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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.

Selected SEC Policy Developments of Interest

Enhanced Disclosure of Corporate Climate-Related Risks. On March 22, 2022, citing the need for more consistent, comparable, and reliable information about how SEC-registered public companies address climate-related risks, the SEC commissioners voted in favor of proposed rules that would amend certain disclosure regulations. The proposed rules would require companies to provide information about their governance, risk management, and strategy regarding climate-related risks in their registration statements and annual reports. They would also be required to disclose targets, commitments, and plans to achieve those targets as well as attendant transition plans. Companies would be required to add disclosures to their audited financial statements as footnotes when the climate risks are likely to have a material impact on line items and the firms' related expenditures. Companies would also have to disclose their Scope 1 and Scope 2 greenhouse gas emissions—emissions that "result directly or indirectly from facilities owned or activities controlled by a registrant." Some companies above a certain size would also be required to disclose Scope 3 emissions, the emissions from upstream and downstream activities in a company's value chain, if the emissions were material to investors or if the company had commitments that included reference to Scope 3 emissions. A common critique voiced by critics such as the U.S. Chamber of Commerce is that the proposed rules would impose burdensome firm costs with requirements that are not material to investors.

Enhanced Disclosures for ESG-Oriented Funds and Investment Advisers. On May 25, 2022, citing concerns over lack of consistent, comparable, and reliable investor disclosures regarding environmental, social, and governance (ESG) fund and ESG investment adviser strategies, the SEC voted 3-1 to issue amendments to regulations implementing the Investment Advisers Act of 1940 and the Investment Company Act of 1940 aimed at addressing such perceived inadequacies. If adopted, the proposals would require such ESG funds to give investors information in their prospectuses on what ESG factors they consider and strategies they employ. These would include whether a fund tracks a securities index, excludes or includes certain asset types, engages in corporate governance conduct such as proxy voting in pursuit of certain goals, or intends to achieve a specific impact.

A subset of ESG funds, *ESG-focused funds*, would be defined as significantly focused on ESG factors. They would also be required to disclose information on the criteria and the data used to fulfill their investment goals and details on the accompanying investment strategies. Environmentally focused ESG-focused funds would also be required to disclose greenhouse gas emission data associated with their portfolio investments, including Scope 1, 2, and 3 emissions data. Another subset of ESG-focused funds, *impact funds*, which pursue specific ESG impacts (e.g., affordable housing), would also be required to disclose data on their annual progress toward such impact goals. Under the proposal, investment advisers who strategically incorporate ESG factors in their advice to institutional and retail investors would have to disclose similar types of information with respect to their ESG factors and strategies in client brochures. A central criticism of the proposal by groups such as the Investment Company Institute, a mutual fund trade group, is that the current SEC rules are effective as is, sufficiently requiring fund disclosure of investment objectives, principal investment strategies, and main investment risks.

Payment for Order Flow. The past few years saw 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) by entities such as Citadel and Virtu—alternately called market makers, wholesalers and internalizers—that execute the trades. Reports indicate that aggregate PFOF revenue more than tripled at four major broker-dealers—TD Ameritrade, Robinhood, E*Trade, and Charles Schwab—to $3.17 billion in 2021 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, have argued 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. In December 2022, six months after SEC Chair Gensler expressed concerns over the fairness of PFOF, the SEC proposed a new set of market structure rules. One rule would require broker-dealers to show how they obtained the best execution for trades for which they receive PFOF. Another would require certain marketable orders for retail investors, orders seeking to trade immediately at the best available prices, to undergo auction-based competition by market centers (including securities exchanges) before they can be executed by a market maker.

Gary Shorter, Specialist in Financial Economics

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