



OFFICE OF
INSPECTOR GENERAL

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 29, 2022

TO: Gary Gensler, Chair

FROM: Nicholas Padilla Jr., Acting Inspector General 

SUBJECT: *Final Management Letter: Changes to the Internal Review Process for Proposed Rules May Impact the Office of the Advocate for Small Business Capital Formation and the Office of the Investor Advocate*

The Office of Inspector General (OIG) recently completed an evaluation of the U.S. Securities and Exchange Commission's (SEC, agency, or Commission) Office of the Advocate for Small Business Capital Formation (OASB).¹ The overall objective was to assess the design and implementation of OASB's operations, policies, and controls—including coordination and collaboration with other SEC divisions and offices and external stakeholders—to determine whether OASB met applicable statutory requirements and strategic goals and objectives.

During the evaluation, we identified a matter related to the agency's internal communication and coordination specific to the rulemaking process. We previously identified an opportunity to strengthen communication and coordination across the SEC's divisions and offices as an emerging theme in our October 2021 statement on SEC's management and performance challenges.² Our observations in the course of conducting the OASB evaluation demonstrate that strengthening communication and coordination remains a growth area for the SEC. Because the matter we identified was outside the scope and objectives of the evaluation, we did not fully assess the matter in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*, nor did we conduct an audit pursuant to generally accepted government auditing standards. However, based on the work performed, the OIG is providing this management letter to bring to your attention this matter, which we further describe below.

Executive Summary

OASB and the SEC's Office of the Investor Advocate (OIAD) were established pursuant to Congressional mandates involving a measure of independence. Among other things, these offices are statutorily required to help ensure that the concerns of specific SEC stakeholders (namely, small businesses and investors) are appropriately considered as decisions are being made and policies are being adopted at the Commission, at self-regulatory organizations, and in Congress. With respect to agency rulemaking, OASB and OIAD rely on the SEC's

¹ U.S. Securities and Exchange Commission, Office of Inspector General, *OASB Complied With Statutory Requirements But Can Improve As It Matures* (Report No. 573; August 30, 2022).

² U.S. Securities and Exchange Commission, Office of Inspector General, *The Inspector General's Statement on the SEC's Management and Performance Challenges October 2021* (October 8, 2021).

rulemaking divisions and offices³ to timely provide drafts of proposed rules for review and comment.

Around December 2021, the Office of the Chair modified the process for coordinating internal reviews of draft agency rules, resulting in OASB and OIAD receiving only fatal flaw drafts⁴ of proposed rules for a brief period of time.⁵ This change was neither formally documented nor communicated to those offices, and, according to the former directors of OASB and OIAD, they were not aware of the change until after it took effect. Although OASB and OIAD personnel stated that they generally were able to carry out their responsibilities during this period, changes to internal processes likely to impact their review and comment related to draft proposed agency rules may unintentionally limit OASB's and OIAD's ability to fulfill their advocacy roles and carry out office functions, and could hinder effective collaboration and information sharing across the agency.

Background

As stated in a 2015 SEC investor bulletin,⁶ rulemaking is the process by which federal agencies implement legislation passed by Congress and signed into law by the President. Legislation, such as the Securities Act of 1933,⁷ the Securities Exchange Act of 1934 (Exchange Act),⁸ the Investment Company Act of 1940,⁹ the Sarbanes-Oxley Act of 2002,¹⁰ and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),¹¹ provides the framework for the SEC's oversight of the securities markets, and the SEC creates or updates rules (also called regulations) under these and other laws as part of its regulatory oversight responsibilities. Specifically, the agency's rulemaking divisions and offices draft a rule proposal, which typically contains the text of the proposed new or amended rule along with a discussion of the issue, or problem the proposal is designed to address, and the likely economic impacts of the proposal. The proposal is then circulated internally for review and comment, as applicable. The Commission then votes on the proposed rule and, if approved, the proposal is published in the Federal Register for public comment for a period of 30 to 60 days.

The SEC Small Business Advocate Act of 2016 (Advocate Act)¹² requires OASB to advocate for small businesses and their investors by, among other things, analyzing the potential impact

³ According to the SEC's rulemaking index, since 2008 rulemaking divisions and offices have included the divisions of Corporation Finance, Economic and Risk Analysis, Investment Management, and Trading and Markets; and the offices of the Chief Accountant, General Counsel, Information Technology, Freedom of Information Act Services, and Municipal Securities.

⁴ A fatal flaw draft is the last draft circulated before the Commission votes on a proposed rule, often only a few days before the vote. It is typically the final version of the rule, to be reviewed only for critical issues, and will not incorporate policy revisions.

⁵ According to agency officials, the change in the rulemaking process was reversed in early 2022.

⁶ Investor Bulletin: *An Introduction to The U.S. Securities and Exchange Commission – Rulemaking and Laws* (August 20, 2015).

⁷ Pub. L. No. 73-22, 48 Stat. 74 (May 27, 1933).

⁸ Pub. L. No. 73-291, 48 Stat. 881 (June 6, 1934).

⁹ Pub. L. No. 76-768, 54 Stat. 789 (August 22, 1940).

¹⁰ Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

¹¹ Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

¹² Pub. L. No. 114-284, 130 Stat. 1447 (December 16, 2016).

on small businesses and small business investors of Commission-proposed regulations that are likely to have a significant economic impact on small businesses and small business capital formation.¹³ Furthermore, the Advocate Act states, “The Commission shall ensure that the [Director of OASB] has full access to the documents and information of the Commission and any self-regulatory organization, as necessary, to carry out the functions of the Office.”¹⁴ Established pursuant to Section 915 of Dodd-Frank and codified at Section 4(g) of the Exchange Act, OIAD is similarly required to analyze the potential impact on investors from proposed rules and regulations.¹⁵ Moreover, the Exchange Act also states, “The Commission shall ensure that the Investor Advocate has full access to the documents of the Commission and any self-regulatory organization, as necessary to carry out the functions of the Office.”

To carry out their office functions, OASB and OIAD rely on the SEC’s rulemaking divisions and offices to timely provide drafts of proposed rules for review and comment. If a proposed rule is determined to have a significant impact on small businesses, their investors, and small business capital formation, OASB will provide comments on the proposed rule to the rulemaking division or office, and in some cases, OASB will develop educational resources, such as videos, to help stakeholders understand how rules may affect small businesses. OIAD strives to review every rule and, if applicable, provides comments to the rulemaking division and office. Both offices are also required to deliver periodic reports to Congress describing actions taken to advocate on behalf of their respective SEC stakeholder groups, including discussions on rulemakings and their potential impact on stakeholder groups.

Results

To address the objectives of our evaluation of OASB, among other work performed, we evaluated OASB’s rulemaking feedback process to determine how OASB identified relevant SEC proposed rules, analyzed proposed rules, and provided comments during the period we reviewed. Furthermore, we interviewed OASB personnel and employees of other SEC divisions and offices to assess rulemaking coordination efforts relevant to our objectives. During the course of our work, SEC personnel stated that, around December 2021, the Office of the Chair modified the process for coordinating internal reviews of draft agency rules, resulting in OASB and OIAD receiving only fatal flaw drafts of proposed rules for review and comment for a brief period of time, and not the 30-day draft¹⁶ or any subsequent drafts. This change was not formally documented or communicated, and, according to the former directors of OASB and OIAD, they were not aware of the change until after it took effect.

Although the Advocate Act and the Exchange Act do not explicitly specify requirements of the agency to provide OASB and OIAD drafts of proposed rules, it has been past practice to involve these offices at the time of the 30-day draft, if not before. Before the change in process, OASB and OIAD received from the SEC’s rulemaking divisions and offices the 30-day

¹³ Although the Director of OASB reports directly to the Commission, the Advocate Act established OASB in January 2019 with some measure of independence.

¹⁴ 15 U.S.C. § 78d(j)(5).

¹⁵ OIAD was established in February 2014. Although the Investor Advocate reports directly to the Chair of the SEC, OIAD is intended to remain somewhat independent.

¹⁶ The 30-day draft is circulated to the Commissioners, for their comment, 30 days before the Commission is expected to vote on a proposed rule.

drafts, subsequent drafts, and fatal flaw drafts of proposed SEC rules for review and comment. The 30-day drafts allowed OASB and OIAD to provide comments, if appropriate, before the rule reached the Commission for voting. When asked about the change in process, personnel from the Office of the Chair explained that providing OASB and OIAD earlier versions of proposed rules was not explicitly required and, because OASB and OIAD do not have the same authority as Commissioners, it was unnecessary for those offices to receive earlier drafts. Following the change in the agency's rulemaking process, OIAD raised concerns and, in early 2022, the change was reversed.

OASB and OIAD acknowledged that the Office of the Chair has the authority to direct the agency's rulemaking process; however, the opportunity to comment on 30-day and subsequent draft rules provides these offices with meaningful opportunities to carry out their office functions early in the process. Although OASB personnel raised concerns about the temporary change in the rulemaking process, they told us that they were nonetheless able to review, as warranted, all rule proposals likely to have a significant impact on small businesses and their investors. OIAD personnel informed us that, during the time the process change was in effect, they received two fatal flaw drafts (but not the corresponding 30-day drafts); they provided comments to the Commission on one of the proposed rules and determined that no comments were needed for the other. However, personnel reported to us that, had the change in the rulemaking process remained in effect, it would have significantly shortened the review and comment period and rendered OIAD's involvement in rulemaking largely ineffective because fatal flaw drafts are typically provided as a courtesy and only comments on perceived fatal errors are accepted at that stage.¹⁷ Generally, we concluded that changes to the SEC's rulemaking process, particularly without notice to the offices likely to be impacted, may unintentionally limit the ability of those offices to carry out their functions, and could hinder effective collaboration and information sharing across the agency.

Notably, the SEC's strategic plan identifies the teamwork of the SEC's staff and its leaders, along with other elements, as the "foundation" of the agency, and acknowledges that "effective and efficient partnership of staff across the agency" is critical to the SEC's ability to carry out its mission.¹⁸ As reported in our October 2021 statement on the SEC's management and performance challenges, opportunities exist to strengthen communication and coordination across divisions and offices. Specifically, we stated, "management's early attention, as needed in response to this emerging theme can be instrumental to (1) prevent the development of systematic and significant challenges, such as potential siloing or duplicative functioning, in the future, (2) continue positive trends in employees views on collaboration, and (3) achieve the goals established in the SEC's most recent strategic plan."¹⁹ Furthermore, federal internal control standards state that effective information and communication are vital for an entity to achieve its objectives, and management should internally communicate the necessary quality information to enable personnel to perform key roles in achieving objectives.²⁰

¹⁷ We acknowledge that, in this scenario, OASB and OIAD could still comment on SEC proposed rules through the public comment process.

¹⁸ U.S. Securities and Exchange Commission, *Strategic Plan Fiscal Years 2018-2022*; Goal 3 and Strategic Goal 3.5; October 11, 2018.

¹⁹ U.S. Securities and Exchange Commission, Office of Inspector General, *The Inspector General's Statement on the SEC's Management and Performance Challenges October 2021* (October 8, 2021).

²⁰ U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government* (GAO-14-704G; September 10, 2014), Information and Communication Component, Principle 14, *Communicate Internally*.

We commend management's commitment to promoting effective and collaborative information sharing across the SEC's divisions and offices, as expressed in your response to our October 2021 statement on the SEC's management and performance challenges. Although we are not making any formal recommendations, we encourage the Office of the Chair to consider, as a management practice, notifying OASB and OIAD before future changes to the rulemaking process, potentially impacting these offices, are implemented.

On September 16, 2022, we provided SEC management with a draft of our management letter for review and comment. On September 28, 2022, the SEC indicated it would not be providing a written response.

We appreciate the courtesies and cooperation extended to us. If you have questions, please contact me or Rebecca Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects.

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