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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 SEC oversees federal securities laws 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 (Dodd-Frank Act; P.L. 111-203). Enacted in the wake of the 2007-2009 financial crisis, the 2010 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.

Jumpstart Our Businesses Startup Act (JOBS Act; P.L. 112-106). This 2012 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 a recent SEC regulatory initiative and briefly discusses the agency's actions in response to the coronavirus pandemic.

The Regulation Best Interest Rule

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 that 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 June 5, 2019, after adopting a fairly similar set of proposed rules in April 2018, the SEC commissioners adopted Regulation Best Interest (Reg BI). Reg BI reforms requirements for broker-dealers when they make investment recommendations to retail customers. According to the SEC, Reg BI is meant to “enhance the broker-dealer standard of conduct beyond existing ... obligations [by] requiring broker-dealers ... to: (1) act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and (2) address [various broker-dealer] conflicts of interest.”

Broker-dealers have until June 2020 to comply with Reg BI. SEC officials and various business groups argue that Reg BI properly balances the need for an enhanced broker-dealer standard of care with the need to preserve the broker-dealer business model, a model deemed to have special appeal to less-affluent investors. Critics, including investor advocates, argue that it effectively preserves the inadequate suitability standard, exposing investors to harm from unaddressed broker-dealer conflicts of interest. In June

2019, the House passed H.R. 3351, the FY2020 Financial Services and General Government (FSGG) appropriations bill. It included an amendment sponsored by House Financial Services Committee Chair Maxine Waters that would have forbidden the SEC from using any of its congressional spending authority to implement, administer, enforce, or publicize the final rules and interpretations with respect to Reg BI. The enacted FY2020 FSGG appropriations (P.L. 116-93, Division C) did not include the SEC restrictions in H.R. 3351. For more information, see CRS Report R46115, *Regulation Best Interest (Reg BI): The SEC's Rule for Broker-Dealers*, by Gary Shorter.

Exemptive Relief for Mutual Fund Borrowing

Mutual funds are the most common pooled investment vehicle. (Others include hedge funds and closed-end funds). The funds invest in U.S. government debt, such as Treasury bills, corporate and municipal bonds, and corporate equity. Also called open-ended funds, their shares are continuously offered and have no limits on the number of shares. When an investor wants to liquidate their fund shares, he or she “redeems” them at net asset value (NAV, the value of the fund's assets minus the value of its liabilities).

As has been the case with a number of financial sectors, the coronavirus has also affected the \$19 trillion mutual fund industry. For example, according to *Morningstar*, which tracks mutual fund developments, investors redeemed \$40 billion in shares from taxable bond funds during the week of March 16, 2020. As a consequence, there have been concerns that intensified shareholder fund withdrawals could result in funds liquidating assets at a financial loss to address surging redemption demands.

On March 23, 2020, the SEC issued an order providing temporary exemptions to the ICA to provide open-end funds: (1) greater ability to borrow from certain fund affiliates; (2) eased rules for lending between fund companies; and (3) the ability to enter into lending or borrowing arrangements that violate a fund's stated policies if prior approval has been granted by the fund's board.

Commenting on the relief, which will extend until at least June 30, 2020, SEC Chairman Jay Clayton said that it “provides funds with additional flexibility to navigate volatile markets while meeting their obligations to investors.”

However, Professors Agarwal and Zhao's 2016 research raised some concerns about making it easier for funds to conduct interfund loans, as the exemptive relief does. They found that mutual fund managers may use interfund loan programs to mitigate the impact of investor outflows after poor fund performance. As a consequence, they argued that poorly performing managers are less likely to be terminated, potentially allowing poor fund financial performance to continue.

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