WACHTELL, LIPTON, ROSEN & KATZ

The attached article, Corporate Governance Update: Commissioner for Capital Markets: Daniel M. Gallagher's SEC Legacy, was published in the New York Law Journal on October 29, 2015

October 29, 2015

Corporate Governance Update: Commissioner for Capital Markets: Daniel M. Gallagher's SEC Legacy

David A. Katz
and
Laura A. McIntosh*

"A good leader is a person who takes a little more than his share of the blame and a little less than his share of the credit." —*John C. Maxwell*

Earlier this month, the U.S. Securities and Exchange Commission bid thanks and farewell to resigning Commissioner Daniel M. Gallagher. Commissioner Gallagher served four years as a Republican minority member of the Commission, years in which the SEC's focus was the implementation of the misbegotten Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Throughout his tenure, he was a forceful critic of Dodd-Frank, both for its substance and for its politicizing effect on the SEC. As the SEC worked to implement regulations required under Dodd-Frank, he was a strong proponent of regulatory restraint and endeavored to mitigate the potentially negative impact of Dodd-Frank-mandated rulemaking on the financial markets. A champion of free and efficient markets, he promoted capital formation and the growth of small businesses. He helped to curtail the outsized influence of proxy advisors and called for modernizing the rules relating to transfer agents. With well-crafted and charismatically delivered speeches, he energized debates and will be recalled as an effective advocate for market-oriented reform.

Commissioner Gallagher's public victories on key issues, and his prolific writings and speeches, do not represent the full extent of his legacy. As a minority voice in a highly politicized era, many of his successes have been and will remain largely invisible. Nonetheless, his influence was significant with respect to actions that the SEC did not take, elements that were omitted from SEC rulemaking, and issues that did not take priority on the SEC's agenda. In a highly challenging regulatory and economic environment, Commissioner Gallagher's work to improve the capital markets on behalf of the nation has been invaluable.

Dodd Frank's Incalculable Burden

During the five years since its passage, the Dodd-Frank Act has simply overwhelmed the SEC's agenda. Dodd-Frank has imposed, in the words of former SEC Chairman Mary Schapiro, an "unprecedented rulemaking burden" on the Commission.[1] To date,

---

* David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

[1] Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Testimony Concerning Economic Analysis in SEC Rulemaking Before the Subcommittee on TARP, Financial Services and Bailouts of Public and

the SEC has adopted final rules for 61 mandatory rulemaking provisions, established five new offices required by Dodd-Frank, and issued over 30 required studies and reports.[2] And there are more to come: The Commission must issue a total of 94 rules under Dodd-Frank. After five years, federal agencies generally are not even two-thirds of the way toward the fulfillment of the Dodd-Frank agenda.[3] This process would be overly burdensome even if the required rulemaking were narrowly tailored and essential; as it is neither, the opportunity cost of the regulatory mandate has been incalculable. Throughout his tenure, Commissioner Gallagher consistently criticized the effects of Dodd-Frank on the SEC and on the nation: "Dodd-Frank has backfired, strangling our economy, increasing the fragility of the financial system, and politicizing our independent financial regulators."[4]

It is quite unfortunate that the mandates of Dodd-Frank have precluded the SEC in recent years from following Commissioner Gallagher's eminently sensible approach to regulation. As he has observed, "Smart regulation involves taking the time to understand how things became the way they are, and, critically, better defining and articulating the goals of regulations. It entails carefully reviewing the results, intended and otherwise, of recently promulgated regulations before rushing into a new round of regulations."[5] No description could be further from the manner in which Dodd-Frank has operated. In the face of the political realities of Dodd-Frank, Commissioner Gallagher nonetheless remained a consistent proponent of regulatory restraint, humility, and reason.[6]

As a substantive matter, Commissioner Gallagher has been a prominent critic of the regulatory agenda set by the Dodd-Frank Act and its irrelevance to the causes of the financial crisis. Indeed, in a stunning example of Dodd-Frank's misplaced priorities, Commissioner Gallagher estimates that he spent fully one-quarter of his time for his first ten months as a Commissioner dealing solely with the conflict minerals regulations required by Dodd-Frank. He subsequently reflected:

Private Programs, Oversight and Government Reform Committee, U.S. House of Representatives, Apr. 17, 2012, available at http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489400.

[2] U.S. Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," www.sec.gov/spotlight/dodd-frank.shtml#main-content (last modified Aug. 6, 2015).

[3] As of September 30, 2015, "[o]f the 390 total rulemaking requirements, 249 (63.8 percent) have been met with finalized rules, and rules have been proposed that would meet 58 (14.9 percent) more. Rules have not yet been proposed to meet 83 (21.3 percent) [of the] rulemaking requirements." Davis Polk, "Dodd-Frank Progress Report: Third Quarter 2015," available at www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

[4] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, "Dodd-Frank at Five: A Capital Markets Swan Song," U.S. Chamber of Commerce, Wash., D.C., Aug. 4, 2015, available at www.sec.gov/news/speech/dodd-frank-at-five.html.

[5] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, Speech, "Market 2012: Time for a Fresh Look at Equity Market Structure and Regulation," SIFMA's 15th Annual Market Structure Conference, Oct. 4, 2012, available at www.sec.gov/News/Speech/Detail/Speech/1365171491376.

[6] *See, e.g.*, U.S. Securities and Exchange Commissioner Daniel M. Gallagher, Speech, "The Impacts of Post-Crisis Global Regulatory Reforms on Financial Markets," Berlin, Federal Republic of Germany, Dec. 10, 2013, available at http://www.sec.gov/News/Speech/Detail/Speech/1370540504942.

> Years from now, I fear, financial historians will marvel at how the Dodd-Frank Act forced regulators to proactively disadvantage American financial institutions as well as the strength and integrity of our capital markets to address such tangential—at best—matters as conflict minerals, resource extraction, and proprietary trading, but gave a complete pass to the main cause of the financial crisis—decades worth of disastrous federal housing policy.[7]

As Commissioner Gallagher implies in the quoted passage, the regulatory burden of Dodd-Frank on the capital markets has been multifaceted. It has been borne not only by the SEC, from a rulemaking and implementation standpoint, but also by the market participants who, on the one hand, must struggle to cope with the onerous requirements imposed by Dodd-Frank, and who, on the other hand, have been deprived of a Commission with the capacity to address issues of immediate, practical, and substantive concern. The requirements of Dodd-Frank effectively have precluded the SEC from pursuing its own, historically more organic, need- and event-driven priorities—at a time when a steady, measured regulatory approach was needed and could have provided great benefits.[8]

Politics and the Regulatory Agenda

Another consequence of Dodd-Frank was the unprecedented politicization of the SEC's agenda. During his tenure, Commissioner Gallagher cast a record-setting sixteen dissenting votes on major SEC rulemakings. Calling this superlative "the hollowest of achievements," he observed, "Those votes represent sixteen proposals or final rules that I could not in good conscience approve, because they do not stay true to our mission…."[9] It is not a coincidence that the record for dissents was set in the era of Dodd-Frank. As Commissioner Gallagher reflected in August:

> If the SEC seems political nowadays, it's because of Dodd-Frank. Not only is it an incredibly ideological piece of legislation ill-suited to an independent agency explicitly constituted in a manner designed to ensure a bipartisan—or non-partisan—approach to regulation—but it is also largely just a series of ill-formed mandates that need to be interpreted and implemented to have any practical effect…. Is it any wonder, that since its passage, these mandates—ambrosia to members of one party,

[7] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, Public Statement, "Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule," Dec. 10, 2013, available at www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370540477693.

[8] *See, e.g.*, U.S. Securities and Exchange Commissioner Daniel M. Gallagher, "The Importance of the SEC's Rulemaking Agenda—You Are What You Prioritize: Remarks at the 47th Annual Securities Regulation Seminar of the Los Angeles County Bar Association," Los Angeles, Calif., Oct. 24, 2014, available at www.sec.gov/News/Speech/Detail/Speech/1370543283858.

[9] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, Public Statement, "Dissenting Statement at an Open Meeting To Approve the 'Pay Ratio' Rule," Aug. 5, 2015, available at http://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html.

anathema to those of the other—have drawn out the different philosophies of the Commissioners?[10]

The Dodd-Frank Act, passed with party-line votes in Congress, has had the unfortunate consequence of making philosophical differences at the SEC look like party politics.[11] Politicization of federal agencies generally has the unfortunate effects of reducing their relevance and effectiveness and casting a shadow over the legitimacy of their decision- and rulemaking authority; the SEC, afflicted by Dodd-Frank, has not escaped this fate. Commissioner Gallagher has called for the depoliticization of the SEC's agenda, through repeal or amendment of Dodd-Frank, so that the Commission can "set a course to once again being a preeminent federal agency and thought leader in the policy debates that have been for too long happening around us."[12]

Market Structure Reform

Commissioner Gallagher led the SEC's bipartisan call for market structure reform in both the equities and fixed income markets. He advocated a meaningful, comprehensive review, one that would examine without bias the roles of regulators and market participants alike. "We should not pursue, as the government so often does, the bureaucratically satisfying—yet intellectually lazy—approach of assuming that the markets and their participants are the source of any perceived problems. We need instead to acknowledge and review the role that regulation has played in creating those problems."[13] Taking the sensible view that regulatory reform will be more effective if it is accomplished through engagement with industry, he has called upon market participants to do their part as well. He has encouraged corporate bond issuers, for example, to work with dealers and exchanges to develop some standardization in debt products in order to reduce liquidity risks and increase transparency for retail buyers.[14]

Along with market structure reform, Commissioner Gallagher successfully drew attention to related elements that have a potentially distorting effect on the market environment. In particular, his robust call to reduce the disproportionate influence of proxy advisers led to the issuance of Staff Legal Bulletin 20 in 2014.[15] SLB 20 represents a much-needed reminder to

---

[10] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, Speech, "Dodd-Frank at Five: A Capital Markets Swan Song," *supra note 4*.

[11] Only six Republicans voted for the Dodd-Frank Act in the House and Senate combined. *See* www.govtrack.us/congress/bills/111/hr4173.

[12] Gallagher, "The Importance of the SEC's Rulemaking Agenda—You Are What You Prioritize," *supra note 8*.

[13] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, Speech, "Remarks to the Georgetown University Center for Financial Markets and Policy Conference on Financial Markets Quality," Sept. 16, 2014, available at www.sec.gov/news/speech/2014-spch091614dmg.html.

[14] *See id.*

[15] Staff Legal Bulletin No. 20, "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," June 30, 2014, available at http://www.sec.gov/interps/legal/cfslb20.htm.

investment advisers that they may not outsource their proxy voting wholesale to proxy advisory firms, which have their own agendas and whose business model can generate significant conflicts of interest. SLB 20 clarifies that investment advisers are not required to vote every proxy or take on all of a client's voting responsibilities. The guidance emphasizes the fiduciary responsibilities of investment advisers to their clients and underscores the responsibility of an investment adviser to oversee, on an ongoing basis, any proxy advisory firm that it retains. Market participants will benefit if SLB 20 reduces the appeal and influence of proxy advisory firms. While there are other steps that the SEC should take to further protect the market and investors from the undue influence and potential conflicts of the proxy advisory business, SLB 20 is a meaningful step in the right direction.[16]

Commissioner Gallagher has also helped lead a bipartisan call for reform of the rules relating to transfer agents.[17] These rules have not been updated in nearly three decades, and it is widely recognized that they are inadequate to address current technological and business realities. This type of problem, arising organically from the market environment, the passage of time, and societal developments, is exactly the sort of issue that the SEC historically has dealt with in a prompt and practical fashion. While Dodd-Frank has all but precluded the SEC from addressing issues outside the party-line mandate, Commissioner Gallagher nonetheless has taken seriously the independent and nonpartisan duty of regulators to work toward creating an environment in which procedural market participants—such as proxy advisers and transfer agents—are facilitating rather than impeding free and efficient markets.

Capital Formation and the Future

The most important market-related issue in the current era may well be capital formation. The opportunity cost of the burdens of Dodd-Frank-mandated rulemaking is perhaps nowhere greater than in this area. Despite the countervailing political and regulatory forces, Commissioner Gallagher worked to emphasize the importance of facilitating and democratizing primary and secondary capital market formation for entrepreneurs and small businesses, with substantial success in the form of Regulation A and Title III of the JOBS Act.[18] Further work

---

[16] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, "Outsized Power and Influence: The Role of Proxy Advisers," Wash. Legal Foundation, Critical Legal Issues Working Paper Series, Aug. 2014, available at http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf.

[17] U.S. Securities and Exchange Commissioners Luis A. Aguilar and Daniel M. Gallagher, Public Statement, "Statement Regarding the Need To Modernize the Commission's Transfer Agent Rules," June 11, 2015, available at http://www.sec.gov/news/statement/modernize-sec-transfer-agent-rules.html.

[18] *See, e.g.*, Samuel Guzik, "Exit: SEC's Dan Gallagher—Enter: The Crowdfunders!" Crowdfund Insider, Oct. 5, 2015

> [W]hat Commissioner Gallagher left behind at the SEC was a rich legacy—one that left its mark along the path pursued by Americans in search of the American dream—a path sorely in need of widening. This is the path traveled by entrepreneurs inspired by a vision, and in need of capital to make that vision a reality. Though he spent four arduous years battling the headwinds created by the likes of Barney Frank, and the Dodd-Frank Act of 2010, he never lost focus or energy in pursuit of new and better avenues for the most underserved population in our Nation's Capital—small business and small business job creators. He has left his mark on a revitalized—and workable—Regulation A+. He has helped push Title III of the JOBS Act to the goal line—and

remains to be done; among other things, Commissioner Gallagher has recommended that the SEC take steps to facilitate capital formation under $5 million, streamline Title III crowdfunding to make it workable for small companies, and simplify required disclosure. He has also called for the creation of venture exchanges as a secondary market for securities issued under Regulation A, and an expanded definition (or elimination of the category) of "accredited investor."[19]

Commissioner Gallagher advanced the crucial point, often overlooked or misunderstood, that "capital formation and investor protections walk hand-in-hand."[20] Widespread adoption of this nonpartisan philosophy—if understood and adopted by the SEC and other regulators—would prove highly beneficial to the American economy. It is not yet too late. Though Dodd-Frank and the recent era of burdensome, often irrelevant, regulation have done significant harm to the efficiency of our markets,[21] Thomas Friedman is nonetheless correct that:

> America still has the right stuff to thrive. We still have the most creative, diverse, innovative culture and open society—in a world where the ability to imagine and generate new ideas with speed and to implement them through global collaboration is *the* most important competitive advantage.[22]

The American markets are resilient and dynamic, fueled by our nation's strong entrepreneurial spirit. Through judicious regulatory actions and the adoption of a rational, nonpartisan agenda, the SEC can play a key role in bolstering capital markets and the growth of small business.

Commissioner Gallagher, notwithstanding his minority position over the last four years, made significant contributions toward the improvement of the capital markets with his thoughtful commentary and determined advocacy. Earlier this year, he gave the Commission a grade of "incomplete" on its regulation of capital formation;[23] his service as a Commissioner merits an A.

> undoubtedly in much better form than the belatedly proposed rules. And he has left a vision, and a foundation, for carrying forward a whole host of measures which will likely take years to come to fruition. But perhaps most importantly, his words and his deeds have undoubtedly inspired an army of emissaries to carry on the battle.

Available at www.crowdfundinsider.com/2015/10/75301-exit-secs-dan-gallagher-enter-the-crowdfunders/.

[19] U.S. Securities and Exchange Commissioner Daniel M. Gallagher, "Grading the Commission's Record on Capital Formation: A+, D, or Incomplete?" Vanderbilt Law School, 17th Annual Law and Business Conference, Nashville, TN, Mar. 27, 2015, available at www.sec.gov/news/speech/032715-spch-cdmg.html.

[20] *Id.*

[21] *See, e.g.*, U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, "The Egregious Costs of the SEC's Pay-Ratio Disclosure Regulation," May 2014 (estimating the annual cost of private sector compliance with the pay ratio rule at $710.9 million, with an annual compliance time of 3.6 million hours), available at www.uschamber.com/sites/default/files/documents/files/Egregious-Cost-of-Pay-Ratio-5.14.pdf.

[22] Thomas L. Friedman, "Time To Reboot America," N.Y. Times, Dec. 23, 2008, available at www.nytimes.com/2008/12/24/opinion/24friedman.html?_r=0.

[23] *See* Gallagher, "Grading the Commission's Record on Capital Formation," *supra note 19.*