

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

September 29, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: October 5, 2021, Full Committee Hearing entitled, “Oversight of the Securities and Exchange Committee: Wall Street’s Cop is Finally Back on the Beat.”

The full Committee will hold a virtual hearing entitled, “Oversight of the Securities and Exchange Commission: Wall Street’s Cop is Finally Back on the Beat” on Tuesday, October 5, 2021, at 12:00 pm Eastern Time on the virtual meeting platform Cisco Webex. There will be one panel with the following witness:

- The Honorable Gary Gensler, Chair, Securities and Exchange Commission

The SEC’s Authorities and Functions

During the peak of the Great Depression, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, which created the Securities Exchange Commission (SEC). The SEC’s stated mission is to: (1) protect investors; (2) maintain fair, orderly, and efficient markets; and (3) facilitate capital formation. The SEC fulfills its mission through rulemaking, supervision, and enforcement. The SEC oversees more than 28,000 market entities, including investment advisers, investment companies, broker-dealers, national securities exchanges, credit rating agencies, clearing agencies, the Financial Industry Regulatory Authority (FINRA), the Public Company Accounting Oversight Board (PCAOB), the Municipal Securities Rulemaking Board (MSRB), and the Financial Accounting Standards Board (FASB).

The SEC oversees more than \$100 trillion in securities trading annually, and intakes the disclosures of around 7,400 reporting companies, including more than 4,000 exchange-listed public companies. The SEC has an annual budget of around \$2 billion that supports approximately 4,500 employees across its headquarters and 11 regional offices. The agency’s largest program divisions are Enforcement, Examinations, Corporation Finance, Trading and Markets, Investment Management, and Economic and Risk Analysis. Smaller program offices include the Investor Education and Advocacy, Investor Advocate, Credit Ratings, the Chief Accountant, and the Office of Minority and Women Inclusion (OMWI), among others.¹

Budget Request for FY 2023

According to the SEC’s FY 2023 budget request, the number of SEC staff decreased by about 4% since FY 2016 when the SEC had 4,650 staff. For FY 2023, the SEC is requesting \$2.169 billion in support of 5,268 positions and 4,913 full-time equivalents. The SEC’s funding is deficit-neutral as appropriated funds are fully offset by transaction fees. The SEC’s budget request states that it is requesting an 8.8% increase in the agency’s funding as compared to FY 2022 in order to address key priority areas. The budget

¹ SEC, [Congressional Budget Justification Annual Performance Plan](#), FY2022.

request further explains that this funding level is needed to hire additional agency personnel to oversee increasingly complex and growing financial markets that are expanding across borders and asset classes, including digital assets.

Market Structure

The SEC is statutorily directed to maintain fair and orderly capital markets. Capital market structure issues relate to the “plumbing” behind how a company raises capital from investors in U.S. financial markets. The recent “meme stock” market events have led to a renewed examination of the U.S. market structure to identify potential regulatory gaps. The Committee held three oversight hearings this year, including receiving testimony from SEC Chair Gensler, to examine these events.² The SEC is also engaged in a review of these aspects of the market structure. Below are some examples of policy considerations related to these market events.

Transparency in short-selling. Volatility surrounding the trading of GameStop and other meme stocks, the resulting “short squeeze” in January 2021, and the collapse of the “family office” Archegos, elicited industry and investor advocate support for increased market transparency, including heightened 13F reporting requirements and short sale reporting. 13F reports are filed by, and contain information regarding, large institutional investors’ holdings of securities and detail the equity holdings of such institutions on a quarterly basis. These reports, however, do not contain information on short or derivatives positions. The collapse of the Archegos fund occurred when it appeared that some market participants were engaged in sophisticated forms of short-selling. Archegos also used highly leveraged derivatives products.³ In July 2021, as a response to meme stocks volatility and the Archegos collapse, the Committee passed H.R. 4618, the “Short Sale Transparency and Market Fairness Act,” led by Chairwoman Maxine Waters, which authorizes the SEC to revise the reporting period for 13F disclosures from quarterly to monthly; shortens the time period to submit such reports; expands the list of items to be disclosed to include certain derivatives; directs the SEC to complete rulemaking pursuant to Section 929X of the Dodd-Frank Act, which requires aggregate short positions to be disclosed on Form 13F; and directs the SEC to study and report the use of confidential filing requests.⁴

Payment for order flow. The rise of zero-commission retail stock trades and the recent episodes of volatility in stock prices have brought a broker-dealer revenue model, referred to as payment for order flow (PFOF), to the attention of policymakers.⁵ There are policy questions regarding the true costs of zero-commission trades and whether the PFOF and other economic inducements conflict with the broker’s obligations to achieve “best execution” for its clients—a legal requirement to seek the most favorable transactions for clients.⁶ PFOF has been banned in the United Kingdom and Canada due to conflict-of-interest concerns. In July 2021, the Committee passed H.R. 4617, the “Order Flow Improvement Act,” led by Rep. Sherman, which requires the SEC to closely study various aspects of PFOF and consider banning or limiting PFOF and other economic inducements.

Gamification of investing. Online brokerage platforms and apps are increasingly using psychological and behavioral “nudges” to encourage certain customer engagement, including features commonly referred to as “gamification.” Gamification features on platforms such as Robinhood have received criticism that gamified online trading platforms encourage behavior similar to that of a gambling

² The full committee held three hearings related to the “meme stock” events, entitled, “Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide,” see [Part I \(Feb. 18, 2021\)](#); also, [Part II \(March 17, 2021\)](#); also, [Part III \(May 6, 2021\)](#).

³ Martin Gruenberg, [Unrecognized Lessons of the Archegos Collapse](#), *Bloomberg* (May 17, 2021).

⁴ See [Amendment in the nature of a substitute to H.R. 4618](#).

⁵ See CRS, [GameStop-Related Market Volatility: Policy Issues](#), (Feb.3, 2021).

⁶ *Id.*

addict.⁷ Regulatory bodies and investor advocates have argued that the effects of gamification on retail investors need to be studied and understood, as some of the prompts may constitute investment advice.⁸ In July 2021, the Committee passed H.R. 4685, the “Trading Isn’t a Game Act,” led by Rep. Casten, which would require the GAO to conduct a study on the positive and negative impacts of the trend of gamification of online trading platforms, such as the use of nudging and other inducements, and require the GAO to issue a report to Congress with recommendations.

Settlement cycles. When an online brokerage firm’s user buys or sells a stock, a clearinghouse records such trades and transfers the stocks and cash between buyers and sellers. This “clearance and settlement” process normally takes two business days (T+2), which adds to the risk exposure for clearinghouses if trades fail to settle and the stock prices fluctuate between the trade date and the settlement date. To cover risk exposure, clearinghouses calculate risk-based deposit requirements. Some have advocated for reducing the settlement cycle to one business day (T+1) or even real-time settlements (T+0).⁹

Corporate bond market efficiency. At around \$11 trillion outstanding,¹⁰ corporate bonds provide significant sources of financing for issuers. The market’s structural vulnerability was a concern during the pandemic-induced selloff in March 2020. Observers argue that one area of vulnerability relates to the timely availability of bond prices for public quotes and pre-trade transparency and have proposed a centralized system to collect and disseminate information publicly.¹¹

Digital Assets

The federal securities laws apply to instruments that qualify as “securities” under existing legal definitions, including stocks, bonds, and investment funds. Recent innovations in financial technology and markets have fostered a new class of digital assets, many of which have the characteristics of securities, and introduce new forms of trading. Multiple agencies currently apply different regulatory approaches to digital assets at the federal and state levels, leading to debates on the role of the jurisdiction of the SEC and other agencies, such as the Commodity Futures Trading Commission, which regulates commodities and derivatives. Since June 2019, the SEC has announced 54 enforcement actions against digital assets or initial coin offering-tied participants that raised at least \$8.2 billion.¹²

Digital securities, market exchanges, and decentralized finance platforms. Cryptocurrency market exchanges are market structures where digital assets and securities are bought and sold by retail investors. Observers, including Chair Gensler, have pointed out that digital securities trading platforms operate similarly to traditional securities exchanges but have not complied with the SEC’s regulatory regime that traditional exchanges are subject to, leading to investor protection concerns.¹³ Chair Gensler has called for cryptocurrency exchanges in particular to register with the SEC, warning that they may be subject to enforcement actions if they do not do so.¹⁴ “Decentralized finance” (DeFi) platforms, which utilize blockchain technology to facilitate trades without traditional financial intermediaries like brokers or clearing firms, have also come under scrutiny by the SEC for misleading investors and selling unregistered offerings.¹⁵

⁷ NBC, “[Gambling addiction experts see familiar aspects in Robinhood app](#),” (Jan. 30, 2021).

⁸ Protocol, “[What regulations, if any, are most likely to emerge from the GameStop-Robinhood Controversy](#),” (April 12, 2021).

⁹ Compliance Week, “[GameStop fallout: SEC eyes reducing stock settlement period](#),” (May 6, 2021).

¹⁰ SIFMA, *U.S. Corporate Bonds Statistics*, (Sept 2, 2021).

¹¹ Jack Pitcher, “[Gensler Turns Spotlight on How Hard It Can Be to Get Bond Prices](#),” *Bloomberg*, (Sept. 14, 2021).

¹² SEC, [Cyber Enforcement Actions](#), the calculations for capital raised made by CRS at the request of the Committee.

¹³ Reuters, “[U.S. SEC chair says more investor protection needed on crypto exchanges](#),” (May 20, 2021).

¹⁴ MarketWatch, “[‘A lot of people are going to get hurt,’ on unregistered crypto exchanges, SEC’s Gensler says](#),” (Sep. 21, 2021).

¹⁵ [SEC Charges Decentralized Finance Lender and Top Executives for Raising \\$30 Million Through Fraudulent Offerings](#) (Aug. 6, 2021).

SEC Regulation of Cryptocurrencies, including Stablecoins. Stablecoins, which are digital assets backed by fiat currencies, have drawn financial stability concerns because of their size and the lack of transparency of their portfolio holdings or reserves. For instance, the largest stablecoin, Tether, which has an estimated valuation of \$68 billion as of September 20, 2021,¹⁶ has been scrutinized for its lack of transparency about its reserves, with approximately half of its holdings in unspecified commercial paper, which are unsecured corporate short-term debt instruments.¹⁷ Facebook attempted to enter the stablecoin market in 2019 with the Libra Association, but suspended its activities after other members pulled out due to investor protection and consumer privacy concerns.¹⁸ Stablecoins have been increasingly scrutinized by the SEC, with Chair Gensler indicating they may fall under the agency’s jurisdiction as security-based swaps.¹⁹

Disclosure Requirements

Publicly traded companies. While current SEC requirements do not mandate Environmental, Social and Governance (“ESG”) disclosures expressly, publicly traded companies must disclose “material” and other information under federal securities laws in annual or other reports.²⁰ The SEC is said to be working on a formal rule proposal to increase disclosure relating to ESG issues, including climate risk, human capital, workforce diversity, and corporate board diversity, among others.²¹ While many issuers have begun disclosing some climate-impact information, those relating to diversity and human capital are sporadic and deficient.

Asset Managers and ESG. Investment funds, which invest money on behalf of others, are increasingly embracing ESG. Bloomberg estimates that global ESG assets could reach \$53 trillion by 2025 (from around \$35 trillion in 2020), representing more than a third of the projected total assets under management. An SEC risk alert highlighted concerns regarding investment advisers’ and funds’ accurate disclosure of their approaches to ESG.²² The SEC research found that although many funds label themselves ESG, their ESG terminologies and practices can vastly differ.²³

Special purpose acquisition companies. Special purpose acquisition companies (SPACs) are a type of “blank-check” company that raise capital through non-traditional initial public offerings (IPOs) with the intention of using the proceeds to acquire other companies later. Unlike traditional IPOs, SPACs do not have commercial operations at the time of the IPO, which is why they are referred to as blank-check or “shell” companies. Given the high-growth trend and dynamic nature of the SPAC market, the SEC’s Investor Advisory Committee has proposed enhancements in SPAC disclosures, including the disclosure of the role of SPAC sponsors, plain-English disclosure of participants’ financial incentives, description of the timeline and target search process of companies acquired by the SPAC, among other things.²⁴

Financial Stability

The U.S. Treasury market. The U.S. Department of the Treasury (Treasury) issues debt that is widely viewed as a safe, reliable, and liquid investment asset. The debt funds federal spending and is used

¹⁶ Coinmarketcap.com, [Today's Cryptocurrency Prices by Market Cap - Tether](#) (accessed Sep. 20, 2021).

¹⁷ CoinTelegraph, [“Regulators scrutinizing Tether’s commercial paper reserves: Comptroller of the Currency,”](#) (Jul. 28, 2021).

¹⁸ The Verge, [Facebook’s Libra Association crumbling ...](#) (Oct. 11, 2019).

¹⁹ Business Insider, [“SEC Chairman signals stablecoins could fall under its rules on security-based swaps...”](#) (Jul. 22, 2021).

²⁰ SEC, [The Laws That Govern the Securities Industry](#), (accessed Sep. 30, 2021).

²¹ CNBC, [“SEC Chair says investors want mandatory disclosure on climate risk,”](#) (July 28, 2021).

²² Staff of SEC Division of Examinations, The Division of Examinations’ [Review of ESG Investing](#), (Apr. 9, 2021).

²³ *Id.*

²⁴ SEC Investor Advisory Committee, [Regarding Special Purpose Acquisition Companies](#) (Aug. 26, 2021).

as price benchmarks for various other financial assets, though there is a statutory debt limit that constrains how much Treasury may borrow. Past episodes of debt limit brinkmanship, such as the one in the summer of 2011, led to credit default swap spreads spiking to as high as 80 basis points on one-year Treasuries and a rating downgrade by Standard & Poor's.²⁵ Secretary Yellen has indicated Congress must raise or suspend the debt limit by October 18, 2021 to avoid the U.S. government defaulting on its debts and causing a financial crisis and economic recession.²⁶ Moreover, the Treasury market itself has also experienced unexpected volatility, including episodes in 2014 and most recently on February 25, 2021.²⁷ In response, some observers have proposed various Treasury market reforms, such as mandated central clearing and expanded reporting.²⁸

Money market mutual funds. Money market mutual funds (MMFs) are commonly considered to be safe alternatives to bank deposits, although, unlike bank deposits, MMFs are not federally insured. However, MMFs, which are often perceived to be safe financial instruments, “broke the buck” and helped trigger major market disruptions in 2008 that accelerated the 2007-2009 financial crisis.²⁹ At the beginning of COVID-19-induced market selloff in early 2020, MMFs demonstrated that they are still susceptible to sudden large redemptions (often called “runs”) that caused dislocations in financial markets, which amplified financial stability concerns.³⁰

Credit rating agencies (CRAs). During the 2007-2009 financial crisis, CRAs assigned high-quality ratings to risky securities, which misled investors and amplified the financial crisis.³¹ As a result, the CRAs paid billion-dollar settlements and earned stricter regulation. A decade later, the industry’s oligopolistic structure and its largely “issuer pays” business model³² remain largely unchanged. The three largest rating agencies—S&P, Moody’s, and Fitch—account for about 95% of all outstanding credit ratings.

China-based issuers. China-based issuers present a growing concern to U.S. investors.³³ Through various investment vehicles and fronts, hundreds of China-based issuers—with more than \$1 trillion in market capitalization—list their shares on the U.S. stock exchanges. Companies with investments in China-based companies also likely raise capital from U.S. investors through unregistered securities (the so-called “exempt offerings” or private markets).³⁴ Most of these China-based companies have also barred U.S. regulators from inspecting the auditors that prepare their financial statements, raising serious transparency and investor protection concerns.³⁵ Through investment funds, U.S. investors are also exposed to risks tied to securities issued domestically in China. Many of these issuers, including Evergrande, are facing financial and political pressures.³⁶

²⁵ Mark Zandi and Bernard Yaros, [Playing a Dangerous Game With the Debt Limit](#), Moody’s Analytics (Sep. 21, 2021).

²⁶ Treasury, [Secretary of the Treasury Janet L. Yellen Sends Letter to Congressional Leadership on the Debt Limit](#) (Sep. 28, 2021)

²⁷ Alex Aronovich, Dobrislav Dobrev, & Andrew Meldrum, [The Treasury Market Flash Event of February 25, 2021](#) (May 14, 2021)

²⁸ Nellie Liang and Pat Parkinson, [Enhancing Liquidity of the U.S. Treasury Market Under Stress](#), (Dec 16, 2020); also, Joint Staff Report, Treasury et al., [The U.S. Treasury Market on October 15, 2014](#) (Jul. 13, 2015); also, Group of Thirty, [U.S. Treasury Markets Steps Toward Increased Resilience](#), (Jul. 2021); also [Testimony](#) of Jonah Crane, Former Deputy Assistant Secretary for FSOC (Jul. 14, 2017).

²⁹ The Balance, [“Reserve Primary Fund, How it Broke the Buck Causing a Money Market Run,”](#) (Feb. 25, 2021).

³⁰ Reuters, [“Regulators target money market funds after Covid-19 turmoil,”](#) (Nov. 16, 2020).

³¹ See [the Financial Crisis Inquiry Report](#), concluding “the failures of credit rating agencies were essential cogs in the wheel of financial destruction,” (Jan 2011), p.xxv.

³² The rating agencies are generally paid by the bond issuers to which they assign ratings, which can create conflicts of interest.

³³ US-China Security and Economic Review Commission, 2020 Annual Report to Congress, [Vulnerabilities in China’s Financial System and Risks for the U.S.](#) (Dec. 1, 2020).

³⁴ SEC, [Disclosure Considerations for China-Based Issuers](#), (Nov. 23, 2020).

³⁵ WSJ, [“SEC pursues plan requiring Chinese firms to use auditors overseen by U.S.,”](#) (Nov 17, 2020).

³⁶ NY Times, [“China and Evergrande ascended together. Now one is about to fall,”](#) (Sept 28, 2021).

Appendix: Legislation

- **H.R. ___, Strengthening the Office of Investor Advocate.** This discussion draft will strengthen the independence and increase reliability of the funding of the SEC’s Office of Investor Advocate. It would also authorize this office to conduct investor testing and other research, and publicize its findings.
- **H.R. ___, Investor Justice Act of 2021.** This discussion draft would create a grant program, administered by SEC’s Office of Investor Advocate, to support investor advocacy clinics.
- **H.R. ___, Empowering States to Protect Seniors from Bad Actors Act.** This discussion draft would create a grant program—similar to the one created by the Dodd-Frank Act’s Sec. 989A, which has not been implemented, housed within the SEC Investor Advocate Office to support and strengthen states’ senior investor protection programs.
- **H.R. ___, To amend the Securities Exchange Act of 1934 to improve the governance of multi-class stock companies, to require issuers to make annual diversity disclosures, and for other purposes.** This discussion draft would establish minimum listing standards for the stock exchanges in two areas of corporate governance: (1) multiple classes of stock with unequal voting rights, and (2) board diversity. The discussion draft would also require newly listed companies that choose to have multi-class stock structure to also include a seven year sunset provision for that multi-class stock structure, eventually leading to “one share, one vote.”
- **H.R. 2620, Investor Choice Act of 2021 (Foster).** This bill would prohibit financial professionals from requiring their clients into pre-dispute arbitration agreements and ban prohibitions on class action lawsuits in customer contracts that investors often are required to sign in order to receive services from broker-dealers or investment advisers.
- **H.R. ___, Whistleblower Protection Reform Act (Green).** This bill is identical to H.R. 2515, which passed the House in 2019 on suspension. It would protect whistleblowers against retaliation, including individuals (1) who blow the whistle internally; (2) who assist in an SEC investigation of these violations, or (3) make disclosures that are required or protected under any law subject to SEC jurisdiction. Currently, these anti-retaliation protections apply only to individuals who report information directly to the SEC.
- **H.R. ___, To prohibit registered investment advisers, brokers, and registered representatives of brokers from facilitating the transaction of or recommending the securities of certain special purpose acquisition companies, and for other purposes.** This discussion draft would prohibit brokers and investment advisers from recommending to retail investors SPACs that grant high percentage of “promote” to the sponsors—a compensation arrangement that offers free shares to the sponsors of the SPACs. Currently, SPAC sponsors receive 20% or more in “promote,” which dilutes the shares of retail investors.