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LXR Group

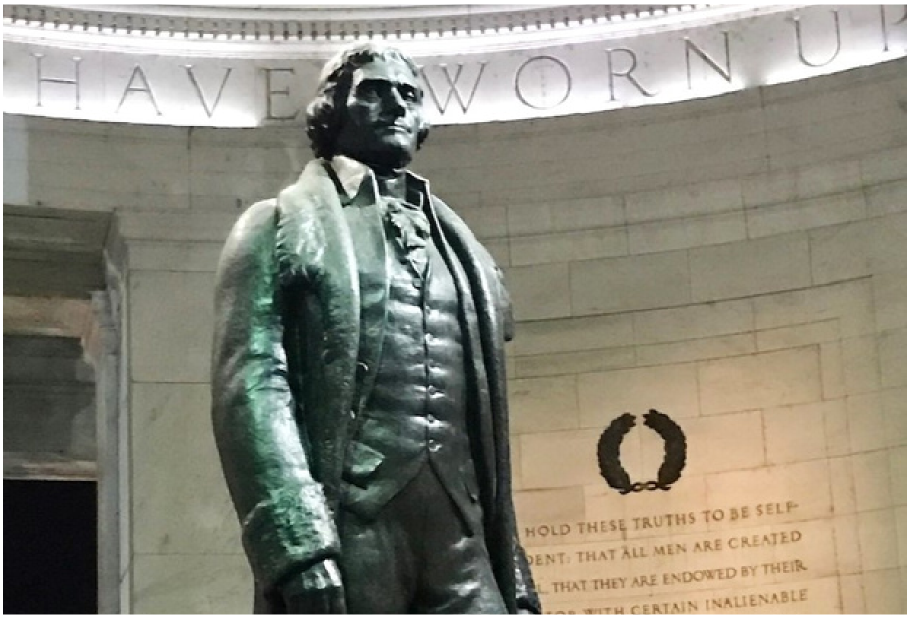
Policy Bulletin

Bringing our clients and subscribers exclusive policy updates and analysis from the world of capital markets, fintech, investor protection and more.

In This Volume:

Plus:

The latest Policy Developments, Congressional Updates and Regulatory News, Upcoming events, and Recommended Reading & Podcasts



Top Developments:

SEC Submits Report to Congress on RIA Mandatory Arbitration Practices. On June 28, the Commission formally transmitted to Congressional appropriations and banking committees a 36-page Staff Report examining the proliferation of mandatory arbitration clauses among SEC-registered investment advisers. The Report, six months in the making, was the direct result of language Congress included in the FY 2023 Consolidated Appropriations Act passed late last year. Among the Report's findings are that "approximately 61% of SEC-registered advisers that serve retail investors incorporated mandatory arbitration clauses into their investment advisory agreements," some of which "contain restrictive terms that could negatively affect the arbitration process or outcome for clients," including "restrictive terms [that] are impermissible in agreements between brokers and their customers."

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(Continued from P.1.) The Report also suggests, largely on the basis of conversations with stakeholders, "that the costs associated with private arbitration with advisers are significantly higher than the costs associated with broker arbitration, and, in some instances, those costs could preclude advisory clients from bringing arbitration claims at all." The Report was the first of its kind and is certain to add to the pressure on policymakers at the Commission and in Congress to identify potential reforms.

> **"Based on Staff estimates, a majority of investment advisory agreements contain mandatory arbitration clauses, and some contain restrictive terms that could negatively affect the arbitration process or outcome for clients."**
>
> **- SEC Staff Study of Mandatory Arbitration by RIAs**

House Oversight, Judiciary, and Financial Services Chairs Still Gunning for Gensler. On June 28, the Republican leaders of three powerful House committees sent a letter to SEC Chair Gary Gensler "blasting" the SEC's "lack of transparency" and raising multiple questions and concerns about the SEC's alleged failure to adequately respond to an earlier letter sent by the same Committee leaders on November 1, 2022. The 2022 letter, which was sent before the midterm election and before any of the signers assumed their current roles, raised questions about Gensler's "commitment to transparency and accountability at the SEC," and accused the SEC of "failing to comply with federal record-keeping statutes," citing "evidence the SEC is currently using so-called 'off-channel' communications platforms for official business."

In their June 28 letter, House Oversight Committee Chair James Comer (R-KY), Judiciary Chair Jim Jordan (R-OH), and Financial Services Committee Chair Patrick McHenry (R-NC) excoriate Gensler for "failing to identify and produce records of official business conducted on non-email or 'off-channel' platform," flatly telling the SEC Chairman the "you failed to respond directly to the five clear requests set forth in the SEC Off-Platform Letter."

The June 28 letter also seems to introduce new concerns, not addressed in the November 1, 2022 letter, related to the SEC's "potential failure to meet its recordkeeping obligations in connection with the Administrative Procedure Act's ("APA") notice and comment rulemaking process," and questioning "whether the SEC has documented all feedback on its proposed rules in relevant comment files as required, including any and all meetings you had with external parties that may have covered rule proposals that were pending at the time." The letter singles out the comment files pertaining to two ongoing SEC rulemakings - climate disclosure and market structure - which the signers and the vast majority of Republicans oppose on political and policy grounds.

The Chairmen conclude the letter by suggesting that the SEC "plays by its own rules" and "acts above the law," and by demanding the Gensler provide "complete and accurate responses" to a list of eight specific requests "no later than July 17, 2023."

Republican Environmental, Social, and Governance (ESG) Working Group Releases Interim Report Outlining Priorities. In a June 23 report, the recently created Republican ESG Working Group, chaired by HFSC Oversight and Investigations Subcommittee Chair Bill Huizenga (R-MI), released a 16-page Preliminary Report on ESG Related Financial Services Concerns. The Report reiterated the Working Group's mandate "to protect the financial interest of everyday investors from progressive activists who are using our institutions to force far-left ideology on Americans." The Report also listed areas that the Working Group "will focus on throughout the 118th Congress," including reforming the proxy voting system, promoting transparency and accountability in the proxy advisory system, enhancing accountability in shareholder voting, increasing transparency and oversight of large asset managers, improving ESG rating agency accountability, strengthening oversight of federal regulatory efforts related to ESG and climate policy via the financial system, promoting transparency and adherence to statutory limits from financial regulators, and protecting US companies from influence of foreign climate regulatory efforts. It characterized "the primary objectives" as "twofold: firstly, to examine the implementation of a partisan and progressive agenda on investors, and secondly, to identify policies and practices that protect investors and our capital markets."

Congressional Developments:

As Digital Asset Market Structure Markup Looms, House Democrats Seek Perspectives on Legislation from Gensler, Yellen. In a June 23 letter to SEC Chair Gary Gensler, Waters asked the SEC chairman to "discuss the impact of this draft legislation on the SEC's existing authorities; its mission and ability to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation; the impact on existing market participants and practices; workload and resources; and any other impact you estimate to be relevant for me to consider." In a separate letter sent the same day to Yellen, Waters asked the Secretary to "explain the effects this draft legislation will have on: the Treasury Department and its mission to promote economic prosperity, ensure the financial stability of the United States, and protect the competitiveness, resilience and integrity of the financial system; Treasury's ability to manage the U.S. government's finances and resources effectively; investor and consumer protections; and, existing market participants and practices in the securities, commodities and payments marketplace."Waters requested that both Gensler and Yellen provide responses in writing by June 30, and thereafter "be prepared to brief House Financial Services Committee Members on your views and recommendations."

Senate Banking Committee Holds Markup on Recovering Executive Compensation Obtained from Unaccountable Practices ("RECOUP") Act. On June 21, the Senate Banking Committee held its first legislative markup of 2023, and in fact, its first markup since 2019. The purpose of the markup was to advance bipartisan legislation that is largely a response to the bank failures of Silicon Valley and Signature Bank from this spring. The legislation, dubbed the RECOUP Act, provides regulators with new tools financially penalize and punish bank executives for reckless mismanagement decisions, including by preventing them from holding on to bonuses they collect while running their companies into the ground. The bill specifically establishes four additional grounds for regulators to remove a senior executive of any insured depository institution, not just failed banks, or prohibit such executive from participating in the affairs of that bank or any other insured depository institution. It would also require banks with more than $10 billion in assets to adopt governance and accountability standards in their bylaws (or an equivalent) "that promote safety and soundness, responsiveness to supervisory matters, and responsible management." The Committee advanced the bill by 21-2 vote, evincing apparently strong bipartisan support. "Republicans and Democrats alike agree these executives failed at the basics of bank management—that they pushed an unsustainable business model because it increased short-term profits in their own compensation…at the expense of their customers," said Committee Chair Sherrod Brown (D-OH).

House Subcommittees Hold Back-to-Back Hearings on SEC Oversight. As LXR Group detailed in a previous volume of our Bulletin on Capital Markets and Financial Services Policy, on June 15, HFSC Chair Patrick McHenry took the remarkable step of abruptly announcing back-to-back oversight hearings focused on the SEC for the following week. The oversight hearings, held on June 22, marked an obvious escalation of the increasingly acrimonious dispute between McHenry and other top HFSC Republicans on the one hand, and the SEC Chair on the other. The hearings also arguably marked, in LXR's opinion, the nadir of Congress's relationship with the Commission in the modern era. The first hearing was held by the Subcommittee on Oversight and Investigations (O&I) and the witness was SEC General Counsel Megan Barbero. The second hearing was held by the Subcommittee on Capital Markets and the witnesses were Haoxiang Zhu, Director of the SEC

Division of Trading and Markets, and Dr. Jessica Wachter, Director of the SEC Division of Economic and Risk (DERA). Among notable takeaways from the hearings was that whereas the first half of 2023 was focused on "capital formation" legislation, the second half is likely dominated by oversight.

"Today's meeting represents the first in a long overdue series of hearings where we will hear directly from division directors at the Securities and Exchange Commission. Given the historic and unprecedented volume of proposed rulemakings being advanced at the SEC under Chair Gensler, it is imperative that this Committee hold public hearings featuring the SEC staff responsible for overseeing these rulemakings."

- Capital Markets Subcommittee Chair Ann Wagner (R-MO), at hearing on oversight of the SEC Division of Trading and Markets.

Additional commentary on the hearings and the notable takeaways is available on the LXR Group's blog.

House Appropriations Subcommittee on Financial Services and General Government advances House version of FY 2024 spending bill. On June 22, the House Appropriations FSGG Subcommittee approved its draft version of the FY 2024 FSGG spending bill by voice vote, As is customary, the Subcommittee deferred consideration of any amendments to the bill or the accompanying Committee Report until the bill's markup in the Full Committee, which is likely to occur shortly after the House returns from the July 4th recess.

For readers who are interested in keeping track of the appropriations process, the Congressional Research Services maintains an "Appropriations Status Table " that is useful in keeping tabs on the 12 regular appropriations bills as they make their way through the House and Senate.

Regulatory Developments:

SEC Investor Advisory Committee Discusses Digital Engagement Practices, Outbound Investment with China; Approves Three Recommendations. On June 22, the SEC Investor Advisory Committee (IAC) held its quarterly meeting. The meeting featured panel discussions dealing with (1) Private Funds/Markets and Outbound Investments in Countries of Concern; (2) Ensuring Digital Engagement Practices Responsibly Expand Investment Opportunities; and (3) Audit Committee Workload and Transparency. Among the highlights of the meeting were robust discussions of the role that U.S. investment – and especially venture capital – has played in accelerating the development and deployment of technologies used by authoritarian nations to monitor dissidents and suppress dissent. For example, U.S. venture capital investors played a critical role in backing the Chinese AI facial-recognition company SenseTime in its early-stage funding rounds, when the company's products were slated for primarily commercial use. SenseTime then pivoted to working with Chinese security services, and the primary impact of its innovation was to improve the PRC's ability to conduct domestic surveillance. Following the panel discussions, the IAC voted to adopt recommendations related to (1) Single Stock ETFs, (2P RIA oversight and (3) Securities Based Swaps.

SEC releases Spring 2023 Reg-Flex Agenda. On June 13, the SEC released its updated biannual regulatory agenda, signaling a continuation of Gensler's ambitious regulatory goals. The updated agenda lists 37 rules in the "final stage," which is generally the option selected by regulators when they intend to adopt a rulemaking proposal within the next 12 months. The most significant rules the agency lists as being poised for adoption by October are its climate-related disclosure and cybersecurity risk governance proposals. Other rules in the final stage include policies impacting conflicts of interest; special purpose acquisition companies; modernization of beneficial ownership reporting; short sale disclosures; and disclosures by investment advisers regarding environmental, social, and governance investment practices. The short-term list also includes many carry-overs from the Fall 2022 Corp Fin agenda.

Other Developments:

North Dakota Becomes Third State to Adopt NASAA Model Restitution Fund Legislation. On June 21, North Dakota became the third state to enact a law inspired by NASAA's Model Act to Create Restitution Assistance Funds for Victims of Securities Violations. NASAA developed the Model legislation in 2021 to make it easier for states to establish a restitution assistance fund. The Model Act establishes eligibility requirements, caps recovery, and prohibits or forfeits recovery in certain circumstances. It also provides state securities regulators with an additional recovery mechanism for the benefit of harmed investors. Other states having adopted legislation based on the NASAA model include Montana and Vermont.

The NASAA model act is designed to provide monetary relief to victims of securities violations where restitution from the wrongdoer does not cover the full loss.

BlackRock files application to launch the first spot-Bitcoin exchange-traded fund in the US; Fidelity Renews Push for Bitcoin ETF on CBOE. On June 15, Blackrock, the world's largest investment company filed an application with the SEC for a Bitcoin spot exchange traded fund (ETF). According to the filing, the fund's assets will "consist primarily of bitcoin held by a custodian on behalf of the Trust," and the custodian will be crypto exchange Coinbase. On June 29, undoubtedly influenced by BlackRock's move, renewed its stalled push to win SEC approval for a spot bitcoin ETF on CBOE. If either ETF is approved, it would be the first crypto spot ETF in the United States. The SEC has not approved a spot Bitcoin ETF to date, despite numerous applicants, saying the proposals have not met anti-fraud and investor protection standards.

Consumer Financial Protection Bureau (CFPB) Seeks Applications for Advisory Committees. Beginning July 3, the Bureau will begin accepting member applications with the goal of "ensur[ing] that the CFPB hears from a variety of external experts with diverse viewpoints." The CFPB has four advisory committees: the Consumer Advisory Board, the Community Bank Advisory Council, the Credit Union Advisory Council, and the Academic Research Council.

Upcoming Events:

- The Senate is in recess until Monday, July 10th
- The House is in recess until Tuesday, July 11th

Recommended Reading and Podcasts:

1. "Joe Biden Tries to Change the Narrative on the Economy" — The New Yorker
2. "Surprise! You Work for Amazon." — The Atlantic
3. "Americans love American stocks. They should look overseas" — The Economist
4. "If Biden Wanted to Ease U.S.-China Tensions, Would Americans Let Him?" — NYT
5. "Big Oil Mulls a Slippery Future" — WSJ
6. "Powell Says Fed's Inflation Fight Could Take Years" — WSJ
7. "The choice between a poorer today and a hotter tomorrow" — The Economist