Testimony before the Financial Services and General Government Subcommittee of the House Committee on Appropriations

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Chairman
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Chairman Graves, Ranking Member Quigley and members of the Subcommittee, thank you for the opportunity to testify today on the President's fiscal year (FY) 2019 budget request for the U.S. Securities and Exchange Commission (SEC).[1]

It is an honor to appear before this Committee for the first time, and I would like to thank the members of this Committee for your support of the SEC, its personnel and its mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation.

Congress's recent funding for the agency, with additional funds for information technology, will provide the SEC with the ability to make significant investments in FY 2018 in furtherance of our efforts to modernize our information technology infrastructure and improve our cybersecurity risk profile. This funding also will allow us to make advances in each part of our tripartite mission. I recognize the vote of confidence that you have shown in the SEC as does our staff. We all appreciate it. I am committed to ensuring that the agency is a prudent steward of this appropriation.

I also look forward to working with each of you on the agency's FY 2019 request during the congressional appropriations process.

Our Mission, Our Perspective and the Importance of our Capital Markets to America

Since joining the SEC last May, I have been increasingly impressed by the SEC staff's professionalism and dedication to serving American investors, issuers and other market participants. I would also like to thank my fellow Commissioners – Kara Stein, Michael Piwowar, Robert Jackson, Jr. and Hester Peirce – for their commitment to the Commission and for working to address a host of issues for the benefit of U.S. investors and our capital markets.

With a workforce of over 4,500 staff in Washington and across our 11 regional offices, the SEC oversees, among other things (1) approximately $82 trillion in securities trading annually on U.S. equity markets; (2) the disclosures of approximately 4,300 exchange-listed public companies with an approximate aggregate market capitalization of $30 trillion; and (3) the activities of over 26,000 registered entities and self-regulatory organizations. These registered entities include, among others, investment advisers, broker-dealers, transfer agents, securities

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the President, the full Commission or any Commissioner.

exchanges, clearing agencies, mutual funds and exchange-traded funds (ETFs) and employ over one million people in the United States.

Our staff recognizes, and is motivated by, the fact that tens of millions of Americans are invested in our securities markets and have to make personal investment decisions — both direct decisions such as which stocks, bonds, mutual funds, ETFs and other securities to purchase and indirect investment decisions such as which broker-dealer or investment adviser to hire. Many other Americans are also invested in our markets through pension funds and other intermediaries. The touchstone for the SEC staff is the long term interests of these Americans. They benefit from investment opportunities, fair and efficient markets and, importantly, investor protection. In turn, we believe serving these interests furthers America's interests. Over the course of my first year at the Commission, I have held town halls at each of our 11 regional offices and with each one of our divisions and offices. These sessions have demonstrated unequivocally that the women and men of the SEC place the long term interests of our Main Street investors first.

We engage and interact with the investing public on an ongoing basis through a number of channels, including through our investor education programs and through the publication of alerts on our Investor.gov website. Recently, the President designated April as National Financial Capability Month, "affirm[ing] the importance of financial literacy and highlight[ing] the need for all Americans to plan for their futures."[2] The designation reiterates the importance of financial literacy and retirement planning – a message that rings especially true at the SEC because educating investors is a vital part of our core mission. Throughout the year, our Office of Investor Education and Advocacy provides information and resources to investors, stressing the importance of saving and investing, researching their investment professionals and being aware of the potential indicators of fraud. My fellow Commissioners and I also participate in these investor education and outreach efforts with military servicewomen and men, seniors and other retail investors.

In charting the course of the SEC, I have noted several guiding principles that have been borne out by my interactions with the men and women of the Commission staff and America's Main Street investors.[3] These principles are embodied in the day-to-day efforts of all divisions and offices, particularly, and worthy of continued emphasis, with regard to focusing on the long term interests of Main Street investors. I have followed these principles in developing a streamlined Regulatory Flexibility Act rulemaking agenda. While the number of items on the short term portion of the agenda is lower than in years past, it does not mean that work at the Commission is slowing down. Rather, this change is rooted in a commitment to increased transparency and accountability regarding rulemaking priorities in an endeavor to be direct with

[2] Presidential Message on National Financial Capability Month (Mar. 30, 2018), *available at* https://www.whitehouse.gov/briefings-statements/presidential-message-national-financial-capability-month/.

[3] *See* Remarks at the Economic Club of New York (July 12, 2017), *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york; The principles are (1) the SEC's tripartite mission – protect investors, maintain fair, orderly and efficient markets and facilitate capital formation – is its touchstone; (2) our analysis starts and ends with the long-term interests of the Main Street investor; (3) the SEC's historic approach to regulation is sound; (4) regulatory actions drive change, and change can have lasting effects; (5) as markets evolve, so must the SEC; (6) effective rulemaking does not end with rule adoption; (7) the costs of a new rule now often include the cost of demonstrating compliance; and (8) coordination is key.

Congress, investors, issuers and other interested parties about what rules the agency intends to pursue and the Commission has a reasonable expectation of completing in the coming year.[4]

Our FY 2019 Budget Request

Our FY 2019 budget will allow the agency to build on its recent efforts in overseeing the U.S. markets and its market participants, protecting American investors, further promoting economic growth and being better prepared to tackle unanticipated issues that arise. Our request of $1.658 billion for SEC operations represents a modest increase above FY 2018's enacted level of $1.652 billion. This level will enable the SEC to continue its work in a number of areas, with a focus on several important components that I will highlight further below, including: (1) leveraging technology and enhancing cybersecurity and risk management; (2) facilitating capital formation across our markets; (3) protecting Main Street investors through multiple channels, including focusing on our most vulnerable investors, markets that are fertile ground for fraud and market integrity efforts such as combating insider trading, market manipulation and accounting fraud; (4) maintaining effective oversight of changing markets; and (5) supporting our leasing efforts.

The SEC's request for FY 2019 would enable us to start lifting the hiring freeze that has been in place since late in FY 2016. Our budget request would support restoring 100 positions, approximately one-quarter of the positions that became vacant during our hiring freeze, to address current critical priority areas and enhance the agency's expertise in key areas, such as retail investor protection and oversight of our equity and fixed income markets. These 100 positions would result in SEC staffing at approximately the same level as in FY 2014. The FY 2019 budget request also relies on the SEC having continued access to the Commission's Reserve Fund to fund information technology improvements, including those related to cybersecurity.

The SEC's funding is deficit-neutral. Any amount appropriated to the agency will be offset by transaction fees. The current transaction fee rate is just over 2 cents for every $1,000 in covered securities sales. The SEC also has been a net contributor to the U.S. Treasury in ways that are not directly related to our appropriations. By law, companies pay a fee to the SEC at the time they register securities for sale. For FY 2019, the fee rate will be set at a level sufficient to collect $660 million. A portion of these collections – $50 million – will be put into the Reserve Fund, which the agency devotes to information technology improvements, while the remaining $610 million will be deposited in the general fund of the U.S. Treasury.

Leveraging Technology, Cybersecurity and Risk Management

Congress's enacted FY 2018 appropriation and our FY 2019 request will allow the SEC to make investments to modernize our information technology infrastructure and improve our cybersecurity risk profile. The agency plans to use its FY 2018 and FY 2019 resources to

[4] Over the past 10 years, the Commission has completed, on average, only a third of the rules listed on the near-term agenda. As examples, 18 rules were listed as to-be-adopted in 2008, and 32 rules were listed in the same category for 2016; in each case, about 27% of the rules were adopted in each year.

advance the implementation of our Office of Information Technology's multi-year IT strategic roadmap to further our mission through advanced data analytics, digital workflows and other tools to maximize efficiency, effectiveness and security. Key IT priorities for FY 2018 and FY 2019 include:

1. Investing in information security to improve monitoring, protect against advanced persistent threats and strengthen risk management;
2. Retiring antiquated "legacy" IT systems to improve our cybersecurity posture while also saving agency funds;
3. Expanding data analytics tools to facilitate earlier detection of potential fraud or suspicious behavior and better identify high-risk registrant activities deserving examination; and
4. Modernizing the EDGAR electronic filing system to make it more secure, more useful for investors and less burdensome for filers.

In particular, cybersecurity at the Commission itself continues to be a priority area. No organization can guarantee that it will be able to withstand all cyberattacks, particularly in an environment where threat actors may be backed by substantial resources. Nevertheless, we must continuously work to remain on top of evolving threats when it comes to securing our own networks and systems against intrusion. This is especially true when protecting mission critical systems as well as systems dealing with sensitive market and other data involving personally identifiable information. This means regularly evaluating progress, pursuing improvements and making it a priority to invest sufficient resources so our systems keep up with the ever-changing threat environment. This also means regularly exploring alternatives that will allow us to further our mission while reducing the sensitivity of the data we collect. This may include, for example, taking in market-sensitive data on a delayed basis where feasible.

Because of the increasing importance of these issues, shortly after joining the Commission, I initiated an assessment of the SEC's overall cybersecurity risk profile and preparedness. This initiative is ongoing and includes an assessment and uplift of the agency's cybersecurity risk profile, including the identification and review of all systems, current and planned, that hold sensitive market data or personally identifiable information. As part of this process, we have engaged outside experts that are in the process of reviewing our systems and data. More broadly, the agency is evaluating its cybersecurity risk governance structure. This has resulted in the establishment of a senior-level cybersecurity working group, a review of our incident response procedures and additional planned enhancements to promote the management and oversight of cybersecurity across the Commission's divisions and offices. We have also established internal incident response exercises and have continued to interact on cybersecurity efforts with other government agencies and committees, including the Department of Homeland Security, the Government Accountability Office and the Financial and Banking Information Infrastructure Committee.

Another important step to strengthen our cybersecurity and risk management efforts is my announcement of a new position, the Chief Risk Officer, to help identify, monitor and mitigate risks across our divisions and offices. We have commenced our search and are making progress in our efforts to fill this vital new position. I also have authorized the hiring of

additional staff and outside technology consultants to aid in our efforts to protect the security of our network, systems and data.

Beyond our overall assessment of the SEC's cybersecurity risk profile, last September I disclosed a prior intrusion of the SEC's EDGAR system. We have ongoing investigations – conducted by our Office of the General Counsel, Office of Inspector General and Division of Enforcement – aimed at helping us understand what transpired, including with respect to the scope of the incident. I am focused on getting to the bottom of the matter and, importantly, using the information gained from the investigations to strengthen our cybersecurity efforts moving forward. I am committed to keeping the Committee informed of the ultimate findings and conclusions of our internal review into the EDGAR intrusion.

In the current fiscal year, we are spending significant resources to reinforce the security of EDGAR, including conducting a detailed penetration test of the EDGAR environment, a security review of EDGAR's code to proactively identify and remediate vulnerabilities and additional security enhancements to the architecture of the EDGAR system.

Further, I directed staff to conduct a review of the sensitive personally identifiable information we gather through SEC forms in an effort to make sure we do not take in more of such information than we need to carry out our mission. With the support of my fellow Commissioners, one recent result of this effort has been to eliminate the requirement for filers of certain forms to continue to provide us with their social security numbers, foreign identity numbers or date or place of birth. With respect to these forms, the Commission's action reflected a conclusion that we would be able to achieve our regulatory objectives without taking in this sensitive personally identifiable information. These are the types of analyses and questions we will continue to consider as we think about data collection use and security at the agency.

Uplifting the agency's cybersecurity program will remain a top priority during FY 2019. Our request would support investment in tools, technologies and services to protect the security of the agency's network, systems and sensitive data. It would also enable funding of multi-year investments to transition legacy information technology systems to modern platforms with improved embedded security features. The FY 2019 request would provide additional staff positions to enable the SEC to expand its cybersecurity protections, particularly with regard to incident management and response, advanced threat intelligence monitoring and enhanced database and system security, and to focus on the security of specific systems. The FY 2019 request also would permit the SEC to hire additional staff positions under the Chief Risk Officer to strengthen and advance the agency's risk management capabilities.

Facilitating Capital Formation

The U.S. capital markets have long been the deepest, most dynamic and most liquid in the world. They provide businesses with the opportunity to grow, create jobs and furnish diverse investment opportunities for investors, including retail investors, pension funds and other retirement accounts. Our markets have provided the U.S. economy with a competitive advantage and American Main Street investors with better investment opportunities than comparable

investors in other jurisdictions. We should strive to maintain and enhance these complementary positions, including by being mindful of emerging trends and related risks.

In executing the SEC's tripartite mission, we have sought to promote an environment conducive to capital formation while ensuring that our markets and our investors remain well protected. Over the past year, our Division of Corporation Finance (Corporation Finance) has carried out several key initiatives, with a particular emphasis on capital-raising opportunities.

Corporation Finance announced that it would accept voluntary draft registration statement submissions for certain securities offerings, including for initial public offerings (IPOs) and offerings within one year of an IPO, for review by the staff on a non-public basis. This expanded policy builds on the confidential submission process established by the Jumpstart Our Business Startups (JOBS) Act. We believe this approach provides a meaningful benefit to companies and investors without in any way diminishing investor protection, and a number of companies have already pursued this path. The Commission also proposed amendments, as required by the Fixing America's Surface Transportation (FAST) Act, to modernize and simplify certain disclosure requirements in Regulation S-K and related rules and forms in a manner that reduces the costs and burdens on registrants while continuing to provide all material information to investors. Corporation Finance also is developing recommendations for the Commission on amendments to the "smaller reporting company" definition, which would expand the number of issuers eligible to provide scaled disclosures.

While progress has been made, I believe the SEC can and should do more to enhance capital formation in our public and private capital markets and, particularly, for small and emerging companies. Fewer emerging companies are choosing to enter the public capital markets than in the past, and, as a result, investment opportunities for Main Street investors are more limited. There has been much debate about the causes and policy implications of this trend, but from my perspective, having a broader portfolio of public companies, especially those at the earlier stage of their growth cycle, ultimately will have positive impacts for our Main Street investors. Because it is difficult and costly for Main Street investors to invest in private companies, they will miss out on the growth phase of these companies to the extent they go public less frequently and later in their life cycle. Additionally, companies going through the SEC public registration and offering process often come out better companies on the other side of an IPO, providing net benefits to the company and our capital markets. While there is not a silver bullet to counter the negative trend in the number of U.S. public companies, we will continue working to enhance capital formation opportunities without sacrificing the important investor protections our public company disclosure system has provided for over 80 years.

Our FY 2019 budget request will further enable the staff to develop and present to the Commission rulemaking initiatives aimed at promoting firms' access to capital markets to generate economic growth while continuing to foster important investor protections. The resources provided by the FY 2019 request also would enable Corporation Finance to further assist companies that seek to raise capital through IPOs, follow-on or exempt offerings and to implement other important capital formation initiatives.

Additionally, the FY 2019 request will provide additional resources for staffing of the Office of the Advocate for Small Business Capital Formation (Advocate). We are in the advanced stages of our efforts to recruit and hire the Advocate, whose mission is to be a resource and voice for small businesses and their investors by providing assistance, conducting outreach to better understand their concerns and making recommendations to the Commission and Congress regarding potential improvements to the regulatory environment. I look forward to the benefits that the Advocate will provide to the Commission, issuers and investors.

Protecting Main Street Investors and Our Markets

In early 2017, as I moved through the confirmation process, it became apparent that a wide range of market participants, including retail investors, and various members of Congress believed that standards of conduct for investment professionals (e.g., investment advisers and broker-dealers) was a matter where Commission action, including coordination with our fellow regulators, would be both appropriate and timely. In June 2017 I issued a request for information, seeking input from the public on a range of potential issues. Since then, I have also had scores of meetings with investors, consumer groups, industry participants and others across the full spectrum of these issues. In particular, the candid comments of retail investors we met with in Missouri, Montana, Illinois and California, as well as those who travelled to New York for a roundtable, on what they expect, and do not expect, from investment professionals resonated with me in considering the appropriate course of action. These interactions, including consultations with my fellow Commissioners and staff, led me to the conclusion that the Commission should lead — but not dictate — in this area in order to (1) address investor confusion regarding the roles of, and the differences between, broker-dealers and investment advisers, (2) establish standards of conduct that meet reasonable investor expectations and adequately address conflicts of interest and (3) minimize the effects of regulatory complexity, both more generally and as a result of the Department of Labor's application of the fiduciary rule to a portion of the market.

Last week, the Commission voted to issue for public comment a comprehensive package designed to address retail investor confusion and potential harm in their relationships with investment professionals. Our rulemaking package would enhance retail investor protection while preserving access, in terms of both availability and cost, to a variety of types of investment services and investment products.

I have included my overview of the rulemaking package as an appendix to my testimony but will provide a brief synopsis. First, to meet reasonable investor expectations and address conflicts of interest, we are enhancing the standard of conduct for broker-dealers. We are also reaffirming — and in some cases clarifying — the standard for investment advisers. Under proposed Regulation Best Interest, a broker-dealer, when making a recommendation of a securities transaction or investment strategy to a retail customer, will be required to act in the best interest of that customer at the time the recommendation is made, including the broker-dealer being prohibited from placing their financial or other interest ahead of the interest of the retail customer. To add clarity for all participants, the proposal provides that the best interest duty is discharged if the broker-dealer complies with a disclosure obligation, a care obligation and two conflict of interest obligations. Under current standards, by contrast, broker-dealers are

permitted to recommend to their retail customer a product that is suitable but worse for the customer than another product that the broker-dealer offers — because the first product makes the broker-dealer more money. Let me be clear: our proposed Regulation Best Interest would address this concern.

How would this new duty be discharged? First, broker-dealers would need to disclose material facts relating to their relationship with the customer. Second, broker-dealers would need to enhance their current compliance framework to meet the demands of a more rigorous best interest standard. Third, and most important, broker-dealers would need to eliminate, or mitigate and disclose, material conflicts of interest related to financial incentives. Disclosure alone would not suffice.

The new broker-dealer best interest obligation draws from the principles applicable to an investment adviser's fiduciary duty. The close relationship is made clear when the proposed Regulation Best Interest is reviewed against the standards applicable to investment advisers. To address confusion regarding the standards applicable to investment advisers, we issued a proposed interpretation reaffirming – and in some cases clarifying – that duty as part of the rulemaking package. With respect to an investment adviser's fiduciary duty, let me be clear, because I believe there is substantial confusion in the marketplace. An investment adviser must seek to avoid conflicts of interest and at a minimum make full and fair disclosure of material conflicts. But it misstates the law and could mislead investors to suggest that investors currently have a legal right to conflict-free advice from an investment adviser.

Second, the rulemaking package would address concerns that retail investors are confused about their relationship with an investment professional. For example, they may mistakenly engage the services of a broker-dealer when, if they were to make a fully informed choice, their preferences would better match those of an investment adviser. Our proposal (1) would require broker-dealers and investment advisers to clearly state what they are, (2) would prohibit stand-alone broker-dealers and their financial professionals from using the terms "adviser" or "advisor" as part of their names or titles and (3) introduce a new short-form disclosure, no more than four pages, to help people identify the services that their financial professional provides, certain conflicts of interest to which they are subject, the fees the investor will pay, and the legal standards of conduct that apply when dealing with their clients or customers. Put bluntly, we want investors to understand <u>who</u> they are dealing with (e.g., what category their investment professional falls into) and, then, what that means and <u>why</u> it matters (e.g., how they are compensated).

We have been thinking about these issues for over 20 years, and about this rulemaking for nearly a year. I urge commenters to review the rule thoroughly, and then engage with us on it — through comment letters, one of the investor roundtables I plan to announce this week or meetings with us. We have provided for a 90 day comment period.

The FY 2019 request would restore seven staff positions within the Division of Investment Management (Investment Management), which plays a critical role in protecting retail investors through its regulation of investment advisers, mutual funds, variable insurance products and ETFs, among other products. The resources would be used to enhance Investment

Management's monitoring and disclosure programs, as well as advance key investor-focused rule-writing priorities, such as standards of conduct for investment professionals.

Additionally, a vigorous enforcement program is at the heart of the Commission's work to protect investors and maintain the integrity of the securities markets. Our Division of Enforcement (Enforcement) has the frontline responsibility of safeguarding our capital markets and American investors, and their dedication and expertise is focused on detecting and pursuing fraud and other misconduct where they may occur. Enforcement is focused on protecting all investors – without favor for account size, geography or other measures of priority – in its efforts to investigate and bring charges against violators of the federal securities laws. Successful enforcement actions impose meaningful sanctions on securities law violators, deter wrongdoing and, most important, have the maximum impact of returning dollars to harmed investors, especially Main Street investors, as well as preventing harm to those investors in the first instance.

During the past year, Enforcement has continued to focus on key areas where misconduct can harm investors, undermine confidence and impair market integrity. This includes such critical areas as retail investor fraud and investment professional misconduct, insider trading, market manipulation and accounting fraud. In furtherance of these initiatives, Enforcement enhanced its focus and expertise through the establishment of a Retail Strategy Task Force and a new specialized unit, the Cyber Unit.[5] The Retail Strategy Task Force's charge is to develop effective strategies and techniques to identify, punish and deter misconduct that most affects everyday investors. The Cyber Unit centralizes, leverages and builds upon the considerable expertise that the Commission has developed in several rapidly developing areas. The Cyber Unit focuses its efforts on the following key areas: (1) hacking to obtain material, nonpublic information and trading on that information; (2) market manipulation schemes involving false information spread through electronic and social media; (3) violations involving distributed ledger technology and initial coin offerings (ICOs); (4) misconduct perpetrated using the dark web; (5) intrusions into online retail brokerage accounts; and (6) cyber-related threats to trading platforms and other critical market infrastructure.

Our FY 2019 request would allow for critical investments in our ability to protect investors by restoring 17 positions for Enforcement to support key enforcement priorities, including expanding the work of the Cyber Unit and the Retail Strategy Task Force.

Another critical tool for the SEC to carry out its mission is our National Examination Program (NEP), led by our Office of Compliance Inspections and Examinations (OCIE). The SEC conducts risk-based examinations of registered entities, including broker-dealers, investment advisers, investment companies, municipal advisors, national securities exchanges, clearing agencies, transfer agents and FINRA, among others. Our examination program is one of many areas where we have focused on doing more with our available resources. Recently, through the reallocation of resources, advancements in OCIE's use of technology and other

[5] Press Release 2017-176, *SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors* (Sept. 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-176.

efficiencies, OCIE increased its examination of investment advisers by more than 40 percent in FY 2017 over FY 2016 – to approximately 15 percent of all SEC-registered investment advisers.

Although this has been a very positive step, more needs to be done to continue to increase investment adviser examination coverage levels, while at the same time being careful to avoid decreasing examination quality. To that end, our FY 2019 request would restore 24 positions within the SEC's NEP, including six additional staff for its Technology Controls Program, which monitors critical securities market infrastructure for significant cyber events and outages. I believe this area will continue to warrant close attention, and I have shared these views with other regulators, particularly in areas where we have overlapping responsibilities and oversight.

We will also continue to explore additional efficiencies and improvements to our risk-based examination program. One way to help us achieve our goals is through the continued use of data analytics. We have developed tools that can scan arrays of data fields to help us analyze and identify potentially problematic activities and firms, allowing us to make better decisions concerning which registered entities to examine and appropriately scope those examinations, among other things.

Effective Oversight of Our Changing Markets

One of the few certainties of trading markets is that they continually evolve and expand, while at the same time becoming more interrelated. Over the last decade, technological advancements and other developments have significantly altered the operations of our securities markets. These dramatic changes in our markets demand the Commission's continuous effort to identify emerging issues and risks in our markets and to strive to ensure that, as technology changes, our regulations continue to drive efficiency, integrity and resilience. The Division of Trading and Markets (Trading and Markets) serves as the SEC's first line in advancing our mission of maintaining markets that are fair, orderly and efficient through its work to regulate the major securities market participants and infrastructure.

While much attention is paid to activity in our equity markets and the $82 trillion in securities traded annually there, it is possible that even more dramatic market changes are occurring in our fixed income markets. These markets are massive – and growing. For example:

- The U.S. corporate bond market has experienced significant growth since the early 2000s. Issuance in the corporate bond market has hit record highs five years running.[6] In 2016, there were nearly 1,400 issues, amounting to $1.5 trillion, of corporate bonds, and

[6] *See* A Financial System That Creates Economic Opportunities: Capital Markets, Report to President Donald J. Trump, U.S. Department of the Treasury (Oct. 2017) at 85, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

there was over $8.5 trillion of corporate bonds outstanding.[7] By comparison, in 2006 there was over $4.8 trillion of corporate bonds outstanding.[8]

- Growth in the U.S. corporate bond market has also outpaced growth in U.S. equities: between 2006 and 2016 the value of corporate bonds outstanding rose by about 76 percent, while equity market cap rose by 40 percent.[9]
- The municipal bond market is large and vital and has experienced significant growth in recent years. By the end of 2016, municipal bond issuers had approximately $3.8 trillion bonds outstanding, up 17 percent from the end of 2006.[10]

The fixed income markets are critical to our economy and, increasingly, Main Street investors, yet over the years less attention has been paid to their efficiency, transparency and effectiveness relative to the equity markets. To address these issues, the Commission recently broadened its review of market structure to include increased attention our fixed income markets. We established a new Fixed Income Market Structure Advisory Committee (FIMSAC), which has already had two public meetings and recently provided a recommendation for a pilot program to study the market implications of changing the reporting regime for block-size trades in corporate bonds.

Over the last year, we also have continued to engage on issues related to our equity markets. The Commission recently proposed a pilot program based on a recommendation from the Equity Market Structure Advisory Committee (EMSAC) to study the effects that transaction-based fees and rebates may have on – and the effects that changes to those fees and rebates may have on – order routing behavior, execution quality as well as market quality more generally. I believe the data generated by a pilot program of this type would help inform the Commission, as well as market participants and the public, about any such effects and thereby facilitate a data-driven evaluation of the need for regulatory action in this area.

While the EMSAC's charter expired in January 2018, the staff is organizing targeted roundtables among market participants on discrete equity market structure issues, which will feature experts representative of a broad diversity of viewpoints. These meetings will provide further opportunities for discussions about critical issues affecting our equity markets. This week, we held our first roundtable focused on market structure issues for thinly-traded exchange-listed securities – an important issue as smaller companies, the securities of which are often relatively illiquid, play an essential role in our economy and may be the larger companies of tomorrow. We should continue to examine whether the current equity market structure – which is uniform for all companies, large and small, liquid and illiquid – meets the needs of all types of companies.

Our FY 2019 request would allow Trading and Markets to recruit 16 additional professionals to expand the agency's depth of expertise in vital areas such as equity and fixed

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[7] *See* 2017 SIFMA Fact Book at 23-24, 31, *available at* https://www.sifma.org/wp-content/uploads/2016/10/US-Fact-Book-2017-SIFMA.pdf.

[8] *See id. at* 31.

[9] *See id.* at 58.

[10] *See id.* at 31.

income market insight and analysis, clearing agency oversight, broker-dealer operations, cybersecurity and electronic trading. The request would also provide resources to continue the staff's work with the FIMSAC and its important work to evaluate, and for the Commission to take, appropriate measures to enhance the efficiency, transparency and effectiveness of fixed income markets.

Leasing

One final, important component of the SEC's funding needs for FYs 2018 and 2019 is to support the leasing of office space. In addition to the funds requested to support our operations, the SEC is requesting funds in FY 2019 necessary to participate in the General Services Administration's (GSA's) competitive procurement process for a successor lease for the SEC's New York Regional Office. As with the SEC's headquarters lease procurement that Congress funded in FY 2018, in accordance with its standard process, GSA has requested that the SEC set aside the funds that might become necessary to cover construction and related costs should the SEC need to move from its current building. None of these funds would be used for the operations of the SEC, and the agency has proposed appropriation language that provides a mechanism whereby any unused portion of these funds would be refunded to fee payers.

Conclusion

Thank you again for the opportunity to present the President's FY 2019 budget request and for your support of the Commission. I appreciate the opportunity to work with the Committee to ensure that the SEC has the resources needed to fulfill our important mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. I look forward to answering any of your questions.

Overview of the Standards of Conduct for Investment Professionals Rulemaking Package

Chairman Jay Clayton

April 18, 2018

1. What are our objectives?

First, enhance retail investor protection and decision making by:

- Raising the standard of conduct for broker-dealers when they provide recommendations to retail investors, and
- Reaffirming and in some instances clarifying the terms of the relationships that retail investors have with their investment professionals.

Second, preserve retail investor access (in terms of choice and cost) to a variety of types of investment services and investment products.

Third, raise retail investor awareness of whether they are transacting with registered financial professionals.

2. What prompted us to act?

Investor Confusion Regarding the Differences Between Broker-Dealers and Investment Advisers. Broker-dealers ("BDs") and investment advisers ("IAs") both provide investment advice to retail investors, but have different relationships and are subject to various different regulatory regimes. However, it has long been recognized that many investors do not have a firm grasp of the important differences between BDs and IAs — from differences in the variety of services that they offer and how investors pay for those services, to the regulatory frameworks that govern their relationship. This investor confusion could cause investor harm if investors fail to select the type of service that is appropriate for their needs, or if conflicts of interest are not adequately understood and addressed.

The Need for Standards of Conduct That Meet Reasonable Investor Expectations and Adequately Address Conflicts of Interest. A wide array of market participants agree that, whether a retail investor engages with a BD or an IA, investment professionals should be held to a standard that meets reasonable investor expectations, including addressing conflicts of interest. Misalignment between reasonable investor expectations and actual legal standards can cause investor harm. For example, retail investors may be harmed if they do not understand when BDs and IAs may have conflicting financial interests. In addition, without sufficient clarity, retail investors may be more deferential to, or place greater reliance on, their BD or IA than they otherwise would. I believe that clarifying the legal standards of conduct that apply

and reducing investor confusion through disclosure can significantly mitigate these potential harms as well as increase investor protection.

I also recognize that, in many cases, self-imposed standards and general professionalism have helped to fill any gap between reasonable investor expectations and legal standards. I applaud these long-standing efforts, but believe that proposing additional regulatory steps is necessary and appropriate. For BDs, this includes proposing to prohibit putting their interests ahead of the interests of their retail customers when making a recommendation of a securities transaction or investment strategy. For IAs, this includes clarifying that we do not believe IAs can simply "disclose away" the effect of their key duties with disclosures.

Regulatory Complexity Resulting from DOL Rule, Reduction in BD Service Offerings. In 2016, the Department of Labor ("DOL") sought to address some of these issues by deeming all investment professionals who provide investment advice to retirement accounts to be "fiduciaries" with respect to those accounts. While the status of the DOL's rule is currently in doubt following the Fifth Circuit's ruling, during the time the rule was in effect it imposed an additional standard of conduct for broker-dealers, amplifying significant regulatory complexity and uncertainty in this area, including through the introduction of multiple regulatory standards to the same investor relationship.

This action and other developments drove significant change in the market for investment advice. A number of BDs limited the products or services they provide to customers, particularly those customers with fewer assets. More specifically with respect to those services, some BDs shifted customers from full-service brokerage, which includes investment advice, to discount brokerage, which does not. Other firms that are dually registered as both BDs and IAs, as well as BDs that have an affiliated IA, shifted customers into advisory accounts, where, depending on the customer's investment strategy, they may pay more in fees for advice and services. This reduction in transaction-based service offerings has, and will continue to have, negative impacts on certain types of retail investors — for example, for buy-and-hold investors that transact infrequently, a brokerage account may be a more appropriate, and potentially less expensive account option. I believe it is important to preserve retail investors' ability to choose to receive transaction-based investment advice from BDs or portfolio-based advice from IAs and that our efforts should not increase the costs borne by retail investors.

Regulatory Complexity More Generally. Our concerns regarding regulatory complexity go well beyond the impact of the DOL rule. I am concerned that there are an increasing number of inconsistencies in the standards of conduct applicable to the provision of financial advice — in regulatory text, inspection, and enforcement — and therefore, regardless of the impact of the DOL rule, the potential for increased investor confusion and harm and decreased investor choice.

An investment professional that provides advice to an investor that has a 401(k), an annuity, and a brokerage account is subject to regulation by no less than five regulators (the SEC, FINRA, DOL, state securities regulators, and state insurance regulators). That relationship may also be

subject to regulation, inspection, and enforcement by banking regulators, state attorneys general, and other state and federal regulators. This level of complexity and uncertainty undoubtedly has the potential to increase the fees paid by retail investors and reduce the availability of retail investor-oriented products and services — particularly for those investors who have fewer assets.

I believe the SEC has broad jurisdiction and decades of relevant expertise with respect to these issues, and is well-placed to bring forward an approach that can be a focal point for regulatory clarity and cooperation across the market. I also value greatly the perspective and experience of our fellow regulators, including state securities and insurance regulators. We frequently work with our state colleagues, particularly on investigations and enforcement matters, and look forward to engaging much more closely with them and our other fellow regulators as we move forward with this rulemaking process.

3. What are we doing?

I believe that we can increase investor protection and the quality of investment services by enhancing investor understanding and increasing required standards of conduct, while simultaneously preserving investor choice, through a comprehensive package of rules and guidance that includes the following:

a. Raising and Clarifying Standards of Conduct for BDs and IAs

We have a proposed rule, and a proposed interpretation, that would enhance the standard of conduct for BDs and reaffirm and, in some instances, clarify the standard for IAs, respectively. The proposed rule for BDs draws from the principles applicable to IAs to enhance existing BD standards of conduct and codify them in the SEC's regulations. As a result, our proposed rule and interpretation would impose common principles across the spectrum of relationships, while applying specific regulatory obligations that reflect the differing relationship types. In other words, while the type of advice provided, whether episodic or ongoing, may be different, the obligations to the investor should embody common best interest principles.

Proposed Rule: Regulation Best Interest.[1] Under this proposed rule, a BD, when making a recommendation of a securities transaction or investment strategy to a retail customer, will be required to act in the best interest of that customer at the time the recommendation is made, without placing the financial or other interest of the BD ahead of the interest of the retail customer. This best interest duty is discharged if the BD complies with a disclosure obligation, a care obligation, and two conflict of interest obligations. Specifically:

[1] The text of Proposed Regulation Best Interest is attached hereto as Annex A.

- Disclosure. The BD must reasonably disclose to the retail customer the material facts relating to the scope and terms of the relationship, including material conflicts of interest associated with the recommendation;

- Care. The BD must exercise reasonable diligence, care, skill and prudence to (A) understand the potential risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (B) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (C) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest;

- Conflicts of Interest. The BD must establish, maintain, and enforce written policies and procedures reasonably designed to identify and then to (A) at a minimum disclose, or eliminate, material conflicts of interest associated with the recommendation; and (B) **disclose and mitigate, or eliminate**, material conflicts of interest arising from financial incentives associated with the recommendation.

This regulation prohibits BDs from putting their interests ahead of their customers' interests. While each of the component obligations of the BD's duty contributes to this outcome, the establishment of policies and procedures to mitigate or eliminate material conflicts arising from financial incentives is perhaps the most critical enhancement over existing standards applicable to BDs; it means that BDs must do more than simply disclose their conflicts of interest. We have drawn on our considerable experiences in examinations and enforcement in formulating our approach in this area. Certain inherently risky sales practices such as contests, trips, and prizes will merit scrutiny in this analysis.

Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation. As this proposed interpretation reaffirms, IAs owe a fiduciary duty to their clients. To the extent that current market conduct falls below what the Commission believes the IA fiduciary duty means, this interpretation would put the market on notice of the Commission's views.

b. Providing Clarity Regarding Fees, Conflicts and other Material Matters

Second, we have a proposed rule that contains a two-pronged approach to increasing clarity for investors. **Put bluntly, we want investors to understand <u>who</u> they are dealing with, i.e., what category — IA, BD, or dual-hatted — their investment professional falls into and, then, what that means and <u>why</u> it matters.** This proposed rule will also help highlight for investors that they are dealing with a registered entity, and that dealing with persons who are not registered raises significant risks.

Proposed Rule: Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles.

This proposed rule has two major component obligations to address the "who" and "why" questions, respectively.

- Clear Labeling. The first prong, labeling, will help investors properly categorize their existing or prospective investment professional by (A) requiring BDs and IAs to be direct and clear about their legal form in communications with investors and prospective investors; and (B) restricting standalone BDs and their financial professionals from using the terms "adviser" and "advisor" as part of their names or title, which are so similar to "investment adviser" that their use by a standalone BD may mislead the BD's prospective customers.

- Fee, Conflict, and Other Material Disclosure. The second prong, disclosure, will help investors understand why the legal categories matter by requiring IAs and BDs, and dual-hatted entities, to provide investors with a standardized, short-form (4 page maximum) disclosure. The disclosure will highlight key differences in: the principal types of services offered, the legal standards of conduct that apply to each, the fees the customer will pay, and certain conflicts of interest that may exist. The disclosure will also provide customers direction as to where and how they might get more information, including on the firm's or investment professional's disciplinary history.

  The disclosure — on Form CRS, or "Customer/Client Relationship Summary" — is intended to advance a layered approach to disclosure. More detailed information about an IA can be found in the IA's ADV Part 2A brochure, and more detailed information about a BD will be required through Regulation Best Interest's Disclosure Obligation.

  To help IAs and BDs, as well as retail customers, begin to visualize what Form CRS would look like, we have provided mock-up forms that would be used by standalone BDs, standalone IAs, and dually-registered firms.[2]

  These paper mock-ups reflect a traditional approach to how firms could choose to communicate with retail investors. Advances in communications technology provide various channels for effective communication, including, for example, interactive summaries. We also recognize that the inclusion of graphic presentations can be more effective than text only presentations. **We are proposing to allow BDs and IAs to use electronic communications and graphics to meet their Form CRS obligations, provided that such presentations are true to the content requirements and page limits of Form CRS.**

[2] The mock-up Client Relationship Summaries are attached here to as Annex B.

Annex A

Rule Text for Regulation Best Interest

Annex B

Form CRS Mock-up – Dual Registrant

Form CRS Mock-up – Standalone Broker-Dealer

Form CRS Mock-up – Standalone Investment Adviser