

Testimony of Gary Gensler

Chair, Securities and Exchange Commission

Hearing Before the Subcommittee on Financial Services and General Government

U.S. House Appropriations Committee

May 26, 2021

Good afternoon, Chairman Quigley, Ranking Member Womack, and members of the Subcommittee. I'm honored to appear before you today for the first time as Chair of the Securities and Exchange Commission. Thank you for inviting me to testify on the agency today. Before I begin, I'd like to note that my views are my own, and I am not speaking on behalf of my fellow Commissioners or the staff.

Having started at the SEC last month, I have been struck by the sheer breadth and scope of the capital markets and the agency's work. The SEC oversees the nearly \$100-trillion capital markets, or measured another way, about \$110 trillion in assets under management. Our responsibilities include 28,000 registered entities, more than 3,700 broker-dealers, 24 national securities exchanges, seven clearing agencies, and more than 2,300 filings from self-regulatory organizations.¹

Those \$100-trillion capital markets affect nearly every American. The \$50-trillion debt markets are how local governments raise funds, how corporations borrow money, or how construction of the hospital down the street gets financed. They also fund our mortgages and auto loans. Our \$45-trillion public equity markets, which get most of the attention, connect Americans

¹ See Securities and Exchange Commission, "Fiscal Year 2021 Congressional Budget Justification | Annual Performance Plan," available at <https://www.sec.gov/files/secfy21congbudjust.pdf>. Numbers from fiscal year 2019. See Securities and Exchange Commission, "National Securities Exchanges," available at <https://www.sec.gov/fast-answers/divisionsmarketregmrexcangeshtml.html>.

looking to invest with public companies seeking to grow, innovate, and hire employees. Our multi-trillion-dollar private equity and venture capital markets also play a significant role.

These markets are also experiencing significant growth. A record 67 million U.S. families held direct and indirect stock holdings in 2019, up 13 percent from 2010.² Total assets invested in registered investment companies have grown by more than two-thirds since 2015.³

Similarly, in the last five years, the number of registered investment advisers our divisions oversee increased from about 12,000 to approximately 14,000. Over the last year alone, the number of individual clients reported by these advisers jumped by nearly 20 percent, to more than 48 million individuals. The aggregate regulatory assets under management these advisers report increased 13 percent over the last year, as well.⁴

As our capital markets have grown, though, the SEC has not grown to meet the needs of the 2020s. At the end of fiscal year 2016, the SEC had 4,650 people on board. Four years later, that number had decreased by about 4 percent.

In fiscal year 2020, the Division of Enforcement's staff had 6 percent fewer staff on board than it did in fiscal year 2016.⁵ As another example, the SEC's Division of Corporation Finance is currently 20 percent smaller than it was five years ago. Other divisions are similarly stretched thin.

As more Americans are accessing the capital markets, we need to be sure that the Commission has the resources to protect them. Despite the lower staff numbers, the agency has

² Data drawn from the public version of triennial Survey of Consumer Finances (SCF): <https://www.federalreserve.gov/econres/scfindex.htm>. The SCF is sponsored by the Board of Governors of the Federal Reserve System with the cooperation of the U.S. Department of the Treasury. The 2019 SCF is the most recent survey.

³ See Investment Company Institute, "2021 Investment Company Fact Book," available at https://www.ici.org/system/files/2021-05/2021_factbook.pdf.

⁴ Based on Form ADV data.

⁵ See Securities and Exchange Commission, "Fiscal Year 2018 Congressional Budget Justification | Annual Performance Plan," available at <https://www.sec.gov/files/secfy18congbudjust.pdf>.

worked hard to keep up its mission and protect investors through more than 700 enforcement actions and more than 50 rulemakings in fiscal year 2020.⁶

While the SEC's formal budget request will be submitted to the Office of Management and Budget later this week, in this testimony I'd like to highlight five of the key capital market trends that will affect our resource needs going forward:

- Initial Public Offerings and Special Purpose Acquisition Companies
- Private Funds
- Crypto Assets
- Fintech
- Data Analytics

After describing these trends, I will touch on the impact the pandemic has had on our work and briefly discuss a number of other initiatives affecting the agency.

Initial Public Offerings and Special Purpose Acquisition Companies

The first trend I'll address is the acceleration of new public company listings. We are in the midst of a once-in-a-generation wave of traditional initial public offerings — companies that are seeking to go public via the stock market. From January 1 to May 19 of this year, nearly 400 companies filed traditional IPO S-1 forms. That is rapidly approaching the number of companies that filed for public offerings in all of 2016.

⁶ See SEC Division of Enforcement 2020 Annual Report, *available at* <https://www.sec.gov/files/enforcement-annual-report-2020.pdf>.

Since the beginning of 2021, 118 traditional IPOs have been completed. In all of 2016, there were 138 traditional IPOs. At the current rate, I expect there will be more traditional IPOs than there were during the dot-com peak of 2000.⁷

IPOs create new disclosures and ongoing streams of work for which SEC staff are responsible. Our role in protecting investors is heightened when a company is being introduced to public investors for the first time. Similarly, 40 Forms 10 — used in spin-offs and other new registrations — have been filed this year, compared to 59 all of last year.

Our capital markets also are witnessing an unprecedented surge in non-traditional IPOs by special purpose acquisition companies (SPACs). In their first stage, SPACs raise cash from the public prior to having operations. These shell companies' sponsors generally have two years to find a target company and make an acquisition through a merger.

The SEC has received 700 S-1 filings year-to-date from these shell companies seeking to go public. Three hundred of these “blank-check IPOs,” as I call them, have been completed so far in 2021. This compares to just 13 in all of 2016.

In their second stage, when the SPAC merges with a target company, they make an S-4 merger filing with the SEC. Those merger filings facilitate the target company's access to the public markets. While many market participants call these “de-SPACs,” I call these “target IPOs,” because they enable target companies to access public markets for the first time. Roughly contemporaneously with these target IPOs, the SPACs often raise capital through a transaction known as private investments in public equity, or “PIPEs.” There have been more than 100 “target IPOs” so far this year.

⁷ Data drawn from SDC Platinum, Thomson Reuters. There were 452 traditional IPOs in 2000.

Recently, private companies also have begun to access the public markets via direct listings. There are two kinds of direct listings. Through a secondary direct listing, a private company's shareholders can sell shares directly on the public exchange. Secondary direct listings first took place two years ago, and there is a modest but increasing number of them.

Further, the SEC recently has approved listing rules filed by exchanges for primary direct listings, where companies can sell shares directly on exchanges without a traditional underwritten public offering. This may be an important mechanism that calls upon SEC resources.

The once-in-a-generation wave in traditional IPOs, along with the unprecedented surge in SPACs, have placed a lot of demands on the SEC's limited resources. Further, the staff has been devoting significant resources to addressing emerging issues in this space. For example, SEC staff recently issued a statement highlighting the potential accounting implications of certain terms that may be common in warrants issued by SPACs.⁸ SEC staff identified a potential error in the accounting for warrants by SPACs in their first stage as blank-check IPOs, as required under long-standing accounting standards set by the Financial Accounting Standards Board.

Beyond the real demands on SEC resources, the surge of SPACs raise a number of policy questions. First and foremost, are SPAC investors being appropriately protected? Are retail investors getting the appropriate and accurate information they need at each stage — the first blank-check IPO stage and the second target IPO stage?

Second, how do SPACs fit in to our mission to maintain fair, orderly, and efficient markets? It could be the case that SPACs are less efficient than traditional IPOs. One recent study⁹ shows

⁸ See U.S. Securities and Exchange Commission, "Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ('SPACs')" (April 12, 2021), *available at* <https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs>.

⁹ See Michael Klausner, Michael Ohlrogge and Emily Ruan, "A Sober Look at SPACs," *Yale Journal on Regulation* (forthcoming 2021), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919.

that SPAC sponsors generate significant dilution and costs. SPAC sponsors generally receive 20 percent of shares as a “promote.” The first-stage investors can redeem when they find the target, leaving the non-redeeming and later investors to bear the brunt of that dilution. In addition, financial advisors are paid fees for the first-stage blank-check IPO, for the PIPEs, and for the merger with the target. Further, it’s often the case that the investors in these PIPEs are buying at a discount to a post-target IPO price. It may be that the retail public is bearing much of these costs.

I’ve asked staff to consider what recommendations they would make to the Commission for possible rules or guidance in this area. Our Corporation Finance, Examinations, and Enforcement Division staffs will also be closely looking at each stage to ensure that investors are being protected. Each new issuer that enters the public markets presents a potential risk for fraud or other violations.

Private Funds

The second trend is a significant growth in the number of private funds, in particular private equity and venture capital funds. There are more than 18,000 private equity funds, a 58 percent increase over the last five years. Meanwhile, the number of venture capital funds increased by 110 percent, to more than 1,700 funds (Fig. 1).

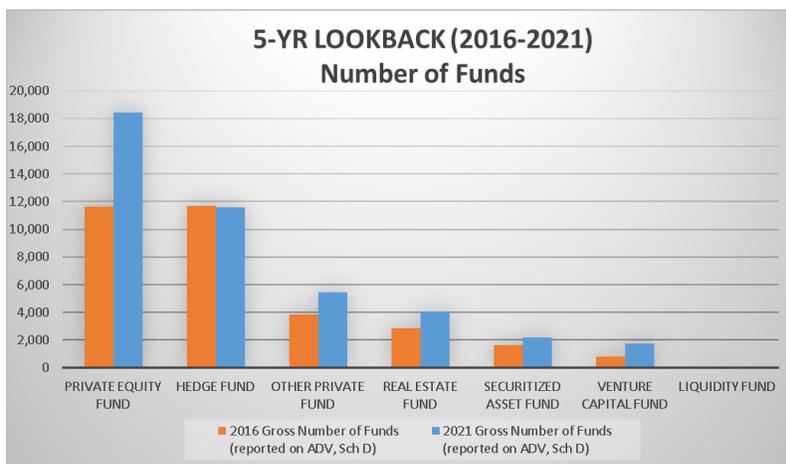


Figure 1

The size of these funds has also grown, with reported gross fund assets increasing by 116 percent in private equity funds and close to 200 percent in venture capital funds over that period (Fig. 2).

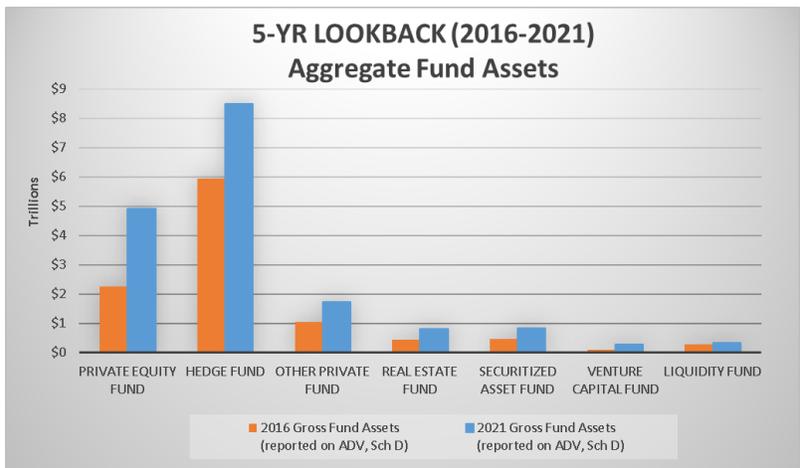


Figure 2

The industry not only is growing; it is evolving. SEC staff are seeing new strategies, structures, and business practices. This trend creates new risks for markets and investors. The SEC is the primary regulator of registered investment advisers to private funds. There is no self-regulatory organization for investment advisers like there is for broker-dealers. The SEC must grow and evolve with the industry. Given the growth and changes in private funds, I've asked staff for recommendations for consideration of enhanced reporting and disclosure through Form ADV, Form PF, or possible other reforms.

The SEC's Divisions of Investment Management, Examinations, and Enforcement continue to focus on advisers to private funds. It is important to hold investment advisers accountable when violations are found. This focus includes disclosures of investment risks and conflicts of interest, fees and expenses, liquidity, valuation of assets, and controls around material non-public information.

Crypto Assets

The third trend relates to the highly volatile and speculative asset class of crypto tokens. Much in the news of late, this asset class, though fluctuating a lot, has grown significantly in scale and valuations over the last five years.

As of this past Monday morning, the overall valuation of this market was about \$1.6 trillion. While that is a more than six-fold increase in just one year, it represents a more than one-third decline in the last 12 days.¹⁰

The first crypto token, Bitcoin, garners much of the news media's attention. On Monday, however, 80 tokens had a market capitalization of \$1 billion, and upwards of 1,600 had a value of more than \$1 million, among more than 5,000 crypto tokens tracked on coinmarketcap.com. Because this is a highly volatile and speculative asset class, these numbers are likely to fluctuate.

On May 26, 2016, exactly five years ago from the date of this hearing, the market capitalization for all crypto assets was about \$9 billion, the vast majority of which was Bitcoin and Ethereum.

In recent weeks, the reported trading volume has ranged from \$130 billion to \$330 billion per day. These figures, however, are not audited or reported to regulatory authorities, as the tokens are traded on unregistered crypto exchanges. That is just one of many regulatory gaps in these crypto asset markets.

Many of these tokens are investment contracts under the securities law. Over the years, the SEC has brought 75 cases in this area.¹¹ The SEC has been consistent in its communication to market participants that those who use initial coin offerings to raise capital or to engage in

¹⁰ Numbers in this section as of May 24, 2021. See CoinMarketCap, *available at* www.coinmarketcap.com.

¹¹ See Cornerstone Research, "Cornerstone Research Report Shows SEC Establishes Itself as a Key U.S. Cryptocurrency Regulator" (May 11, 2021), *available at* <https://www.cornerstone.com/Publications/Press-Releases/Cornerstone-Research-Report-Shows-SEC-Establishes-Itself-as-a-Key-U-S-Cryptocurrency-Regulator>.

securities transactions must comply with the federal securities laws. Asset managers that invest in these assets may come under securities laws, too.

There are many challenges and gaps for investor protection in these markets. Tokens currently on the market that are securities may be offered, sold, and traded in non-compliance with the federal securities laws. Furthermore, none of the exchanges trading crypto tokens has registered yet as an exchange with the SEC. Altogether, this has led to substantially less investor protection than in our traditional securities markets, and to correspondingly greater opportunities for fraud and manipulation. The Commission has prioritized token-related cases involving fraud or other significant harm to investors.

Additionally, crypto lending platforms and so-called decentralized finance (“DeFi”) platforms raise a number of challenges for investors and the SEC staff trying to protect them. The SEC also is seeking comment on crypto custody arrangements by broker-dealers.¹²

I look forward to working with fellow regulators and with Congress to fill in the gaps of investor protection in these crypto markets.

Fintech

Our capital markets are also being shaped by technology, both at traditional firms and fintech startups. In January and February, we saw major market events that were largely centered on mobile brokerage apps and about which I recently testified. There are many startups in wealth management, asset management, and robo-advising as well.

Many of these developments will enable greater access to our capital markets. They also bring new competitors into a market. At the same time, they can put additional demands on SEC

¹² See Securities and Exchange Commission, “SEC Issues Statement and Requests Comment Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers” (Dec. 23, 2020), *available at* <https://www.sec.gov/news/press-release/2020-340>.

resources — not only in examinations and enforcement matters, but also in new rulemakings and policy areas. These new business models and technologies raise a variety of policy questions around gamification, behavioral prompts, the use of data analytics, and more.

Data Analytics

I believe we are only at the very beginning of our economy’s growing reliance on the rapidly changing field of data analytics known as deep learning — a technology within artificial intelligence that is particularly adept at prediction and classification tasks. Our capital markets are no exception to this trend. We are starting to see AI-based funds, high-frequency traders, and asset management platforms, along with predictive tools and sentiment analysis.

As I co-wrote in a paper last year when I was still at the Massachusetts Institute of Technology, data analytics presents potential benefits, including increased efficiency, greater financial inclusion, enhanced user experience, optimized returns, and better risk management. With greater adoption, however, I believe these advancements also raise questions about the fairness, bias, and robustness of the individual analytic models themselves. I also think that as the financial sector matures in its use of deep learning in the capital markets, it’s appropriate to consider how such data analytics may affect systemic risks.¹³ I’ve asked staff to take a close look at these various developments.

Similarly, I am also interested in how we as an agency can continue to update our use of data analytics. As markets change, we need to adjust at the Commission, evaluating how we assess data and incorporate machine learning and deep learning into our examination and enforcement functions.

¹³ See Gary Gensler and Lily Bailey, “Deep Learning and Financial Stability” working paper (Nov. 1, 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723132.

The Consolidated Audit Trail (CAT) can play a key part in the SEC’s response to these trends. The SEC has required national securities exchanges and the Financial Industry Regulatory Authority (FINRA) to “track all activity throughout the U.S. markets in National Market System (NMS) securities.”¹⁴ The data that CAT will provide when implementation is complete will significantly enhance the self-regulatory organizations’ and SEC’s capabilities to identify potentially violative conduct and develop data-driven policies.

Pandemic

I also wanted to touch on the impact of the pandemic on our work.

I have deep appreciation and respect for the SEC’s staff, which has been overseeing the markets remotely and executing the agency’s mission under difficult circumstances the last 15 months. Our team will continue to work remotely until at least Labor Day, as announced in April. Our return to the office will be guided by data, science, and guidance from the Centers for Disease Control and Prevention and other authorities in the federal government.

Separately, early in the pandemic, we witnessed some system-wide issues affecting critical parts of our short-term funding markets, including treasury, repo, and money market funds markets. We also saw challenges in these markets in September 2019. It’s important to ensure the transparency and resilience of these markets, which have grown in recent years and underlie so many aspects of the economy. I am directing staff to look into these issues, in coordination with other federal agencies.

Other Initiatives

Before I close, I’d like to discuss four other initiatives affecting the agency. First, rules on security-based swaps will go into effect this year. These rules will require the registration and

¹⁴ See Securities and Exchange Commission, “Rule 613 (Consolidated Audit Trail),” *available at* sec.gov/divisions/marketreg/rule613-info.htm.

regulation of security-based swap dealers. There are separate rules requiring dealers to report security-based swap transaction data to the public. The agency estimates that 45 to 50 entities will register as security-based swap dealers. The SEC has stood up a staff joint venture to help coordinate actions among staff, but investment in several areas will be needed to complete our work in this area.¹⁵

Second, in 2019 the SEC put in place a new rule, called Regulation Best Interest, to protect retail customers. We want to ensure that, when providers of investment advice work with retail customers, their advice is genuinely in the “best interest” of those customers. The SEC staff will implement the rule in ways that will maximize investor protection. At the same time, we are keeping an open mind about what guidance or other updates, if any, may be needed to ensure that broker-dealers fully understand the rules and that Regulation Best Interest lives up to the promise of its name.

Third, I’ve asked staff to consider economic analysis and input from the public on disclosures. Moving forward, I look forward to staff recommendations on proposing rules regarding issuer disclosure of climate risks and human capital. I anticipate that this will be the initial steps in our broader efforts to update our disclosure regime for modern markets.

Finally, SEC staff are actively engaged with other agencies and market participants on the transition from LIBOR, formerly known as the London Interbank Offered Rate. I believe LIBOR has outlived its usefulness, and I support the transition away from this rate. SEC staff are working on this transition through various channels, including the Alternative Reference Rates Committee;

¹⁵ See Securities and Exchange Commission, “SEC Announces the Creation of the Security-Based Swaps Joint Venture, Led by Division of Examinations and Division of Trading and Markets” (Dec. 18, 2020), *available at* <https://www.sec.gov/news/press-release/2020-323>.

engagement with the industry; publication of staff statements; and coordination with domestic and foreign regulators.

Conclusion

In conclusion, the SEC has been entrusted by Congress to fulfill a critical mission overseeing our capital markets that touch every part of our economy and affect nearly every American. The scope, scale, and complexity of our capital markets have continued to grow. The SEC, however, is working with fewer staff than five years ago. As more Americans are accessing the capital markets, we need to be sure that the Commission has the resources to protect them. I look forward to working with Congress on additional resources so the SEC can stay apace of these important trends.

Thank you. I look forward to your questions.