MAXINE WATERS, CA
CHAIRWOMAN

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

PATRICK MCHENRY, NC
RANKING MEMBER

September 19, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: September 24, 2019 hearing entitled "Oversight of the Securities and Exchange Commission: Wall Street's Cop on the Beat."

The Committee on Financial Services will hold a hearing at 10:00 a.m. on Tuesday, September 24, 2019, in Room 2128, Rayburn House Office Building entitled, "Oversight of the Securities and Exchange Commission: Wall Street's Cop on the Beat." This will be a one-panel hearing with the five Commissioners from the Securities and Exchange Commission (SEC):

- Chairman Jay Clayton
- Commissioner Robert J. Jackson Jr.
- Commissioner Hester M. Peirce
- Commissioner Elad L. Roisman
- Commissioner Allison Herren Lee

Background

During the peak of the Great Depression, Congress passed the Securities Act of 1933 (Securities Act) and the Securities and Exchange Act of 1934 (Exchange Act), which created the SEC. The SEC's mission is to: (1) protect investors; (2) maintain fair, orderly, and efficient markets; and (3) facilitate capital formation. The SEC oversees over 27,000 market participants, including investment advisers, mutual funds and exchange traded funds, broker-dealers, national securities exchanges, credit rating agencies, clearing agencies, the Public Company Accounting Oversight Board (PCAOB), the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), and the Financial Accounting Standards Board (FASB). The SEC also oversees over $97 trillion in securities trading annually and reviews the disclosures of approximately 4,400 exchange-listed public companies with an approximate aggregate market capitalization of $34 trillion.

Private Markets v. Public Markets

The Securities Act requires issuers to disclose all material facts about securities that they publicly offer for sale, so that investors can make fully informed investment and voting decisions. Every offer and sale of securities must be registered with the SEC, unless there is an exemption. For registered securities, issuers must file a registration statement with the SEC, which contains

audited financial statements, as well as detailed disclosures about the issuer's business operations, financial condition, risk factors, and its management.[1]

A security offered or sold in reliance on an exemption is known as an "exempt offering" and the markets for these exempt offerings are known as "private markets." Investors in exempt offerings receive significantly less information about the security than investors in registered offerings. Generally, exempt offerings are limited to sophisticated investors who are judged not to need the protections of the securities laws.[2] Public companies can issue both registered offerings and certain exempt offerings, while private companies may only issue exempt offerings.

The private markets have grown significantly and are now more than double the size of the public markets: in 2018, issuers raised roughly $2.9 trillion of capital through exempt offerings, compared to only $1.4 trillion through public offerings.[3] Changes to the securities laws have made it significantly easier for companies to remain private longer and raise capital through the private markets. For example, in 1990 the SEC adopted Rule 144A ,which facilitated a new type of exempt offering by relaxing restrictions on the resale of certain private securities.[4] The National Securities Markets Improvement Act of 1996 made it more attractive for companies to issue private securities under Rule 506 by preempting state securities registration requirements.[5] Finally, the Jumpstart Our Business Startups Act of 2012 (JOBS Act) increased the number of record shareholders that a company can have before becoming a public company and triggering the public reporting requirements from 500 shareholders to either: (1) 2,000 total shareholders; or (2) 500 shareholders who are non-accredited investors.[6] In addition, the JOBS Act (1) created a new exempt offering that allows issuers to use general solicitation, (2) increased the amount that issuers are allowed to raise under Regulation A, and (3) created a new exempt offering for "crowdfunding" offerings.

In June 2019, the SEC issued a concept release to solicit comments on ways to harmonize the current exempt offering framework.[7] Specifically, the SEC sought comments on ways to make it easier for issuers (especially smaller issuers) to raise capital in the private markets.[8]

Public company disclosures

Public companies are required to file periodic and current reports with the SEC to disclose certain business and financial information.[9] These reports provide investors with the information they need to make informed investment and voting decisions. Regulation S-K (Reg S-K) requires companies to disclose information that is reasonably likely to have a material effect on a

---

[1] *See generally* SEC, FORM S-1, *available at* https://www.sec.gov/about/forms/forms-1.pdf.
[2] *See generally* SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. 30460, 30462–30463 (June 26, 2019).
[3] SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. at 30465.
[4] *See* SEC, RESALE OF RESTRICTED SECURITIES; CHANGES TO METHOD OF DETERMINING HOLDING PERIOD OF RESTRICTED SECURITIES UNDER RULES 144 AND 145: FINAL RULE, 55 Fed. Reg. 17933 (April 30, 1990).
[5] *See* Public Law 104-290, at § 102 (1996).
[6] *See* Public Law 112-106 (2012).
[7] SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. 30460.
[8] *Id.* at 30461 (stating that "we seek to identify gaps in our framework that may make it difficult, especially for smaller issuers, to rely on an exemption from registration to raise capital at key stages of their business cycle.").
[9] *See e.g.*, Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)].

company's financial condition or its operating performance.[10] Information is considered "material" if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to make an investment or voting decision.[11] However, Reg S-K does not require companies to *only* disclose information that meets the standard of "materiality," and the SEC has broad authority to require the disclosure of information if it would be in the public interest or would protect investors.[12] Moreover, Congress can — and has — mandated additional disclosures when there is a public policy interest at stake.[13]

Environmental, social, and governance (ESG) matters generally include issues relating to environmental sustainability, such as climate change; social issues such as human rights and labor practices; and governance issues such as gender, racial, and ethnic diversity at both the executive and board levels. Investors have increasingly been demanding more — and better — disclosure of ESG information from public companies.[14] Many investors view ESG information as important for evaluating reputational risks and *financial* performance.[15] Moreover, credit rating agencies now incorporate ESG factors into their ratings methodologies.[16]

In recognition of the growing importance of ESG disclosures in the investment landscape, the International Organization of Securities Commissions (IOSCO) published a statement on January 18, 2019 emphasizing "the importance for issuers of considering the inclusion of environmental, social and governance (ESG) matters when disclosing information material to investors' decisions."[17] However, while the SEC is a member of IOSCO, it was the only member regulator not to sign on to the IOSCO statement on ESG disclosures.

In October 2018, a coalition of large public pension funds, asset managers, law professors, and non-profit organizations filed a petition with the SEC for a rulemaking on ESG disclosures.[18] The petition called on the SEC to develop a comprehensive ESG disclosure framework, and identified seven specific issues that the SEC could act on immediately: (1) climate risk; (2) annual ESG disclosures based on the Global Reporting Initiative (GRI) framework; (3) gender pay ratios; (4) human capital management; (5) human rights; (6) political spending; and (7) tax disclosure.[19]

---

[10] *See generally* 17 C.F.R. part 229, SEC, COMMISSION GUIDANCE REGARDING MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (December 29, 2003), *available at* https://www.sec.gov/rules/interp/33-8350.htm.
[11] *See Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); *see also* 17 CFR § 240.12b-2 (defining "material").
[12] *See* SEC, BUSINESS AND FINANCIAL DISCLOSURE REQUIRED BY REGULATION S-K: CONCEPT RELEASE, 81 Fed Reg. at 23921.
[13] *See e.g.*, Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112-158, § 219, 126 Stat. 1214 (2012).
[14] *See e.g.*, Donnelly Financial, *The Future of ESG and Sustainability Reporting: What Issuers Need to Know Right Now*, at 3 (November 14, 2018) (finding that 65% of institutional investors "often or always consider environmental and social issues in their investment decisions," and 95% "often or always consider governance issues — for all investments.").
[15] *See e.g.*, Bank of America, *ESG: Good Companies Can Make Good Stocks*, at 1 (December 18, 2016); Nordea, *Cracking the ESG Code*, at 1 (September 5, 2017).
[16] Standard & Poor's, *How Does S&P Global Ratings Incorporate Environmental, Social, and Governance Risks Into Its Ratings Analysis*, at 2 (Nov. 21, 2017).
[17] IOSCO, *Statement on Disclosure of ESG Matters by Issuers*, at 1 (January 18, 2019), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf.
[18] Cynthia A. Williams, Jill E. Fisch, et al., *Request for Rulemaking on Environmental, Social, and Governance (ESG) Disclosure*, File No. 4-730 (Oct. 1, 2018), *available at* https://www.sec.gov/rules/petitions/2018/petn4-730.pdf.
[19] *See id.* at 13–16.

Enforcement

The SEC is responsible for prosecuting violations of the securities laws in cases involving everything from corporate disclosure violations to fraudulent sales of complex financial products. In civil enforcement actions before a court, the SEC may seek injunctions to prohibit further violations, civil monetary penalties, or the return of illegal profits (called disgorgement). A court may also bar or suspend an individual from serving as a corporate officer or director. Similarly, in administrative actions, the SEC may seek cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties, and disgorgement.

In 2017, the Supreme Court, in *Kokesh v. SEC*, held that disgorgement is a penalty and therefore subject to a five-year statute of limitations.[20] As a result of that case, the SEC may only bring cases for disgorgement within five years of the date of the violation, regardless of whether the SEC was able to detect it within five years of the violation. According to the SEC, the case has cost investors over $800 million by limiting the time the SEC has to recover funds.[21]

Cryptocurrency

The Federal securities laws apply to securities, including stocks, bonds, and investment contracts, regardless of whether they are digital. In April 2019, the SEC issued guidance on when a digital asset is an "investment contract" under the so-called "Howey test."[22] Under that test, an investment contract exists when there is: 1) an investment of money, 2) a common enterprise, and 3) a reasonable expectation of profits derived from the efforts of others. If a digital asset meets this test, it is a security and must either register with the SEC or meet an exemption.

The securities laws also govern investment companies, which issues securities to investors in exchange for money that it invests on a collective basis in other securities. Exchange-Traded Funds (ETFs) are a type of investment company, which can be redeemed by the fund like mutual funds, but also allow investors to trade throughout the day on an exchange at market prices. If an asset is an investment company and not exempt from registration, it must comply with regulations designed to minimize conflicts of interest, including regular disclosure of their financial condition and investment policies to investors.

On June 18, 2019, Facebook announced its plans to develop a new cryptocurrency, called Libra, and a digital wallet to store this cryptocurrency, called Calibra. Libra will be built on blockchain, backed by a reserve of assets, and governed by the Libra Association.[23] The Libra Association ("Association"), which is currently comprised of Facebook and 27 other members, is an independent, not-for-profit organization headquartered in Geneva, Switzerland. Its members will verify Libra transactions within the Libra blockchain. Facebook hopes to have recruited over 100 firms into the Association by the target launch date of early 2020.

---

[20] *Kokesh v. SEC*, 581 U.S. (2017).
[21] Dave Michaels, *Supreme Court 2017 Decision Has Cost Investors Over $800 Million, SEC Says*, WSJ (May 16, 2018), https://www.wsj.com/articles/supreme-court-2017-decision-has-cost-investors-over-800-million-sec-says-1526487555,
[22] *Framework for "Investment Contract" Analysis of Digital Assets*, SEC https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_ednref5; *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (first establishing the "Howey test").
[23] *Introducing Libra*, Libra (last accessed 07/02/2019), https://libra.org/en-US/white-paper/#introducing-libra

According to Facebook's white paper on the Libra, Association transactions would be "fully backed" by bank deposits and short-term government securities that will be held in the Libra Reserve. New Libra tokens would only be created when certain authorized resellers purchase them from the Association. Libra tokens could only be destroyed when authorized sellers sell them back to the Association in exchange for the underlying assets. The interest from the assets in the Reserve would fund operating expenses and be used to pay dividends to investors in the "Libra Investment Token." Facebook intends to sell Libra Investment Tokens to members of the Association and other investors to fund its startup costs.

The Libra Investment Token could amount to a security since it is intended to be sold to investors to fund startup costs and would provide them with dividends. The Libra token itself may also be a security, but Facebook does not intend to pay dividends and it is unclear if investors would have a "reasonable expectation of profits." However, the offer of Libra could be integrated into the offering of the Libra Investment Token, thereby deeming both securities. [24] Like ETFs, Libra would be redeemable by certain authorized resellers and bought and sold in the open market.

Fiduciary

On April 18, 2018 the SEC proposed a three-part regulatory package, consisting of: (1) a "best interest" standard of conduct for brokers pursuant to Section 913(f) of Dodd-Frank ("Regulation Best Interest" or "Reg BI"); (2) guidance on the fiduciary standard of conduct for investment advisers; and, (3) Form CRS, a 4-page maximum relationship disclosure containing key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay, and certain conflicts of interest that may exist.

As part of its proposal, the SEC instructed the SEC's Investor Advocate to conduct investor testing of Form CRS. The results of the SEC's investor testing were mixed. Form CRS appeared to be helpful for investors who already read the documents when choosing an adviser, and who have more investing experience, but less helpful for investors who would not otherwise read the documents. In addition, even after reading the Relationship Summary, investors still reported that "there were areas of confusion for participants, including differences between types of accounts or financial professionals."

On June 5, 2019, the SEC finalized Reg BI largely as proposed with both Democratic Commissioners dissenting.[25] According to Democratic Commissioner Jackson, the "rules retain a muddled standard that exposes millions of Americans to the costs of conflicted advice. Even worse, contrary to what Americans have heard for a generation, the Commission today concludes that investment advisers are not true fiduciaries."[26] Other critics of the regulation stated that it was inconsistent with investors needs and expectations.[27]

---

[24] *See e.g.,In re Kik Interactive*, Complaint, SEC, Case No, 19-cv-5224 (Jun. 4, 2019), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf

[25] *See* 17 CFR §§240.15*l*-1, 240.17a-3, 240.17a-4.

[26] Commissioner Robert J. Jackson Jr., *Statement on Final Rules Governing Investment Advice*, SEC (June 5, 2019) https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd.

[27] *SEC Adopts Anti-Investor Advice Standards on Partisan Vote*, Consumer Federation of America (June 5, 2019) https://consumerfed.org/press_release/sec-prepares-to-adopt-anti-investor-advice-standards-on-partisan-vote/.