

Recommendations to
the SEC to Modify its
Procedural Framework to
**PREVENT
REGULATION BY
ENFORCEMENT**



FINANCIAL
SERVICES
INSTITUTE

January 2024



Recommendations to the SEC to
Modify its Procedural Framework to
PREVENT REGULATION BY ENFORCEMENT

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The Financial Services Institute**

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Table of Contents

I. Introduction	1
II. Executive Summary	4
III. What Is Regulation by Enforcement and How Is It Done?.	7
A. Working Definition	8
B. When Is It Not Regulation by Enforcement Despite Application to Novel Fact Patterns or New Technology.	9
C. SEC Enforcement Staff’s Extensive Power to Force Parties to Settle to Novel Case Theories	9
IV. Regulation by Enforcement Harms the Markets, the Investing Public and the Commission Itself	12
A. Unfair Treatment of Market Participants	13
B. Potential for Unintended Harmful Consequences Affecting the Markets and the Investing Public	13
C. Weakening Public Trust of the SEC and Its Staff and the Credibility of SEC Actions	13
V. Strong Concerns Expressed by SEC Commissioners	14
A. SEC Commissioner Statements on the Pitfalls of Regulation by Enforcement	15
B. Dissenting Statements by Commissioners in Recent Regulation by Enforcement Cases.	16
1) Misapplication of the Duty of Care for Investment Advisers in the Context of Seeking Best Execution	16
2) Expansion of Disclosure Obligations on Executive Compensation	17
3) Expansion of Investment Adviser Obligations Relating to Proxy Votes	18
4) Expansion of Corporate Disclosure Controls and Procedures Requirements	19
5) Extension of Fraud Liability to Third-Party Vendors Not Directly Involved in Securities Transactions	19
6) Expansion of Corporate Internal Control Obligations to Potential Insider Trading	20
VI. Case Studies Part 1: Lack of Appropriate Rulemaking and Guidance.	22
A. Share Class Selection Disclosure Initiative: A De Facto Attack Against A Shares and 12b-1 Fees.	23
B. Secondary Liability Relating to the Pre-Released ADR Enforcement Initiative.	25
VII. Case Studies Part 2: Appropriate Rulemaking and Guidance.	26
A. Appropriate Rulemaking Process Resulting in Reg BI	27
B. Appropriate Rulemaking Process Resulting in Proposed Rules for Cybersecurity	27

Table of Contents

VIII. SEC Should Adopt Policies and Procedures to Detect and Prevent Regulation by Enforcement.	30
A. Staff and Commission Should Consider the Following Factors Prior to any “First of Its Kind” Enforcement Action	31
1) Will the first of its kind enforcement action be reasonably perceived as a new standard of conduct or novel interpretation of an existing standard or rule?	31
2) Has there been reasonable and fair notice to both the subject of the enforcement action and to other potentially affected parties of the standard and interpretation underlying the enforcement action, including rules, guidance such as FAQs and alerts, public statements, or reports from the Commission or the Staff?	31
3) Has the Staff been aware of the existence of the practice that is subject of the enforcement action for an extended time period without any efforts to alert potentially affected parties of the Staff’s concerns?	32
4) Has the Staff obtained and considered feedback from potentially affected parties or their representatives, including financial industry groups, regarding the effect of the de facto policy or standard underlying the enforcement action?	32
5) Would an alternative to the enforcement action, including rulemaking, Staff alerts, or 21(a) Report of Investigation be a more effective and fairer Commission action?	32
B. Requirements for Recommendation and Advice Memos on Enforcement Actions and Initiatives to Discuss the Above Factors	33
C. Press Releases, Litigation Releases, Administrative Summaries or Other Public Announcement of Such First of Its Kind Action Should Reference Prior Notices, Alerts, or Statements Warning Against the Practice in Question	34
D. The Above Requirements Should Be Incorporated Into the SEC’s Enforcement Manual	34
E. Periodic Fairness Audits by the Office of the Inspector General to Assess Compliance With the Above Policies and Procedures	34
IX. Conclusion	35

SECTION I

INTRODUCTION

Introduction

The Financial Services Institute (“FSI”) acknowledges the important role of the U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) to protect the investing public, maintain the integrity of our financial markets, and promote capital formation. The Commission and the performance of its mission is critical to maintain the status of the U.S. financial markets as the best in the global financial market. To do so successfully, the Commission must remain fair in how it conducts its duties. To assist the Commission, FSI is publishing this white paper with recommendations to the Commission to adopt a procedural framework, through concrete policies and procedures, to detect and prevent certain unfair enforcement practices by the Commission and its Staff. As discussed below, the SEC has continued to use its enforcement powers to establish *de facto* rules without due process, fair notice, and consideration of public comments reflecting industry practice. Without notice or opportunities to comment, “regulation by enforcement” improperly circumvents the statutory requirements for agency rulemaking, violates the rights of those the agency regulates, and frustrates productive approaches to best protect investors.

We believe that both the Commission and FSI are in full agreement that fairness is of paramount importance to the SEC’s mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The SEC and participants in the financial markets have, at times, diverged on the question of what is fair or unfair, that is, whether certain enforcement cases, initiatives, and practices constitute unfair regulation by enforcement as opposed to enforcement investigations preceded by fair and reasonable notice based on clearly established legal requirements.

FSI supports the SEC’s mission to protect the investing public and agrees that the Commission and its Staff should not have to spell out every specific conduct or practice that may run afoul of the federal securities laws. Instead, the Commission and its Staff should and can rightfully expect regulated parties to make reasonable efforts to understand and interpret existing statutory provisions and rules, along with Commission and Staff guidance, in determining whether certain conduct is impermissible and potentially subject to SEC enforcement actions. Principles-based regulation is key to achieving this balance because it provides appropriate flexibility to entities with diverse business models to comply with regulations without requiring the Commission to anticipate every nuanced application of a regulation in advance. The practice also enables industry growth and advancement in technology without the Commission having to adjust a regulation each time a new business model is adopted, or an industry advancement is made.

However, firms and individuals regulated by the SEC should have reasonable notice as to what conduct would constitute violation of the federal securities laws and rules thereunder. Prior to bringing a novel enforcement case based on negligence, for instance, there should be clear notice as to what would constitute reasonable conduct or adequate disclosure. Those regulated by the SEC should also have the opportunity to provide feedback to any new standards or new interpretations of existing statutory provisions or rules, particularly before such new standards are applied in SEC enforcement actions.

As discussed below, FSI recommends that the SEC adopt what we expect to be non-controversial policies and procedures to detect and prevent unfair and improper SEC practices involving regulation by enforcement. These recommended steps should not be difficult to adopt as the proposed procedural framework is intended to leverage existing Commission process and infrastructure.

The SEC and the financial industry have a common interest in ensuring that the SEC performs its duties to protect the investing public in a fair and just manner. It is critical to the SEC's mission that its actions and decisions are perceived by the public to be fair and not in violation of the rights of those the agency regulates. FSI believes that these policies and procedures, if adopted by the Commission, will greatly advance this common interest.

“The SEC and the financial industry have a common interest in ensuring that the SEC performs its duties to protect the investing public in a fair and just manner.”

SECTION II

EXECUTIVE SUMMARY

Executive Summary

Unfair practices by agencies, such as the SEC, undermine the integrity of the agencies' missions, do harm to the regulated, and violate their basic rights. Public perception of unfairness degrades a government agency's moral authority and dilutes the deterrence value of its enforcement authority. Such perception hampers the Commission's mission to protect the investing public and foster capital formation. FSI thus believes that the Commission and market participants have a common interest in detecting and preventing regulation by enforcement.

Regulation by enforcement is when an enforcement action penalizes certain conduct that market participants did not previously understand to be a violation of the federal securities laws, despite these market participants' reasonable efforts to interpret existing laws, regulations, policies, and guidance from the SEC and other agencies. Without fair notice, market participants are also denied the opportunity to provide comments and feedback. This paper discusses examples of this unfair practice.

FSI recognizes, however, that applying straightforward legal theories to novel fact patterns is a legitimate and reasonable undertaking by the SEC in its enforcement efforts. As such, it is not rulemaking by enforcement if the SEC is applying the federal securities laws to a novel fact pattern that nevertheless clearly involves fraud or other illegalities, particularly misconduct that is intentional or reckless. In and of itself, a disagreement between regulated entities and the SEC regarding the merit of a rule being enforced by the SEC is not regulation by enforcement, provided that there was prior notice and opportunity for comments.

The danger of unfair regulation by the SEC and its Staff is clear and present because of the SEC Enforcement Staff's extensive power. This power is frequently used to force parties to settle to novel case theories. Threats of exponentially greater sanctions and more severe charges, individual liability, and disproportionately overburdensome investigative steps that can destroy a business often mean a regulated party is confronted with an offer of settlement one can ill afford to refuse. The settlements are then inappropriately used as precedents, creating a snowball effect in the form of de facto national standards.

Concern about regulation by enforcement is shared by several SEC Commissioners. In recent years, these Commissioners issued dissenting opinions regarding a broad range of SEC enforcement actions involving both financial market participants and public companies and their executives in which the Commissioners criticized the Commission for unfair enforcement actions that improperly created new standards or expanded the scope of existing rules.

As discussed below, there are also additional cases showing that unfair regulation by enforcement is ongoing. Yet, there are also recent case studies that show the Commission and its Staff, when willing, can productively engage in the legitimate rulemaking process, provide fair notice to the public, seek and consider public comments, and formulate rules to tackle difficult and complex issues.

FSI recommends that the SEC adopt what should be non-controversial policies and procedures to detect and prevent unfair and improper SEC practices involving regulation by enforcement. This procedural framework includes:

- Factors the Commission and Staff should consider prior to any novel enforcement actions, such as evidence of prior notice, reasonable alternatives to enforcement action, and the extent of inaction by Staff despite awareness of the issue;
- Discussion of these factors in recommendation or advice memos to the Commission;
- Transparency on such deliberation, including references in public releases on prior notices regarding the potential of such novel enforcement actions;
- Incorporation of such procedures in the SEC Enforcement Manual; and
- Periodic fairness audits by the Office of the Inspector General to ensure compliance with such procedures.

SECTION III

WHAT IS REGULATION BY ENFORCEMENT AND HOW IS IT DONE?

What Is Regulation by Enforcement and How Is It Done?

A. Working Definition

At a basic level, regulation by enforcement is when an enforcement action involves certain conduct that market participants did not previously understand to be a violation of the federal securities laws despite these market participants' reasonable efforts to interpret existing laws, regulations, policies, and guidance from the SEC and other agencies. In such instances, market participants would not have had an opportunity to provide comments or feedback on the apparent standard. The resulting standard is less likely to be effective because it lacks the practical on-the-ground industry perspective that would allow the new standard to work as intended.

FSI has identified the following indicia of regulation by enforcement where market participants did not have adequate notice or opportunity to comment on *de facto* standards established by SEC enforcement actions:

- Regulatory enforcement action (or an indication of noncompliance) without prior notice of the regulatory obligation, either by law, rule, litigated precedent, or clear explicit guidance;¹
- Enforcement actions without a reasonable time to comply with new rules, regulations, or guidance;
- Leveraging settled enforcement actions to establish legal obligations not previously disclosed to or known to industry;
- Prescriptive directives on regulatory obligations established through enforcement of a principles-based rule without prior notice or appropriate guidance;
- Regulations adopted without notice and comment rulemaking, contrary to due process and Administrative Procedure Act requirements;
- New interpretation(s) of an existing statute or rule not accomplished through rulemaking preceded by notice and comment, which provides stakeholders the opportunity to publicly comment;² and
- Staff-adopted guidance without prior engagement with the industry and a clear statement of regulatory expectations that provides a *reasonable* time to comply (guidance should not be applied retroactively).

“At a basic level, regulation by enforcement is when an enforcement action involves certain conduct that market participants did not previously understand to be a violation of the federal securities laws despite these market participants' reasonable efforts to interpret existing laws, regulations, policies, and guidance from the SEC and other agencies.”

¹ For example, see Comm'r Hester M. Peirce, *The SEC Levels Up: Statement on In re Activision Blizzard*, SEC (Feb. 3, 2023), <https://www.sec.gov/news/statement/peirce-statement-activision-blizzard-020323>; see also *infra* Section V.B.3.

² For example, see Comm'rs Hester M. Peirce and Mark T. Uyeda, *Statement Regarding In the Matter of Stephen J. Easterbrook and McDonald's Corporation*, SEC (Jan. 9, 2023), <https://www.sec.gov/news/statement/peirce-uyeda-easterbrook-mcdonalds-202301>; see also *infra* Section V.B.1.

B. When Is It Not Regulation by Enforcement Despite Application to Novel Fact Patterns or New Technology

FSI recognizes that applying straightforward legal theories to novel fact patterns is legitimate and appropriate. As such, it is not rulemaking by enforcement if the SEC is applying the federal securities laws to a novel fact pattern that nevertheless clearly involves fraud or other illegalities. Examples include insider trading, misappropriation of investor funds, and market manipulation involving novel facts. In such cases, an industry participant's conduct is outside accepted industry practices and norms, and the conduct satisfies the requisite mental state. For instance, no one would dispute the fairness of the SEC going after individuals for hacking into newswire services to facilitate insider trading, even though the matter involved new and unusual facts and circumstances.³

FSI's concerns with regulation by enforcement is with the unfair process that lead to a *de facto* rule and related policy results. Therefore, a disagreement between regulated entities and the SEC regarding the merit of a rule that is the subject of a novel enforcement action is not, in and of itself, regulation by enforcement, provided that there was prior notice and opportunity for comments. For instance, even after consideration of comments from the public, the SEC may nevertheless finalize a rule with which market participants have significant concerns. Rules and agency guidance, even if disfavored by certain industry participants, but finalized after notice and comment and industry feedback, at least demonstrate transparency and fair notice.

C. SEC Enforcement Staff's Extensive Power to Force Parties to Settle to Novel Case Theories

Some may argue that the risk of regulation by enforcement is overstated because a party ultimately has the legal right to defend itself in litigation against unreasonable and aggressive SEC enforcement action. But the reality is that the SEC can use its investigative and enforcement power to force parties to settle to novel and untested legal and policy theories, especially given the high costs and protracted timelines parties must endure when faced with combating an enforcement action through litigation. If parties refuse to voluntarily participate in these enforcement initiatives and instead choose to litigate, they may also face direct threats of harsher enforcement action by the SEC. The threat of harsher sanctions if a party is perceived to be not "cooperative" adds to this pressure.

In addition, rulemaking by enforcement has, in many instances, been enabled by a more expansive use of negligent fraud theories within the SEC's enforcement program. Typically, it is not easy for the SEC to establish a new standard through enforcement action if it must prove that someone intentionally committed securities fraud. Presumably, it would be hard to prove intent to deceive if the alleged misconduct was not already known to be improper. However, since the financial crisis, the SEC has increasingly been willing to bring enforcement actions based on the theory of "negligent fraud," i.e., that a person or entity committed fraud by failing to meet a certain standard of conduct or disclosure that the SEC views as "reasonable."⁴ As previously explained by the Commission, the scope of this negligent fraud liability is broad.⁵

³ FSI does not take a position on the current debate regarding SEC enforcement actions applying the federal securities laws to certain cryptocurrencies. Regulation of cryptocurrency by the SEC and other related agencies falls outside the material, scope, and topics covered in this paper. That said, we believe that the recommended procedural framework discussed in this paper may contribute to any dialogue involving fair notice in the context of agency enforcement actions.

⁴ See *SEC Enforcement Actions: Addressing Misconduct That Led To or Arose From the Financial Crisis*, SEC (last modified July 15, 2019), <https://www.sec.gov/spotlight/enf-actions-fc.shtml>.

⁵ *In the Matter of Flannery and Hopkins*, SEC (Dec. 15, 2014), <https://www.sec.gov/litigation/opinions/2014/33-9689.pdf>. This Commission opinion was overturned by the First Circuit on other grounds involving insufficient evidence, including insufficient evidence to prove materiality. *Flannery v. SEC*, 810 F.3d 1 (1st Cir. 2015).

This approach provides the SEC with a great deal of room to define reasonable standards through enforcement action. For instance, a financial firm may believe in good faith that it has disclosed all material facts to its clients or customers.⁶ However, despite the firm's good faith, the SEC may determine that the firm should have known that more details needed to be disclosed. Or a firm may in good faith believe that it had fulfilled its duty of care in performing due diligence prior to recommending an investment to a customer or client. However, despite the firm's good faith, the SEC may determine that the firm should have known that more due diligence was required. In both situations, the SEC can claim that the firm was negligent in connection with the disclosure or conduct failure resulting in "fraud."

Certain SEC Staff enforcement practices, when combined with the negligent fraud theory, place extreme pressure on financial firms to settle. For instance, the Staff may indicate to a financial firm that if the firm does not agree to a settlement involving negligence, the Staff may recommend enforcement action based on intent or recklessness. Thus, entities considering both potential reputational damage and cost of a trial would more likely settle as opposed to taking the case to trial or risk the SEC alleging intent to deceive. In particular, a firm charged with intentional fraud may not survive as a business in the immediate future even if it may have prevailed in litigation years later.

The Staff may also indicate to a financial firm that the Staff is willing to recommend negligent fraud settlement against the firm only but leave open the possibility of charges against individuals if the firm does not settle. Confronted by the potential reputational, financial, and emotional trauma and damage an individual may suffer in such circumstances, firms often settle to protect their employees and principals.

The Staff may also indicate to a financial firm that if the firm does not settle, the Commission may ultimately seek an exponentially greater amount of monetary sanctions in litigation. In addition to disgorgement of alleged ill-gotten gain, the Commission has significant statutory discretion to seek extraordinarily large sums in civil penalties, based on how it may define an individual "violation," e.g., number of customer accounts or number of trades and multiply a statutory maximum civil penalty amount by that number.

“Most disturbingly, financial firms have received what amounts to settlement demands from the Staff in the middle of an investigation.”

Most disturbingly, financial firms have received what amounts to settlement demands from the Staff in the middle of an investigation. In such instances, the Staff usually indicate that if the financial firm does not settle now, the Staff will undertake what would likely be additional burdensome investigative steps, including threats of reaching out to the firm's customers and clients.⁷ Some firms cannot survive if the Staff reaches out to their customers or clients with questions as to whether fraud was committed, even if such firms ultimately can prove their innocence at a later point. To avoid such burdensome and damaging investigative steps, many firms would accept such offers that they can ill afford to refuse.

⁶ In this white paper we use the term financial firm to refer to broker-dealers, investment advisers, firms with affiliated broker-dealers and investment advisers, and dual broker-dealer investment adviser registrants.

⁷ To the extent the Staff employs investigative steps with the primary goal of pressuring a party to settle, such investigative steps may violate the scope of the applicable Commission's formal order for investigation. Indeed, even the Commission itself does not have the statutory basis to authorize such investigative steps, to the extent the purpose of such steps is not primarily related to the investigation of facts.

Even members of the U.S. Supreme Court recognize the SEC's power to pressure parties to settle. As Justice Gorsuch stated in his recent concurring opinion in *Axon Enterprise, Inc. v. FTC*:

And how many people can afford to carry a case that far anyway? Ms. Cochran's administrative proceedings have already dragged on for seven years. Thanks in part to these realities, the bulk of agency cases settle. See *Tilton v. SEC*, 824 F. 3d 276, 298, n. 5 (CA2 2016) (Droney, J., dissenting) ("vast majority" of SEC cases settle); Tr. of Oral Arg. in No. 21-1239, p. 6 ("more than 90 percent" of such cases settle). Aware, too, that few can outlast or outspend the federal government, agencies sometimes use this as leverage to extract settlement terms they could not lawfully obtain any other way.⁸

On balance, the risk of litigating under a negligent fraud theory, combined with the extensive litigation timelines, reputational risks, and high costs noted above makes settlement a much more palatable option for entities facing such SEC enforcement actions. As noted above in Justice Gorsuch's concurring opinion, it is not surprising that the vast majority of SEC matters settle.

⁸ *Axon Enter., Inc. v. FTC*, 143 S. Ct. 890, 918 (2023).

SECTION IV

**REGULATION BY ENFORCEMENT HARMS THE MARKETS,
THE INVESTING PUBLIC AND THE COMMISSION ITSELF**

Regulation by Enforcement Harms the Markets, the Investing Public and the Commission Itself

A. Unfair Treatment of Market Participants

In our democracy, no one should be subject to government agency enforcement action without prior fair notice of the standards, rules, or laws that form the basis of the alleged violation. Without fair notice by a government agency, a party has no way to reasonably comply with such standards or provide their objections to the government prior to the setting of the standards or rules. Otherwise, enforcement action without fair notice goes against the letter and spirit of the Administrative Procedures Act and violates the basic rights of the regulated, including their constitutional right of Due Process under the Fifth Amendment of the U.S. Constitution.

“In our democracy, no one should be subject to government agency enforcement action without prior fair notice of the standards, rules, or laws that form the basis of the alleged violation.”

B. Potential for Unintended Harmful Consequences Affecting the Markets and the Investing Public

Without the opportunity to elicit and consider public comments, new *de facto* rules and standards created by enforcement action may harm the markets and the investing public. For instance, a draconian or overly cumbersome standard being set by an enforcement action may have the unintended consequence of regulated parties no longer being willing to provide the type of financial services that are the subject of the enforcement action. Or the Commission may establish a new standard or rule that, without input from the industry, may result in higher fees or expenses to the investing public. Similarly, regulation by enforcement runs the risk of unintended system disruption and inefficiency in the capital markets, creating an unnecessary burden to capital formation.

C. Weakening Public Trust of the SEC and Its Staff and the Credibility of SEC Actions

The SEC cannot effectively regulate the financial industry if industry participants reasonably believe that some of the SEC's enforcement actions are unfair. Without providing fair notice of standards that are the subject of enforcement actions, industry participants will have less incentive to invest in personnel and resources to comply with what they would view to be arbitrary and unpredictable standards.

Perceptions of unfairness resulting from regulation by enforcement will also weaken deterrence. Historically, SEC enforcement actions resulted in reputational damage to firms and individuals. This reputational impact played as important a role as financial sanctions in deterring misconduct. Perceptions of unfairness would weaken the SEC's moral authority and thus the deterrence value of its enforcement actions. Any perceived “toughness” would be diluted by such perception of unfairness, resulting in the loss of public trust in the agency. If SEC enforcement actions are perceived to be arbitrary and unpredictable, it would make the U.S. financial markets less attractive for financial firms. It would also foster cynicism that SEC enforcement actions are an unfortunate “cost of doing business.” This does not assist in fostering true cultures of compliance.

SECTION V

STRONG CONCERNS EXPRESSED BY SEC COMMISSIONERS

Strong Concerns Expressed by SEC Commissioners

We understand that regulators may be skeptical of complaints from the regulated regarding unfair enforcement practices. Indeed, one past SEC Commissioner has criticized the financial industry’s concerns regarding regulation by enforcement as disingenuous, arguing that the complaints reflect that the industry is “in favor of neither regulation nor enforcement.”⁹

In addition, we note that the Commission and its Staff have explained that the federal securities laws, including the antifraud provisions, are intended to be principles-based and have sufficient flexibility to address new technology and new developments in the markets based on these principles without needing to prescribe new rules or standards each time.¹⁰

However, as shown by the case study examples we highlight in this paper, some of these enforcement actions set standards that financial market participants could not have divined based on general securities laws principles. In addition, as discussed below, multiple SEC Commissioners have expressed concerns, particularly recently, on regulation by enforcement. While one may argue that these Commissioners tend to align with the same political party, there is no question that the Staff and the Commission should always consider and address policy and fairness concerns from SEC Commissioners.

A. SEC Commissioner Statements on the Pitfalls of Regulation by Enforcement

Concern about regulation by enforcement is not limited to the private sector. Several SEC Commissioners have—in both formal statements and dissenting opinions—expressed their skepticism about the practice.¹¹ For example, in a 2014 speech at the Securities Enforcement Forum, Commissioner Michael S. Piowar argued against regulation by enforcement because the practice bypasses notice and comment rulemaking and therefore raises Constitutional concerns under the Due Process Clause of the Fifth Amendment.¹² By creating regulations through enforcement actions, Commissioner Piowar argued individuals are deprived of any notice that their actions may violate the law, which infringes on the notions of fundamental fairness that underlay the Due Process Clause.¹³ Additionally, he explained that proceeding in this manner results in highly complex regulatory schemes and obscures the policy goals that inform the purpose of a given regulation, which ultimately results in a misalignment between agency action and existing policy-making priorities.¹⁴

In her 2019 speech, Commissioner Hester M. Peirce expressed similar due process concerns.¹⁵ By way of example, she explained her issues with the SEC’s “Share Class Selection Disclosure Initiative,” a voluntary self-disclosure program that allowed investment advisers who allocated clients to higher cost-share brackets without disclosing that the investment adviser received a fee for doing so, even when a lower cost share—

9 Mark Schoeff Jr., *SEC Member Robert Jackson Calls Out Critics of Agency ‘Rulemaking by Enforcement’*, INVESTMENT NEWS, (Dec. 9, 2019), <https://www.investmentnews.com/sec-member-robert-jackson-calls-out-critics-of-agency-rulemaking-by-enforcement-170856>.

10 See *Fireside Chat with Gurbir S. Grewal*, SEC Historical Society (May 17, 2023), <https://www.sechistorical.org/museum/events/2023-fireside-grewal.php>.

11 See Comm’r Michael S. Piowar, *Remarks to the Securities Enforcement Forum 2014*, SEC (Oct. 14, 2014), <https://www.sec.gov/news/speech/2014-spch101414msp#>; Comm’r Mark T. Uyeda, *Remarks at the “SEC Speaks” Conference 2022* (Sept. 9, 2022), <https://www.sec.gov/news/speech/uyeda-speech-sec-speaks-090922>.

12 See Piowar, *supra* note 11.

13 *Id.*

14 *Id.*

15 See Comm’r Hester M. Peirce, *“Reasonableness Pants,”* Remarks at Rutgers Law School (May 8, 2019), <https://www.sec.gov/news/speech/speech-peirce-050819>.

without a fee—was available.¹⁶ As a result of the initiative, the SEC settled with over 79 investment advisers and firms.¹⁷ Although not disagreeing with the result of the action, Commissioner Peirce raised due process concerns because of the aggregate nature of the settlements, which were pursued collectively by the SEC, erasing the individual distinctions between each firm’s actions.¹⁸ She also noted that the SEC failed to satisfy its duty to be clear with those it regulates:

[W]hen we see a widespread problem that is affecting investors, we—the Commission—should issue our own guidance or promulgate a rule and put an end to the problem before it hurts investors further. Doing this is better for investors than waiting many years to bring a large enforcement initiative. It is also respectful of the due process of the firms we regulate by giving them notice of what the SEC expects from them.¹⁹

Commissioner Mark T. Uyeda has also expressed concerns about regulation through enforcement actions.²⁰ During a speech at the 2022 “SEC Speaks” Conference, Commissioner Uyeda discussed the importance of avoiding the issuance of new interpretations of existing rules or statutes through SEC enforcement actions.²¹ Throughout the speech, he argued that regulation by enforcement prevents the public from providing their perspective on regulatory issues, which in turn can lead to a “myopic approach” to SEC regulation.²² Commissioner Uyeda also stated that regulation by enforcement may result in a failure to provide “nuanced and comprehensive guidance” to market participants, instead requiring entities to apply a distinctive factual analysis—that was developed in response to a specific set of case facts—to unique situations that were not contemplated during the initial enforcement action.²³

B. Dissenting Statements by Commissioners in Recent Regulation by Enforcement Cases

In addition to their public statements, several Commissioners have criticized regulation by enforcement in dissenting statements to Commission enforcement actions. Many of these dissents argue that certain Commission enforcement actions have no basis in existing legal authority or otherwise fall outside the scope of current regulatory provisions. These enforcement actions involve novel interpretations of existing regulations. They are implemented without public input or notice. As a result, these decisions by the SEC arguably create Due Process and other enforcement concerns as detailed above.

“In addition to their public statements, several Commissioners have criticized regulation by enforcement in dissenting statements to Commission enforcement actions. Many of these dissents argue that certain Commission enforcement actions have no basis in existing legal authority or otherwise fall outside the scope of current regulatory provisions.”

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 Uyeda, *supra* note 11.

21 *Id.*

22 *Id.*

23 *Id.*

1) *Misapplication of the Duty of Care for Investment Advisers in the Context of Seeking Best Execution*

In an enforcement action against two affiliated registered investment advisers,²⁴ the SEC found that both firms “failed to provide full and fair disclosure regarding their conflicts of interest” in connection with selection of share classes of mutual funds for their clients and resulting transaction fees on certain accounts. But in addition to findings of disclosure deficiencies, the Commission took the extra step to find that they breached their “duty to seek best execution” by failing to evaluate the reasonableness of certain transaction fees and default sweep accounts.²⁵

In their dissenting statement, Commissioners Peirce and Uyeda objected to what they believed to be an unwarranted application of the duty of best execution to mutual fund share class selection. They agreed with the premise that the advisers in question may have faced a conflict of interest, but they took the position that the Commission’s Order overreached and “create[d] novel regulatory interpretations through enforcement” because “there is no legal authority cited in the Commission Order for the finding that mutual fund share class selection implicates an investment adviser’s duty to seek best execution.”²⁶ They also noted that the decision in this instance to link the duty of best execution with the duty of care contradicted another recent Commission Order which found that a failure to seek best execution was a violation of the duty of loyalty.²⁷ Overall, the dissent expressed concern about the confusion in recent cases regarding the classification and enforcement of the duty to seek best execution and other standards of adviser conduct within both the duty of loyalty and the duty of care.²⁸ Ultimately, the dissent argued, “[i]f the Commission’s interpretations regarding an adviser’s standard of conduct are to have any meaning, the different categories of duties and the corresponding conduct that those duties implicate must be respected.”²⁹ Not only does this failure to clearly interpret the relevant statutory provisions undermine the Commission’s authority, it “has detrimental consequences for all regulated entities.”³⁰

2) *Expansion of Disclosure Obligations on Executive Compensation*

In a January 2023 dissenting statement to an settled enforcement action against a public company and its CEO, Commissioners Peirce and Uyeda argued that the SEC’s Order finding that the public company violated Section 14(a) of Exchange Act Rule 14a-3 would require corporations to make new executive compensation disclosures outside of those typically adopted as industry practice.³¹ The action in question arose in 2019 after the company classified the termination of its CEO as “without cause,” even though the company found that the CEO had engaged in inappropriate personal relationships with company employees and had withheld information regarding his misconduct during an internal investigation.³² According to the SEC Order, the company “failed to disclose that it exercised discretion in terminating [the CEO] ‘without cause’ under the relevant compensation plan documents after finding that he violated corporate policy, allowing [the CEO] to retain certain equity-based compensation that would have been forfeited if the company had terminated him for cause.”³³ By failing to disclose the company’s use of discretion in characterizing the termination as “without cause,” the company failed to provide all relevant disclosures required by Items 402(b) and 402(j) of Regulation S-K, which require companies to “disclose all material elements of compensation of named executive officers,” and to disclose all “material factors regarding agreements that provide for payments to a named executive officer in connection with his or her termination.”³⁴

24 Comm’rs Hester M. Peirce and Mark T. Uyeda, *Statement Regarding Huntleigh Advisors, Inc. and Datatex Investment Services, Inc.*, SEC (Feb. 27, 2023), <https://www.sec.gov/news/statement/peirce-uyeda-statement-huntleigh-datatex-022723>.

25 *Id.*

26 See Peirce and Uyeda, *supra* note 24.

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.*

31 Comm’rs Hester M. Peirce and Mark T. Uyeda, *Statement Regarding In the Matter of Stephen J. Easterbrook and McDonald’s Corporation*, SEC (Jan. 9, 2023), <https://www.sec.gov/news/statement/peirce-uyeda-easterbrook-mcdonalds-202301>.

32 See *In the Matter of Stephen J. Easterbrook and McDonald’s Corp.*, Securities Act Release No. 11144 (Jan. 9, 2023), <https://www.sec.gov/litigation/admin/2023/33-11144.pdf>.

33 *Id.* at 2.

34 See Peirce and Uyeda, *supra* note 31.

While not condoning the behavior of the former CEO or questioning the company's decision to terminate him, Commissioners Peirce and Uyeda argued that requiring the company to disclose its use of discretion in the classification of executive termination decisions goes beyond the disclosures required in the text of Section 14(a) of the Exchange Act, and the rules and regulations thereunder, and are otherwise contrary to existing industry practice.³⁵ In particular, they argued that the majority decision "creates a slippery slope that may expand Item 402's disclosure requirements into unintended areas" which would exceed the scope of disclosures commonly accepted as industry practice.³⁶

They also noted that this interpretation of Item 402's requirements would be completely novel, and can "be read to suggest that the underlying reason why the company decided to terminate a named executive officer 'without cause' instead of 'with cause,' and vice versa, need to be disclosed under Item 402."³⁷ Instead, they argued, if the SEC would like to expand disclosure requirements under Item 402, they should go through the standard notice and comment rulemaking process so that impacted entities understand all applicable SEC rules and regulations before being subject to their enforcement.³⁸ As such, this type of enforcement action falls squarely within a prong of FSI's working definition of regulation by enforcement: providing a new interpretation of an existing statute or rule not accomplished through notice and comment rulemaking, depriving stakeholders the opportunity to publicly comment.

3) *Expansion of Investment Adviser Obligations Relating to Proxy Votes*

Commissioners Peirce and Uyeda also issued a dissenting statement regarding an enforcement action against an investment adviser for providing a "standing order" to its proxy service provider.³⁹ At issue was the investment adviser's instructions to a third-party service provider to always vote client proxies in favor of management and against shareholder proposals.⁴⁰ In addition to a charge of negligent fraud, the Order included a finding of violation of Rule 206(4)-6, which requires investment advisers to adopt and implement policies to ensure that advisers "vote client securities in the best interest of clients." In particular, the Commission found that the investment adviser did not have any policies or procedures in place to ensure that votes issued pursuant to the standing order provided benefit for the clients in question.⁴¹

In their dissent, Commissioners Peirce and Uyeda argued that this Order overstepped existing SEC guidance because there was no indication that the advisers would have been better off if the votes were allocated differently, and there was no existing conflict of interest in the votes' allocation.⁴² Instead, the Order could be broadly interpreted to imply that the proxy practices in question were "per se improper" even though there is no guidance under the existing rule that prohibits a client and adviser from deciding that a standing order is in the best interest of the client, especially when there may be high costs associated with reviewing each individual proxy decision.⁴³ In particular, the Commissioners expressed concerns about the wide-ranging consequences of the Order for small and mid-size investment advisers, especially since the enforcement action was made in the absence of explicit regulatory guidance prohibiting the behavior.⁴⁴

35 *Id.*

36 *Id.*

37 *Id.*

38 *Id.*

39 Comm'rs Hester M. Peirce and Mark T. Uyeda, *Statement Regarding In the Matter of Toews Corporation*, SEC (Sept. 20, 2022), <https://www.sec.gov/news/statement/peirce-uyeda-statement-toews-corporation>.

40 *In the Matter of Toews Corp.*, Investment Advisers Act Release No. 6139 (Sept. 20, 2022), <https://www.sec.gov/files/litigation/admin/2022/ia-6139.pdf>.

41 *Id.*

42 See Peirce and Uyeda, *supra* note 39.

43 *Id.*

44 *Id.*

4) *Expansion of Corporate Disclosure Controls and Procedures Requirements*

In February 2023, Commissioner Peirce issued a dissenting statement regarding an enforcement action relating to a public company's workplace misconduct.⁴⁵ Commissioner Peirce argued that the Commission failed to give prior notice to entities of the regulatory obligation, either by law, rule, litigated precedent, or clear guidance.⁴⁶ The SEC investigation into the company began after reports of workplace misconduct that the SEC alleged were not adequately disclosed on Form 19-K under Exchange Act Rule 13a-15(a), which requires issuers to "maintain disclosure controls and procedures."⁴⁷ The company had disclosed some risks related to recruitment and staff retention, including that the company may have difficulty attracting and retaining talent—or that it may incur significant costs to do so.⁴⁸ However, the SEC alleged that the company lacked policies and procedures designed to collect data on allegations of workplace misconduct, or ensure that such information was available to the company's management and disclosure team.⁴⁹

In her dissenting statement, Commissioner Peirce indicated that while she found the allegations of widespread workplace misconduct at the company troubling, the SEC action in question was unwarranted because the company had not violated any *securities* laws.⁵⁰ Specifically, she argued, in its decision, "the Commission alleges no fraud, misrepresentations, omissions, or investor harm" and in fact, "the Order does not articulate any securities law violations" at all.⁵¹ Instead, relying on the findings of the Commission Order, she emphasized that the company's disclosure of risk in the area of hiring and retention of skilled personnel on Form 19-K was overall sufficient.⁵² In particular, she noted that workplace misconduct is but one factor in a company's overall employee turnover rate and that if the SEC is to play a role in ensuring that workplace misconduct is reported to the disclosure committee, it is hard to see where such disclosure requirements might end.⁵³ Commissioner Peirce further stated that "if we are to find a company in violation of a rule, we at least ought to articulate clearly what conduct violated the rule and how it did so."⁵⁴

5) *Extension of Fraud Liability to Third-Party Vendors Not Directly Involved in Securities Transactions*

Commissioners Peirce and Uyeda also dissented from an enforcement action against a pricing data provider.⁵⁵ Although not a direct seller of securities, the respondent provided customers with prices for more than 2.5 million securities.⁵⁶ It also provided a score, which evaluates the consistency of data used in their pricing model and was often used as a reference point by investors for "difficult to price" assets.⁵⁷

45 See Peirce, *supra* note 1.

46 *Id.*

47 *In the Matter of Activision Blizzard, Inc.*, Securities and Exchange Act Release No. 96796 (Feb. 3, 2023), <https://www.sec.gov/litigation/admin/2023/34-96796.pdf>.

48 *Id.* at 3–4.

49 *Id.*

50 Peirce, *supra* note 1.

51 *Id.*

52 *Id.*

53 *Id.*

54 *Id.*

55 Comm'rs Hester M. Peirce and Mark T. Uyeda, *Statement on In the Matter of Bloomberg Finance, L.P.*, SEC (Jan. 24, 2023), <https://www.sec.gov/news/statement/peirce-uyeda-statement-bloomberg-finance-012423>.

56 *Id.*

57 *In the Matter of Bloomberg Finance L.P.*, Securities Act Release No. 11150 (Jan. 23, 2023), <https://www.sec.gov/litigation/admin/2023/33-11150.pdf>.

In connection with the score, the respondent disclosed the use of two algorithms that evaluate data consistency.⁵⁸ In some instances, the company used an “Evaluator Input Tool” to incorporate single data points not captured by the underlying algorithms, which produced a price based solely on one data point for certain securities with limited market data.⁵⁹ The Commission found that in its disclosures, the respondent failed to divulge to customers that pricing information for certain securities could be based on a single data point input manually using the Evaluator Input Tool.⁶⁰ The Commission found that this failure to disclose constituted negligent fraud under Section 17(a)(2) of the Securities Act because the formula associated with those securities had not been “generated in accordance with the disclosed methodologies” and therefore the pricing data provider had omitted a material fact.⁶¹

However, the dissenting Commissioners argued that the relevant negligent fraud theory only prohibits material misstatements “in the offer or sale of securities” and would not apply to respondent in this instance because the company “was not offering or selling,” it was merely pricing securities.⁶² Therefore, the dissent argued, any sale by respondent was of its pricing services, not of the securities themselves.⁶³ While the dissenting Commissioners indicated that the SEC may want to consider implementing oversight for pricing agencies, they concluded that “[a] one-off enforcement action that rests on a strained reading of Securities Act Section 17(a)(2) is not the right way to make regulatory policy.”⁶⁴ Ultimately, Commissioners Peirce and Uyeda argued that the SEC Order adopted an overly-broad reading of Section 17(a)(2), and that if the Commission wanted to regulate pricing service activity, they should proceed with the pending notice and comment rulemaking process.⁶⁵

6) *Expansion of Corporate Internal Control Obligations to Potential Insider Trading*

Commissioners Peirce and Roisman expressed their dissent over an enforcement action that alleged corporate internal control violations for securities trading that the Staff could not prove to be illegal insider trading.⁶⁶ According to the Commission Order, the company had a policy that any stock buybacks comply with all applicable laws and regulations, including those that prevent companies from repurchasing stock while in possession of material non-public information. However, in 2015 and 2016, the company’s board of directors authorized the company to engage in over \$2 billion in share repurchases even though the company lacked sufficient internal accounting controls to ensure that the company’s actions were “executed in accordance with management’s authorization.”⁶⁷ Specifically, the SEC found that the company did not have sufficient controls in place to ensure that the company was not in possession of material non-public information before the buyback was executed, and as a result of this failure, the company proceeded with buyback transactions which were “not executed in accordance with management’s authorization.”⁶⁸

58 *Id.* at 4.

59 *Id.*

60 *Id.*

61 *Id.* at 5.

62 See Peirce and Uyeda, *supra* note 24.

63 *Id.*

64 *Id.*

65 *Id.*

66 Comm’rs Hester M. Peirce and Elad L. Roisman, *Statement of Commissioners Hester M. Peirce and Elad L. Roisman – Andeavor LLC*, (Nov. 13, 2020), <https://www.sec.gov/news/public-statement/peirce-roisman-andeavor-2020-11-13>. Commissioners Peirce and Uyeda recently issued a similar dissent in connection with another enforcement matter. Comm’rs Hester M. Peirce and Mark T. Uyeda, *The SEC’s Swiss Army Statute: Statement on Charter Communications, Inc.*, SEC (Nov. 14, 2023), <https://www.sec.gov/news/statement/peirce-uyeda-statement-charter-communications-111423>.

67 *In the Matter of Andeavor LLC*, Securities Exchange Act Release. No. 90208 (Oct. 15, 2020), <https://www.sec.gov/litigation/ad-min/2020/34-90208.pdf>.

68 *Id.* at 2.

Later, the company's CEO directed the company to repurchase over \$250 million in shares.⁶⁹ At the time this repurchase was ordered, the CEO was scheduled to resume conversations with another company, which had begun earlier, to discuss a potential acquisition of the company at a large premium.⁷⁰ The stock repurchase was approved by the company's legal department, despite its knowledge of the merger discussions, "based on a deficient understanding of all relevant facts and circumstances regarding the two companies' discussions, [and] that those discussion did not constitute material non-public information."⁷¹

The Commission Order found that the company violated Section 13(b)(2)(B) of the Exchange Act, which requires a system of "internal accounting controls" because the company repurchased stock from shareholders while the company possessed material non-public information about a potential merger.⁷² Ultimately, the Order concluded that the company "used an abbreviated and informal process to evaluate the materiality of the acquisition discussions."⁷³

In their dissenting statement, Commissioners Peirce and Roisman indicated that while they believe that insider trading is unacceptable, they also believe that the enforcement action expanded the internal control provision beyond its purpose, plain language, and historical interpretation.⁷⁴ In particular, they argued that "the Commission has never before found that the 'internal accounting controls' [provision] . . . include[s] management's assessment of a company's potential insider trading liability" and therefore "[t]his application of Section 13(b) (2)(B) exceeds its limited scope."⁷⁵ Commissioners Peirce and Roisman contended that the SEC Order effectively expanded the meaning of "accounting controls" to a "generic 'internal controls' requirement."⁷⁶

69 *Id.*

70 *Id.*

71 *Id.*

72 Peirce and Roisman, *supra* note 66.

73 *Andeavor*, *supra* note 67.

74 Peirce and Roisman, *supra* note 66.

75 *Id.*

76 *See id.*

SECTION VI

CASE STUDIES PART 1: LACK OF APPROPRIATE RULEMAKING AND GUIDANCE

Case Studies Part 1: Lack of Appropriate Rulemaking and Guidance

A. Share Class Selection Disclosure Initiative: A De Facto Attack Against A Shares and 12b-1 Fees

As FSI has addressed in the past, and consistent with Commissioner Peirce’s statement discussed above, there remain concerns regarding unfair enforcement practices in the SEC’s Share Class Share Disclosure Initiative (“SCSDI”), which the Division of Enforcement launched in February 2018.⁷⁷ With the benefit of hindsight and after over a hundred enforcement actions, the ultimate outcome of the SCSDI is a *de facto* regulatory presumption against the use of mutual fund A share classes and 12b-1 fees.⁷⁸ This presumption has evolved to become one that can only rarely be cured through disclosure and has essentially become a rule, though with no notice or comment or any other opportunities for industry input. And yet, prior to the 2018 SCSDI Announcement—which noted that “differing share classes facilitate many functions and relationships . . . investment advisers must be mindful of their duties when recommending and selecting share classes for their clients and disclose their conflicts of interests related thereto”⁷⁹—the Commission did not issue guidance or request comment on this very topic.⁸⁰

“With the benefit of hindsight and after over a hundred enforcement actions, the ultimate outcome of the SCSDI is a de facto regulatory presumption against the use of mutual fund A share classes and 12b-1 fees.”

More notably, the Division of Enforcement had brought and settled several enforcement actions against investment advisers over Rule 12b-1 prior to 2018,⁸¹ and therefore knew of the existence of these practices. The Staff recognized the receipt of 12b-1 payments presented a conflict of interest and believed that investment advisers were “not adequately disclosing or acting consistently with the disclosure regarding conflicts of interest related to their mutual fund share class selection practices,” but only made that key statement in 2019 as part of announcing several dozen settlements.⁸²

77 Press Release, SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors, SEC (Feb. 12, 2018), <https://www.sec.gov/news/press-release/2018-15>.

78 Rule 12b-1 of the Investment Company Act of 1940 authorizes funds to pay distribution, marketing, and certain shareholder service fees out of fund assets, passing these expenses through to the investor. 17 CFR § 270.12b-1. Rule 12b-1 payments can create a conflict of interest where an adviser is selecting share classes of a mutual fund, as some share classes may result in an additional payment under Rule 12b-1 to the adviser whereas other share classes (typically, institutional share classes), will not.

79 SEC Press Release, *supra* note 77.

80 We note that the July 2016 Risk Alert from the Office of Inspections and Examination (now the Division of Examinations) highlighted a focus on “certain registered advisers and their associated persons that may be receiving undisclosed compensation or other financial incentives.” OCIE Risk Alert, OCIE’s 2016 Share Class Initiative, SEC (July 13, 2016), <https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf>.

81 See e.g., *In the Matter of Packerland Brokerage Servs., Inc.*, Investment Advisers Act Release No. 4832 (Dec. 21, 2017); *In the Matter of SunTrust Inv. Servs., Inc.*, Investment Advisers Act Release No. 4769 (Sept. 14, 2017); *In the Matter of Envoy Advisory, Inc.*, Investment Advisers Act Release No. 4764 (Sept. 8, 2017); *In the Matter of Cadaret, Grant & Co., Inc.*, Investment Advisers Act Release No. 4736 (Aug. 1, 2017); *In the Matter of Pekin Singer Strauss Asset Mgmt. Inc.*, Investment Advisers Act Release No. 4126 (June 23, 2015); *In the Matter of Manarin Inv. Counsel, Ltd.*, Investment Advisers Act Release No. 3686 (Oct. 2, 2013).

82 Press Release, SEC Share Class Initiative Returning More Than \$125 Million to Investors, SEC (Mar. 11, 2019), <https://www.sec.gov/news/press-release/2019-28>.

Furthermore, there was an opportunity for rulemaking as, alongside SCSDI, the Commission was also in the midst of the comment process for the Investment Adviser Interpretation (“Interpretation”), as part of the Regulation Best Interest (“Reg BI”) rulemaking (proposed in 2018,⁸³ adopted in 2019).⁸⁴ The SEC proposed and ultimately adopted the Interpretation, which purported to consolidate and reaffirm aspects of the fiduciary duty investment advisers owe their clients under Section 206 of the Advisers Act. Both the comment process on the proposal and the commentary surrounding the adoption of the Interpretation uncovered confusion and disagreement among stakeholders regarding the purpose of the rulemaking and whether it reshaped fiduciary duties for investment advisers.⁸⁵ However, the Commission did not address share class matters in the proposed or final Interpretation.

In October 2019, just a few months after the Commission adopted the Interpretation and the first phase of SCSDI matters were settled, the Division of Investment Management issued staff guidance, in the form of an FAQ, regarding disclosures of certain financial conflicts related to investment adviser compensation (“2019 FAQ”). The 2019 FAQ substantiates—and somewhat legitimizes—the positions previously articulated in the course of SEC examinations and enforcement actions. At the time, the 2019 FAQ also indicated that the SEC Staff would continue to expand its focus beyond 12b-1 fees and revenue sharing to evaluate how investment advisers manage conflicts of interest associated with the receipt of compensation from investments the advisers recommend to their clients. Based on recent enforcement efforts, the Staff has continued to investigate conduct tied to share class selection and fees that could differentiate one share class from another.⁸⁶

The SEC’s enforcement approach has had varying levels of success when faced with litigation. For example, in the *Ambassadors* litigation the court granted the Commission’s motion for summary judgment as to the Section 206(4) and Rule 206(4)-7 allegations and denied the Commission’s motion for summary judgment as to the Section 206(2) allegations, effectively wholly disagreeing with the concept of 206(2) negligent fraud.⁸⁷ And, the SEC lost in a jury trial against a small investment adviser.⁸⁸ Apparently, the SEC was unable to convince the jury that the firm breached its fiduciary duty despite allegations consistent with the factual basis for other settled actions.⁸⁹ Since then, case theories in share class matters have moved beyond disclosure case theories and the duty of loyalty to encompass duty of care case theories, which were barely mentioned in the 2019 FAQ.

The SCSDI reflects a longstanding distaste by the Commission and its Staff with A shares and 12b-1 fees and resulted in a de facto prohibition without rulemaking. Based on this view, the SEC could have addressed this concern through reopening the Interpretation for notice and comment, but it failed to do so.

83 *Proposed Rule: Regulation Best Interest*, Exchange Act Release No. 83062, 83 FR 21574 (May 9, 2018, proposed Apr. 18, 2018); *Proposed Commission Interpretation Regarding Standard of Conduct for Investment*, Investment Adviser Release No. 4889, 83 FR 21203 (May 9, 2018, proposed Apr. 18, 2018); *Form CRS Relationship Summary; Amendments to Form ADV*, Exchange Act Release No. 83063, 83 FR 21416 (May 9, 2018, proposed Apr. 18, 2018); *Required Disclosures in Retail Communications and Restrictions in the Use of Certain Names or Titles*, Exchange Act Release No. 83063, 83 FR 21416 (May 9, 2018, proposed Apr. 18, 2018).

84 *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 86031, 84 FR 33318 (July 12, 2019); *Form CRS Relationship Summary; Amendments to Form ADV*, Exchange Act Release No. 86032, Investment Advisers Act Release No. 5247, 84 FR 33492, 33501 (July 12, 2019) (“Form CRS Adopting Release”); the Interpretation, *supra* note 4; *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Investment Adviser Act Release No. 5249, 84 FR 33681 (July 12, 2019).

85 See, e.g., Rick Fleming, Investor Advocate, SEC, *Statement Regarding the SEC’s Rulemaking Package for Investment Advisers and Broker-Dealers*, SEC (June 5, 2019), <https://www.sec.gov/news/public-statement/statement-regarding-sec-rulemaking-package-investment-advisers-broker-dealers>.

86 See, e.g., *In the Matter of HighPoint Advisor Group, LLC*, Advisers Act Release No. 6003 (Apr. 27, 2022), <https://www.sec.gov/litigation/admin/2022/ia-6003.pdf>.

87 *SEC v. Ambassador Advisors, LLC, et al.*, No. 5:20-cv-02274 (E.D. Pa. filed May 13, 2020).

88 See *SEC v. CapWealth Advisors LLC et al.*, No. 3:20-cv-1064 (M.D. Tenn. filed Dec. 11, 2020).

89 *How a \$1.3bn RIA beat the SEC in a 12b-1 fee trial*, CITYWIRE (Nov. 16, 2022), <https://citywire.com/pro-buyer/news/how-a-1-3bn-ria-beat-the-sec-in-a-12b-1-fee-trial/a2402598>.

B. Secondary Liability Relating to the Pre-Released ADR Enforcement Initiative

In a 2020 settled administrative proceeding, the SEC created a novel rule that a registered broker-dealer needed to monitor *contractual* obligations of other parties in a securities transaction even though the broker-dealer only had an ancillary role in facilitating the transaction. The SEC faulted a registered broker-dealer for not adequately supervising its securities lending desk personnel who in turn allegedly failed to monitor the compliance with terms of a contract between two other parties who had entered into a contract governing the sale of “Pre-Released American Depositary Receipts” (“pre-released ADRs”). The SEC alleged that the broker-dealer’s lending desk personnel should have detected one of the contracting parties’ material breach of the contractual obligations set forth in their Deposit Agreement.⁹⁰ By failing to detect the contractual breach, the firm personnel participated in what the SEC characterized as securities fraud involving the contract breach. In turn, the firm failed to supervise its personnel with a view to prevent its personnel’s alleged fraud. The SEC found fault with the broker-dealer firm even though the firm specifically notified the relevant parties that it would not monitor compliance with the terms of contract for which the firm was not a party.⁹¹

Through this enforcement action, the SEC has established an apparent rule that a market participant with an ancillary role in a securities transaction must monitor other parties’ compliance with the terms of contracts even if it is not a party to the contract.⁹² Not only has there been no prior notice of such an expansive rule, but there is also no apparent consideration by the Commission of the potentially extensive costs and market disruption such a rule would cause.

⁹⁰ *ABN AMRO Clearing Chicago LLC*, Exchange Act Release No. 88139 (Feb. 6, 2020), <https://www.sec.gov/litigation/admin/2020/34-88139.pdf>.

⁹¹ *Id.* at 2.

⁹² See, e.g., *SEC Continues to Bring Actions against ADR Lenders*, Cleary Gottlieb Client Alert, (Sept. 18, 2019), <https://www.cleary-gottlieb.com/news-and-insights/publication-listing/sec-continues-to-bring-actions-against-adr-lenders-for-use-of-uncovered-pre-released-adrs>.

SECTION VII

CASE STUDIES PART 2: APPROPRIATE RULEMAKING AND GUIDANCE

Case Studies Part 2: Appropriate Rulemaking and Guidance

A. Appropriate Rulemaking Process Resulting in Reg BI

As mentioned above, Reg BI was proposed in 2018 and adopted in 2019. Reg BI has four component obligations: (1) the Conflict of Interest Obligation; (2) the Disclosure Obligation; (3) the Care Obligation; and (4) the Compliance Obligation.⁹³ Furthermore, while Reg BI has been subject to several statements and FAQs,⁹⁴ these refine questions that were partially addressed in rulemaking and require further clarification, as opposed to attempting to address new areas or new obligations beyond the four core obligations. Reg BI also underwent a full rulemaking instead of the SEC attempting to evolve the standard of care for broker-dealers through application of a theory of negligent fraud to the then-existing suitability standard.⁹⁵

There remains the potential for the SEC—whether the Staff or the Commission—to further define certain contours of Reg BI beyond the standard available through rulemaking and follow-up issuance of guidance, as well as through settlement orders, particularly with regard to applying the Reg BI standard to individual registered representatives. Therefore, it is imperative that Reg BI continues to be applied pursuant to the rule text and guidance and not extended in ways that were not contemplated during rulemaking and guidance drafting. In turn, new rule proposals addressing conflicts of interest should not be overly lengthy and should be additive rather than duplicative.⁹⁶

B. Appropriate Rulemaking Process Resulting in Proposed Rules for Cybersecurity

Cybersecurity—and the importance of protecting client information, other confidential information, and the fact that the financial services industry continues to be a target of cyber criminals—could have been a tempting area to create standards through enforcement actions. Instead, we have witnessed an appropriate, reasonable, long runway toward increased cybersecurity requirements for all parts of the financial services industry under SEC jurisdiction. Rulemaking began in 2022,⁹⁷ followed by 2023 rulemaking.⁹⁸

93 17 CFR § 240.15 I-1 (2019) sets out the four obligations in the following order: (1) Disclosure Obligation; (2) Care Obligation; (3) Conflict of Interest Obligation; and (4) Compliance Obligation. We have re-ordered them to reflect the approach which most broker-dealers take to surfacing conflicts, ensuring disclosure, and generally integrating both processes together, along with compliance with the Care Obligation.

94 See generally *Regulation Best Interest, Form CRS and Related Interpretations*, SEC (modified Apr. 20, 2023), <https://www.sec.gov/regulation-best-interest>.

95 While the Commission appropriately uses the rulemaking process to address policy concerns here, FSI remains concerned that the Commission and the Staff may attempt to expand Reg BI through enforcement actions. This concern is not unfounded as then-SEC Commissioners Allison Herren Lee and Robert Jackson Jr. previously suggested that Reg BI could be amended via enforcement. *Reg BI will be Shaped by Enforcement Decisions, Democratic SEC Commissioners Say*, INVESTMENT NEWS (Dec. 6, 2019), <https://www.investmentnews.com/reg-bi-will-be-shaped-by-enforcement-decisions-democratic-sec-commissioners-say-170850>.

96 See, e.g., *Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*, Exchange Act Release No. 97990, Investment Advisers Act Release No. 6353, 88 FR 53960 (Aug. 9, 2023, proposed July 26, 2023).

97 *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies*, Exchange Act Release No. 11028, 87 FR 13524 (Mar. 9, 2022, proposed Feb. 9, 2022).

98 See, e.g., *Cybersecurity Risk Management Rule for Broker-Dealers, Clearing Agencies, Major Security-Based Swap Participants, the Municipal Securities Rulemaking Board, National Securities Associations, National Securities Exchanges, Security-Based Swap Data Repositories, Security-Based Swap Dealers, and Transfer Agents*, Exchange Act Release No. 97142, 88 FR 20212 (Apr. 5, 2022, proposed Mar. 15, 2023).

The runway culminating in 2022 and 2023 rulemaking began in March 2014, when the SEC sponsored a Cybersecurity Roundtable where SEC Commissioners and Staff, along with industry representatives, addressed the importance of cybersecurity to the integrity of the market system and customer data protection. Soon after, in April 2014, the Office of Compliance Inspections and Examinations (now the Division of Examinations) published a Risk Alert announcing a series of examinations to identify cybersecurity risks and assess cybersecurity preparedness in the securities industry. The Staff followed up with additional risk alerts publishing observation and findings (February 2015) and inclusion of cybersecurity in exam priorities in 2015. Furthermore, a September 2015 Risk Alert provided additional guidance and expectations to the industry.

Since 2015, the SEC's examinations program has noted in each of its annual "Priorities" releases, as well as in a focused January 2020 Cybersecurity and Resiliency Observations report, the importance of practices to manage cybersecurity risks and maintain operational resiliency that SEC examiners have observed through "thousands of examinations of broker-dealers, investment advisers, clearing agencies, national securities exchanges and other SEC registrants. . . ." The report covered areas of governance and risk management, access rights and controls, data loss prevention, mobile security, incident response and resiliency, vendor management, and training and awareness.

There have been settled orders, but these orders focused on expectations that could be surmised from the many Risk Alerts and other SEC reports on cybersecurity. For example, in 2015, the SEC brought its first ever enforcement action against an investment adviser in connection with a cyber breach.⁹⁹ The action involved a breach of a third-party-hosted web server that held personally identifiable information ("PII") of the investment adviser's clients. The SEC faulted the investment adviser for failing to have any written policies to safeguard client PII. At the time, the SEC did not set forth any requirements to assess an outside vendor's ability to safeguard client data, which would have been an example of regulation by enforcement, as compared to the policies and procedures violation.

More recently, in 2018, the SEC settled with a dual broker-dealer/investment adviser registrant charged with violating Rule 30(a) of Regulation S-P (the "Safeguards Rule" or "Reg S-P") and Rule 201 of Regulation S-ID (the "Identity Theft Red Flags Rule" or "Reg S-ID").¹⁰⁰ Notably, this was the first SEC enforcement action charging violations of the Identity Theft Red Flags Rule, as well as violations of Reg S-P. The SEC alleged that intruders had impersonated contractors of the firm by calling a support line and requesting the contractors' passwords be reset. By using these reset passwords, the cyber intruders then gained access to the personal information of the firm's customers and clients, thereby allowing them to create new online profiles and obtain unauthorized access to account documents for three customers. In resolving the matter, the firm agreed to retain an independent compliance consultant and pay a \$1 million civil monetary penalty. Much of the facts in the 2018 Order aligned with concerns stated as early as the 2014 and 2015 Risk Alerts.

And, even more recently, on August 30, 2021, the SEC settled with several firms through orders that focused on the implementation of policies and procedures and the types of technologies utilized,¹⁰¹ as opposed to the harm that occurred in the 2018 enforcement action where unauthorized access occurred. The SEC found that the three financial firms violated the Safeguards Rule, which is designed to protect confidential customer information. The SEC also found that two affiliates of one of the firms had inadequate compliance procedures in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 in connection with their breach notifications to clients. The SEC fined the firms between \$200,000 and \$300,000 each, after taking into consideration each firm's remedial measures.

99 *In the Matter of R.T. Jones Cap. Equities Mgmt., Inc.*, Investment Advisers Act Release No. 4204 (Sept. 22, 2015), <https://www.sec.gov/litigation/admin/2015/ia-4204.pdf>.

100 *In the Matter of Voya Fin. Advisors, Inc.*, Securities Exchange Act Release No. 84288, Investment Advisers Act Release No. 5048 (Sept. 26, 2018), <https://www.sec.gov/litigation/admin/2018/34-84288.pdf>.

101 *Id.*

These orders from 2015 to 2021 are notable for how they did not focus on novel case theories—or new unexpected cybersecurity requirements—and instead focused on standard policies and procedures requirements or instances of harm. Now, with years of examinations data, as well as these enforcement actions, the SEC can inform its rulemaking efforts related to cybersecurity and privacy of customer/client information. While the rulemaking may be onerous, it will have occurred through notice and comment, rather than through enforcement orders, thereby respecting the industry’s right to due process.

SECTION VIII

**SEC SHOULD ADOPT POLICIES AND PROCEDURES TO
DETECT AND PREVENT REGULATION BY ENFORCEMENT**

SEC Should Adopt Policies and Procedures to Detect and Prevent Regulation by Enforcement

FSI believes that both the Commission and the market participants have a common interest in ensuring that there is fair notice and adequate opportunity for feedback on any potential new rule or standard. We understand that reasonable minds may disagree as to whether an enforcement action is in fact regulation by enforcement resulting in lack of fair notice. However, we believe that a procedural framework to detect and prevent such unfair practices, as proposed below, should be uncontroversial and consistent with the policy interests of the Commission.

A. Staff and Commission Should Consider the Following Factors Prior to any “First of Its Kind” Enforcement Action

1) *Will the first of its kind enforcement action be reasonably perceived as a new standard of conduct or novel interpretation of an existing standard or rule?*

An enforcement action may be “first of its kind” for a variety of reasons. For instance, an enforcement action may be first in enforcing a relatively new but pre-existing rule such as Reg Bl. Or it may be a first due to a novel fact pattern such as an offering fraud using new technology. These instances should not trigger concerns involving regulation by enforcement. However, a first of its kind enforcement action that establishes a new standard of conduct or new interpretation of an existing rule will likely involve regulation by enforcement. The SEC’s enforcement department should specifically address when a case may contain novel issues in its recommendation memo and make it a practice to articulate that the case is applying novel facts or technologies to established rules and regulations.

2) *Has there been reasonable and fair notice to both the subject of the enforcement action and to other potentially affected parties of the standard and interpretation underlying the enforcement action, including rules, guidance such as FAQs and alerts, public statements, or reports from the Commission or the Staff?*

Assuming that the enforcement action may be perceived as establishing a new standard or new interpretation, the Commission and the Staff should determine whether there has been adequate notice. The gold standard of fair notice, of course, is an actual rule. However, even where a rule exists, it may not be apparent that the rule requires certain standards or conduct. In such instances, the Commission should determine whether there has been prior guidance such as alerts, FAQs, public statements or 21(a) reports of investigation that would evidence fair notice.

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In determining whether there has been fair notice, if the recommended enforcement action involves allegations of negligence as opposed to intent, there should be heightened scrutiny on this point. As discussed above, the negligent fraud theory is most susceptible to abuse in connection with regulation by enforcement. On the other hand, it is less likely that there is inadequate notice if the alleged misconduct involves intent to defraud.

3) *Has the Staff been aware of the existence of the practice that is subject of the enforcement action for an extended time period without any efforts to alert potentially affected parties of the Staff's concerns?*

Legal and compliance personnel should not be required to be more perceptive than the Staff in identifying potentially violative conduct. In considering an enforcement recommendation involving a first of its kind case, the Commission should ask the Staff (including Staff of the Division of Examination and other relevant divisions) whether the Staff has been aware of the existence of the practice that is the subject of the enforcement action. If the Staff has been aware of the practice for an extended period and did not alert the market participants of any concerns, query whether the Staff itself previously recognized the practice to be problematic. When formulating a theory of violation against a practice previously not identified by the Staff as problematic, enforcement actions should be measured as opposed to based on an approach the industry could not have predicted.

4) *Has the Staff obtained and considered feedback from potentially affected parties or their representatives, including financial industry groups, regarding the effect of the de facto policy or standard underlying the enforcement action?*

One of the risks of regulation by enforcement is that the Commission would create a new *de facto* rule without considering potential inadvertent harm to the market and to the investing public. Thus, even if the Commission and the Staff believe that there has been reasonable notice prior to a novel enforcement action, they should consider whether they have obtained and considered feedback from potentially affected parties or their representatives. It is not enough that a defendant/respondent in such a case have the opportunity for a Wells Submission. Such defendant may determine based on its self-interest to settle without making a Wells Submission nor would such a defendant necessarily consider the potential impact of the novel enforcement action on other parties.

5) *Would an alternative to the enforcement action, including rulemaking, Staff alerts, or 21 (a) Report of Investigation be a more effective and fairer Commission action?*

When the Staff has concerns regarding a practice or conduct based on an examination or investigation, an enforcement action may not be the best option for the Commission, especially in the absence of prior enforcement action involving such practice or conduct. Particularly when some of the factors discussed above militate against an enforcement action, the Commission and the Staff may consider other tools to alert market participants to the Commission or the Staff's concerns.¹⁰²

The fairest approach to address such concerns would be to engage in the rulemaking process. In recent years, the Commission has done so in connection with Reg BI and with the cybersecurity rules, as discussed above. Even when market participants ultimately do not agree with a particular rule, the process provides for fair notice and, importantly, the opportunity for them to be heard by the Commission regarding concerns and suggestions on rule proposals, consistent with the Administrative Procedures Act and the Due Process Clause.

¹⁰² When an investigation or examination is conducted by the Staff in a fair and thoughtful manner regarding a novel issue, the correct conclusion may be to recommend a rule proposal, alert, or report of investigation. In connection with investigations and examinations, individual members of the Staff should not be rewarded for enforcement action. They should be rewarded and incentivized by investigations and examinations that resulted in rule proposals, alerts, reports of investigations, and thoughtful engagement and discussions with the industry.

But even if the Commission does not wish to enact a new rule, there are other options to address concerns short of an enforcement without fair notice. For instance, the Division of Examinations has issued risk alerts based on trends and issues its Staff identified from examinations of registrants. Similarly, Commissioners and Staff express their policy concerns through public speeches and statements that are accessible to the public.¹⁰³

In addition, in the past, the Commission had great success in alerting the public to new policy positions and concerns via Reports of Investigation under Section 21(a) of the Securities Exchange Act of 1934 without bringing an actual enforcement action. For instance, the enforcement Staff conducted a series of investigations of corporate issuers that experienced cybersecurity breaches to determine whether the corporate issuers had deficient internal controls against such risks in violation of Sections 13(b)(2)(B)(i) and (iii) of the Exchange Act. Because it was then a novel concept, the Commission in 2018 chose not to bring any enforcement action but instead alerted corporate issuers through a Report of Investigation that internal control requirements should include reasonable policies and procedures to address cybersecurity risks.

Similarly, the Enforcement Staff in or around 2013 investigated whether a streaming services company and its CEO violated Regulation FD and Section 13(a) of the Exchange Act concerning the CEO's use of his personal social media page, on July 3, 2012, to announce that the company had streamed one billion hours of content in the month of June. The Commission chose to not bring an enforcement action in light of the then relatively novel issue of the application of Reg FD to social media. Instead, the Commission issued a Report of Investigation to address questions regarding: (1) the application of Regulation FD to the CEO's post; and (2) the applicability of the Commission's August 2008 Guidance on the Use of Company Web Sites to emerging technologies, including social networking sites.

B. Requirements for Recommendation and Advice Memos on Enforcement Actions and Initiatives to Discuss the Above Factors

The recommendation memo is the key document that the Commission and its counsels consider in connection with a recommendation by the Division of Enforcement to the Commission to authorize an enforcement action. The approximately 20-page or so document typically contains a discussion of relevant facts and analysis of applicable laws. The recommendation memo also alerts the Commission to any significant policy issues related to the matter. Where appropriate, the memo may discuss litigation risks if the matter is litigated. The memo typically reflects views of relevant Divisions and Offices of the Commission. In connection with the launching of a major enforcement initiative, the Commission may also receive an advice memo from the Staff regarding the initiative, even if there is no specific enforcement recommendation requiring authorization by the Commission.

For the Staff and the Commission to adequately consider the factors described above to detect and avoid unfair regulation by enforcement, we believe that there should be a requirement that in connection with first of its kind cases or similar novel enforcement recommendations, the recommendation or advice memo address the questions raised above.

¹⁰³ In connection with a new rule where market participants are acting in good faith to comply but are nevertheless viewed by the Staff to be deficient, risk alerts instead of enforcement actions are more effective in promoting compliance. Similarly, if a large segment of the industry is somehow "getting it wrong" in connection with a particular connect, the Staff should consider the possibility that its views have not been effectively communicated and a risk alert or other communications may be warranted.

C. Press Releases, Litigation Releases, Administrative Summaries or Other Public Announcement of Such First of Its Kind Action Should Reference Prior Notices, Alerts, or Statements Warning Against the Practice in Question

Assuming that the Commission and its Staff determined that a novel enforcement action was preceded by fair notice, it should highlight such notices, such as alerts, statements, or reports in public releases regarding the enforcement action. Such public statements will enhance the public's perception of the fairness of the action. For instance, the Division of Enforcement previously included facts reflecting prior notice and statements of concerns regarding the relevant conduct in its public announcement of a major enforcement initiative.¹⁰⁴

D. The Above Requirements Should Be Incorporated Into the SEC's Enforcement Manual

The Enforcement Manual provides general policies and procedures as guidance to the Staff of the Division of Enforcement in connection with enforcement investigations. Inclusion of the proposed procedures discussed in this paper will ensure consistent practices by the Staff to detect and preventing regulation by enforcement.

E. Periodic Fairness Audits by the Office of the Inspector General to Assess Compliance With the Above Policies and Procedures

The SEC's Office of Inspector General ("OIG") is an independent office within the Commission that conducts, supervises, and coordinates audits and investigations of the programs and operations of the SEC. The mission of the Office of Inspector General is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the Commission. Periodic fairness audits by OIG, particularly in connection with novel enforcement actions and initiatives, would promote the integrity of the Commission and its actions, consistent with the mission of the office.

Adopting the above recommendations would be an efficient way to address many of the issues cited by Commissioners and regulated entities regarding regulation by enforcement actions. By requiring SEC Staff to compile Recommendation and Advice Memos on Enforcement Actions, which discuss factors such as whether there has been fair notice and reasonable opportunity for regulated entities to submit comments and feedback, the Commission will have to address why they are proceeding with an action when one or more of the indicia of regulation by enforcement are present. In fact, the Commission would need to address the indicia of regulation by enforcement directly in its responses to each of the questions listed in in Section VII(A). Had such processes been adopted ahead of the enforcement actions listed above, the SEC may have issued guidance notifying regulated entities of their interpretations of existing statutory regulations, which would reduce due process and notice concerns consistently raised in regulation by enforcement actions.

¹⁰⁴ See, e.g., *Municipalities Continuing Disclosure Cooperation Initiative*, SEC (last modified Nov. 13, 2014), <https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml>.

SECTION IX

CONCLUSION

Conclusion

At its best, the SEC does credit to our democracy by exercising the federal agency's tremendous enforcement power in a fair and deliberate manner. However, actual—and the reasonable perception of—unfair practices involving regulation by enforcement harm this legacy of the Commission and impair its effectiveness in protecting the investing public, maintaining an orderly market, and promoting capital formation. FSI's recommended procedural framework to detect and prevent unfair regulation by enforcement will instead boost the confidence and trust of market participants, the investing public, and Congress in the Commission.

FSI looks forward to working with the Commission and its Staff on this important endeavor.

BACKGROUND ON THE FINANCIAL SERVICES INSTITUTE

The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry. The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 53 percent of all producing registered representatives.¹⁰⁵ These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers ("IBD").¹⁰⁶ FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate \$35.7 billion in economic activity. This activity, in turn, supports 408,743 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly \$7.2 billion annually to federal, state, and local government taxes.¹⁰⁷

Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI members and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

¹⁰⁵ Cerulli Associates, Advisor Headcount 2016, on file with author.

¹⁰⁶ The use of the term "financial advisor" or "advisor" in this section is a reference to an individual who is a dually registered representative of a broker-dealer and an investment adviser representative of a registered investment adviser firm. The use of the term "investment adviser" or "adviser" in this section is a reference to a firm or individual registered with the Securities and Exchange Commission (SEC) or state securities division as an investment adviser.

¹⁰⁷ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2020).