Insight

Overreach at the SEC

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Executive Summary

- Under Chair Gensler the SEC has issued a near-unprecedented number of rulemakings with the potential to upend the operations of broad swathes of the economy; nearly double that of his predecessors at the same point in their tenure.
- These rulemakings will add billions of dollars in regulatory costs and millions of hours in compliance for the entities that the SEC regulates.
- What characterizes rulemaking under Chair Gensler is a lack of consideration as to the costs – or potential legality – of these actions, or a clear demonstration of the urgent necessity for such significant market restructuring in the first place.

Introduction

On April 17, 2021, Gary Gensler began his term as the incumbent chair of the Securities and Exchange Commission (SEC). What followed has been a staggering number of rulemakings from the agency as Chair Gensler seeks to remake every section of the financial services sector, from private markets to the stock market and to environmental disclosure rules, and beyond. In a series of some 50-odd rulemakings, the SEC has to-date added at least $6 billion in increased annualized costs to industry and an additional 6 million compliance hours. This paper reviews the SEC's most significant rulemakings under Chair Gensler and a consideration of the ramifications of the SEC's actions for itself, the entities it regulates, and the wider economy.

Key SEC Proposed and Final Rules

Shareholder Proposals

November 3, 2021

In issuing Staff Legal Bulletin 14L, the SEC "reset" the shareholder proposal process, rescinding Staff Legal Bulletins 14I through K, issued under previous SEC leadership. The effect of the previous standards had been to reduce the burden on companies seeking to have the SEC support efforts to avoid certain shareholder votes. 14L reversed this leniency, directing SEC staff to, when considering whether a shareholder vote should go ahead, provide less weight to whether there is a sufficient "nexus" between a policy issue and the company and instead consider whether the issue has "social policy significance" (issues based typically on environmental, social, or governance-related policies). The SEC also reversed 2017 guidance that allowed companies to exclude proposals that considered questions related to less than 5 percent of a company's assets.

The combined effect of this reversion of the shareholder proposal process will be to significantly increase the number of questions that can be brought by shareholders at an annual meeting, on topics only tangentially aligned with the company's business model, over decisions that might be immaterial to a company's bottom line (and, one might think, to the performance of a shareholder's stock). This projected increase will come in addition to a significant historic increase in overall proposals

despite 14I through K. The SEC has further proposed that companies be unable to exclude proposals on the basis of duplication, so the sky truly has become the limit for disingenuous shareholders.

Private Funds

Proposed rule March 24, 2022, final rule adopted August 23, 2023

Between December 2021 and March 2022, it became clear that Chair Gensler intended to fundamentally rebuild the $27 trillion private market in the most significant regulatory update to the industry in nearly a century. As originally drafted, the rule required registered private funds to distribute quarterly financial statements and an annual audit requirement. These financial statements would include information on fees charged, and the SEC will require that certain fees be "fair and equitable." The rule also adds new restrictions on certain activities, including fund borrowing arrangements.

The cost of this significant additional regulatory burden will pass to investors, the category the SEC is nominally trying to protect. The SEC estimated in its rulemaking process that this rule alone would cost the industry $961 million annually. Dissenting board member Hester Peirce noted that the role of the SEC is not typically to protect highly informed investors from assuming risk, and questions remain as to whether the SEC actually has the authority to regulate private markets. Perhaps most baffling, the SEC justification for upending its highly destabilizing actions was to point to a lack of competition in private markets with zero evidence to demonstrate it – fees and market consolidation remain low.

After significant industry outcry, the final rule, adopted in August 2023, removed most but not all of the initial controversial requirements, most notably prohibitions against liability disclaimers, and will allow private fund advisors to participate in most activities given disclosure and consent requirements. Despite "watering down" the final rule, the SEC has still been the subject of a lawsuit led by the Managed Funds Association, the American Investment Council, and the National Association of Private Fund Managers, which allege that the SEC's rule, in addition to destabilizing private markets with unnecessary new compliance burdens, goes beyond the SEC's statutory mandate and violates administrative law.

Mandatory Disclosures for Public Companies of Climate-Change Risks

March 21, 2022

In what is perhaps the most controversial of the proposed rules under Chair Gensler, in March 2022 the SEC released a?proposed rule?that would, for the first time, require public companies operating in the United States to provide climate-related information in both their registration statements and annual reporting. These disclosures would require businesses to provide information on the climate-related risks they face, their governance and risk management processes in place to mitigate those risks, and their greenhouse gas (GHG) emissions.?These disclosures would cover not just the financial risks stemming from climate (itself notoriously difficult to model) but would extend to both a company's GHG emissions and its climate-related strategy and risk processes.?

In addition, the proposed rule would mandate that for certain aspects of the proposed requirements, most notably those sections related to GHG disclosures, public companies must obtain, over time, first “limited” and then “reasonable” “assurance” of the accuracy of the data provided. “Assurance” in this instance is guided by the attestation standards of global accountancy and seem to suggest that data provided in these disclosures will eventually require third-party audit or consultation.?

The SEC proposal presents two unique data challenges. The first is the difficulty in assessing GHG emissions along an entire supply chain. The second is the reliance on the accounting concept of materiality, itself a somewhat subjective measure on which to hang an entire disclosure framework, as businesses will be required to decide for themselves what is material to whom, dooming comparability from inception. Both these questions are made immeasurably more complex by the proposed requirement that businesses assess these over the long term and timeframes that could span decades.?

In attempting to enhance and make comparable disclosure practices that in many cases already exist, the SEC’s proposed rule raises serious questions ranging from constitutionality to even the basic necessity of a regulatory land-grab that seeks to tell businesses not only what they must do but also?how?they must address climate change. In what amounts to a desire to influence capital allocation decisions on the basis of political and social ends, the SEC arrogates a brand-new mission statement to itself – policing climate change – that it has neither the knowledge base nor likely the constitutional mandate to perform. This is hardly a convincing platform on which to construct a new disclosure regime that is already largely being adhered to voluntarily, would be extraordinarily costly, and most important, not be of sufficient quality to drive investor decisions for years to come.?

Stock Trading

December 14, 2022

The GameStop trading frenzy in January 2021 (a classic example of a “short squeeze” or a situation where investors bet against a stock, and its prices instead rise) led to calls in government for action, despite there being little evidence of wrongdoing or a class of abused victims. In December the SEC released its response to the GameStop “problem” in the form of the most significant regulatory update to stock market rules in decades. To protect individual investors, the SEC proposed rule would artificially constrain high-volume, high-speed brokerages, despite individual investors comprising their key clients. Under the SEC’s proposal, small-broker stock orders would be sent to auctions, enabling a wide variety of actors (from high-speed traders to traditional investors) to “compete” to fulfill stock orders. The SEC’s proposal would also seek to circumvent “payment for order flow” practices by requiring brokers to ensure that their customers get the best possible deal on the market.

While industry reaction has not been as heated as with other SEC proposals under Chair Gensler, trade association SIFMA (the Securities Industry and Financial Markets Association) noted in a statement that the SEC should proceed slowly on such significant and complex changes with a view to the potential for negative and unforeseen consequences. In this the SEC’s stock trading rule has suffered from the same shortcomings as its other regulatory initiatives, including a lack of obvious policy justification and insufficient consideration as to compliance and regulatory cost.

Other SEC Measures

While the above SEC rulemakings were highlighted for their significance (both to markets and for understanding the appropriate role of the SEC itself), the list is far from comprehensive. Chair Gensler has

issued nearly 50 substantive rulemakings during his tenure to date, covering topics as wide ranging as greenwashing, whistleblowing, swaps rules, and even AI.

Although the number and pace of SEC rulemakings is nearly unprecedented, any consideration of the SEC's impact under Chair Gensler would be incomplete without at least drawing attention to the ways in which the agency exerts its influence outside of the traditional rulemaking process. Chief among these measures are SEC enforcements (how the SEC polices its rules) and guidance (regulatory pronouncements ancillary to and interpretative of rulemakings). Both systems allow for the SEC to shape policy in a way that falls outside of the rulemaking process – most notably outside of rulemaking controls. While recognizing the possibility for hypocrisy in calling out the excessive number of SEC rulemakings and simultaneously calling for more, the only thing worse than an SEC rulemaking is the SEC making rules in a manner that is inconsistent, opaque, and outside of due process.

Nowhere is this awkward paradigm better demonstrated than in the SEC's approach to crypto. In lieu of Congress producing a comprehensive, whole-of-government approach to the regulation of digital assets, a patchwork of regulation is emerging out of non-rulemaking policy pronouncements from the SEC and the Commodities Futures Trading Commission. The most significant of these is the major crypto offensive launched by the SEC in the form of lawsuits against industry giants Binance and Coinbase. While the two sets of lawsuits are quite different, fundamentally both Binance and Coinbase have been accused of failing to register their exchanges with the SEC, something they would only be required to do if the cryptocurrencies on their exchanges would be more appropriately considered securities rather than commodities. This represents unsettled law – digital assets as a concept being significantly newer than the decades-old securities regulatory framework that grants the SEC its regulatory scope and powers.?In brief, Chair Gensler asserts that cryptocurrencies are securities because he says so.

Ramifications

A recent study by the Committee on Capital Markets Regulation analyzed SEC rulemakings under Chair Gensler and his confirmed predecessors. The committee found that under Chair Gensler, the SEC has published 47 substantive rulemakings, *double* that of his predecessors at the same points in their tenure, and without the backdrop of widespread collapse of the financial services sector. Perhaps most damning, the committee found that of these rulemakings, only eight (17 percent) were required by statute, making the vast majority of SEC work voluntarily undertaken.

Not only is this effort not specifically required by statute, but in several cases has appeared to contravene it. As noted above, the wide scope of SEC rulemakings raises questions as to whether the SEC is issuing rulemakings without the mandate of Congress. The Administrative Procedure Act requires that rulemakings be issued "within jurisdiction delegated to the agency and as authorized by law" and cannot be published on the basis of public interest alone – for novel categories of rulemaking, including those relating to the environment and digital assets, specific instruction from Congress is lacking.

In addition, the SEC has restricted public comment on these rulemakings in a manner unprecedented in its history. The Financial Services Forum in early 2022 found that where the SEC had historically given the public 60 to 90 days to comment on a proposal, under Chair Gensler the public had at least 60 days to comment only 7 percent of the time, with the average comment period being 38 days. This is an unacceptably short period of time for industry and the public to weigh in on rulemakings that, as noted above, are one-in-a-century or one-in-a-decade – even more so where the SEC has to date published 3,765 pages to the Federal Register to review. The Office of the Federal Register's Guide to the Rulemaking Process recommends that agencies provide comment periods of "180 days or more" on complex rules. This timeline is hurting more than just industry. The SEC's own inspector general noted that the rulemaking pace was

stretching staff thin, with the SEC seeing attrition numbers at their highest in a decade.

The total annualized cost of final rules overseen by the SEC under Chair Gensler is over $6 billion, with an estimated increase of 6 million additional compliance hours. This does not include the costs of the SEC's proposed rules, which number at least thirty. The financial impact in the form of increased uncertainty and compliance costs has the potential to hamstring the financial services sector at a critical time for the economy.

Conclusions

The SEC's unprecedented pace of rulemaking risks increased compliance costs passed to consumers, decreased competition in industry and market activity, and fears of market instability and the withdrawal of investor confidence. Despite these risks, Chair Gensler has used the SEC to embark on the single most transformative agenda seen in the agency's history, reaching into every section of economy and shaking it, seemingly just because he can. A marked lack of regard to the potential costs (or indeed constitutionality) of his rulemakings is one thing, but what truly characterizes Gensler's approach is a poorly articulated need for the existence of these rulemakings at all, or a demonstration of the urgent problems they are designed to address. Why break what isn't broken?