



Winklevoss Highlights Subjective Aspects Of SEC Mission

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A lot has been written about the decision of the U.S. Securities and Exchange Commission to deny the application of Bats BZX Exchange Inc. for a rule change to permit the listing and trading of shares of the Winklevoss Bitcoin Trust.[1] The debate was also amplified by a dissent from SEC Commissioner Hester M. Peirce to that decision.[2] Peirce has also spoken more recently on this topic in a speech she delivered on Sept. 12.[3] The alternative perspective that I would like to explore is how this debate is really about the different philosophies that SEC commissioners can have regarding the appropriate role of the commission.

It is well-established that the SEC has three missions: (1) protect investors; (2) maintain fair, orderly and efficient markets; and (3) facilitate capital formation. It is also recognized that in its role the SEC is often called upon to balance consideration of those missions when considering a proposal. SEC commissioners may often prioritize the prongs of that mission differently when deciding an issue and of course there are subjective elements to each of those prongs. Put differently, SEC commissioners may have quite different philosophies regarding the proper role of the SEC and its regulatory role and those different philosophies play an important role in the decisions of the SEC.

It is generally accepted that the SEC is not a merit regulator but rather relies on full disclosure to permit the market and its participants to determine whether a particular investment has merit, the risks involved, and the price it should trade at. This approach can be characterized by the view that if the potential investment otherwise meets the requirements of the securities laws and there is adequate disclosure provided to investors regarding the investment, its terms and the risks involved, then it should be permitted to be offered. Thus, the markets and its participants will determine the merits of an investment, not the SEC. Investor protection is provided by the

disclosure to market participants and the fair, orderly and efficient operation of the markets. Put differently, the SEC is not there to protect investors from making a bad investment decision.[4]

What should be apparent though, is that there is a subjective element to the SEC's mission. What does investor protection mean? Protection of investors from what and at what cost? What does it mean to maintain fair, orderly and efficient markets or to facilitate capital formation? And how should those missions be weighed against each other? These are the subjective determinations that are greatly influenced by the philosophical views of the commissioners and by those of the staff of the SEC.

The SEC is frequently called on to weigh in on the proper application of these philosophies. This occurs in providing interpretations of the securities laws, deciding enforcement cases, adopting rules or, as in this case, approving or disapproving listing standards for an exchange. In many cases, the determinations that the SEC must make, or the matters it must consider, are better defined than in others.[5] And the statutes and their regulatory regimes themselves often reflect different approaches to regulation. As an example, the regulatory approach under the Securities Exchange Act of 1934 is very rules-driven, whereas the approach under the Investment Advisers Act of 1940 is very principles-driven. In any event, it still comes down to the determinations that the SEC commissioners make in applying their philosophies regarding regulation and their view of the proper role of the SEC.

In addition to the contexts discussed above, however, the statutes also often provide the SEC with the obligation to oversee the actions of others. For example, Section 19[6] of the Exchange Act governs the SEC approval of rule changes of self-regulatory organizations, and Section 6(b) of the Exchange Act[7] sets forth certain standards that apply. As you would expect, the difference in opinion that exists between SEC commissioners is positioned by them as the proper interpretation and application of the provisions of the Exchange Act to the current case. That reflects the discussion that the commission should be having — the proper application of the law. But what many miss is that underlying this discussion are the subjective elements in those determinations and the weighing of those various subjective elements by the SEC commissioners. That evaluation is, in many respects, influenced by the different philosophical views they each have regarding the proper role of the SEC in carrying out its mission. What does it mean to "protect investors" or "to maintain fair, orderly and efficient markets" or to "facilitate capital formation"?

The application of different philosophies by commissioners of the SEC is not new. During 2004, there were two examples[8] of commissioners disagreeing with the positions that the majority had taken and they expressed that in dissenting opinions. These two examples concerned the commission's rules regarding the registration of hedge fund advisers and the corporate governance of investment companies.

While I have focused in this article on the philosophical differences of commissioners, a future commissioner once analyzed commission action from a somewhat different perspective. Troy A. Paredes, then a professor of law at Washington University in St. Louis School of Law and who served as an SEC commissioner from 2008 to 2013, authored a paper[9] that analyzed the

decision of the commission to regulate hedge fund advisers from the vantage point of political and psychological influences affecting the commission. He pointed out that the commission: (1) likely did not want to be caught flat-footed and embarrassed again as it had been by Enron, WorldCom, the mutual fund abuses, and the like; and (2) he believed that the risk of fraud and other hedge fund abuses also weighed on the commission. He noted that with concerns like these, he believed that the commission could feel compelled to act, and these political and psychological influences can, according to Paredes, result in overregulation. I would note here that both Commissioner Paul S. Atkins and Commissioner Cynthia A. Glassman issued a dissent to the decision by the commission to regulate hedge fund advisers, the very same decision analyzed by Paredes.

Returning now to the SEC's decision not to approve the listing standards for the exchange-traded bitcoin product, I won't weigh in on what the proper interpretation of the Exchange Act should be. I will, however, note that the way it is viewed by the various commissioners is greatly influenced by the philosophical view they each have regarding regulation and the proper role of the SEC. That is the perspective that I find most interesting.

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[1] Sec. Rel. No. 34-83723 (available at <https://www.sec.gov/rules/other/2018/34-83723.pdf>).

[2] Dissent of Commissioner Hester M. Peirce (available at <https://www.sec.gov/news/public-statement/peircedissent-34-83723>).

[3] Speech by Commissioner Hester M. Peirce "Motherhood and Humble Pie: Remarks before the Cato Institute's FinTech Unbound Conference" Sept. 12, 2018 (available at <https://www.sec.gov/news/speech/speech-peirce-091218>).

[4] I would note that prior to the enactment of the National Securities Markets Improvements Act of 1996, the states often had merit provisions in place.

[5] Note Section 6(c) of the Investment Company Act of 1940 which provides "The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provisions of this title or of any rule or

regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." And Section 2(c), which provides, "(c) Consideration of Promotion of Efficiency, Competition, and Capital Formation. Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

[6] Section 19(b)(1) provides:

Each self-regulatory organization shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization (hereinafter in this subsection collectively referred to as a "proposed rule change") accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Commission shall, as soon as practicable after the date of the filing of any proposed rule change, publish notice thereof together with the terms of substance of the proposed rule change or a description of the subjects and issues involved. The Commission shall give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule change. No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.

(2) APPROVAL PROCESS.—

(A) Approval Process Established.

(i) In general. — Except as provided in clause (ii), not later than 45 days after the date of publication of a proposed rule change under paragraph (1), the Commission shall —

(I) by order, approve or disapprove the proposed rule change; or

(II) institute proceedings under subparagraph (B) to determine whether the proposed rule change should be disapproved.

[7] Section 6(b)(5) provides, "The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair

discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange."

[8] SEC Release No. IC-26520 Investment Company Governance Sept. 7, 2004 Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins (available at <https://www.sec.gov/rules/final/ic-26520.htm#dissent>); and SEC Release No. IA-2333 Registration Under the Advisers Act of Certain Hedge Fund Advisers Dec. 2, 2004 Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins (available at <https://www.sec.gov/rules/final/ia-2333.htm#dissent>).

[9] Washington University in St. Louis School of Law, Faculty Working Paper Series, Paper No. 06-03-02, March 24, 2006 On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission.