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# Introduction to Financial Services: The Securities and Exchange Commission (SEC)

## Origins, Structure, and Market Oversight

To help restore confidence in the securities markets in the wake of the stock market crash of 1929, Congress passed the Securities Exchange Act of 1934, which authorized the creation of the Securities and Exchange Commission (SEC). The SEC is an independent, nonpartisan regulatory agency responsible for administering federal securities laws. It has broad regulatory authority over significant parts of the securities industry, including stock exchanges, mutual funds, investment advisers, and brokerage firms.

The federal securities laws overseen by the SEC are broadly aimed at (1) protecting investors; (2) maintaining fair, orderly, and efficient markets; and (3) facilitating capital formation. These laws provide clear rules for honest dealing among securities market participants, including antifraud provisions, and disclose information deemed necessary for informed investor decisionmaking.

The SEC's budget is set through the congressional appropriations process. The appropriations are offset by sale fees on stock and other securities transactions that the SEC collects from securities exchanges. Annual collections, which tend to exceed the SEC's annual appropriations, go directly to the U.S. Treasury's general fund. Over the last few years, the SEC's enacted annual budget has been in the \$1.6 billion to \$1.7 billion range. The agency is led by five presidentially appointed commissioners, including a chairman, all of whom require Senate confirmation. Commissioners have five-year staggered terms and no more than three commissioners may belong to the same political party.

## Significant Securities Laws Overseen by the SEC

The SEC oversees an array of securities laws, several of which have been amended over time. Applicable significant securities laws include those described below.

**Securities Act of 1933 (Securities Act; P.L. 73-22).** This act sought to ensure that investors are given salient information on securities offered for public sale and to ban deceit, misrepresentations, and other kinds of fraud in the sale of securities. The act requires issuing companies to disclose information deemed germane to investors as part of the mandatory SEC registration of the securities that those companies offer for sale to the public. Potential investors must be given an offering *prospectus* containing registration data. Certain offerings are exempt from such registration requirements, including private offerings to financial institutions or to sophisticated institutions.

**Securities Exchange Act of 1934 (Exchange Act; P.L. 73-291).** In addition to creating the SEC, this act established self-regulatory organizations (SROs) in the securities industry, which are SEC-regulated entities, including stock exchanges, with quasi-governmental authority responsible for policing their members and the attendant securities markets. Under the act, the Financial Industry Regulatory Authority (FINRA), a SEC-regulated SRO, is the principal regulator of broker-dealers.

## Investment Company Act of 1940 (ICA; P.L. 76-768).

This act regulates the organization of investment companies, including mutual funds. Investment companies such as mutual funds are primarily engaged in investing in the securities of other companies. In an attempt to minimize the potential conflicts of interest that may arise due to the operational complexity of investment companies, the act generally requires investment companies to register with the SEC and publicly disclose key data on their investment objectives, structure, operations, and financial status.

## Investment Advisers Act of 1940 (IAA; P.L. 76-768).

Investment advisers are firms or sole practitioners that are compensated for advising others about securities investments, including advisers to mutual funds and hedge funds. In general, under the act, advisers managing a certain amount of assets must register with the SEC and conform to the act's regulations aimed at protecting investors.

**Sarbanes-Oxley Act of 2002 (SOX; P.L. 107-204).** Passed in the aftermath of accounting scandals at firms such as Enron and Worldcom during 2001 and 2002, SOX sought to improve the reliability of financial reporting and the quality of corporate audits at public companies. Among other things, it created the Public Company Accounting Oversight Board (PCAOB) to oversee the quality of corporate accountants and auditors and shifted responsibility for the external corporate auditor from corporate management to independent audit committees.

## Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203).

Enacted in the wake of the 2007-2009 financial crisis, the Dodd-Frank Act mandated sweeping financial regulatory changes, many of which affected the SEC. The act required the SEC to adopt rules to help ensure that those who securitize certain debt retain a significant interest in assets that they transfer; reformed the regulation of credit rating agencies; required hedge fund advisers to register with the SEC; and created an interagency financial risk monitoring panel, the Financial Stability Oversight Council (FSOC), with the SEC chair as a member.

**The Jumpstart Our Businesses Startup Act of 2012 (JOBS Act; P.L. 112-106).** The act was broadly aimed at stimulating capital formation for companies, particularly newer and smaller firms. It also eases regulatory requirements for certain initial public offerings (IPOs) through the creation of a new entity called an *emerging growth company* and through *Regulation Crowdfunding* that permits companies to provide securities to retail investors through regulatory exemptions under the Securities Act.

## Selected Policy Issues

Congress has an ongoing oversight and legislative interest in a range of securities-related regulatory issues involving the SEC. This In Focus highlights two recent SEC initiatives that have drawn significant congressional interest.

### The Best Interest Proposal

SEC-registered investment advisers, who are directly overseen by the agency under the IAA, are generally subject to a fiduciary standard, requiring them to act solely in the interests of their retail clients. By contrast, broker-dealers, regulated by the Exchange Act and largely overseen by FINRA, are generally subject to a less demanding retail client standard, the suitability standard. The suitability standard requires broker-dealers to reasonably believe that their investment advice is suitable for their clients with respect to factors such as a client's financial goals and needs.

Propelled in part by the perception that many retail investors do not understand the differences in the standards of client care broker-dealers and investment advisers owe to retail investors, the Dodd-Frank Act required that the SEC conduct a study on various aspects of standards of client care for retail investors. Released in 2011, the SEC staff study recommended a uniform fiduciary standard for the retail advice given by all types of financial professionals, including broker-dealers.

On April 18, 2018, the SEC commissioners adopted (with one dissenting vote, Commissioner Kara Stein, who asserted that the proposal was a wasted opportunity to achieve meaningful progress) a package of proposals related to the duty of care financial professionals owe to retail investors. Arguably, the most significant and most contentious part of the package is Regulation Best Interest (Reg BI), which would require a broker-dealer "to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer." Among other things, a broker-dealer would discharge this best interest mandate by (1) informing its retail clients about key facts germane to their relationship, including broker-dealer material conflicts of interest; and (2) having reasonable basis to believe that a recommended investment product or a series of transactions are in the retail customer's best interest.

The SEC's Reg BI proposal would also generally apply to investment advice broker-dealers give to ERISA-based retirement account holders (ERISA, the Employee Retirement Income Security Act of 1974; P.L. 93-406).

SEC Chair Jay Clayton lauded the proposal as a significant advance that would prohibit broker-dealers from placing their interests before their clients' interests, an "essential" part of the "fiduciary standards." Supporters of the rule include the Securities Industry and Financial Markets Association, known as SIFMA, a group of broker-dealers and asset managers. Supporters argue that Reg BI's principles-based and non-definitional approach will provide greater regulatory flexibility when gauging a broker-dealer client's best interest in the future.

Critics of the Reg BI proposal has come from various entities, including investor and consumer advocates such as the Consumer Federation of America. Among their concerns is that it does not contain the word *fiduciary*; that it is not analogous to such a standard; and that it leaves "best interest" undefined, raising potential compliance concerns.

### The Maker-Taker Pilot

Regulated by the SEC, the maker-taker regime permits securities brokers to receive size-limited rebates from certain domestic securities exchanges for providing market liquidity in the form of executed limit orders (i.e., an order to buy or sell a stock at a specific price or better) to the exchanges. Supporters of the voluntary maker-taker regime argue that it enhances both exchange trading and off-exchange trading venues such as dark pools, which unlike exchanges are unimportant in the critical securities' price discovery process. Others, however, criticize the maker-taker regime for incentivizing brokers to make trades on fee providing exchanges, potentially discouraging their use of other trading venues that may provide the best trade execution and securities' prices more favorable to their clients.

In December 2018, the SEC approved a proposal to implement a two-year pilot program that would assess the impact of the maker-taker regime via three stock test groups. One test group will prohibit rebates altogether. Another will be subject to a limited rebate regime. The third will be a control group subject to the current rebate regime

## CRS RESOURCES

CRS In Focus IF11062, *Introduction to Financial Services: Capital Markets*, by Eva Su

CRS In Focus IF11073, *The SEC's Best Interest Proposal for Advice Given by Broker-Dealers*, by Gary Shorter

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