

Speech

Cleveland, Kondo, and Capital: Remarks before the American Chamber of Commerce



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Tokyo, Japan

Aug. 7, 2019

It is an honor to be with you today. I have long wanted to visit Japan. Indeed, one of the options I explored following college was coming to Japan to teach English. Instead I ended up in Austria—not teaching English. My would-have-been students are certainly better off for it, but I am pleased to finally have the chance to be here in a learning, rather than teaching, capacity. Before I begin, I must give a standard disclaimer: the views I express today are my own views and not necessarily those of the United States Securities and Exchange Commission or my fellow Commissioners.

One of the reasons I wanted to become a Commissioner was because I believe in the transformative power of the capital markets. Capital markets bring people together in joint endeavors to improve society. The capital markets match people who have new ideas with people who have money to invest, and the combination can produce products and services that improve everyone’s well-being. In the process, the lives of the entrepreneur and the investor can markedly improve as each enjoys the fruits of her contributions to the project. Employees of the enterprise and local communities may also benefit.

I am from Ohio—a state that draws its name from a Native American word for “good river.” I was happy to learn, however, that Ohio sounds a lot like a Japanese phrase of greeting. That connection is appropriate because Ohio and the region within which it sits—the Midwest—are known for their congenial people. Perhaps that is why Honda chose to build a plant in Ohio more than three decades ago, although I suspect that the decision to locate in Ohio had more to do with Ohio’s rich history as a center of manufacturing. Cleveland, where I grew up, is part of what some people refer to—often with derision in their voices—as the Rust Belt. The term is intended to convey the aging of the city’s manufacturing base, but the city is still vibrant and there is no shame in having been a center of industrial production during key years of a nation’s growth. Historian Naomi Lamoreaux has done extensive work to understand what caused Cleveland to be a hotbed of innovation at the turn of the twentieth century.^[1] The Cleveland story was not one of government plans and grants, but of bright minds congregating together, inspiring one another, and financing one another. Lamoreaux and her coauthors explain:

the networks that formed around innovative firms like Brush Electric and White Sewing Machine became engines of local economic development. They encouraged the geographic concentration both of technological creativity and of venture capital. They also matched inventors who had promising ideas with business people who possessed the managerial skills needed to transform these ideas into productive enterprises.^[2]

Had they been born one hundred years earlier, Silicon Valley's entrepreneurs would all have been living in Cleveland.

I daydream about having these innovation networks spring up organically all over the country and the world to unleash the talents of the next generation of entrepreneurs and invigorate the communities in which they are located. As a government official, I spend a lot of time thinking about what the government can do toward this end. Government's role, as I see it, is not deciding where or how innovation takes place, but rather laying the groundwork within which healthy capital formation happens spontaneously as people think, produce, and interact with one another. That groundwork consists of a predictable, efficient, evenly applied set of rules within which individuals and the companies they form can enter into the mutually beneficial arrangements that allow capital to be put to productive use. Government does not need to be the innovator or guide the hands of the people who have the ideas or the money that generate innovation. In setting and enforcing consistent, clear, and considered rules, the government plays the only role it needs to.

Indeed, when government attempts to step in to the process of innovation or the process of capital allocation, it runs the risk of ruining the whole effort. Innovators and entrepreneurs get rewarded when they make things people need or want, so they instinctively respond to the needs of society. Government, by contrast, gives people what it thinks they need and want regardless of whether they actually need and want those things, and the mechanisms for notifying the government that it missed the mark are imprecise, slow, and of limited effect. When government asserts itself into the capital allocation process, the results are not any better because once again the feedback mechanism is simply inferior to the market's accountability mechanism. Government allocates capital to politically expedient projects or projects that make the allocating bureaucrats happy, rather than to projects that would make society happier and better off.

I became a Commissioner about a year and a half ago, well into my agency's long history. As one would expect from a government agency that was born in the 1930s, we have written lots of rules. One can learn much about America's government regulators by watching American television. There are multiple TV shows about people who hoard things in their homes.^[3] These people, many of whom feel powerless to stop, collect masses of things over time. After watching a few episodes, some of us may feel better about our own clutter by thinking that, in relative terms, our heaps of junk are not so bad. Others of us react in the opposite way—we go on wild binges of throwing things out.

Some wise counsel imported from Japan has been extremely helpful in this regard. Marie Kondo has made a brisk business of showing the rest of us how to pare back our possessions and improve our dispositions. Marie Kondo enjoyed a high point of popularity in Washington, DC during the government shutdown at the beginning of the year, which forced many government employees to stay home and legally prohibited them from doing their jobs.^[4] After a few days of sleeping late and going to matinees in the movie theater, many furloughed workers turned to Marie Kondo for inspiration about how to spend their time away from the office. As a result, by shutdown's end, closets had never been so clean and thrift stores in the Washington, DC area had never been so full.

What does all of this house cluttering and cleaning have to do with government? Just as an old person who has lived in a house for decades collects lots of stuff and has trouble throwing out the pieces that have served their purpose well but are now just in the way, a regulatory agency that has been around for decades collects lots of rules and, rather comfortable with the dusty volumes lying around, resists throwing out the ones that no longer serve a valid purpose. The rules that objective observers see as unnecessary and standing in the way of progress, the regulators see as worth preserving because they once had value and might come in handy again. Just as I pitifully mutter to myself, "You just never know when I might need the three broken vacuum cleaners cluttering my closet," we regulators reflexively say, "You just never know when we might need that rule!"

Once again, an export of Japanese wisdom should help to inspire decluttering. I am not speaking of Marie Kondo as we might have too few rules if we retained only the ones that "spark joy." Instead, let us look for inspiration to former Financial Services Agency Commissioner Nobuchika Mori. He made the point in a speech four years ago that it is always important to keep in mind that one goal of financial regulation is "to enable the financial system to

contribute to economic growth.”^[5] In the midst of post-crisis financial stability regulatory efforts, Commissioner Mori issued a timely call for regulatory prudence:

The production lines of the regulation factories have been significantly expanded after the global financial crisis. . . . Might it not be the case that factories and production lines have gained their own momentum and that even leaders’ instructions cannot slow them down?

Of course, each new proposal is well intended, has good justifications, and is persuasive enough to convince people of its contribution to financial stability. However, if dozens of specialized doctors surround a patient and inject different strong medicines for every symptom, what would be the combined effects on the patient?^[6]

SEC Chairman Jay Clayton has made it a hallmark of his tenure to look at the SEC’s rulebook with an objective and practical eye. He recognizes that we cannot afford to nostalgically hang on to the rules of the past with the interpretive dust that has accumulated on them. Some of the phenomena that signal potentially unhealthy regulatory hoarding are the declining number of public companies, the difficulties that smaller entities face in competing in our markets, the inability of certain rules to accommodate modern technologies, and the fragmentation of international markets. Chairman Clayton has therefore led the agency in an effort to take a closer look at our rules.

Sometimes, we take a look at a rule, find that it is functioning perfectly well, and therefore leave it untouched; replacing old rules that are working well with modern substitutes would be foolish. In other instances, a rule might be functioning relatively well, but a few tweaks and a fresh coat of interpretive paint could make it work better in the modern marketplace. Sometimes a rule does not work anymore, but the problem it was designed to solve persists, so a new rule more attuned to the realities of the modern marketplace is necessary. In yet other instances, removing the rule altogether would free up the resources and time of regulated entities without compromising investor protection or market functioning. As we engage in regulatory housekeeping, we have to take care not to add to the regulatory burden by adopting new requirements that do not solve a real problem. After all, a person who undertakes the substantial effort to rid his house of junk ought not go out and buy a new set of junk to take the place of the discarded items. New rules are sometimes necessary, of course, and some of our recent initiatives have included new requirements. I would like to take you through some areas in which we are making changes or contemplating changes to our rules and some areas where I would like us not to change.

The regulation of public companies is a part of our jurisdiction that is crying out for reform. We have seen the trend of companies waiting longer to go public and have been asking ourselves what we can do to encourage companies to go public earlier and to remain public. We want to ensure that retail investors can participate in the growth of these companies. There are a number of reasons that companies might choose not to go public. For small companies, the Sarbanes-Oxley requirement that auditors attest to the effectiveness of the company’s internal controls has been particularly painful as it requires companies to spend scarce investor funds on assurance that many investors simply do not want at that stage of the company’s life. Accordingly, we recently proposed to eliminate this requirement for certain pre-revenue companies.^[7] One supportive commenter, the Biotechnology Innovation Organization, noted that “[t]he low market demand for voluntary 404(b) compliance is a clear sign that investors would prefer that our companies instead focus on science rather than costly and unnecessary compliance.”^[8]

We have undertaken other efforts to cut unnecessary costs, while ensuring that investors nevertheless get information they need and on which they can rely. These modernization measures include a proposal to streamline “the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses,”^[9] a statutorily-mandated proposal to allow closed-end funds “to use the securities offering rules that are already available to operating companies,”^[10] a proposal to allow all issuers to “test the waters” by “communicat[ing] with potential investors to gauge their interest in a contemplated registered securities offering,^[11] amendments to simplify the financial disclosure requirements for guarantors and issuers of guaranteed securities,^[12] revisions to certain unworkable provisions of the auditor independence requirements,^[13] a rulemaking to eliminate or simplify certain reporting requirements under Regulation S-K,^[14] expanded the pool of companies that can use Regulation A to raise funds,^[15] modernized our outdated mining disclosure requirements,^[16] and expanded the number of

companies that count as smaller reporting companies and thus are subject to reduced requirements.[17] Some of these changes may sound small as I rattle them off in a list, and I would have liked some of them to go further. Many commenters, however, have welcomed these changes and the spirit in which they come—namely, in the words of one commenter on the guarantor rule:

creat[ing] an improved disclosure framework for both investors and registrants, better aligning disclosure requirements with the information that . . . investors consider meaningful in making an investment decision and streamlining required disclosure to be clearer and more concise, while meaningfully reducing the burden on registrants and allowing registrants to focus resources on disclosures that are material to their particular facts and circumstances.[18]

In addition to looking at what we can do to reduce the burden for public companies, we are looking at ways to streamline our exemptions from registration with an eye toward keeping capital flowing at all stages of a deserving company's development. Earlier this summer, we issued a comprehensive concept release looking at a wide range of issues ranging from accredited investors to crowdfunding to private placements.[19] As we explained, "the scope of exempt offerings has evolved over time through Commission rules and legislative changes," which has resulted in a tangled framework that is difficult for small companies to wade through.[20]

The second big area of regulatory reform is our regulation that relates to the provision of financial services to retail investors. One major initiative in this area, which we completed earlier this summer, is a package of rules related to the provision of investment advice to retail clients. The rulemaking came in response to a concern that clients receiving investment advice from broker-dealers were not protected by a clear, sufficiently strong standard of care. We not only adopted a new standard to ensure that broker-dealers not put their interests ahead of those of their clients, but we also spelled out the broad outlines of the fiduciary standard for investment advisers, and adopted a simple disclosure requirement applicable to both broker-dealers and investment advisers who provide advice to retail clients. The disclosure portion of the package responds in part to a concern that investors are drowning in disclosure as a result of many years' worth of regulatory requirements interpreted by cautious lawyers. We are thinking about other ways we can better tailor information to the needs of retail investors. For example, we proposed a summary prospectus for variable insurance products,[21] which would give retail investors a much more manageable overview of the products than they now get, and make it easier for fund companies to communicate electronically with shareholders.[22] More broadly, I look forward to making it easier for firms to communicate with their clients in a way that responds to the needs and preferences of their clients.

Another rule that we are working on as part of our effort to modernize the retail asset management space is a rule for exchange-traded funds, which—to this point—have operated pursuant to less formal, and non-standardized exemptive orders. For a new product, such an ad hoc approach can be appropriate, but exchange-traded funds have been around for a quarter century. In addition, we have proposed a rule to eliminate the need for many fund-of-funds arrangements to get exemptive relief,[23] which has generated a lot of comment—not all of it positive—and therefore illustrates the importance of making these changes through a process that allows the public an opportunity to comment.

Another major area of reform relates to market structure. We are looking at how well our rules governing equity and fixed income markets serve issuers and investors. On the fixed income side, the Chairman established a Fixed Income Market Structure Advisory Committee to advise us on potential reforms. In announcing last week that he would extend the Committee's charter by one year, the Chairman noted that the Committee's work had prompted consideration of issues like the regulatory framework for fixed income trading platforms and block trading.[24] On the equity side, we have taken steps to ensure that investors have the information they need to assess execution quality; a new rule requires broker-dealers to provide customers specific disclosures related to the routing and execution of their orders.[25] Public disclosure about alternative trading systems also is improving under a new rule that requires more comprehensive, public disclosure about how these trading platforms operate. We also plan to conduct a pilot program to assess the effect that exchange transaction fees and rebates have on how our equity markets work.[26] The Chairman, consistent with his theme of reconsidering our rules to see

whether they should stay or go, has pledged to take a fresh look at one of the key equity structure rules. As he explained recently:

Regulation NMS is the primary regulation governing equity market structure, yet it has remained largely untouched since first adopted in 2005. It was designed to address equity market structure challenges that were prevalent over a decade ago. It is clear that the market challenges we faced in the early 2000s are not the same as the issues that we confront over a decade later. Some of the challenges we face today may, in fact, be consequences of Regulation NMS and other rules. [27]

There are a number of other rules that are on the rewriting agenda. The rules and interpretations around the proxy voting process and the participants in that process, including proxy advisors and shareholder proponents, are in need of reform. The rules governing transfer agents, which are very old, also need to be refreshed in response to the many problems our examination and enforcement staff have identified. I have advocated for new rules to accommodate the unique aspects of digital assets. The SEC, along with many other regulators around the world, has attempted to force all digital assets into the existing securities framework, but there may be better ways to protect token purchasers and token marketplaces. Well-crafted regulations for digital assets could be a model for future regulation of new products and services.

Let me end with an area in which I do *not* think our rules need updating. It is an area in which there has been increasing regulatory pressure emanating from all over the world, but involves matters only indirectly related or sometimes not related at all to the mission with which the Securities and Exchange Commission is charged. These matters are categorized in the United States as environmental, social, and governance issues, and elsewhere are discussed under the rubric of sustainable finance. Our existing framework, the touchstone of which is materiality, works to ensure that investors receive the information that they need to make investment decisions that turn on the long term value of the company in which they are investing. The attempt to supplement financial materiality with social significance could undermine our other efforts to ensure that companies and their investors are not bearing the cost of producing and analyzing unnecessary disclosure.

Thank you all for your attention. I would be happy to take questions or suggestions on rules in need of change, elimination, or modernization and to hear about similar efforts in Japan. Our capital markets are a shared resource, so efforts we undertake in the United States to reform the regulatory structure should be informed by wisdom from Japan and all across the globe. Our efforts, if successful, will generate benefits far beyond our borders. We Ohioans, inspired by our state's heart-like shape, refer to it as "the heart of it all." If our capital markets function as they ought, there will be many hearts of innovation beating all across the world in a combined effort to nurture our global economy with the ultimate goal of improving the well-being, and unleashing the talents, of people everywhere.

[1] Naomi R. Lamoreaux, Margaret Levenstein, and Kenneth L. Sokoloff, *Financing Invention During the Second Industrial Revolution: Cleveland, Ohio 1870-1920*, NBER Working Paper Series, Working Paper 10923, 2004, available at <https://www.nber.org/papers/w10923.pdf>.

[2] *Id.* at pp. 35-36.

[3] See, e.g., "Hoarders," available at <https://www.aetv.com/shows/hoarders>, and "Hoarding: Buried Alive," available at <https://www.tlc.com/tv-shows/hoarding-buried-alive/>.

[4] Lauren Flynn Kelly, "Secondhand News: In the Age of 'KonMari,' Furloughed Residents Find Solace in Purging Closets," *Life & Times Hyattsville*, Jan. 14, 2019, available at <http://hyattsvillelife.com/secondhand-news-in-the-age-of-konmari-furloughed-residents-find-solace-in-purging-closets/>.

[5] Nobuchika Mori, Commissioner, Financial Services Agency, Japan, Remarks at the Thompson Reuters 6th Annual Pan Asian Regulatory Summit: Rethinking Regulatory Reforms, at 2, Oct. 13, 2015, available at <https://www.fsa.go.jp/common/conference/danwa/20151013/01.pdf>.

[6] *Id.* at 3.

[7] Sec. & Exch. Comm'n, Release No. 34-85814, Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, Proposed Rule, May 9, 2019, *available at* <https://www.sec.gov/rules/proposed/2019/34-85814.pdf>.

[8] Letter from Cameron Arterton, Vice President, Biotechnology Innovation Organization, to Vanessa Countryman, Secretary, Securities and Exchange Commission, at 6, Jul. 29, 2019, *available at* <https://www.sec.gov/comments/s7-06-19/s70619-5881309-188765.pdf>.

[9] Sec. & Exch. Comm'n, Release No. 33-10635, 34-84765, IC-33465, Amendments to Financial Disclosures about Acquired and Disposed Businesses, Proposed Rule, May 3, 2019, *available at* <https://www.sec.gov/rules/proposed/2019/33-10635.pdf>.

[10] Sec. & Exch. Comm'n, Release No. 33-10619, 34-85381, IC-33427, Securities Offering Reform for Closed-End Investment Companies, Proposed Rule, Mar. 20, 2019, *available at* <https://www.sec.gov/rules/proposed/2019/33-10619.pdf>.

[11] Sec. & Exch. Comm'n, Release No. 33-10607, Solicitations of Interest Prior to a Registered Public Offering, Proposed Rule, Feb. 19, 2019, *available at* <https://www.sec.gov/rules/proposed/2019/33-10607.pdf>.

[12] Sec. & Exch. Comm'n, Release Nos. 33-10525, 34-83701, Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, Proposed Rule, Jul. 24, 2018, *available at* <https://www.sec.gov/rules/proposed/2018/33-10526.pdf>.

[13] Sec. & Exch. Comm'n, Release Nos. 33-10648, 34-86127, FR-85, IC-33511, Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Final Rule, Jun. 18, 2018, *available at* <https://www.sec.gov/rules/final/2019/33-10648.pdf>.

[14] Sec. & Exch. Comm'n, Release Nos. 33-10618, 34-85381, IA-5206, IC-33426, FAST Act Modernization and Simplification of Regulation S-K, Final Rule, Mar. 20, 2018, *available at* <https://www.sec.gov/rules/final/2019/33-10618.pdf>.

[15] Sec. & Exch. Comm'n, Release No. 33-10591, Conditional Small Issues Exemption under the Securities Act of 1933 (Regulation A), Final Rule, Dec. 19, 2018, *available at* <https://www.sec.gov/rules/final/2018/33-10591.pdf>.

[16] Sec. & Exch. Comm'n, Release Nos. 33-10570, 34-84509, Modernization of Property Disclosures for Mining Registrants, Final Rule, Oct. 31, 2018, *available at* <https://www.sec.gov/rules/final/2018/33-10570.pdf>.

[17] Sec. & Exch. Comm'n, Release Nos. 33-10591, 34-83550, Smaller Reporting Company Definition, Final Rule, Jun. 28, 2018, *available at* <https://www.sec.gov/rules/final/2018/33-10513.pdf>.

[18] Letter from Maya McReynolds, Senior Vice President, Corporate Finance and Chief Accounting Officer, Dell, to Brent Fields, Secretary, Sec. & Exch. Comm'n, at 5, Dec. 3, 2018, *available at* <https://www.sec.gov/comments/s7-19-18/s71918-4717469-176701.pdf>.

[19] Sec. & Exch. Comm'n, Release Nos. 33-10649, 34-86129, IA-5256, IC-33512, Concept Release on Harmonization of Securities Offering Exemptions, Concept Release, Request for Comment, Jun. 18, 2019, *available at* <https://www.sec.gov/rules/concept/2019/33-10649.pdf>.

[20] *Id.* at 5-6.

[21] Sec. & Exch. Comm'n, Release Nos. 33-10569, 34-84508, IC-33286, Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, Proposed Rule, Oct. 30, 2018, *available at* <https://www.sec.gov/rules/proposed/2018/33-10569.pdf>.

[22] Sec. & Exch. Comm'n, Release Nos. 33-10506, 34-83380, IC-33115, Optional Internet Availability of Investment Company Shareholder Reports, Final Rule, Jun. 5, 2018, *available at* <https://www.sec.gov/rules/final/2018/33-10506.pdf>.

[23] Sec. & Exch. Comm'n, Release Nos. 33-10590, IC-33329, Fund of Funds Arrangements, Proposed Rule, Dec. 19, 2018, <https://www.sec.gov/rules/proposed/2018/33-10590.pdf>.

[24] Jay Clayton, Chairman, Sec. & Exch. Comm'n, Remarks to the SEC Fixed Income Market Structure Advisory Committee, Jul. 29, 2019, *available at* <https://www.sec.gov/news/public-statement/clayton-remarks-fimsac-072919>.

[25] Sec. & Exch. Comm'n, Release No. 34-84528, Disclosure of Order Handling Information, Final Rule, Nov. 2, 2018, *available at* <https://www.sec.gov/rules/final/2018/34-84528.pdf>.

[26] Sec. & Exch. Comm'n, Release Nos. 33-10618, 34-85381, IA-5206, IC-33426, FAST Act Modernization and Simplification of Regulation S-K, Final Rule, Mar. 20, 2018, *available at* <https://www.sec.gov/rules/final/2019/33-10618.pdf>.

[27] Jay Clayton, Chairman, Sec. & Exch. Comm'n, and Brett Redfearn, Director, Sec. & Exch. Comm'n Div. of Trading and Markets, Remarks at Gabelli School of Business, Fordham Univ.: Equity Market Structure 2019: Looking Back & Moving Forward, Mar. 8, 2019, *available at* <https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019>.