

Speech

SECret Garden: Remarks at SEC Speaks



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I would like to begin with the standard disclaimer plus an additional one that ties with the theme of this speech. The views I represent are my own and not necessarily those of the Commission or my fellow Commissioners. The supplemental disclaimer is that the views of the staff are not necessarily those of the Commission either.

My cousin recently reminded me of a well-known children's book, *The Secret Garden* by Frances Hodgson Burnett. The book tells the story of a troubled, young girl who finds herself living with her widowed uncle and troubled cousin on an estate in the wind-swept British moors. The estate has a number of gardens, but one of them has been sealed shut for ten years. The garden is walled and any sign of the erstwhile door is

obscured. Even speaking of the garden seems to be frowned upon. Without giving too much of the story away, the girl manages to find the garden door and its buried key. She shares the secret with her cousin and a friend with a green-thumb, and the garden flourishes under its new caretakers, who in turn flourish. By reminding me of this story, my cousin got me thinking about the secret gardens at the SEC, gardens that have been sealed up longer and that are not as rosy or good for the health as the one in the classic story. These gardens are the topic about which I would like to speak today.

The complexity of the federal securities laws is no secret. Indeed, this complexity is likely a big reason most of us are in the room today. We are drawn to this body of law because it promises a lifetime of interesting problems to solve. We will never get bored; there is always something new and unexpected to be discovered. We constantly challenge one another with legal questions the answers to which reside in a tangled statutory and regulatory web.

From one perspective, the complexity of the regulatory framework governing our markets really should not surprise us, given the sheer size and complexity of our markets and the intricate processes and many participants that keep those markets running. Nevertheless, we probably all have asked—as we have been engrossed in the hard but enjoyable and often lucrative work of teasing apart an interesting legal question—whether there is a dark side to the fascination this remarkably nuanced area of the law affords us. The very complexity that has made our careers so rewarding can create a compliance minefield for market participants. For those with real skin in the game, unraveling that complexity can be a matter of professional life and death.

In an ideal world, we might hope for a radical simplification of our statutes and rules. We could revisit eighty-some years of legislative, regulatory, and even judicial precedent. We could identify what is essential and what is not. We could make the necessary revisions and

amendments to update the language and concepts of the mid-twentieth century for the markets of the mid-twenty-first century. That hope, alas, is unlikely to become reality any time soon.

In our less-than-ideal world, however, the Commission and its staff have some tools at their disposal that, if used correctly, can help provide clarity, certainty, and workability to the people who operate within our regulatory framework. Commission and staff guidance can help practitioners and market participants navigate the complexity of the federal securities laws and understand how to apply provisions enacted and promulgated decades ago to novel developments that, even a few years ago, none of us in this room—much less the drafters of these laws so many years ago—could have imagined.

For significant matters that may have programmatic effects, the Commission itself occasionally provides guidance or relief.^[1] As you all know, Commission-level processes can be unwieldy, dreadfully slow, and impracticable in many situations where interpretative questions arise. For example, a firm required to report information to the Commission may need guidance on how to complete a particular field in an online form. A broker-dealer seeking to comply with the net-capital rule may need clarity regarding the capital treatment of a particular debt instrument. An OCIE examiner may find herself confronted with a quirk in an adviser's custodial arrangement. None of these situations is conducive to routine Commission involvement, and requiring Commission action on all of them would quickly overwhelm the Commissioners' offices and leave us with no time to address any of the other work of the agency (including updating our rulebooks to make this guidance less necessary). Needless to say, people looking for answers to questions like these would not appreciate the inevitable delay that waiting for Commission-level answers would entail. In these circumstances, staff-level guidance performs a critical function; it helps to ensure that the Commission is responsive to our markets and that market participants are able to timely meet their obligations under our rules.

However—and you must have known there would be a “however”—in my conversations with market participants since joining the Commission fifteen months ago, I have grown increasingly concerned that this necessary guidance—due to a lack of transparency and accountability—may have turned into a body of secret law. This secret law, as a practical matter, binds market participants like law does but is immune from judicial—and even Commission—review.^[2] We have our own secret garden—a tangle of staff pronouncements hidden beyond a wall without a readily accessible entrance.

Now, as with just about everything else in our securities universe, this concern is not new. For the first 35 years or so of the Commission’s existence, for example, no-action letters were generally not made available to the public, and, even if they were, they were not generally accessible, given the technological and other limitations of the era.^[3] In a testy exchange between Professor Kenneth Davis and Commission Chairman Manny Cohen at an administrative law symposium in the late 1960s, Professor Davis suggested that the newly enacted Freedom of Information Act required Commission no-action letters to be publicly available because they were law, and secret law is—in his words—“an abomination.”^[4] Chairman Cohen objected, responding that an unpublished no-action letter “is not secret law,” that “it may be lore, l-o-r-e, but it is not law.”^[5]

Chairman Cohen was, of course, correct as a technical, legal matter. As I noted in my disclaimer, statements of the SEC’s staff—or, for that matter, of any of its Commissioners—are not to be taken as the views of the Commission. Only the Commission acting as a body can speak for itself.^[6] At the same time, I am increasingly concerned that, as a practical matter, Professor Davis may have had the better of the argument, particularly from the viewpoint of the practitioner and the market participant.

Before I explain my thinking in this regard, I would like to spend a few moments reflecting on no-action letters from Commission staff. This

particular tool, used appropriately, can be extraordinarily helpful to market participants, particularly when no-action positions are made public, as they generally are today. A short time after the exchange between Professor Davis and Chairman Cohen, the Commission determined to make these letters public. Our rules currently provide that no-action requests and the staff's written responses as a general matter are to be made available to the public "as soon as practicable after the response has been sent or given to the person requesting it."[\[7\]](#)

Requiring these letters to be published has produced several benefits. It enhances consistency in staff-level guidance across time and across similarly-situated market participants. It creates an informal process that sheds public light on areas where our rules may be clunky or ambiguous or where they are producing unintended results (perhaps because they are being applied to novel technologies or business models). It allows for the provision of expressly tailored relief that preserves the integrity of our regulatory framework. It also keeps the staff accountable to the Commission and to the public by ensuring that the no-action process, although it is intrinsically informal, is also—at least at its end point—transparent. Finally, it helps to ensure that the views of the staff as articulated in these letters do not, over time, fall out of sync with the views of the Commission and the realities of the market.[\[8\]](#)

Consider, for example, the no-action letter provided by the staff in October 2017 to address concerns arising out of regulatory changes in Europe relating to compensation for research by certain financial firms. [\[9\]](#) My former colleague, then-Commissioner Stein, responded to this MiFID II relief by issuing a statement setting forth her concerns that the relief did not adequately consider certain issues related to transparency and investor protection.[\[10\]](#) Although her statement did not represent the Commission's view and thus did not affect the relief provided by staff, I am confident that the knowledge that commissioners are looking over their shoulders sharpens the staff's thinking on issues raised by guidance that they provide.

Similarly, in September 2018, staff in the Division of Investment Management announced that the division was withdrawing two no-action letters that had been issued in 2004 relating to proxy advisory services.^[11] In doing so, staff noted that the decision to withdraw the letters took into account developments since the letters were initially issued. In my estimation, the letters should never have been issued, and it certainly is time to reassess the industry that grew up around those no-action letters with their purportedly limited reach. The decision to withdraw these letters reflects ongoing engagement with market realities that is foundational to effective regulation.

Some requests for clarification or guidance are inappropriate for handling through a time-consuming process that results in a published response. Indeed, as a Commissioner, I hope that the staff is engaging productively and responsively with market participants. I would not want to see this engagement become so burdensome to either staff or market participants that it discourages people from seeking informal guidance or the staff from providing it. However, when staff provides non-public guidance, Professor Davis's concerns become much more pronounced, and I believe that there is a line that can be crossed where non-public staff guidance goes from being merely helpful "I-o-r-e" lore to something that is more akin to secret law that, for all practical purposes, binds at least some (though perhaps not all) market participants without any opportunity for review or appeal.^[12]

For example, when I hear that staff simply will not accept certain applications for entire categories of products or types of businesses for reasons not found in our rules, I wonder whether that line has been crossed. Likewise, when I hear, as I did a few months ago, that one particularly complex set of Commission rules does not matter much in practice because firms operate instead under a set of published and unpublished letters and other directives from staff, I am pretty certain that line has been crossed. Or when I hear that examiners and SROs are examining firms against the terms of draft no-action letters and

notes of telephone calls with Commission staff, I am confident that line has been crossed.

Again, as a technical matter, none of this guidance is “I-a-w” law, and it seems unlikely that a court would readily defer to this kind of guidance. In many of these cases, however, *sub rosa* guidance by staff does, as a practical matter, bind market participants, affecting the scope of their rights and obligations and limiting the range of permissible activities. It is important for those of us working at the Commission to be honest with ourselves about this: for the affected party, this kind of guidance operates no differently from duly enacted law or regulations issued pursuant to the APA. On second thought, let me revise that: it operates no differently from duly enacted law or regulation, save for the fact that because it is, as Professor Davis would put it, “secret law,” it is not subject to processes to ensure that it conforms to our legislative authority; it is impossible to determine whether it applies to all similarly situated parties equally; and it is insulated from effective oversight or review, whether by the Commission or the courts.

For example, when the Commission prevents a registration filing from going effective or denies an application to list a new product, it typically gives reasons for doing so, and those reasons are subject to political and legal scrutiny. When the staff disapproves a filing or application on authority expressly delegated by the Commission, it also must give reasons for doing so, and, if those reasons appear inadequate, a single member of the Commission can pull the delegation and have the matter considered by the entire Commission.^[13] Moreover, a party whose application is denied could also petition for review of the denial by the entire Commission.^[14] A final order of the Commission would then be subject to judicial review.^[15] In addition, as I have already noted, even staff guidance, if provided publicly, is subject to Commission oversight and to political and public accountability.

A formal or informal process of public engagement with the Commission and its staff also has the advantage of ensuring that we

grapple seriously with the issues presented to us. When we or the staff engage publicly with market participants, we have an incentive to develop the strongest arguments for our position. Our thinking also benefits from public comment, which can further inform our thinking—and the market’s thinking—about these issues. True, any weaknesses in our position will be more visible, and we will have to work harder, but having to confront those weaknesses publicly—with the prospect of Commission or judicial review—can only help refine our thinking on issues presented by market participants.

The problems are a bit different, but no less troubling, when firms have to have access to novel interpretations or non-published or draft staff guidance to get credit for complying with our rules. Market participants begin wondering whether they are subject to the same requirements and standards as their competitors. Firms without access to the high-priced lawyers who have gained a sight into the secret garden may indeed be at a fatal competitive disadvantage. Even more problematically, market participants may be unable to effectively push back when, for example, an examiner insists that a regulation means something that may be doubtful under any reasonable reading of the Commission’s rules or policy as spelled out in publicly available materials.^[16] Finally, when a patchwork of public and non-public guidance has become so comprehensive that market participants can say, only half-jokingly, that entire sections of our rulebook are irrelevant, similar questions about fairness and transparency arise: Are all similarly situated firms aware of the non-public guidance? Does the staff’s guidance reflect a thorough consideration of the likely benefits and costs of that guidance? Does access to our markets depend on hiring counsel that has access to the non-public views of the staff?^[17] Will market participants change their behavior in ways that may not make sense under our rules as written to comply with the vast body of guidance, much of which may not be publicly available?

All of these issues point, in turn, to a much larger question, which is this: Is the Commission regulating the markets and market participants

in a way that is designed to cultivate and maintain the public trust over the long term?

The American public, through Congress, has entrusted the Commission with the regulation of our financial markets. That trust is premised on transparency and fairness in the promulgation and application of regulatory requirements by the Commission pursuant to processes established, again, by Congress. This delegation is the sole basis of our authority, and it is premised on the Commission's actions—and the interpretive decisions of its staff—being subject to democratic accountability and some form of review.^[18] Absent confidentiality concerns, all of our regulatory gardens should be open to the public.

The issue I have raised today is not unique to the SEC. It is common for a secret garden of barely discernible directives to grow up alongside a complex regulatory framework. We want to provide timely, meaningful, flexible guidance to meet the needs of a growing, changing marketplace. Our staff are striving every day to achieve our regulatory mandates as effectively and efficiently as possible. The practices that I worry about are almost always the product of good intentions and diligence. For the sake of the integrity of the SEC, all of us in this room nevertheless must ask ourselves how and where the lines are being crossed. Let us work together to take down the walls of the secret gardens at the SEC, or at least to make doorways into these gardens, so that the public can get a glimpse inside, assess the quality of what is growing within, and hold us accountable for what is found there.

^[1] See, e.g., Securities and Exchange Commission, Release No. 34-84511; File No. S7-24-18, Commission Statement on Certain Provisions of Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants (Oct. 31, 2018), available at <https://www.sec.gov/rules/policy/2018/34-84511.pdf>.

[2] See Robert A. Anthony, “Well, You Want the Permit, Don’t You?” Agency Efforts to Make Nonlegislative Documents Bind the Public, 44 Admin. L. Rev. 31, 32 (1992) (noting that administrative agencies often “impose[] obligations or standards that as a practical matter are mandatory” and that “may escape judicial review altogether”).

[3] See Donna M. Nagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework, 83 Cornell L. Rev. 921, 948-49 (1998) (noting, among other things, that “[i]n the early years of the SEC’s no-action letter process, the regulatory interpretations announced therein were generally available only to the particular requestors”). In an administrative law symposium held in the late 1960s, then-Chairman Cohen acknowledged the general unavailability of Commission no-action letters and explained that this policy was in part driven by the confidentiality concerns of requesting parties and by a desire to encourage firms to seek advice from Commission staff. See Panel Discussion, “Public Information Act and Interpretative and Advisory Rulings,” 20 Admin. L. Rev. 1, 24-31 (1967).

[4] Panel Discussion, *supra* note 3, at 29.

[5] *Id.* at 29.

[6] Chairman Clayton made this point eloquently in a statement issued last September. See Chairman Jay Clayton, Statement Regarding Staff Views, September 13, 2018, available at <https://www.sec.gov/news/public-statement/statement-clayton-091318>. He emphasized the distinction between the Commission’s “rules and regulations, which generally have the force and effect of law,” and staff statements, which “are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties.” *Id.*

Although staff statements are only lore, staff views are not meaningless for market participants. Our rules explain that, “[w]hile opinions expressed by members of the staff do not constitute an official

expression of the Commission's views, they represent the views of persons who are continuously working with the provisions of the statute involved." 17 CFR 202.1(d). That rule goes on to note that "any statement by the director, associate director, assistant director, chief accountant, chief counsel, or chief financial analyst of a division can be relied upon as representing the views of that division." *Id.*

[7] 17 C.F.R. 200.81(a). The rule does provide that persons requesting no-action relief may request confidential treatment for a specified period of time "not exceeding 120 days from the date [of] the response." 17 C.F.R. 200.81(b).

[8] See Nagy, *supra* note 3, at 954 (stating that "on the occasions—however seldom—when the Commission's views diverge from those of its staff, the Commission generally communicates such disagreements to the public by announcing that the public may no longer rely on the previously expressed staff views").

[9] See Division of Trading and Markets, No-Action Letter Regarding Section 28(e) of the Securities Exchange Act of 1934 and MiFID II, October 26, 2017, *available at* <https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf>.

[10] Commissioner Kara M. Stein, Statement on the Staff's No-Action Relief Regarding MiFID II, Oct. 26, 2017, *available at* <https://www.sec.gov/news/public-statement/statement-stein-2017-10-26>.

[11] Division of Investment Management, Statement Regarding Staff Proxy Advisory Letters, IM-INFO-2018-02, September 2018, available at <https://www.sec.gov/divisions/investment/imannouncements/im-info-2018-02.pdf>.

[12] See Anthony, *supra* note 2, at 32 (noting that informal guidance "may escape judicial review altogether").

[13] See Commission Rule of Practice 431(c) (providing that “[t]he vote of one member of the Commission, conveyed to the Secretary, shall be sufficient to bring a matter before the Commission for review”).

[14] See Commission Rules of Practice 430 and 431.

[15] See, e.g., 15 U.S.C. 78y(a) (stating that “[a] person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit”).

[16] There is one important avenue for recourse. OCIE operates a hotline for registrants with examination complaints. See Office of Compliance Inspections and Examination, “Examination Hotline for SEC-Registered Entities,” *available at* https://www.sec.gov/ocie/ocie_hotlineshtml.

[17] Former Commissioner Fleischman has noted that, before no-action letters were made generally available, “knowledge of the letters’ very existence was a professional advantage limited (outside of the ranks of the staff) to a few *cognoscenti*.” Separate Statement of Commissioner Fleischman, Morgan Stanley & Co., Inc., Exchange Act Release No. 28,990, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,718, at 81,391, 81,392 (Mar. 20, 1991) (quoted in Nagy, *supra* note 3, at 948). At the administrative law symposium described above, one practitioner stated that his firm “tr[ie]d to collect copies of no action letters that we hear about,” noting that “they are very helpful to us in framing requests for further no action letters.” Panel Discussion, *supra* note 3, at 44-45.

[18] Questions of legitimacy for administrative agencies have drawn increasing scholarly attention in recent years. See, e.g., Paul Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (2018); Philip Hamburger, *Is Administrative Law Unlawful?* (2015).