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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 enacted budget for FY2016 was $1.61 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 (IPOs); 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

Congress has an ongoing interest in a range of securities-related issues. Some significant issues are described below.

Regulatory Relief Extensions of the JOBS Act. Recent congressional sessions have seen the introduction of legislation aimed at extending a key JOBS Act goal of boosting small and emerging company capital formation and growth by reducing various disclosure-based regulations described by some as costly and burdensome. At times, such legislation, which the SEC would be required to implement and enforce if enacted, has been criticized for providing corporate regulatory relief at the expense of what some described as vital disclosure-based investor protections. Congress may revisit a number of those bills, which included additional regulatory relief for *emerging growth companies.*

The CEO-Worker Pay Ratio. In August 2015, the SEC finalized required rulemaking under Section 953 of the Dodd-Frank Act. The rule requires public companies to disclose their total chief executive officer (CEO) pay (which they already do), the pay of their median-paid employee, and the ratio between the two. The required disclosures go into effect for pay provided in fiscal years that begin on or after January 1, 2017. Proponents of the disclosures argue that the CEO-worker pay ratio disparity will help to direct corporate boards away from awards of excessive CEO pay, which some say is widespread. Critics charge that the median employee pay data will be costly to calculate and that the pay ratio will provide no meaningful investor data. Bills to repeal the section have been previously introduced.

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. A 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 that provides investors with historically low trade execution costs and expanded trading venue choices. Some, however, charge that the regulation has led to securities markets more prone to trading disruptions with potential systemic implications. As such, Reg. NMS has attracted increasing scrutiny from securities industry stakeholders and congressional committees. In addition, SEC officials have said that agency staff is examining the regulation and its implications.

Pilot Program to Explore Widened Quoting and Trading Increments. Starting in 2001, the SEC mandated the decimalization of the nation's equity markets. Prior to that, the minimum price quote (offer to buy or sell a share of a security) pricing increment (tick size) was $0.0625, which changed to one cent ($0.01) with decimalization.

In 2012, the JOBS Act directed the SEC to conduct a study for Congress on how decimalization had affected the number of IPOs and the trading liquidity of small capitalization (cap) companies. The act also authorized but did not require the SEC to designate a minimum quoting and trading increment for the securities of *emerging growth companies* larger than $0.01 and less than $0.10. Animating this interest in reexamining decimalization is the notion that a wider tick size would allow trading intermediaries, called market makers, to earn more money when they trade the securities of small cap firms, thus deepening the trading markets in those firms. In turn, it is argued that this would result in a large amount of small cap research coverage and greater interest in underwriting small cap IPOs, changes viewed as vital to a healthier small cap secondary market.

In May 2015, to help it evaluate the impact of lengthening the tick sizes on small cap securities, the SEC approved a pilot program that it had directed FINRA and national securities exchanges to develop. Begun in October 2016, the pilot will run for one year, involves stocks with a market capitalization of $5 billion or less and a share price of $2 per share or more, and has one control group and three test groups, each trading about 400 stocks, which will provide various tests of the impact of quoting and trading at $0.05 minimum increments. One of the three experimental groups also will trade under the "trade-at rule," which generally prevents price matching by trading centers that do not currently display the best price. The rule has been advocated by various exchanges, including the New York Stock Exchange and Nasdaq, which have been losing trade volume to dark pools (non-public exchange secondary market trading venues used by institutional investors due to their trade anonymity). The pilot's skeptics, however, argue that increased market maker profits would likely translate into higher investor costs but lead to little change in the level of small cap market research.

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