Sept. 14, 2022

From: Americans for Financial Reform
To: Interested Media
Re: Gensler at SEC Oversight Hearing tomorrow

The SEC's regulatory agenda is under attack, and Chair Gary Gensler is appearing before the Senate Banking Committee tomorrow.

This memo addresses SEC work in eight areas: 1. Climate Risk Disclosures, 2. ESG Fund Rules and Attacks on ESG, 3. Cryptocurrency, 4. Private Funds, 5. Activist Hedge Funds, 6. Stock Buybacks, 7. Executive Compensation, 8. Human Capital Management Disclosures.

To speak to a policy expert in any of these areas: email Carter Dougherty (carter@ourfinancialsecurity.org) *and* William Pierre-Louis (william@ourfinancialsecurity.org).

1. Climate Risk Disclosures

The growing consideration of climate change and the energy transition is reshaping capital markets in a way that all investors and registrants must take into account, with many attempting to already despite difficulties due to lack of standardized disclosure. The SEC has both the authority and the responsibility to mandate climate and ESG-related disclosures so that all investors and market participants have comparable, freely available information on some of the most significant risks to individual firms, portfolios, and markets—risks related to the climate crisis and the clean-energy transition. Investors are saying plainly that they need this information—particularly greenhouse gas emissions—for accurate valuation of securities. The SEC should finalize its climate risk disclosure rule as soon as possible.

According to one survey by PricewaterhouseCoopers of investors representing more than $14 trillion in assets under management, 80 percent took environmental, social, and governance (ESG) factors into account in making investment decisions and 67 percent of large investors, family offices, and endowments want their investments to "contribute to reaching the Paris climate agreement goal."[1] The Net Zero Asset Owners Alliance—consisting of 74 institutional investors with $10.6 trillion in aum—has also committed to Paris alignment.[2] Shareholder

[1] Abby Schultz, "Future Returns: Wealthy See a Role in Investing to Tackle Climate Change," Barron's Penta, Sept. 21, 2021, *available at* https://www.barrons.com/articles/future-returns-wealthy-see-a-role-in-investing-to-tackle-climate-change-01632255522

[2] PricewaterhouseCoopers (PwC). 2021. "PwC's 2021 Global Investor Survey." PwC. Accessed May 9, 2022. https://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/2021-esg-investor-survey.html.

proposals and even proxy fights tied to the transition have reached record levels of support.[3] Firms that can successfully accommodate investor ESG expectations will have access to a larger pool of investment funds, and potentially a lower cost of capital, than firms that cannot. Indeed, the widespread phenomenon of "greenwashing" via false or misleading claims about climate progress may reflect a belief by companies that investors and other market participants will allocate their money based on these considerations.

In response to the SEC's climate proposal, a large majority of investors, most asset managers (including BlackRock and Vanguard) and major banks (including Bank of America, Citi, and Wells Fargo) explicitly support inclusion of GHG emissions, including Scope 3, with some suggesting tweaks. Even investors with no ESG orientation who may have no problem financing a company without a credible plan for reducing emissions might think twice if the lack of such a plan increases the risks of adverse actions by investors and financial institutions and jeopardizes returns.

2. ESG Fund Rules and Attacks on ESG Investing

A massive amount of capital has found its way into ESG funds, with one estimate projecting ESG assets may reach $53 trillion by 2025, which would be a third of global assets under management. While this channeling of capital into ESG funds is indicative of investor interest in ESG investing, the thoroughly unregulated nature of ESG in investment products and services means that investors are in danger of being misled by exaggerated or unfounded ESG-related claims, often referred to as greenwashing in the climate context and ESG-washing more generally.

While some greenwashing and ESG-washing is fraudulent and actionable under current law (made clear by the enforcement actions recently taken by the Commission and other law enforcement agencies), there is a broader need—due to widely varying understandings of what ESG investing is—for investors to have information about what ESG-branded investment products and their managers do and do not do. For example, many investors may be surprised to learn that Amazon tends to be among the largest holdings in ESG funds even though it has come under fire for its harmful labor practices, high greenhouse gas emissions (especially when suppliers and sellers are taken into account), predatory pricing, and other issues. Similarly, many investors may be surprised to learn that a private prison company facing a lawsuit alleging forced labor is considered by some important players in the ESG investment industry as a socially responsible investment.

[3] Climate Action 100+. 2021. "As Climate Risks Skyrocket, Largest Asset Managers Vote for More Climate-Related Shareholder Proposals, Tipping Support to Record Levels in 2021." Climate Action 100+, December 6, 2021. https://www.climateaction100.org/news/as-climate-risks-skyrocket-largest-asset-managers-vote-for-more-climate-related-shareholder-proposals-tipping-support-to-record-levels-in-2021/.

Additionally, beyond ESG-branded funds' underlying investments, investors may be surprised to learn that large asset managers with substantial assets under management in ESG-branded funds often vote against—or abstain from voting on—shareholder proposals and other important issues even though voting proxies in their clients' best interest is a key component of advisers' fiduciary duty. The SEC should finalize its proposed rules on fund names and ESG disclosures as soon as possible, and continue enforcing existing laws to tackle greenwashing.

Apart from the SEC's specific lines of work, we are now facing a coordinated campaign against corporate accountability, responsibility, and transparency by forces intent on stifling any change in governance and financial rules and practices that could jeopardize their wealth and power—even though it means driving us into a deeper state of climate emergency and economic and racial inequality. Opponents are attempting to weaponize what is in fact an effort to deny the realities of the climate crisis and fundamental demands for justice and equity as a false populist narrative about challenging excessive corporate power.

ESG investing is smart investing. ESG investing has proven to yield competitive financial returns. ESG strategies have taken off in recent years because many investors recognize that prudent, long-term thinking is in their best interest. ESG is an effective way to better manage investment risks and opportunities.

ESG disclosures are about transparency. Investors want to know how big corporations operate, including their impacts on communities and the environment and the ESG-related risks and opportunities they face. The data tells us that ESG factors are financially material and that investors are eager for clear and consistent information to inform where they invest, based on their own interests and priorities.

3. Cryptocurrency

The recent crash in digital asset markets — which saw some retail investors lose their entire net worth overnight, and wiped out roughly $2 trillion in market value in a matter of weeks[4] — has underscored the need for regulatory action to protect investors and markets from the risky and predatory financial practices found through the digital asset space.

The SEC has in fact taken action; by one count the SEC has issued 108 or more enforcement actions since 2013 to address fraud, misleading practices, or unregistered securities offerings or actors in the digital asset space.[5] Yet, crypto industry critics have simultaneously claimed the

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[4] Andrew Corkery and Juliet Fuisz, "After $2 trillion crypto crash, what happens next?" PBS, Jul. 17, 2022, *available at* https://www.pbs.org/newshour/show/after-2-trillion-crypto-crash-what-happens-next#:~:text=Digital%20currencies%20have%20now%20lost,%243%20trillion%20in%20November%202021.

[5] Cornerstone Research Cryptocurrency Enforcement Update, 2021 (97 cases): https://www.cornerstone.com/wp-content/uploads/2022/01/SEC-Cryptocurrency-Enforcement-2021-Update.pdf; Additional Cases compiled from

SEC is both too aggressive in its enforcement efforts, and not acting quickly enough to provide the industry with "clarity" on its regulatory approach to digital assets.[6]

In fact, SEC Chair Gensler (and Chair Clayton before him) have consistently communicated their perspective that many digital asset offerings and exchanges are operating as unregistered securities or securities exchanges, and should register or face potential enforcement actions, including Chair Gensler's comments to SEC Speaks on September 8, 2022.[7] And Chair Gensler has been particularly blunt: "Not liking the message isn't the same thing as not receiving it … These are not laundromat tokens: Promoters are marketing and the investing public is buying most of these tokens, touting or anticipating profits based on the efforts of others."[8]

Nonetheless, crypto industry pressure has resulted in several members of Congress introducing legislative proposals that, in the name of providing regulatory clarity, could actually strip or erode SEC authority (and state securities' regulators as well) to regulate those digital assets and actors operating as securities exchanges, brokers and offerers, or even erode SEC oversight of existing securities markets as well.[9]

For AFR's position on legislation getting a hearing today in the Senate Agriculture Committee, see here.

We encourage members of the Senate Banking Committee to view with extreme skepticism the crypto industry assertions that regulatory clarity or exceptionality is needed for the digital asset industry. Instead they should focus on how Congress can support the SEC and other regulators in using their existing regulatory authority to ensure that the digital asset industry is held to account using existing standards for financial products, services and actors.

SEC Enforcement Action Website, as follows: SEC v. Crowd Machine, Inc. et. al (false, misleading statements, unregistered offering); SEC v. Garcia (fraud); BlockFi Lending LLC (registration); SEC v. Barksdale, et. al (fraud); SEC v. MCC International Corp., et. al (fraud, unregistered offerings); SEC v. Block Bits Capital, LLC, et. al (fraud, unregistered securities offering); SEC v. Chiang, et. al (fraud, unregistered securities offerings); SEC. v. Wahl, et. al (Coinbase trader, insider trading); SEC Okhotnikov, et. al (fraud); Boom Protocol, LLC (unregistered offering); SEC v. Dragonchain, Inc., et. all (unregistered offering).

[6] Samuel, Wan, "SEC Chair Gensler responds to Coinbase allegations of failing to provide crypto clarity," Cryptoslate, Sept. 23, 2021, *available at* https://cryptoslate.com/sec-chair-gensler-responds-to-coinbase-allegations-of-failing-to-provide-crypto-clarity/.

[7] "Kennedy and Crypto," Securities and Exchange Commission, Sept. 8, 2022, *available at* https://www.sec.gov/news/speech/gensler-sec-speaks-090822.

[8] "Gensler: Crypto Trading Platforms May Need to Spin off Businesses," Politico Pro, Sept. 8, 2022 (behind paywall)

[9] Nikhilesh De, "SEC Chair Gensler Suggests Lummis-Gillibrand Bill May 'Undermine' Market Protections," CoinDesk, Jun. 14, 2022, *available at* https://www.coindesk.com/policy/2022/06/14/sec-chair-gensler-suggests-lummis-gillibrand-bill-may-undermine-market-protections/; Turner Wright, "Toomey drafts bill to exempt stablecoins from securities regulations," Cointelegraph, Apr. 7, 2022, *available at* https://cointelegraph.com/news/toomey-drafts-bill-to-exempt-stablecoins-from-securities-regulations; Robert Kuttner, "Will Congress Let Crypto Pick Its Regulator?" The American Prospect, Aug. 16, 2022, *available at* https://prospect.org/economy/will-congress-let-crypto-pick-its-regulator/.

4. **Private Funds**

Trillions of dollars in corporate borrowing is hiding in the shadows due to the companies and the banks they hire being able to rely on outdated exemptions that allow companies to avoid registering that debt with the SEC and providing limited financial and other disclosures to investors.

The SEC has moved forward significant proposals that would enable financial regulators to gain more insight into the $18 trillion private fund industry (hedge funds and private equity firms predominantly) but need to similarly address the lack of transparency into the securities and other debt that those funds also issue.

Similarly, that lack of transparency has also enabled private market issuers (including their private equity owners) to ignore proper underwriting practices by using non-standard methods of reporting their earnings, which studies have shown frequently are well overstated when looking back years later.

5. **Activist Hedge Funds**

Activist hedge funds have been aggressively campaigning against two important SEC rules, including by falsely implying[10] that labor opposes these rules. These rules—one on beneficial ownership and another on swaps—would narrow loopholes hedge funds use to: 1) secretly build large ownership stakes in public companies; 2) engage in what is in essence legalized insider trading before disclosures of large ownership stakes are made public; and 3) use their newly-acquired ownership stake to extract value and boost short-term returns at the expense of long-term value. These tactics hurt workers, companies, communities, and regular investors by leaving companies in a weakened state that ultimately results in fewer jobs, worse pay, losses to long-term investors, and a declining U.S. economy. The SEC should finalize its proposed rules as soon as possible.

Currently, any holder exceeding 5% of a company's outstanding shares has 10 days to file a Schedule 13D if the transaction is associated with an intention of influencing control of the issuer, while passive holders of greater than 5% have until 45 days after the calendar year when they cross that threshold to file a Schedule 13G. These timelines were originally set under the Williams Act in the 1960s when paper filings and fax machines were the standard. Under Dodd-

[10] Michelle Celarier, "The Ferocious Well-Heeled Battle Against the SEC's New Rules on Hedge Fund Activism," Institutional Investor, June. 21, 2022, *available at* https://www.institutionalinvestor.com/article/b1yl2hgxzlykbk/The-Ferocious-Well-Heeled-Battle-Against-the-SEC-s-New-Rules-on-Hedge-Fund-Activism

Frank, amendments to Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 gave the SEC the authority to modernize public reporting associated with large positions in line with today's technological advances. The SEC is therefore proposing to shorten Schedule 13D reporting to 5 days from 10 days, while Schedule 13G filers exceeding 5% would have to report their holdings anywhere from 5 days after to 5 days after the end of the month.

The SEC is also proposing to close the information asymmetry enabled by the lag time between a shareholder holding greater than 5% of a stock, and the number of days until they have to publicly disclose such a position. To address the communication of material non-public information between investors who intend to influence control of the company and would have to file a future Schedule 13D and a select group of other shareholders, the SEC is proposing that any such advanced communication before a 13D filing would constitute the set of investors as a "group" and require a joint filing disclosing their collective 13D positions.

6. Stock Buybacks

Stock buybacks occur when a company purchases its own shares in the open market, boosting earnings per share (EPS) and benefiting corporate executives who receive about 80% of their compensation in stock options and awards. Money spent on stock buybacks come at the expense of investments in workers' wages and benefits, research and development, product safety, and other investments necessary for long-term equitable and sustainable economic growth. Buybacks also exacerbate economic inequality and the racial wealth gap.

Spending on stock buybacks has grown exponentially since 1982—when the SEC created a safe harbor that some argue legalized stock market manipulation—and reached a whopping $6.3 trillion in the 2010s. Before 1982, companies had to worry about being held liable for market manipulation under the Securities Act. The SEC should finalize its important proposed rule to bring much-needed transparency to companies' stock buyback practices, and consider further rulemaking once it has more data to analyze their effects on capital markets.

7. Executive Compensation

Executive compensation has skyrocketed in the last few decades while worker wages have stagnated. Additionally, executive compensation packages can incentivize overly risky and inappropriate behaviors, which can have negative effects on companies and the economy as a whole. Indeed, the incentives behind some executive compensation packages are widely acknowledged to have been a central contributor to the 2008 financial crisis. For that reason, Dodd-Frank mandated important executive compensation rulemakings, some of which this SEC has taken important steps to implement. The SEC should finalize and implement its proposed rules, and issue a proposed rule to implement section 956 of Dodd-Frank, which required the

SEC and other agencies to prohibit incentive-based compensation in certain financial institutions that "encourages inappropriate risks" within nine months of its passage.

8. Human Capital Management Disclosures

The SEC has human capital management disclosures for issuers in its agenda, but it has yet to propose a rule. As the Human Capital Management Coalition argued in its rulemaking petition (listed below under resources), "[t]here is broad consensus that human capital management is important to the bottom line, and a large body of empirical work has shown that skillful management of human capital is associated with better corporate performance, including better risk mitigation . . . effective human capital management [is] essential to long-term value creation and therefore material to evaluating a company's prospects." We want to encourage the SEC to propose a comprehensive rule as soon as possible.

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