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SEC Update

By Gary O. Cohen

SEC Releases Five-Year Strategic Plan

The Securities and Exchange Commission (SEC) has released its "strategic plan"[1] (Plan) for fiscal years 2022 through 2026. This Update summarizes the Plan regarding asset management regulation, especially registered mutual funds (funds). The Plan states that the SEC would be "bringing cases" regarding any "deceptive conduct by registered . . . funds."[2]

Plan Document

Federal law[3] requires the head of each executive agency, including the SEC, to make available on the agency's website a strategic plan containing specified information. This information includes, among other things, the agency's comprehensive mission statement, general goals and objectives, and how the goals and objectives are to be achieved.[4] There is some ambiguity as to whether the law requires the strategic plan to cover four or five years.[5]

SEC Chair Gary Gensler presented the Plan with one eye on the United States' competition with other nations, as follows:

> The SEC oversees our $100 trillion capital markets, representing about 40 percent of the capital markets worldwide. . . . We can't take our leadership in capital markets for granted. Technology and business models always are changing, and it is important for our agency to evolve in kind. Even gold medalists need to practice and hone their craft, especially to ensure that they stay ahead of the other nations who wish to surpass them.[6]

The Plan makes clear that it sets forth Chair Gensler's "vision for the next four years."[7] The Plan states that "[i]t was developed in consultation with, and with input from, all Commissioners, but may not necessarily represent the views of all Commissioners."[8] Commissioners Hester M. Peirce and Mark T. Uyeda, who have issued dissenting statements about actions taken by the Commission, did not dissent about the Plan.[9]

The Plan is more conceptual than concrete and more oriented to goals than the means to reach the goals. Unlike the SEC's "regulatory flexibility agenda,"[10] the Plan is not a specific "to-do" list.

The Plan document itself does not appear to be dated. However, the SEC press release[11] announcing release of the Plan is dated November 7, 2022. The SEC's fiscal year 2023 began on October 1, 2022.

SEC Tasks and Goals

The Plan starts off by listing the broad and diverse tasks that the federal securities laws place on the SEC. The SEC states that its task regarding asset management is to:

> [o]versee the activities of more than 29,000 registered entities, including investment advisers, *mutual funds*, exchange-traded funds, broker-dealers, and transfer agents, who collectively employ at least 1 million individuals in the United States.[12]

The goals of the Plan are threefold:

1. "[p]rotect the investing public against fraud, manipulation, and misconduct";
2. "[d]evelop and implement a robust regulatory framework that keeps pace with evolving markets, business models, and technologies"; and
3. "[s]upport a skilled workforce that is diverse, equitable, and inclusive and is fully equipped to advance agency objectives."[13]

This column addresses each of these goals in terms of asset management regulation.

Protect the Investing Public

The Plan specifies action in the asset management space relating to the SEC's goal of protecting the public against fraud, manipulation, and misconduct. The SEC says that it would be "bringing cases" regarding any "deceptive conduct by registered . . . funds" and "failure to act in accordance with the [sic] fiduciary duty."[14]

The SEC does not indicate what deceptive fund conduct or breach of fiduciary duty it has in mind. However, indications are that the SEC could take action regarding investment advisory and other fees paid by registered funds. This could include failure of registered fund directors to discharge their statutory duty under Section 36(a)[15] of the Investment Company Act of 1940 regarding investment advisory and other fees that funds pay.

Chair Gensler's book about funds warns fund shareholders that the "company managing your mutual fund does not share your interest," "has its own shareholders and profits to consider," and "wants to charge high management fees that come directly from your returns."[16] Chair Gensler has expressed little confidence that all fund directors will protect fund shareholders against high investment advisory fees. He has said that "[m]any directors view their role as simply auditing the performance of the adviser and making sure there is no malfeasance or accounting problems, rather than acting as the shareholders' advocate."[17]

Similarly, a book about funds written by William Birdthistle, Director of the SEC's Division of Investment Management, warns that "the level or magnitude of [investment advisory and other] fees is the most direct source of peril for a fund investor"[18] Like Chair Gensler, Director Birdthistle has said that not all fund directors will protect fund shareholders from high fees. He has said that "[f]und trustees are expected to police the interests of the fund's shareholders," but history has demonstrated that "some trustees have performed that role better than others."[19]

The SEC Staff is currently conducting an inquiry into the implementation of the Section 15(c) process for fund director approval of investment advisory contracts.[20] The Staff apparently does not believe that all fund shareholders are looking out for their best interests by redeeming out of funds with poor returns and/or high fees. As Director Birdthistle has observed, "sometimes in our least exemplary funds, we see less exit than we might expect."[21] Director Birdthistle has argued that "the SEC has been disappointing" in its "inaction" and the SEC "should bring suit . . . to challenge truly stratospheric fees" and "against outlier advisers that charge the most outrageous fees."[22]

Following the SEC's release of its Plan, the SEC's Division of Examinations published its exam priorities for 2023. The Division states that it will "evaluate boards' processes for assessing and approving advisory and other fund fees, particularly for funds with weaker performance relative to their peers."[23]

Develop Regulatory Framework

The Plan makes two notable statements relating to the SEC's goal of developing and implementing a robust regulatory framework that keeps pace with evolving technologies.

First, the SEC will pursue "broadening the use of machine learning and artificial intelligence."[24] However, the Plan gives no information about this pursuit.

By way of background, the SEC's Investor Advocate, in a report to Congress, complained that "one area in which there remains much room for improvement is machine-readability."[25] The Investor Advocate faulted the Commission when it "bypassed opportunities to make disclosure machine readable"[26] because of "cost to issuers."[27] The Investor Advocate has strongly supported machine readability "because it would help investors utilize publicly-available data from multiple sources."[28]

More recently, the SEC has required that disclosure to be in machine readable format. For example, the SEC stated the following in adopting disclosure requirements for fund shareholder reports:

> In addition, we believe the use of Inline XBRL will promote the benefits of tagging information in the streamlined shareholder report more effectively than requiring a nonmachine readable data language such as ASCII or HTML. The Inline XBRL tagging requirements will enable automated extraction and analysis of data in the shareholder reports for retail investors and other market participants who seek to access information about funds, both directly and through information that intermediaries such as data aggregators and financial analysts provide. Providing a standardized, structured data framework could facilitate more efficient investor large-scale analysis and comparisons across funds and across time periods.[29]

The SEC's second statement regarding its goal of developing a robust regulatory framework is that the SEC will pursue protection of its data. The SEC said that it is "moving aggressively to the cloud, remaking its technology environment to optimize capabilities, costs, resilience, and security for the agency as a whole."[30]

By way of background, the Government Accountability Office (GAO), in years past, has faulted the SEC for "weaknesses" in "information security control."[31] The GAO has found that these weaknesses limited the "effectiveness" of the controls "in protecting the confidentiality, integrity and availability of a key financial system."[32] The SEC subsequently strengthened its information security controls apparently to the GAO's satisfaction.[33]

Support Skilled Workforce

The Plan makes two notable statements involving the SEC's goal of supporting a skilled workforce that is diverse, equitable, and inclusive, and is fully equipped to advance SEC objectives.

First, the Plan talks about balancing telework and in-office work. The Plan says that "[i]t is also important that the agency find ways to harness the benefits of telework as highlighted during the pandemic, while also maintaining the collaboration and culture-building that comes from in-office presence."[34]

Second, the Plan talks about getting the Staff broader training and experience. The Plan says that

> [i]n order to maintain maximum flexibility in responding to market trends and technological innovations, it is important to provide collaboration and cross-training opportunities to more employees agency-wide. By encouraging employee rotations and details, the agency will be able to think more globally, analyze the market more comprehensively, and respond more expeditiously to events.[35]

This initiative could help alleviate the so-called silo problem that has been said to exist at the SEC. Norm Champ, a former Director of the Division of Investment Management, has written a book[36] that describes this problem. He said that the SEC's lack of "consistency in policy and procedures" has given rise to Staff "fiefdoms" or "silos" where "each one will guard its own territory and power, often in competition" and "refuse to share information with their coworkers."[37] He went on to say that this was "an environment" where "many SEC employees never reached out or collaborated beyond their immediate work team but stayed in their silos repeating the same information practices."[38]

Conclusion

The SEC has released its "strategic plan" for fiscal years 2022 through 2026. The Plan's three goals are to: (1) protect the investing public against fraud, manipulation, and misconduct; (2) develop and implement a robust regulatory framework that keeps pace with evolving markets, business models, and technologies; and (3) support a skilled workforce that is diverse, equitable, and inclusive and is fully equipped to advance SEC objectives. The Plan states that the SEC would be "bringing cases" regarding any "deceptive conduct by registered . . . funds,"[39] but does not set out any specifics.

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NOTES

1 SEC, Strategic Plan Fiscal Years 2022–2026 (Nov. 23, 2022) [hereinafter Plan], available at *https://www.sec.gov/files/sec_strategic_plan_fy22-fy26.pdf.* The SEC announced the release of the Plan in Press Release, SEC, SEC Publishes FY22-26 Strategic Plan (Nov. 23, 2022) [hereinafter SEC Press Release], available at *https://www.sec.gov/news/press-release/2022-210#:~:text=The%20SEC's%20new%20Strategic%20Plan,markets%2C%20business%20models%2C%20and%20technologiest.* SEC Chair Gary Gensler separately announced the SEC's release of the Plan two months later. Gary Gensler, Chairman, SEC, Message from the Chair, Strategic Plan Fiscal Years 2022-2026 (Jan. 27, 2023), available at *https://www.sec.gov/strategic-plan.* The text of Chair Gensler's announcement is the same as the text that appears on page 3 of the Plan.

The SEC earlier released a *draft* strategic plan for comment. *Draft* 2022–*2026 Strategic Plan for Securities and Exchange Commission*, Exchange Act Release No. 95588 (Aug. 24, 2022) (proposal), available at *https://www.sec.gov/rules/other/2022/34-95588.pdf.* The SEC announced the release of the draft Plan for public comment in Press Release, SEC, Draft 2022–2026 Strategic Plan for Securities and Exchange Commission (Aug. 24, 2022), available at *https://www.sec.gov/rules/other/2022/34-95588.pdf.*

2 Plan, *supra* n.1, at 7. For discussion of this Plan statement, *see infra* nn.14-23 and accompanying text. This Update, which is dated March 23, 2023, addresses registered, but not private, funds.

3 5 U.S.C §306(a).

4 5 U.S.C. §306(a)(1)-(9).

5 The law provides: "The strategic plan shall cover a period of not less than 4 years following the fiscal year in which the plan is submitted." 5 U.S.C. §306(b). The SEC Press Release, *supra* n.1, states that

the law requires a strategic plan to cover "a four-year period." However, the SEC titles the Plan as covering a five-year period, namely 2022 through 2026.

6 Plan, *supra* n.1, at 3. Chair Gensler further says: "While more retail investors than ever before are accessing US markets, other countries are developing competitive markets." *Id.* at 6.

7 Federal law provides that "the *head* of each agency shall make available on the public website of the agency a strategic plan and notify the President and Congress of its availability." 5 U.S.C. 306(a) (emphasis added).

8 Plan, *supra* n.1, at 4-5.

9 *See* SEC, Speeches and Statements, available at *https://www.sec.gov/news/speeches-statements*.

10 Executive Office of the President, Office of Management and Budget, Office of Information and Regulatory Affairs, Agency Rule List – Fall 2022, SEC, available at *https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=9BBB768864D2D8DE9C19BD6C1A169992243E85E4FF44909E99BAF5CE161D679AD847FA15DA5F087B92A3385072661673C992.*

11 SEC, Press Release, *supra* n.1.

12 Plan, *supra* n.1, at 4 (emphasis added).

13 *Id*. at 6.

14 *Id.* at 7. Section 36(a) of the Investment Company Act of 1940 imposes a fiduciary duty on fund directors as follows:

> The Commission is authorized to bring an action in the proper district court . . . alleging that a person who is, or at the time of the alleged misconduct was, serving or acting [as a director of a registered investment company] . . . has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person serves or acts, or at the time of the alleged misconduct, so served or acted.

15 Section 36(a) is quoted *supra* n.14.

16 Gregory Baer & Gary Gensler, "The Great Mutual Fund Trap" 115 (2002). For a summary and discussion of the book, *see* Gary O. Cohen, "SEC Chair Gensler's Mutual Fund Views Revealed in His Book," *The Investment Lawyer*, Vol.28, No.11, at 21 (Nov. 2021).

17 *Id*. at 112-113.

18 William A. Birdthistle, Empire of the Fund 72 (2016) [hereinafter Director Birdthistle's Book]. For a summary and discussion of the book, *see* Gary O. Cohen, "SEC IM Division Director William Birdthistle's Mutual Fund Views Revealed in His Book," *The Investment Lawyer,* Vol.25, No.4 (Apr. 2022).

19 *Id.* at 37.

20 For information about the SEC Staff probe, *see* Gary O. Cohen, "SEC Probes Fund Section 15(c) Process," *The Investment Lawyer,* Vol.30, No.3, at 30 (Mar. 2023).

21 William Birdthistle, Director, SEC Division of Investment Management, Remarks at the ICI Investment Management Conference 6 (Mar. 28, 2022), available at *https://www.sec.gov/news/speech/birdthistle-remarks-ici-investment-management-conference-032822.*

22 Director Birdthistle's Book, *supra* n.18, at 216. Section 36(b) of the Investment Company Act of 1940 authorizes the SEC to bring suit regarding compensation or payments paid by funds as follows: An action may be brought under this subsection by the Commission . . . against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company . . . to such investment adviser or person.

23 SEC Division of Examinations, 2023 Examinations Priorities 16 (2023), available at *https://www.sec.gov/files/2023-exam-priorities.pdf.* The SEC announced the publication in Press Release, SEC, SEC Division

of Examinations Announces 2023 Priorities (Feb. 7, 2023), available at *https://www.sec.gov/news/press-release/2023-24.*

24 Plan, *supra* n.1, at 9.

25 SEC Office of Investor Advocate, Rick A. Fleming, Report of Activities Fiscal Year 2020 at 11, available at *https://www.sec.gov/advocate/reportspubs/annual-reports/sec-investor-advocate-report-activities-2020.pdf.*

26 *Id.* at 1.

27 *Id.* at 21.

28 *Id.* at 12.

29 *Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds*; *Fee Information in Investment Company Advertisements*, Securities Act Release No. 11125, Exchange Act Release No. 96158, Investment Company Act Release No. 34731 at 193 (Oct. 26, 2022), available at *https://www.sec.gov/rules/final/2022/33-11125.pdf.*

30 Plan, *supra* n.1, at 13.

31 Government Accountability Office, A Report to the Chair, U.S. Securities and Exchange Commission, Information Security, SEC Needs to Improve Controls over Financial Systems and Data 1 (April 2014) (GAO-14-419), available at *https://www.gao.gov/products/gao-14-419.*

32 *Id.* at 4. The GAO, for example, found as follows regarding “Access controls”:

> [The] SEC did not consistently protect its system boundary from possible intrusions; identify and authenticate users; authorize access to resources; encrypt sensitive data; audit and monitor actions taken on the commission’s networks, systems, and databases; and restrict physical access to sensitive assets.

Id. at unnumbered first page titled, “What GAO found.”

33 The author did not find any recent GAO faulting of the SEC’s information security controls.

34 Plan, *supra* n.1, at 13.

35 *Id.*

36 Norm Champ, Going Public (2017). For a summary and discussion of the book, *see* Gary O. Cohen, “Going Public by Norm Champ: A Tell-Some Expose of ‘Bureaucratic Warfare,’ ‘Bizarro Decisions’ and ‘Political Hit Jobs,’ by a Former Director of the SEC’s Division of Investment Management,” *The Investment Lawyer*, Vol.24, No.9, at 10 (Sept. 2017).

37 *Id.* at 56.

38 *Id.*

39 Plan, *supra* n.1, at 7.

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