invariably the top issue that clients around the world raise with BlackRock . . . They are seeking to understand both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy. These questions are driving a profound reassessment of risk and asset values."); U.S. SIF Foundation, Report on U.S. Sustainable, Responsible and Impact Investing Trends 2018 at 1 (2018) ("Sustainable, responsible and impact (SRI) investing in the United States continues to expand at a healthy pace. The total U.S.-domiciled assets under management using SRI strategies grew from $7.7 trillion at the start of 2016 to $12.0 trillion at the start of 2018, an increase of 38 percent. This represents 26 percent—or 1 in 4 dollars—of the $46.6 trillion in total U.S. assets under professional management.").

[13] *See* Governance & Accountability Institute, Inc., Flash Report: 86% of S&P 500 Index® Companies Publish Sustainability/Responsibility Reports in 2018 (May 16, 2019) (finding that sustainability reporting by S&P 500 companies has grown from 20% in 2011 to 86% in 2018).

[14] *See* Christine Robinson et al., Deloitte & Touche LLP, *#DeloitteESGnow - Sustainability Disclosure Goes Mainstream* (Sept. 24, 2019) (noting that investors increasingly rely on ESG disclosure but "remain dissatisfied with the current state of this content"); *see also* Sara Bernow et al., McKinsey & Company, *More than values: The value-based sustainability reporting that investors want* (Aug. 2019) (finding that "investors say they cannot readily use companies' sustainability disclosures to inform investment decisions and advice accurately"); Task Force on Climate-Related Financial Disclosures, Phase I Report of the Task Force on Climate-Related Financial Disclosures (2016) ("[U]sers of climate-related financial disclosure commonly identify inconsistencies in disclosure practices, a lack of context for information, and uncomparable reporting as major obstacles to incorporating climate-related risks as a consideration in the investment, credit, and underwriting decisions over the medium and long term."). What's more, the private ordering of tailored disclosure that's happening now advantages larger investors over those who lack the power to demand specific disclosure from large companies. The avenue those smaller investors do have to engage companies on these subjects—the shareholder proposal process—the Commission is proposing to narrow, reducing corporate accountability to shareholders.

[15] *See generally* Proposed Rule: Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, Exchange Act Rel. No. 87458 (Nov. 5, 2019), https://www.sec.gov/rules/proposed/2019/34-87458.pdf.

[16] *See* Comment of the Interfaith Center on Corporate Responsibility (Jan. 27, 2020) ("In our view, the proposed 12-fold increase in the ownership threshold is unwarranted and unfair. It is entirely inconsistent with the Commission's oft-touted focus on protecting smaller investors."); Comment of Jantz Management (Jan. 21, 2020) ("Examination of the highest dollar requirement shows that forcing a shareholder to maintain $25,000 in her portfolio concentrated on a single company intensely increases inequity in the proxy process. Based on wealth, the top 10% with half a million or more in savings are the only individual investors with the means to hold a minimum diversified portfolio of at least 20 equities meeting the Commission's new dollar threshold."). *See also* Recommendation of the Investor as Owner Subcommittee of the SEC Investor Advisory Committee Relating to SEC Guidance and Rule Proposals on Proxy Advisors and Shareholder Proposals at 12 (Jan. 16, 2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-proxy-advisors-shareholder-proposals.pdf ("The proposed changes regarding initial threshold requirements obviously raise the effective cost for small and medium-sized shareholders to bring proposals, and the proposed changes on the use of representatives will do so indirectly. Meanwhile, the higher initial thresholds will be trivial for large shareholders, and they will be able to bring proposals without relying on representatives."). Requiring smaller investors to wait three years before submitting a shareholder proposal—tripling the current waiting period—raises the risk that such shareholders' will be unable to submit timely, value-enhancing proposals to address issues as they arise. *See* Comment of NorthStar Asset Management (Feb. 3, 2020) ("Company controversies and missteps cannot be predicted, nor can they be postponed until a three year holding period has passed; a shareholder should not be required to wait out such a timeframe when engaging the company could have significant benefits for both the Main Street investor and shareholders at large.").

[17] *See generally* Proposed Rule: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Rel. No. 87457 (Nov. 5, 2020) ("Proxy Advisor Proposal"), https://www.sec.gov/rules/proposed/2019/34-87457.pdf.

[18] *See, e.g.*, Comment of CalSTRS (Feb. 3, 2020) ("The Proxy Advisor Rule proposal introduces substantive hurdles that impact the ability of investors, like CalSTRS, to efficiently vote our proxies in a timely manner . . . We are concerned that the proposed rule seeks to solve problems that simply do not exist and, if implemented, risks further diminishing the rights of shareholders and their ability to hold corporations accountable."); Comment of the National Conference on Public Employee Retirement Systems (Feb. 3, 2020) ("We are concerned the SEC's proposed changes to the exemptions for proxy voting advice will have a detrimental effect on state and local governmental pensions' access to timely, independent corporate governance research."); Comment of the Council of Institutional Investors (Jan. 30, 2020) ("We believe the proposed requirements would significantly and negatively impact the ability of institutional investors to obtain independent, timely, and cost-effective research and advice from our proxy advisors. We also believe the proposed requirements are largely premised on the incidence of factual errors and methodical weaknesses in proxy voting advice businesses' analyses. The Release, however,

fails to provide reliable evidence to support that premise. Setting aside our strong principles-based objections, the rules as proposed are simply unworkable.") Comment of AllianceBernstein (Feb. 3, 2020) ("We believe that the proposed company review framework as currently drafted may compromise the independence of the research undertaken by proxy voting advisory firms."); Comment of Council for Investor Rights and Corporate Accountability (Feb. 3, 2020) ("The prospect of disputes and even litigation arising from the registrant's pushback during a two-stage review might well lead proxy advisors to shy away from criticizing the registrant's corporate governance or executive pay policies and practices or supporting precatory shareholder proposals. And the risk of self-censorship would be more pronounced if registrants have the latitude to attack the advisory business's methodology, analysis and recommendations. Such attacks on proxy advisors' draft advice could cause them to alter the conclusions in their final reports to avoid litigation exposure."); Comment of Investment Adviser Association (Feb. 3, 2020) ("The Proposal would make it more difficult for investment advisers to vote proxies, including by significantly compressing an already very challenging timeline, increasing the costs and barriers to entry for proxy advisory firms, increasing costs and burdens for investment advisers, and negatively affecting the independence of advice.");

[19] *See, e.g.*, Proxy Advisor Proposal, *supra* note 17, at 39 and fn. 94. Instead, we simply count the claims made by issuers in proxy filings and report them without any evaluation of their merit. More troublingly, we have not provided the public with sufficient information about that data for anyone to identify the relevant filings and evaluate the claims on their own.

[20] According to the economic analysis, between 2016 and 2018, issuers filed additional definitive proxy materials *alleging* factual errors in only 0.3% of cases (of the 17,296 registrants that filed proxy materials during this time, the staff identified only 54 instances in which the registrant alleged factual errors).

[21] *Id.* at 43-44.

[22] *See* FINRA Rule 2241 (requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to promote objective and reliable research and that prohibit, among other things, prepublication review of a research report by a subject company for purposes other than verification of facts).

[23] *See* Commissioner Allison Herren Lee, Statement on Shareholder Rights (Nov. 5, 2019), https://www.sec.gov/news/public-statement/statement-lee-2019-11-05-shareholder-rights.