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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 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) investor protection; (2) maintaining fair, orderly, and efficient markets; and (3) facilitating capital formation. They do so by providing clear rules for honest dealing among securities market participants, including antifraud provisions, and a disclosure regime that requires the various entities involved in securities markets to disclose information deemed necessary for informed investment decision making.

The SEC's budget is set through the congressional appropriations process. The appropriations are offset by fees the SEC collects from securities exchanges on the sales of stock and other securities transactions. Annual collections, which tend to exceed the SEC's annual appropriations, go directly to the U.S. Treasury's general fund. The agency's FY2014 and FY2015 budgets were and are, respectively, $1.35 and $1.50 billion. The SEC 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.

## Major Securities Laws Overseen by the SEC

**Securities Act of 1933 (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 also receive an offering *prospectus* containing registration statement data. Certain offerings are exempt from such registration requirements, including private offerings and offerings made to a limited number of sophisticated persons or institutions.

**Securities Exchange Act of 1934 (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. The Financial Industry Regulatory Authority (FINRA), an SEC-regulated SRO that is the primary regulator of the nation's broker-dealers, is also regulated under the Exchange Act.

> [T]he job we are trying to do here in the Securities and Exchange Commission [is] to reassure capital as to its safety going ahead and reassure the investor as to the protection of his interests… by making available adequate information to the public. *Joseph P. Kennedy, first SEC Chair, 1934*

**Investment Company Act of 1940 (P.L. 76-768).** This act regulates the organization of investment companies, including mutual funds. Investment companies 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 information about their investment objectives, structure, operations, and financial status.

**Investment Advisers Act of 1940 (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. Generally, under the act, advisers managing a certain amount of assets must register with the SEC and conform to regulations under the act 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 (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 the registration of advisers to hedge funds; and created an interagency financial risk monitoring panel, the Financial Stability Oversight Council, 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. Among other things, it eases the regulatory requirements for initial public offerings; expands numerical shareholder thresholds for when private companies are subject to public company disclosure requirements; and creates a new corporate entity called an *emerging growth company* that is subject to reduced public company regulatory obligations.

## Selected Policy Concerns

**Equity Crowdfunding.** Congress has considered several legislative proposals to reduce the regulatory burden on small and emerging firms. One such effort involves crowdfunding, funding ventures through small amounts of capital provided by a multitude of individuals. In exchange for their funding, donors may receive anything from a thank-you item such as a t-shirt to a product produced by the funded venture. Feature films, video games, scientific research, and political action committees are among the ventures and products that have benefited from crowdfunding. Under the Securities Act, donors cannot be given ownership interests or stock (equity) in a crowdfunded enterprise. Crowdfunding raised an estimated $5 billion in 2013, and many say equity-based crowdfunding could greatly increase that figure.

The JOBS Act loosened the equity crowdfunding prohibition, allowing crowdfunded ventures to issue securities. In October 2013, as required by the act, the SEC published proposals for implementing equity crowdfunding. Some proposals have been criticized for being prohibitively costly to comply with and perhaps pricing many enterprises out of equity crowdfunding. SEC officials, however, say the proposals reconcile the agency's mandate to implement the JOBS act with the its statutory investor protection mission.

**Fiduciary Rules.** The Exchange Act of 1934 subjects broker-dealers to a *suitability* standard with respect to the financial advice they give their clients, a standard that is primarily enforced by FINRA. The Investment Advisers Act established a higher level of client care, a *fiduciary* standard of care, for SEC-registered investment advisers that provide financial advice. Surveys, however, report that consumers are often unaware of such key distinctions.

In 2010, the Dodd-Frank Act granted the SEC broad authority to impose a uniform standard of conduct for broker-dealers and investment advisers when providing personalized investment advice. A 2011 SEC report required by the Dodd-Frank Act recommended two policy options for the SEC: (1) adopting rules to establish a uniform fiduciary standard for broker-dealers and investment advisers or (2) harmonizing current rules for broker-dealers and investment advisers to reduce confusion among retail clients.

Officials at the Securities Industry and Financial Markets Association (SIFMA), a broker-dealer and asset manager trade group, have advocated for a uniform standard via SEC rulemaking amending the Securities Act and the Investment Advisers Act. Investment adviser groups, however, have argued that such an approach would dilute the effectiveness of the current fiduciary standard and urged the SEC to subject broker-dealers to the fiduciary standard in the Investment Advisers Act. Officials at SIFMA countered that doing so would unfairly disadvantage the many fee-based investment advisers, significantly harming less affluent investors with limited access to lower-cost financial options. In late 2014, an SEC staff report said the agency would be evaluating the fiduciary standard recommendations in the 2011 report to facilitate likely agency rulemaking in FY2015.

**Regulation National Market System.** The Securities Acts Amendment of 1975 (P.L. 94-29) amended the Securities Exchange Act. The law directed the SEC to coordinate with the securities industry to create a *national market system* to integrate the trading, clearance, and settlement of securities transactions among the various trading venues. Over time, the SEC adopted several rules to advance this national market system, including Regulation National Market System (Reg. NMS) in 2005. One key part of the regulation, the *order protection rule*, sought to better address the shift from human-based trading to electronic trading. Across trading venues, investors must receive the best possible price for a given trade. If the best-priced offer to buy or sell a given security is available elsewhere, a trade must then be routed there for execution.

By various accounts, Reg. NMS has helped to shape a market providing investors with historically low tradeexecution costs and the opportunity to choose between an unprecedented number of competing trading venues. Some observers, however, say the market also has significant problems. Critics allege that (1) some investors may find accessing the many individual trading venues to be burdensome and costly; (2) the market's potential for trading disruptions may have systemic implications; and (3) the market has been conducive to the growth of *dark pools* (alternatives to stock exchanges that do not reveal the size and price of trading orders to nonparticipants) and *high-frequency trading* (using complex algorithms to analyze multiple securities markets and rapidly trading orders based on that analysis), which have drawn criticism for harming some investors. The role Reg NMS may have played in helping to shape such a market has been a growing focus of various securities industry stakeholders and congressional committees with SEC oversight. SEC officials have said the agency will be examining the regulation.

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