SECURITIES AND EXCHANGE COMMISSION STAFF ROUNDTABLE ON THE PROXY PROCESS 4-725

Comments of Hugh Carter Donahue, Ph.D.

November 15, 2018

[redacted]

"The second industrial revolution, unlike the first, does not present us with such crushing images as rolling mills and molten steel, but with "bits" in a flow of information travelling along circuits in the form of electronic impulses. The iron machines still exist, but they obey the orders of weightless bits," Italo Calvino observes in *Six Memos for the Next Millennium,*[1] 1998.

Introduction

Trust and risk[2] embody and express new ways of thinking affording long term orientations and implementations modernizing market structures through self-sustaining, self-correcting, transparent, verifiable revelations yielding efficient markets, which could and would curtail regulatory, compliance and transaction costs.

Trust and risk power core principles, which the Department of Treasury is articulating for capital markets in A Financial System That Creates Economic Opportunities to advance Executive Order 13772.

"The United States successfully derives a larger portion of business financing from its capital markets, rather than the banking system, than most other advanced economies," Treasury observed in its October, 2017 recommendations. Noting $260T capital markets and asset backed securities and that "investor confidence in the integrity of markets, supported by robust disclosure and regulatory protections, is a critical element of capital formation," Treasury continues that "there are significant challenges with regulatory harmonization and efficiency, driven by a variety of factors including joint rulemaking responsibilities, overlapping mandates, and jurisdictional friction."

Therefore, Treasury recommends:

"• Promoting access to capital for all types of companies, including small and growing businesses, through reduction of regulatory burden and improved market access to investment opportunities;

• Fostering robust secondary markets in equity and debt;

• Appropriately tailoring regulations on securitized products to encourage lending and risk transfer;

• Recalibrating derivatives regulation to promote market efficiency and effective risk mitigation;

• Ensuring proper risk management for CCPs and other financial market utilities (FMUs) because of the critical role they play in the financial system;

• Rationalizing and modernizing the U.S. capital markets regulatory structure and processes; and

• Advancing U.S. interests by promoting a level playing field internationally."

In particular, Treasury recommends that "pertaining to securitized products collateralized by other consumer and commercial asset classes…,[r]ecalibrating regulations affecting this market should be viewed through the lens of making the economics of securitization, not the regulatory regime governing it, the driver of this market."[3]

Trust and risk embody and express structural opportunities to guide proxy advisory firms, voting and shareholder proposals. Each has its own complexities, manners, rules of the road, fiduciary obligations and legal requirements defining the scopes of and presenting pathways toward available innovation.

All are catching up with affording technologies in one way or another.

These opportunities, which may come more fully into markets and public policy thanks to the Securities and Exchange Commission Roundtable on the Proxy Process, could and would advance efficient markets for "securitized products collateralized by other consumer and commercial asset classes" with available information technologies as well.

Trust and Risk: Structural Opportunities

By trust and risk, I mean that an individual, enterprise or institution makes apparent or clear a heretofore private intention or asset to one or another individual, enterprise or institution in return for compensation of one or another value, or kind.

Sufficient trust in the monetary and risk values of a revelation of an intention or asset clarifies risk adequately to rationalize investment decisions to buy, hold or sell.

First, Internet and mobile communications are ripe for scaling wealth creation with trust and risk.

Second, individuals, enterprises and institutions are receptive to being compensated in one way or another for the data and meta data, which they create with daily Internet and mobile communications.

Third, broadband wireline Internet and wireless mobile communications have created and continue to generate data and metadata driving up the values and reducing the costs of communicating at this point in time and could well do so into the foreseeable future.

Fourth, search (Alphabet/Google), workstation and portable lap-top computers, mobile phone and payment (Apple), online retail (Amazon), social networking (Facebook), largely invisible, absolutely indispensable operating system (Microsoft) and entertainment (Netflix) incumbents (AAAFMN) have consolidated first mover advantages in their respective lines of business, but their market scope is not immutable and could well change, for the 2016 election privacy scandals and repeated security breaches at major retailers and banks are provoking interest in fresher approaches to Internet and electronic transactions.

Fifth, successive generations of Internet and network innovations, now in a 5th iteration, are in development, planning and deployment.

John Maynard Keynes offers guidance on ways of assessing these dynamics, principally regarding inertial orientations informing decision making.

"The state of long-term expectation, upon which our decisions are based, does not solely depend, therefore, on the most probable forecast we can make. It also depends on the *confidence* with which we make the forecast – on how highly we rate the likelihood of our best forecast turning out to be quite wrong. If we expect large changes but are very uncertain as to what the precise form of these changes will take, then our confidence will be weak.

The *state of confidence*, as they term it, is a matter to which practical men always pay the closest and most anxious attention….

The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made….

In practice, we have tacitly agreed, as a rule, to fall back on what is, in truth, a *convention*. The essence of this convention…lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reason to expect a change. This does not mean that we really believe that the existing state of affairs will continue indefinitely. We know from extensive experience that this is most unlikely. The actual results of an investment over a long term of years very seldom agree with the initial expectation… We are assuming, in effect, that the existing market valuation, however arrived at, is uniquely *correct* in relation to our existing knowledge of the facts which will influence the yield of the investment, and that it will only change in proportion to changes in this knowledge; though, philosophically speaking, it cannot be uniquely correct, since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation. In point of fact, all sorts of considerations enter into the market valuation which are in no way relevant to prospective yield." [4]

The SEC roundtable presents opportunities to supersede such inertia in the proxy process.

Trust & Risk: Prospective Scoping

Trust and risk incent efficient markets by directly rewarding any party for risk revelations throughout the life of any instrument or asset-backed or residential mortgage-backed security.

Trust and risk monetize new behavior and sustain standardization by verifying current and evolving monetary and risk values of credit and debt instruments in real time and near real time.

This innovative architecture deploys and leverages the quality and quantity of data, a generational improvement over largely retrospective credit scoring.

Trust and risk generate granular market information useful alike to participants in the proxy process.

In this way, trust and risk democratize capital markets with available information technologies to incent and provide contemporaneous, verifiable behavioral data to supplement statistically based valuations, which cornerstone proxy assessments.

Through crowd-sourced behavioral innovations, trust and risk provide a second, robust means of valuation to clarify real-time and near real-time market and risk values.

By so doing, trust and risk stimulate liquidity. This is crucial, because the predictive reliability of risk analytics dries up without adequate liquidity.

This sustainable orientation modernizes markets.

These capabilities respond to G-20 risk rating reforms.

Trust & Risk: Value and Utility for the Proxy Process and Capital Markets

Trust and risk yield timely value and utility for the proxy process. As the Government Accountability Office noted, five United States firms, Institutional Shareholder Services (ISS), Glass Lewis & Co. (Glass Lewis), Egan-Jones Proxy Services (Egan-Jones), Marco Consulting Group (Marco Consulting), and ProxyVote Plus, provide proxy advisory services in America. Two firms, ISS and Glass Lewis, control 97% of sector activity according to a recent report.

Each and all of these proxy process incumbents would benefit with adoption of trust and risk informing recommendations.

For investors, exchanges and regulators, trust and risk create sustainable vehicles, which also curtail regulatory costs.

Such utilities are timely in so far as the proxy advisory industry is imputed to be afflicted with structural deficiencies, notably

"• Rampant conflicts of interest that can impact the objectivity of voting recommendations made to institutional investors.

• A one-size-fits-all approach to voting recommendations that ignores the unique characteristics and operations of individual companies.

• A lack of willingness to constructively engage with issuers, particularly small and midsize issuers that are disproportionately impacted by proxy advisory firms.

• A lack of transparency throughout the research and development of voting recommendations.

• Frequent and significant errors in analysis and an unwillingness to address errors."[5]

Trust and risk realize NASDAQ capital market reforms by addressing these alleged market failures.

Similarly, trust and risk clarify risk weighted assets, which could and would increase exchange volumes and could and would enhance asset values.

This is also the case with options. Spreads are too wide, because wide spreads mitigate maker/taker risks as volatility returns as markets adjust to Federal Reserve discontinuance of zero lower bound interest rates.

Curb appeal is symptom and artifact of these lethargies, demurrals and aversations.

Wide spreads and curb appeal express different sides of the same coin within incumbent margin and capital requirements.

Market takers cannot trust making risks on spreads, because they cannot make rational calculations regarding the underlying values and competitive risks of taking one option over another within existing margin and capital requirements.

Market makers cannot price, or lower spreads, without excessive risk to underlying values due to volatility.

So, spreads remain too wide and curb appeal reigns as a term of art in options markets.

Once market takers trust that they can reach rational calculations to invest in options and market makers trust they can set prices and spreads (not necessarily at smaller spreads), market makers and takers would be able and will take risks in one or another option, for there is no shortage of liquidity at this time. Curb appeal could and would then fade out as an artifact of the present regime.

Endnotes

---

[1] Italo Calvino, *Six Memos for the Next Millennium*, (1998).

[2] Hugh Carter Donahue, *The Revelation Economy Scaling Internet Trust and Risk*, (coolbook/Amazon Kindle, 2018) provides a fuller discussion of innovation, market administration and history.

Hugh Carter Donahue, "Re-Energizing the Moribund Bond Market," Futures Magazine, January, 2015 articulates some of the ideas outlined here.

[3] U.S. Department of Treasury, *A Financial System That Creates Economic Opportunities Capital Markets*, Report to President Donald J. Trump on Core Principles for Regulating the United States Financial System, October, 2017.

[4] John Maynard Keynes, *The General Theory of Employment Interest and Money*, 1935

[5] NASDAQ and Center for Capital Markets Competitiveness, United States Chamber of Commerce, *Proxy Season, 2018, Examining Developments and Looking Forward*, 2018.