Speech

Sunsets, Russets, and Rule Resets

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Thank you, Peter [Easton] for that kind introduction. I appreciate the chance to be with you at today's conference to discuss Hot Topics at the Securities and Exchange Commission. It is a small population of people who would describe anything the SEC does as hot, but I suspect there are more than a few in this room who might be a part of that unusual crowd. Given that we share an interest in these issues, I hope that we can keep the conversation as interactive as possible, but I will start with a few observations about SEC rulemaking and the SEC's agenda. Before I begin, I must give the standard disclaimer that the views that I represent are my own and do not necessarily represent those of the Securities and Exchange Commission or my fellow Commissioners.

I talk frequently about my home state of Ohio. In the ensuing conversations, I have learned that people from the coasts do not know a lot about the middle of the country. "Ohio? That's the state that grows all the potatoes, right?" My response usually goes something like: "No, actually, that's Idaho, which is about 1600 miles away from my beloved Buckeye state." Were someone to make that mistake today, I might respond with a bit more enthusiasm: "Actually, you are thinking of Idaho, which does have lots of potatoes, but doesn't have any regulations." That would be a *slight* exaggeration. Last month, Idaho's legislature did not reauthorize the rules on the state books, which meant, absent emergency action to retain them, they would all expire in July.[1] Idaho's rules sunset every year unless they are reauthorized. Usually they are. This year, they were not. Most rules likely will remain on the books through a temporary workaround, but the governor announced that he would "use the unique opportunity to allow some chapters of Idaho Administrative Code that are clearly outdated and irrelevant to expire on July 1, 2019."[2]

Even though Idaho will celebrate July 4th with most of its rules intact, watching from afar the state's regulatory introspection has caused me to do some thinking about the SEC's rules. The SEC has been around for 85 years. We are not as old as Idaho, but we are not young either. In that long life, we have managed to accumulate a lot of regulations. I wonder what our rulebook would look like if we had a process in place that did not automatically carry over rules from one year to the next. My guess is that we would have fewer and simpler rules in place of the complex tangle we have now.

Simplicity is important, but elusive. To quote the Marquis de Lafayette, who allegedly once slept here—or at least near here,[3] "laws must be clear, precise and uniform."[4] We strive for clarity, precision, and uniformity, but one concern that I commonly hear from the entities we regulate is just how difficult it is to divine what our rules require. The prospect of facing an enforcement action because you did not understand what the rules were keeps many compliance officers, accountants, and in-house lawyers up at night. Our corner of the law is highly complex, not only because our rules interact with one another in interesting ways, but because the markets they regulate also are intricate, intertwined, and ever-changing. To make matters worse, knowing the letter of the law is not enough; our rules come to life through guidance from the Commission or the SEC's staff

and judicial decisions, so the regulatory lawyer—already tired from reading through the rulebook—must be on the lookout for relevant guidance and case law.

We do not have a simple set of rules, but perhaps flexibility of application is an unintended benefit of all this complexity? Not really, but maybe there is some hope for progress on the flexibility front. Idaho has a unique opportunity to jettison a lot of outdated rules in one fell swoop; getting rid of antiquated rules at the SEC involves more procedural hurdles, but we can develop a culture of revisiting our rules periodically. In some recent rulemakings, for example, we have explicitly committed to collecting data and revisiting the rules or particular aspects of them based on what the data say.[5]

We also can do a better job of encouraging our examinations and enforcement staff, who have deep knowledge about what is going on in the industry, to flag for our rulemaking divisions rules that are in need of updating. Enforcement attorneys, for example, have frontline knowledge about how our transfer agent rules need to be updated and strengthened to better protect investors from fraud, and our compliance examiners routinely in the course of their work see the need for updates to our advertising and custody rules. If the only recognition staff receives is linked to enforcement actions, enforcement lawyers and compliance examiners are unlikely to be part of the agency's broader effort of identifying rules that need to be modernized. We need, therefore, to reward staff whose insights inform our rulemaking priorities, rather than simply counting the number of completed enforcement actions their work generates.

As we write rules, we need to be thinking of ways we can inject some flexibility into the obligations we impose to make them better able to change with the times. If we avoid baking particular technology into rules when we write them, they will accommodate changing technology. I have urged caution, for example, in mandating that firms use particular record-keeping technology or particular data-tagging technology. We can set objectives that different firms can achieve in different ways. For example, I have argued for greater flexibility to allow financial professionals and funds to deliver information to retail customers in whatever way works best for each firm's customer base. We can allow companies to grow into their regulatory obligations by building relief for small entities into our rules, something that our new Small Business Capital Formation Advocate and new Small Business Advisory Committee are likely to urge us to do.

Last week, we started the process of updating and making more flexible one rule that has proved—since it was first adopted—to be quite costly. Section 404(b) of the Sarbanes-Oxley Act requires public companies to have their internal controls audited by an independent auditor. Specifically, we proposed to allow certain small, low-revenue companies to opt out of the auditor attestation requirement.[6] Contrary to some reports, these companies will still undergo the normal financial statement audit, and managers will still be required to conduct an assessment of the companies' internal controls. We simply made optional the additional safeguard of having an independent auditor attest to those internal controls.

We want to hear feedback about whether such a change lines up with investors' weighing of the costs and benefits of such an attestation. On the one hand, having an auditor look at a company's internal controls provides a measure of comfort that the company is not squandering precious investor capital. On the other hand, the costs of auditor attestation are especially difficult to stomach and likely not as meaningfully protective for investors in a company that is not producing revenues and is therefore reliant on outside capital to cover all expenses. Many small companies and their investors have expressed concern about the diversion of desperately scarce resources to the 404(b) audit. In fact, at a meeting a few days before we announced our proposal, a small company CFO told us that auditor attestation would add 20 to 33 percent to his independent auditor bill.[7]

Although the proposal is a positive step from the perspective of making our rules more flexible, we missed an opportunity to make our rules simple. In 2007, the SEC introduced the concept of the Smaller Reporting Company or "SRC."[8] Such companies are eligible for scaled disclosure and, pursuant to our 2007 rulemaking, were automatically exempt from 404(b) attestation requirements. At the time, the Commission noted the benefit to smaller companies of aligning these categories and therefore simplifying the process. Almost one year ago, we adopted amendments to our definition of SRCs, to expand the pool of companies eligible for scaled disclosure.[9] We did not, however, make complementary changes to the 404(b) exemption. I voted in favor of those amendments, but with reservations about their limited scope because they did not deal with the auditor attestation piece, which I understood to be a major concern for many companies and

investors.[10] Last week, we proposed amending our definition of accelerated filers, and again I supported the proposed amendments, but again with reservations about their scope. Had we proposed to re-align the non-accelerated filer and SRC definitions, not only would all SRCs be able to opt out of the attestation requirement, but we would restore some much-needed simplicity to the regulatory framework for small companies. Indeed, it is hard to explain in words, even when supplemented with pictures, which companies are eligible for which relief and for how long. As I suggested at last week's open meeting, GPS developers may find mapping regulatory obligations a bigger challenge than mapping highways.

A regulatory GPS would be of little value without international functionality. Another rule proposal we issued last week illustrates the challenges of regulating in a global market. This second proposal relates to the security-based swap markets.[11] This proposal is part of our effort to finalize rules mandated by Dodd-Frank. Since the passage of Dodd-Frank, the rulemaking resources of the SEC have been stretched to capacity, but the staff, under Chairman Clayton's leadership, is making great progress toward completing the rulemaking. One of the challenges of building a new regulatory framework for the security-based swap market in the United States is that our domestic market is only part of a larger global market that developed mostly free of the burdens of potentially conflicting national regulatory requirements. Moreover, participants in the market, both at home and abroad, are almost exclusively sophisticated, institutional players. As a result, we and other regulators have had to work hard to determine where our rules should end and those of our regulatory counterparts overseas should begin. Last week's proposal is an attempt to lay out a workable framework that allows us an appropriate level of oversight of these large markets without imposing duplicative or conflicting regulation on global firms attempting to serve a global, sophisticated clientele. The proposal included guidance about how our rules would apply to transactions in which involvement by U.S. personnel is limited, two potential ways for modifying the way we count transactions toward our *de minimis* registration threshold, and certain accommodations to reflect some points of conflict between our rules and those of our foreign counterparts. This may sound like a stretch to a room full of accountants, but resolving cross-border issues related to the swaps markets is a hot topic at the SEC, and we are looking forward to receiving comments.

International accounting and auditing issues are top of mind at the SEC too. Our Chief Accountant, Wes Bricker, has, of course, been spearheading efforts in these areas, including through his leadership at the international Monitoring Group.[12] The Monitoring Group brings together members committed to audit quality. Wes is an excellent ambassador with a keen interest in ensuring that financial reporting responsibilities remain with their rightful owners and financial statements retain their integrity.

While international harmonization is important, sometimes one jurisdiction's early action in an area helps other jurisdictions to think about how they address the same area. The question of compensation for research is one such area. The European Union's Markets in Financial Information Directive, or MiFID II, required the unbundling of brokerage and research fees. The apparent result has been a marked drop in the coverage of small companies.[13] To resolve concerns about how compliance with MiFID II would affect the provision of research in the United States, the SEC staff issued time-limited no-action relief when MiFID II went into effect.[14] As the expiration date of that relief looms, we are assessing how to proceed, and the European experience will help inform that assessment.

So too in other areas we can learn from what our foreign counterparts do. For example, we can look to Bermuda's experience with digital asset regulation to assess potential regulatory approaches to this emerging asset class.[15] The Bermuda Monetary Authority recently released draft guidance for crypto custodial services.[16] This proposed code of practice addresses such difficulties as how to store private keys for hot and cold storage while preserving necessary liquidity, what safeguards should be in place to prevent unauthorized access, and how to frame internal audit of same transactions to ensure their integrity.[17]

Not only can we learn from other regulators, but we can learn from academics like you. I was very interested to see the paper by Shiva Rajgopal, who is presenting on the next panel.[18] That paper identifies the misalignment between academic accounting research and real world problems and suggests some potential reasons for the mismatch. I hope that you get to the bottom of the issue in your discussion. Good research can help us identify and settle on solutions for difficult problems. I have noticed, however, that it is often hard to align the needs of policymakers and the research agendas of academics. This problem is not limited to accounting, but includes other disciplines like economics and law. In that vein, I appreciate your willingness to

talk about an issue that has profound implications for you; it is no small sacrifice to change the course of one's research agenda, when so many pressures in your profession counsel against doing so.

Given the value that research can have for our research agenda, we are always eager to hear ideas about how we can work more productively with academics. I am pleased that our new Chief Economist, S.P. Kothari—a former professor of accounting and finance, in addition to being former Deputy Dean of the MIT Sloan School of Management—brings with him to the Commission an understanding of the value of research that is aimed at addressing real world problems with solutions that take account of how the world works. You will hear more tomorrow from my colleague Commissioner Jackson about academic research at the Commission, so let me close by saying that I welcome your assistance in helping us to think through issues on our regulatory agenda and to identify issues that should be on our agenda.

Thank you for your gracious attention. The SEC is not Idaho, where every rule is potentially on the chopping block, but there is much on the SEC's rulemaking agenda. I would be happy to discuss any of these hot topics with you.

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[1] Press Release, Brad Little, Governor of Idaho, Governor Little Outlines Process to Keep Administrative Rules in Effect (Apr. 23, 2019), https://gov.idaho.gov/pressrelease/governor-little-outlines-process-to-keep-administrative-rules-in-effect/?mod=article_inline.

[2] *Id.*

[3] *See*, History of Our Virginia Resort, Lansdowne Resort and Spa, https://www.lansdowneresort.com/virginia-resort-about/history.

[4] Marquis de Lafayette, Address to the French National Assembly Regarding the Rights of Men and Citizens (July 11, 1789).

[5] *See, e.g.*, Transaction Fee Pilot for NMS Stocks, SEC Release No. 34-84875 (Dec. 19, 2018), https://www.sec.gov/rules/final/2018/34-84875.pdf; Investment Company Reporting Modernization, SEC Release No. 33-10442 (Dec. 8, 2017), https://www.sec.gov/rules/final/2017/33-10442.pdf.

[6] *See* Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, SEC Release No. 34-85814 (May 9, 2019), https://www.sec.gov/rules/proposed/2019/34-85814.pdf.

[7] Small Business Roundtable, SEC, 26:20, 1:05:00 (May 6, 2019), https://www.sec.gov/news/upcoming-events/small-business-roundtable-050619.

[8] *See* Smaller Reporting Regulatory Relief and Simplification, SEC Release No. 33-8876 (Dec. 19, 2007), https://www.sec.gov/rules/final/2007/33-8876.pdf.

[9] *See* Smaller Reporting Company Definition, SEC Release No. 33-10513 (June 28, 2018), https://www.sec.gov/rules/final/2018/33-10513.pdf.

[10] Hester M. Peirce, Commissioner, SEC, Statement at Open Meeting on Amendments to Smaller Reporting Company Definition (June 28, 2018), https://www.sec.gov/news/public-statement/peirce-statement-smaller-reporting-companies-062818.

[11] *See* Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, SEC Release No. 34-85823 (May 10, 2019), https://www.sec.gov/rules/proposed/2019/34-85823.pdf.

[12] For a recent overview of his work, see Wesley Bricker, Chief Accountant, SEC, Remarks Before the 2019 Baruch College Financial Reporting Conference: Aiming Toward the Future (May 2, 2019), https://www.sec.gov/news/speech/speech-bricker-050219.

[13] *See MiFID: One Year On*, CFA Institute 14 (2019), https://www.cfainstitute.org/-/media/documents/survey/cfa-mifid-II-survey-report.ashx (finding that 47% of buy-side respondents and 53% of sell-side respondents reported a decrease in coverage of small- and mid-cap stocks).

[14] Press Release, SEC, SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Oct. 26, 2017), https://www.sec.gov/news/press-release/2017-200-0.

[15] Digital Asset Business Act 2018 (Berm.), http://www.bermudalaws.bm/laws/Annual%20Laws/2018/Acts/Digital%20Asset%20Business%20Act%202018.pdf.

[16] Digital Asset Custody Code of Practice (Draft), Berm. Monetary Auth. (Dec. 2018), https://www.bma.bm/viewPDF/documents/2018-12-29-05-19-21-Digital-Asset-Custody-Code-of-Practice.pdf.

[17] Press Release, Berm. Monetary Auth., BMA Publishes Digital Asset Code of Practice for Consultation (Dec. 18, 2018), https://www.bma.bm/news-and-press-releases/bma-publishes-digital-asset-code-of-practice-for-consultation.

[18] Shiva Rajgopal, Integrating Practice Into Accounting Research (May 2, 2019), https://care-mendoza.nd.edu/assets/319874/shiva_ms_paper_on_theory_meets_practice_sr_may2.pdf.