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BY E-MAIL: RULE-COMMENTS@SEC.GOV

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Request for Public Comment on the Securities and Exchange Commission's Disclosure Effectiveness Initiative—Recommendations on Regulation S-X and Certain Financial Disclosure Provisions in Regulation S-K

Ladies and Gentlemen:

This letter is submitted with respect to the "Disclosure Effectiveness" initiative launched last year by the U.S. Securities and Exchange Commission ("the Commission"). In particular, I am responding to the Commission's invitation for public comment. I appreciate this opportunity.

I hold the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School and was the inaugural director of the Commission's Division of Economic and Risk Analysis (initially "Division of Risk, Strategy, and Financial Innovation") (2009-2011). My scholarship focuses on the law and economics of capital markets and corporate governance.

I applaud the Commission undertaking a comprehensive review of the longstanding disclosure regime, including Regulations S-K and S-X. For the initiative to reach its full potential, I believe the Commission should do more than address the vitality of particular disclosure items.

It should also address fundamental issues as to the *means* and *ends* of its disclosure system. In a series of articles that began in 2012, I suggested that classic, seemingly timeless understandings have been undermined by market, regulatory, and technological developments.[1] These developments have disclosure implications. I offered a path forward.

[1] The "too complex to depict" concept and a new analytical framework for "information" were introduced in Henry T. C. Hu, *Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEXAS L. REV. 1601-1715 (2012) [hereinafter Hu, *Too Complex to Depict*], *available at* http://ssrn.com/abstract=2083708. In 2013, a new system for mandatory public disclosure, one developed and administered by bank regulators, came into effect. The analytical framework was refined and the implications of parallel public disclosure universes was discussed in Henry T. C. Hu, *Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests*, 30 YALE J. ON REG. 565-663 (2014) [hereinafter Hu, *Disclosure Universes*], *available at* http://ssrn.com/abstract=2442092. The most recent of the three articles offers a concise discussion of these matters and, among other things, explicitly relates the research to the SEC's Disclosure Effectiveness initiative. *See* Henry T. C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 BUSINESS LAWYER 347-405 (Spring 2015), [hereinafter Hu, *Financial Innovation and Governance Mechanisms*], *available at* http://ssrn.com/abstract=2588052. In addition, this 2015 article discusses "decoupling," including the need for the Commission to address "hidden (morphable) ownership" techniques involving the use of, e.g., cash-settled equity swaps to avoid Section 13(d) disclosure. *Id.* at 354-81.

With respect to means, the basic approach to information that the SEC has used since its creation—one relying on "intermediary depictions" of objective reality—is manifestly insufficient to capture the extraordinarily complex objective realities that are now being created. I showed the existence of this "too complex to depict" problem, both in financial innovation-related contexts (e.g., JPMorgan Chase "London whale" derivatives exposures and asset-backed securities) and non-financial innovation-related contexts (e.g., pension funding and research-intensive companies). I offered a new analytical framework for "information" to address this problem, one that involves a portfolio of approaches to information, a portfolio not only relying on "intermediary depictions" but also on "pure information" and "hybrid information."

With respect to regulatory ends, the challenges are also significant. In 2013, a new system of mandatory public disclosure came into effect, the first since the creation of the Commission. The Federal Reserve and other U.S. bank regulators now run a "parallel disclosure universe." Certain financial institutions must make public disclosures mandated not only by the Commission, but also by bank regulators. The longstanding exclusivity of the Commission is gone. Moreover, this new public disclosure system is not directed at the Commission's classic ends of investor protection and market efficiency. And, as implemented, this new disclosure system dwarfs the Commission's in sophistication as to the quantitative aspects of market risk and the impact of economic stress. With respect to some of the most important Commission-reporting companies, the role of the Commission and its classic regulatory ends have become more complicated.

I. Regulatory Challenges

A. *The "Too Complex to Depict" Problem and New Approaches to "Information."* The core approach to information that the Commission has relied on since the start is one that this scholarship terms the "descriptive mode," one that relies on "intermediary depictions" of objective reality. An intermediary—such as a corporation issuing shares—stands between objective reality and the investor. The corporation observes and analyzes the objective reality, crafts a depiction of the pertinent aspects, and transmits its depiction to investors. *See, e.g.,* Hu, *Disclosure Universes*, *supra* note 1, at 576 ("Figure 1 – Descriptive Mode").

In a number of financial and non-financial contexts, the descriptive mode is no longer sufficient. Consider, for example, the impact of modern financial innovation on certain too big to fail banks. Here, there are two basic roadblocks to the descriptive mode. First, such innovation has resulted in objective realities that are far more complex than in the past, often beyond the capacity of the English language, accounting terminology, visual display, risk measurement, and other tools on which all depictions must primarily rely. Second, even a well-intentioned and sophisticated intermediary either may not truly understand—or may not function as if it understands the reality it is charged with depicting. If the intermediary itself suffers from such "true" or "functional" misunderstandings, any depiction it offers will necessarily be flawed.

The three articles illustrate the insufficiency of the descriptive mode in a variety of "depiction-difficult" situations, including certain too big to fail banks, asset-backed securities, pension funding, and high technology companies.

B. *Parallel Disclosure Universes with Divergent Ends and Means.* The mention of the word "disclosure" usually conjures up the Commission system for mandatory public disclosure, the system's classic goals of investor protection and market efficiency, and implementation by way of Form 10-K's and other SEC-dictated documents.

Beginning in 2013, certain financial institutions must not only make public disclosures mandated by the Commission's system, but also those mandated by a new system developed by the Federal Reserve and other bank regulators in the shadow of the Basel Committee on Banking Supervision and the Dodd-Frank Act. Already, this new bank regulator system, which stemmed in large part from a belief that disclosures on the complex risks from modern financial innovation were manifestly inadequate, dwarfs the SEC system in sophistication as to the quantitative aspects of market risk and the impact of market stress.

Unlike the Commission's system, the bank regulator public disclosure system is not directed at the interests of investors and market efficiency but, instead, is directed at the well-being of the bank entities themselves and the reduction of systemic risk. The regulatory means diverge as well, not only as to specific risk-related disclosures, but even as to overarching concepts like "materiality" and the availability of private enforcement. The 2014 *Disclosure Universes* and 2015 *Financial Innovation and Governance Mechanisms* articles show how this new morphology of public information is unsustainable in the long run.

II. Pathways to Reform

Certain steps could help address these "too complex to depict" and "parallel disclosure universe" concerns. I briefly outline a few of the steps discussed in the articles.

A. *The "Too Complex to Depict" Problem*

(1) *Moving Toward Portfolio Diversification and "Informational Neutrality" Across Modes of Information in "Depiction Difficult" Contexts and Industries.*[2] With revolutionary advances in computer- and web-related technologies, investors need no longer rely nearly exclusively on the descriptive mode and its intermediary depictions. The "transfer mode" allows "pure information" about the objective reality to be transmitted directly to investors. The "hybrid mode" draws on elements of both of the other modes, and investors rely on "moderately pure information."

In particular, I strongly encourage the Commission to adopt in a systematic way a "portfolio of informational approaches." The disclosure system needs to be "diversified" across three different modes of information—each with its own virtues and faults. That way, investors are not reliant on a single type of information. Instead, they can triangulate the truth using the portfolio of informational approaches. Specifically, the Commission should consider how to systematically deploy three modes of information:

- <u>The "descriptive mode"</u> (Figure 1 in *Disclosure Universes*, at page 576). This is the Commission's customary approach. As mentioned above, it relies on business entities observing and analyzing their objective realities, crafting depictions of the pertinent aspects, and transmitting those depictions to investors.

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[2] *See, e.g.,* Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 1, at 381-93, 395-99.

- The "transfer mode" (Figure 2 in *Disclosure Universes*, at page 579). In contrast, the focus here is on the "transfer" of objective reality itself. Under this approach, the business entity is taken out of the picture entirely and "pure information" flows directly to investors.

- The "hybrid mode" (Figure 3 in *Disclosure Universes*, at page 582). Lastly, this approach falls in between the other two modes, drawing on elements of both. It results in "moderately pure information" being provided to market participants and can occur in a number of ways.

All three modes of information deserve equal consideration for the informational portfolio, even if the Commission continues to rely most heavily on the descriptive mode. An overarching principle of "informational neutrality" across modes of information in this sense of equal consideration is needed. Perhaps surprisingly, such a principle has direct implications for such matters as to how confidential treatment requests should be handled.

Together, the three articles discuss how such a portfolio approach can help improve transparency with respect to complex banks, asset-backed securities, pension reporting, and companies in research-intensive industries (especially young high technology firms).[3]

(2) *Improving Implementation of the Existing Descriptive Mode in Both Bank and Non-Bank Contexts*[4]

Changes that are far more incremental than the systematic deployment of a portfolio of informational approaches can also be helpful. One example would be in the area of improving the implementation of the existing descriptive mode in both bank and non-bank contexts.

For instance, the elements of the SEC disclosure requirements most pertinent to the subject matter of risk and to banks specifically are badly out of date. The Guide for Statistical Disclosure by Bank Holding Companies was adopted in 1976, and it has remained largely unchanged as epochal changes in the nature of banking, finance, and financial science occurred over the subsequent four decades.

Item 303 of Regulation S-K, the Management's Discussion and Analysis of Financial Reporting and Results of Operations, is applicable to all reporting entities. It was adopted in 1980, substantially refined later that decade, and supplemented by a bewildering stream of guidance of varying degrees of formality and legal import (e.g., "Dear CFO" letters, "CF Disclosure Topic 4," "Commission Statement," "Commission Guidance," "Compliance & Disclosure Interpretations," and "Interpretive Guidance").

The key SEC provision in relation to the Value at Risk issues central to the 2012 JPMorgan Chase credit derivatives debacle is the market risk rule, set out in Item 305 of Regulation S-K. That rule, applicable to all reporting entities, was adopted in 1997, and was never amended, notwithstanding

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[3] On August 27, 2014, the Commission adopted revisions to Regulation AB (applicable to asset-backed securities) that reflected a degree of reliance on "pure information." *See* Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 1, at 396-397; *cf.* Hu, *Too Complex to Depict*, *supra* note 1, at 1628-50 (a 2012 analysis of too complex to depict issues in the asset-backed securities context, and how "pure information" can help).

[4] *See, e.g.,* Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 1, at 393-95.

substantial advances in the associated financial science. The failure to amend is especially distressing because, at its adoption, the Commission promised that "as more standard risk measurement risk practices and methods of reporting market risk are developed," it would review the rule.

Updating these three elements related to risk should be a central aspect of the Commission's Disclosure Effectiveness initiative. *Disclosure Universes and Modes of Information* offers specific suggestions as to how to substantially revise the market risk rule (e.g., how to improve the use of VaRs and other techniques as depiction tools). In addition, bank regulators have undertaken efforts to require better public disclosures not only as to market risk but also to other risks that banks face. Such efforts involve a far more sophisticated and comprehensive approach to risk than the Commission has undertaken. They offer insights that the Commission would find helpful both in bank and non-bank contexts.

B. *Parallel Disclosure Universes: Divergent Ends, Divergent Means, and the Need for Resolution of the New Morphology of Public Information*[5]

Having two sets of regulators with widely divergent ends and full authority over the same informational territory is ultimately unsustainable. In the long run, Congressional resolution may be needed. In the interim, the Commission should at least think about certain possible formal or informal reforms that might further disclosure effectiveness.

- Consideration of Comparative Advantages. The Commission and bank regulators should consider coordinating their efforts, including in novel ways. One may involve considering the principles of comparative advantage. The Commission has a relative, perhaps even an absolute, advantage concerning risk information of a qualitative nature. The Commission's Management's Discussion and Analysis requirements, for instance, which were fine-tuned over a generation, are uniquely suited to capture difficult-to-measure trends and uncertainties that quantitative risk models may fail to detect. Conversely, the Federal Reserve and other bank regulators have more experience and a deeper understanding of quantitative risk information, such as bank stress tests. Some "soft" form of boundary setting, slicing risk along quantitative/qualitative lines in the context of public disclosures in the case of dually-regulated entities, could be considered.

- Consideration of Somewhat Greater Symmetry in Regulatory Burdens. The Commission has made significant reforms to its rule-making process, including through the 2012 Division of Risk, Strategy, and Financial Innovation/Office of General Counsel's *Memorandum to Staff of the Rulemaking Divisions and Offices re: Current Guidance on Economic Analysis in SEC Rulemaking*. Nevertheless, in contrast to the situation with bank regulators in respect to bank regulator disclosure rule-making, the SEC's disclosure rule-making efforts remain subject to judicial review (and the attendant uncertainties). The cost-benefit analysis set out in the adopting release for the bank regulator disclosure system that became effective in 2013 consisted of roughly one page. Coordination involving the Commission and bank regulators in respect of disclosure matters that they have in common are hindered by such stark regulatory asymmetry.

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[5] *See, e.*

g., Financial Innovation and Governance Mechanisms, supra note 1, at 399-404.

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The Commission has a unique regulatory role with respect to capital markets. The fulfillment of its core mission is essential not only to the investor protection and market efficiency but also to the panoply of transparency-dependent corporate governance mechanisms, including equity-based compensation systems to align management and shareholder interests, the market for corporate control, and the monitoring of management behavior and performance. The Disclosure Effectiveness initiative is a critical element to all this. In this connection, I urge the Commission not only to improve particular disclosure rules, but to systematically consider the overarching issues of means and ends

I appreciate the opportunity to share my views. I would be glad to discuss any questions the Commissioners or the staff may have with respect to my comments.

Thank you.

Sincerely,

/s/ Henry T. C. Hu

Henry T. C. Hu
Allan Shivers Chair in the Law of Banking and Finance

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