Speech

Governance and Transparency at the Commission and in Our Markets

Chairman Jay Clayton

Remarks at the PLI 49th Annual Institute on Securities Regulation - New York, N.Y.

Nov. 8, 2017

Thank you, Keith [Higgins], for that gracious introduction.[1] Let me return the sentiment. Keith – you are a member of an esteemed group of Division Directors, some of whom are here today, who have served the Commission and, most importantly, investors very well. The PLI 49th Annual Institute on Securities Regulation demonstrates the efforts by many to ensure that there is continuous education about the securities laws, as well as ongoing, candid dialogue about the state of our securities markets. I am honored to be here.

My remarks will focus on governance and transparency. These issues are, of course, related. Among its many benefits, transparency facilitates effective governance. My first topic will be transparency with respect to the operations of the Securities and Exchange Commission (the "SEC" or the "Commission"). Then I will turn to transparency in our securities markets – or said another way, how we can reduce opacity and, thereby, enhance our efforts to deter, mitigate, and eliminate fraud.

Commission Governance – The SEC's Agenda

Rulemaking is a key function of the Commission. And, when we are setting the rules for the securities markets, there are many rules we, the SEC, must follow. The most well-known is the Administrative Procedure Act, or the APA.[2] Another statute – a transparency-oriented one – is the Regulatory Flexibility Act, or the RFA.[3] The goal of the RFA is to fit regulatory and informational requirements to the scale of businesses.[4] That objective – in two words, regulatory proportionality – rings true with me. Under the RFA, federal agencies must "prepare an agenda of all regulations under development or review."[5] The agenda then distinguishes between rulemakings to be accomplished in the near-term – one-year – and the long-term – more than a year.[6]

For understandable reasons, the SEC's near-term agenda has swelled over the years. The Commission has limited resources, and rulemaking is, by its very nature, time- and resource-intensive. As a result, if all, or substantially all, of the rulemakings listed on previous near-term agendas were to evolve through to adoption, the process would take years. A quick data point: over the past 10 years, the Commission has completed, on average, only a third of the rules listed on the near-term agenda.[7] Let me be clear that I am not criticizing the approach of my predecessors. Prior Commission Chairs Mary Schapiro, Elisse Walter, and Mary Jo White, and Acting Chairman Michael Piwowar all were charged with an unprecedented number of mandates, and the Commission was highly productive in promulgating rules during their tenures. I expect that if I were in their shoes, my "Reg Flex" agendas would have looked much the same.

The next near-term agenda, which will be published as part of the federal government's Unified Agenda in coming months, will be shorter than in the recent past. This change is rooted in a commitment to increase transparency and accountability. Some may question the prioritization reflected in the near-term agenda. They have a right to do so, and we welcome constructive comments. We should endeavor to be transparent to Congress, investors,

issuers, and other interested parties about what rules we intend to pursue and have a reasonable expectation of completing over the coming year. And then, we must set forth to do it.

A shorter near-term agenda does not mean that that work of the SEC is slowing down. I am pleased that we are already making progress on many of our near-term projects. Between early October, when we submitted our agenda to OMB, and today, the agency has already completed two of the listed rulemakings.[8] In crafting the near-term agenda, we were mindful to reserve capacity for the Commission to react to major events or changes in the broader regulatory landscape. Recently, we provided timely, targeted relief to publicly traded companies, investment companies and others affected by Hurricanes Harvey, Irma, and Maria.[9] The Commission and the staff also provided interpretive guidance to assist companies with their efforts to comply with the pay ratio rule, and the staff issued a legal bulletin on shareholder proposals.[10] Separately, last month Commission staff issued three related no-action letters to provide market participants with greater certainty about the application of U.S. regulation as they engage in efforts to comply with the European Union's Markets in Financial Instruments Directive, or MiFID II, in advance of the January3rd implementation date.[11] This was our first significant "at bat" on MiFID II. I expect there will be many more pitches to come as our European colleagues seek to restructure their approach to various national, regional, and global markets. Geographic and activity-specific regulatory changes driven by MiFID II will almost certainly have substantial ripple effects that the SEC and other U.S. regulators will be called on to anticipate and address.

Commission Governance – Approach to the Agency's Five-Year Strategic Plan

We are applying a similar streamlining approach to the Commission's new strategic plan. In early 2018, we are required to lay out the agency's vision for the next four years.[12] The current strategic plan, developed in 2014, contains 66 strategic initiatives and 58 performance goals and indicators. When we complete the new strategic plan, I expect those numbers will be noticeably smaller and will reflect, on a Commission-wide basis, (1) the key challenges and trends facing our markets and regulatory programs, (2) the agency's most important strategic priorities, and (3) the initiatives we are pursuing to help us attain those goals. The plan will reflect what we need to do, what we should do, *and* what we believe we can do. Said another way, the strategic plan will reflect how we – my fellow Commissioners Kara Stein and Michael Piwowar, the senior leadership of the Commission, and I – see the future of the agency and how we plan to monitor our progress.

Commission Priorities–Longer-Term Agenda

I also am giving a lot of thought to the SEC's agenda over a longer period. Mandatory Dodd-Frank rulemakings are top of mind.[13] I have discussed with Commissioners Stein and Piwowar their views on SEC priorities and how to achieve them. And, assuming the confirmation process proceeds, I look forward to engaging with Hester Peirce and Robert Jackson, in areas where they each have expressed interest.

Shareholder Engagement and the Proxy Process

An area not on the near-term rulemaking agenda that is worthy of discussion is the proxy process, including how investors participate in corporate governance at public companies. Shareholder engagement is a hallmark of our markets, and our proxy rules – to use a highway analogy – provide a key lane for engagement, as well as much debated guardrails. Given the core role of the proxy process in public company governance, I believe the Commission should be "lifting the hood" and taking a hard look at whether the needs of shareholders and companies are being met. How are shareholders of all types getting information, and what information are they getting? Even if well-informed, are shareholders able to effectively participate in the voting process? What are the costs and burdens of the proxy system on companies, and how are they borne by shareholders? How are proxy rules affecting the ultimate beneficial owners of public companies – a majority of whom are "silent" retail investors?

Over the years, participants in the proxy process – companies and shareholders alike – have expressed concerns about a variety of proxy matters. In 2010, the SEC solicited input on several proxy matters in a concept release on

the U.S. proxy system.[14] Since that time, the SEC staff has taken steps to enhance the proxy process, but calls for action are becoming more frequent and are growing louder. [15] It is clear there are still opportunities for improvement. I believe the Commission should consider reopening the comment file on the 2010 "Proxy Plumbing" concept release to solicit updated feedback from market participants about what works and what does not work in our proxy system.

While there are a number of proxy matters that are timely for review, I will touch on two topics today: retail shareholder participation and shareholder proposals.

Retail Shareholder Participation. I have become increasingly concerned that the voices of long-term retail investors may be underrepresented or selectively represented in corporate governance. For instance, the SEC staff estimates that over 66% of the Russell 1000 companies are owned by Main Street investors, either directly or indirectly through mutual funds, pension or other employer-sponsored funds, or accounts with investment advisers. [16] And, if foreign ownership is excluded, that percentage approaches approximately 79%. Yet it is not clear whether in our rulemaking processes the views and fundamental interests of long-term retail investors are being advocated fully and clearly, either by individual investors or groups that represent them. Since I arrived at the agency, I have made concerted efforts to reach Main Street investors across the country, and this has resulted in productive conversations with individuals, as well as those who advocate for them.[17] Many others at the SEC, including Rick Fleming, our Investor Advocate, and the Office of Investor Education and Advocacy, concentrate on retail investors generally and have specific outreach efforts focused on investors who are teachers, students, serve in the military, or live in retirement communities.[18]

A majority of Main Street America's dollars are invested in vehicles where the investor – the person with their money at risk – is not the voting shareholder. Often voting power rests in the hands of investment advisers who owe a duty to vote proxies in a manner consistent with the best interests of the fund and its shareholders.[19] A question I have is: are voting decisions maximizing the funds' value for those shareholders?

In situations where the voting power is held by or passed through to Main Street investors, it is noteworthy that non-participation rates in the proxy process are high. In the 2017 proxy season, retail shareholders beneficially-owned 30% of the shares in U.S. public companies; however, only 29% of those shares voted.[20] This may be a signal that our proxy process is too cumbersome for retail investors and needs updating.[21]

Shareholder Proposals. The shareholder proposal process is a corporate governance issue that is subject to diverse and deeply held beliefs. Various stakeholders – companies, fiduciaries, individual investors, and investor groups – have established views on the appropriate set of rules for shareholder proposals, and there seems to be little ground for building a consensus. While I am supportive of rules that allow shareholder proposals, I am searching for a way to reconcile the multiple positions and find common ground.

History has shown that shareholder proposals can gain traction and lead to corporate governance changes that better track the long-term interests of Main Street investors. They also create costs, including out-of-pocket costs and the use of board and management time that otherwise could be devoted to the operation of the company itself. Some are of the view that companies should focus as much energy on shareholder engagement as is demanded. Others want management to dedicate as much time as possible to company operations for the benefit of all shareholders. The shareholder proposal process is not the only piece of this puzzle, but it is a piece worth examining.

Questions exist about the appropriate level of ownership that should be required to submit shareholder proposals, as well as whether our current resubmission thresholds are too low. The concern is that the thresholds allow proposals that shareholders previously rejected to be repeatedly resubmitted even though they receive a small fraction of shareholder support. We hear strong views on all sides, but one of my guiding principles is that we have to consider whether our rules are serving the long-term interests of Main Street investors. We need to make sure that those investors have a seat at the table as we examine the proxy process.

Deterring, Mitigating, and Eliminating Misconduct through Transparency and other Measures

Now I will turn to transparency in our securities markets. Enforcement is an essential component of the Commission's work. I and my fellow Commissioners have empowered our Co-Directors of Enforcement, Stephanie Avakian and Steven Peikin, to pursue an effective enforcement program that reflects the risks to retail investors in today's marketplace. In addition, as we carry out the Commission's mission, a question we should be continuously asking is: are there opportunities to deter, mitigate, or eliminate wrongdoing *before* an enforcement action becomes necessary?

Looking back at enforcement actions, a common theme emerges – where opacity exists, bad behavior tends to follow. As Joseph Pulitzer said: "There is not a crime, there is not a dodge, there is not a trick, there is not a swindle, there is not a vice which does not live by secrecy." The remainder of my remarks will concentrate on topics that have proven over time to be fertile ground for fraud on investors. The SEC may not yet have policy or rulemaking answers in these areas, but we are on the lookout for ways to fight the type of opacity that can create an environment conducive to misconduct.

Fee Disclosure. A narrative that flows throughout the Commission's inspection and enforcement programs is complex, obscure, or hidden fees and expenses that can harm investors. For example, some firms may invest clients' money in a mutual fund share class that charges a 12b-1 fee when a lower-cost share class of the same fund is available, or advisers may improperly choose to use fund assets to pay expenses that should be paid by the firm.[22] And customers may be deceived if brokers charge fees that are designed to cover the costs of services provided, while also marking up the prices of securities to earn a profit that is not disclosed.[23] I expect that our Enforcement Division will continue to be active in pursuing cases where hidden or inappropriate fees are at issue, but we also are exploring whether more can be done to clarify fee disclosures made to retail investors and, thereby, deter and reduce the opportunities for misbehavior.

Penny Stocks. The SEC's enforcement record also shows that many penny stocks have a conspicuous lack of transparency with respect to their financial condition and other key business information. Investors are often unable to find current, reliable information about penny stock issuers because many OTC companies are not required to provide current audited financials or other key information to investors. The shortage or absence of this critical information makes it at best very difficult for investors to evaluate the potential risks and rewards of such investments. Moreover, once one broker has performed certain required reviews of the company, others may "piggyback" on their efforts and quote the security without doing their own review. This "piggybacking" may continue for years even in the face of major corporate changes. So public information about penny stock issuers may not only be stale, but it could be inaccurate.

In addition to informational deficiencies, many penny stocks may be subject to insufficient custody arrangements. The resulting heightened risk of poor recordkeeping and lack of transparency can open the door to fraud and exploitation. Let me assure you, the Commission will continue to vigorously pursue bad actors in the penny stock market, but we also will examine ways to bring more light into the opaque aspects of this market.

Transaction Processing. Another scenario where obscurity may exist is when a retail investor purchases a "restricted security." For example, the retail investor may not understand that an "insider" is reducing his investment in the company while those known to him are promoting an investment. This opacity can be attractive to would-be bad actors. The Commission has noted, "[t]he need to prevent unregistered securities distributions is particularly acute in the microcap market, where OTC issuers may not be subject to certain of the Commission's disclosure requirements and there is an increased potential for fraud and abuse."[24] Because transfer agents are often responsible for removing legends on restricted shares, they are well-positioned to help prevent illegal distributions of unregistered securities. We have observed, however, that some transfer agents repeatedly disregard "red flags." In February 2017, the Commission charged a transfer agent that processed more than 200 transfers of shares after removing the restrictive legends on those shares based on opinion letters that were facially deficient.[25] This is an

area that we will continue to monitor, but regardless of what actions we take, it is incumbent on transfer agents to be diligent.

Initial Coin Offerings.There is also a distinct lack of information about many online platforms that list and trade virtual coins or tokens offered and sold in Initial Coin Offerings, or ICOs. Through these platforms, individual investors can buy and sell tokens in the secondary market using virtual or fiat currencies. But investors often do not appreciate that ICO insiders and management have access to immediate liquidity, as do larger investors, who may purchase tokens at favorable prices. Trading of tokens on these platforms is susceptible to price manipulation and other fraudulent trading practices.

The Commission recently warned that instruments, such as "tokens," offered and sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws.[26] The Commission also cautioned that any person or entity engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.[27]In addition to requiring platforms that are engaging in the activities of an exchange to either register as national securities exchanges or seek an exemption from registration, the Commission will continue to seek clarity for investors on how tokens are listed on these exchanges and the standards for listing; how tokens are valued; and what protections are in place for market integrity and investor protection.

Investor Education. Clearly, there are fraudsters in our marketplace who are seemingly unafraid of, or undeterred by, the risk of being caught. The SEC can target the underlying conduct of those fraudsters – and we do – but we also can and should arm investors with information that makes it more difficult for them to be defrauded. We think this will be particularly valuable when bad actors have shifted from the registered space for investment advisers and broker-dealers to the unregistered space. To that end, and a specific example of shedding light in areas that are dark, we are creating a website that will contain a searchable database of individuals who have been barred or suspended as a result of federal securities law violations. This resource is intended to make the prior actions of repeat offenders and fraudsters more visible to investors. The SEC also encourages investors to ask questions, and we help them figure out the right questions to ask.[28] We remind investors repeatedly that they should conduct a background check before investing with a financial professional, and we are showing them how to do just that.[29]

Conclusion

I will start where I began, which is to say that a thoughtful approach to transparency can enhance both governance and investor protection. I am committed to increasing transparency about SEC operations, and we also are focused on transparency efforts that further the long-term interests of retail investors.

Thank you.

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[1] My words are my own and do not necessarily reflect the views of my fellow Commissioners or the SEC staff.

[2] Pub. L. 79–404, 60 Stat. 237.

[3] Regulatory Flexibility Act of 1980, Pub. L. No. 96-354. Pursuant to this statute, federal agencies are required to publish an agenda of rules that they are developing that are likely to have a significant economic impact on a substantial number of small entities.

[4] *Id.*

[5] The Commission develops a "Reg Flex" agenda on a semiannual basis as part of the federal government's Unified Agenda of Regulatory and Deregulatory Actions. The agenda is published by the Office of Management and Budget ("OMB"). *See* Executive Order 12866 and *Introduction to the Unified Agenda of Federal Regulatory and Deregulatory Actions* [82 FR 40234 (Aug. 24, 2017)].

[6] Agencies have been advised that unless they "realistically intend to take action in the next 12 months" on a particular item, they should consider removing the item from the agenda. *See* Memorandum: Spring 2017 Data Call for the Unified Agenda of Regulatory and Deregulatory Actions (Mar. 6, 2017), *available at* https://www.whitehouse.gov/the-press-office/2017/03/06/memorandum-spring-2017-data-call-unified-agenda-federal-regulatory-and.

[7] As examples, 18 rules were listed as to-be-adopted in 2008, and 32 rules were listed in the same category for 2016; in each case, about 27% of the rules were adopted in each year.

[8] We proposed amendments to modernize and simplify disclosure requirements, as required by the FAST Act. The Commission also adopted amendments to designate certain securities listed, or authorized for listing, on the Investors Exchange as covered securities that are exempt from state law registration requirements. *See Fast Act Modernization and Simplification of Regulation S-K*, Release No. 33-10425 (Oct. 11, 2017), *available at* https://www.sec.gov/rules/proposed/2017/33-10425.pdf; *Covered Securities Pursuant to Section 18 of the Securities Act of 1933*, Release No. 33-10428 (Oct. 24, 2017), *available at* https://www.sec.gov/rules/final/2017/33-10428.pdf.

[9] Release No. 34-81760 (Sept. 28, 2017), *available at* https://www.sec.gov/rules/other/2017/34-81760.pdf, and *Regulation Crowdfunding and Regulation A Relief and Assistance for Victims of Hurricane Harvey, Hurricane Irma, and Hurricane Maria*, Release No. 33-10416 (Sept. 28, 2017), *available at* https://www.sec.gov/rules/interim/2017/33-10416.pdf.

[10] *Commission Guidance on Pay Ratio Disclosure*, Release No. 33-10415 (Sept. 21, 2017), *available at* https://www.sec.gov/rules/interp/2017/33-10415.pdf; Division of Corporation Finance, U.S. Securities and Exchange Commission, *Guidance on Calculation of Pay Ratio Disclosure* (Sept. 21, 2017), *available at* https://www.sec.gov/corpfin/announcement/guidance-calculation-pay-ratio-disclosure; Division of Corporation Finance, U.S. Securities and Exchange Commission, SEC Staff Legal Bulletin No.14I, *Shareholder Proposals* (Nov. 1, 2017), *available at* https://www.sec.gov/interps/legal/cfslb14i.htm.

[11] *See* Press Release No. 2017-200, SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Oct. 26, 2017), *available at* https://www.sec.gov/news/press-release/2017-200-0.

[12] Government Performance and Results Modernization Act of 2010, P.L. 111-352.

[13] The Commission has a number of statutorily-mandated items that we need to address, and we are continuing to consider how to advance those while also pursuing other initiatives that are central to the fulfilment of our statutory mission. Mandated rulemakings include those required by both the Fixing America's Surface Transportation Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[14] *Concept Release on the U.S. Proxy System*, Release No. 34-62495 (July 14, 2010) [75 FR 42982 (July 22, 2010)].

[15] *See e.g.*, Division of Investment Management and Division of Corporation Finance, U.S. Securities and Exchange

Commission, SEC Staff Legal Bulletin No. 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* https://www.sec.gov/interps/legal/cfslb20.htm.

[16] The SEC staff estimates that the value of 66% of the Russell 1000 is approximately $18.1 trillion.

[17] For example, in recent months I have engaged with retail investors in Georgia, Illinois, Missouri, Montana, Utah, and Virginia.

[18] *See e.g.*, https://www.sec.gov/page/investor-advocate-landing-page; https://www.sec.gov/oiea; "Specialized Resources," *available at* https://www.investor.gov/additional-resources.

[19] *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Release No. 33-8188 (Jan. 31, 2003), *available at* https://www.sec.gov/rules/final/33-8188.htm; *see* also *Proxy Voting by Investment Advisers*, Release No. IA-2106 (Jan. 31, 2003), *available at* https://www.sec.gov/rules/final/ia-2106.htm.

[20] *See* ProxyPulse, 2017 Proxy Season Review, September 2017, *available at* https://www.pwc.com/us/en/governance-insights-center/assets/pwc-proxypulse-2017-proxy-season-review.pdf .

[21] A 2005 SEC rule proposal would have allowed proxy cards to be sent with the notice of availability of proxy materials, but that component was not included in the final rule. It is still an open question whether eliminating at least one "click" in the process to vote would result in more Main Street investors voting their proxies. *See Internet Availability of Proxy Materials,* Release No. 34-52926 (Dec. 8, 2005) [70 FR 74598 (Dec. 15, 2005)]; *Internet Availability of Proxy Materials* Release No. 34-55146 (Jan. 22, 2007) [72 FR 4148 (Jan. 29, 2007)].

[22] *See e.g.*, https://www.sec.gov/litigation/admin/2017/34-81611.pdf; https://www.sec.gov/litigation/admin/2017/ia-4695.pdf.

[23] *See e.g.,* https://www.sec.gov/litigation/admin/2017/34-80332-s.pdf.

[24] *See Transfer Agent Regulations*, Release No. 34-76743 (Dec. 15, 2015) [80 FR 81948 (Dec. 31, 2015)], *available at* https://www.sec.gov/rules/concept/2015/34-76743.pdf.

[25] *See* https://www.sec.gov/litigation/admin/2017/33-10303.pdf (transfer agent settled, on a neither admit-nor-deny basis, an administrative proceeding finding violations of Section 5 of the Securities Act of 1933).

[26] *See Report on Investigation Pursuant to Section 21(a) of the Securities and Exchange Act of 1934; The DAO,* Release No. 81207 (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[27] *Id.* Any failure to register or operate without an exemption is a violation of Section 5 of the Exchange Act.

[28] *See e.g.,* https://www.sec.gov/investor/pubs/sec-questions-investors-should-ask.pdf.

[29] *See e.g.*, https://www.investor.gov/.