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

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. Sale fees on stock and other securities transactions that the SEC collects from securities exchanges offset the appropriations. Annual collections, which historically exceeded the SEC's annual appropriations, go directly to the U.S. Treasury's General Fund. Over the past few years, the SEC's enacted annual budget has been in the $1.6 billion to $1.7 billion range. The SEC is led by five presidentially appointed commissioners, including a chair, subject to Senate confirmation. Commissioners have staggered five-year 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 (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 (P.L. 73-291). In addition to creating the SEC, the act governs securities transactions on the secondary market and gives the agency regulatory oversight over self-regulatory organizations, including stock exchanges such as NASDAQ, that have quasi-governmental authority to police their members and attendant securities markets. The Financial Industry Regulatory Authority (FINRA), the principal regulator of broker-dealers, is also a self-regulatory organization.

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 key data on 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. 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 (P.L. 107-204). Passed in the aftermath of accounting scandals at firms such as Enron and Worldcom during 2001 and 2002, Sarbanes-Oxley 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 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 (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, with the SEC chair as a member.

Jumpstart Our Businesses Startup 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 through the creation of a new entity called an *emerging growth company* and through *Regulation Crowdfunding*, which permits companies to provide securities to retail investors through regulatory exemptions under the Securities Act of 1933.

Policy Developments of Interest

Regulation BI. Broker-dealers execute securities trades and provide investment recommendations. They are licensed and regulated by state securities regulators, the SEC, and FINRA, an SEC-regulated entity that broker-dealers must also join. Traditionally, broker-dealers provided transaction-specific discrete investment recommendations and were compensated via commissions for individual transactions. Broker-dealers have generally made investment recommendations under the *suitability standard*, a FINRA rule requiring that recommendations are consistent with customers' interests. By contrast, investment advisers—another type of financial professional that typically offers more ongoing investment counsel (such as retirement planning) and is compensated by fixed fees or a percentage of total assets managed—tend to follow the *fiduciary standard*, a non-statutory and stronger client obligation derived from court rulings and SEC enforcement case rulings.

Section 913 of Dodd-Frank directed the SEC to evaluate existing regulations for advisers and broker-dealers and gave the SEC authority to impose a fiduciary standard on broker-dealers akin to that already applied to advisers. Dodd-Frank also required the SEC to study this issue. The resulting 2011 staff study recommended that the SEC adopt a uniform fiduciary standard.

On June 5, 2019, then-SEC Chair Jay Clayton and other SEC commissioners voted 3-1 to adopt Regulation Best Interest (Reg BI) under the Securities and Exchange Act of 1934 (P.L. 73-291). 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" with those clients. Reg BI went into effect in June 2020.

SEC officials and various business groups argued 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 a dissident commissioner and various investor advocates such as the Consumer Federation of America, a consumer advocacy group, argued that the regulation effectively preserves the inadequate suitability standard, exposing investors to harm from unaddressed broker-dealer conflicts of interest. On December 4, 2020, after the 2020 election and before Joe Biden was sworn in as President, Chair Maxine Waters of the House Financial Services Committee urged Biden to rescind Reg BI.

On May 6, 2021, responding to questions during a House Financial Services Committee hearing, SEC Chair Gary Gensler said the agency would "through examination, enforcement, and guidance, ensure that the rule is fully complied with as written … but we're also going to evaluate. If it's not serving the purpose of investors, then we will update and freshen that rule as well as other rules."

Payment for Order Flow. The past few years have seen an unprecedented surge in retail investor securities trading at major discount broker-dealers such as Robinhood, Charles Schwab, TD Ameritrade, and E*Trade. Among the factors that have driven this are the zero trading commissions that many of them now charge for trades. The nonexistent commissions are often subsidized by a controversial rebate paid to the broker-dealers of fractions of a penny per share called payment for order flow (PFOF). Alphacution, a research firm, reported that total PFOF revenue at four major broker-dealers—TD Ameritrade, Robinhood, E*Trade, and Charles Schwab—was $2.5 billion in 2020, up from $892 million in 2019.

At the center of policy debates over PFOF is the broker-dealer's duty of best execution with respect to the execution of customer trades, a duty that is chiefly enforced by FINRA, the frontline regulator of broker-dealers. *Best execution* denotes the broker-dealer's obligation to seek the most favorable terms for a customer's transaction in the context of the prevailing circumstances. PFOF's supporters assert that such trades do conform to best execution and indirectly benefit investors by subsidizing low- or zero-commission rates and other services. Critics, however, argue that because broker-dealers do not generally pass the PFOF rebates onto their clients, they may have economic incentives to send retail orders to rebating market makers, creating potential conflicts over their duty of best execution. SEC Chair Gensler reportedly shares such concerns and has said that the agency is considering reforms ranging from greater disclosure to an outright ban. S. 3102 would prohibit the banning of PFOF.

Related CRS Products

CRS Report R46115, *Regulation Best Interest (Reg BI): The SEC's Rule for Broker-Dealers*, by Gary Shorter.

CRS In Focus IF11800, *Broker-Dealers and Payment for Order Flow*, by Gary Shorter.

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

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