SEC Chair's Testimony Gives Firms Insight on Commission's Priorities and Direction

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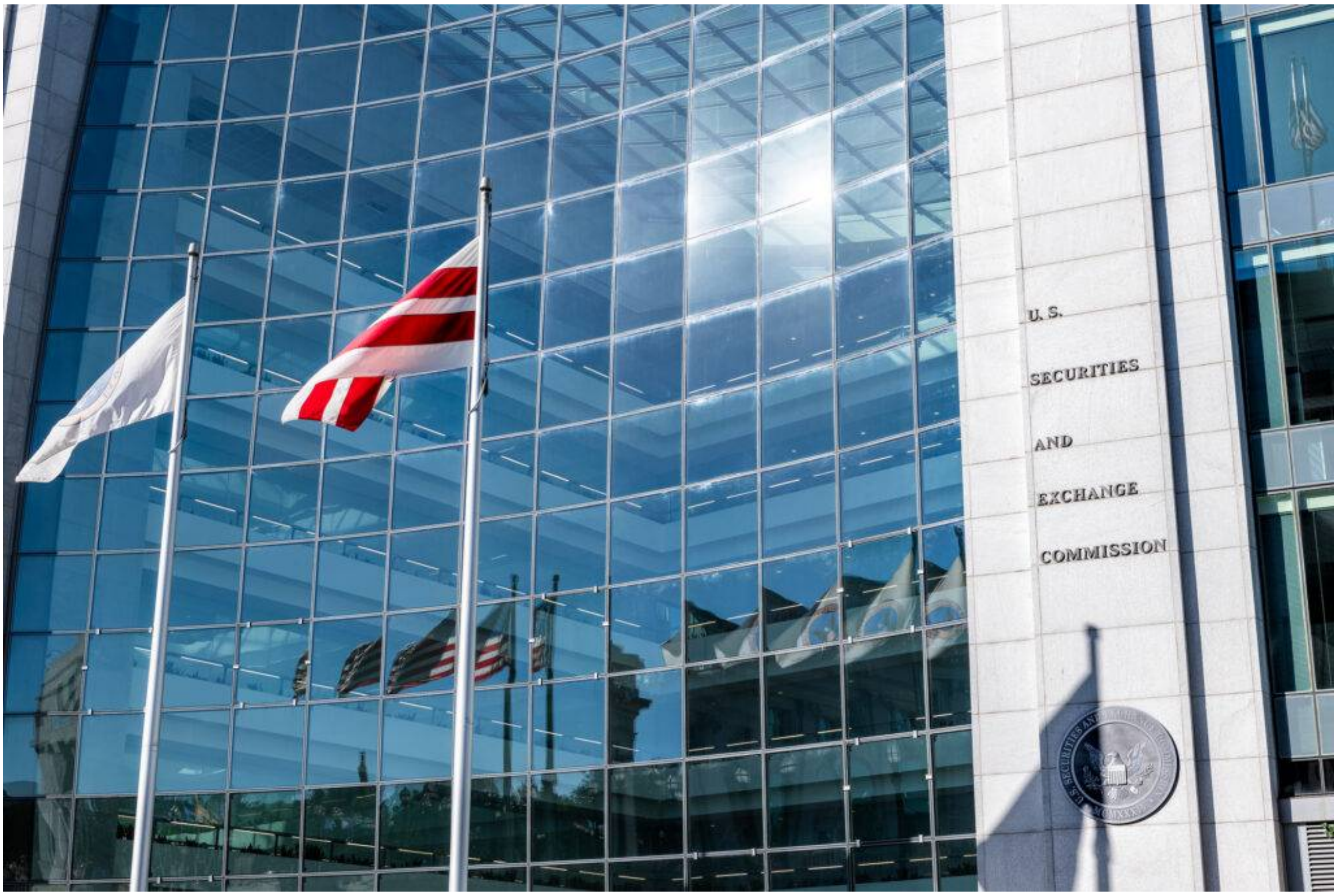

By Les Abromovitz, Senior Director

Though most financial professionals are more interested in the lurid testimony in the Johnny Depp-Amber Heard defamation trial, they will benefit by reviewing what SEC Chair, Gary Gensler, had to say when he testified before Congress. On May 17, 2022, Gensler testified at a hearing before the Subcommittee on Financial Services and General Government U.S. House Appropriations Committee. His testimony can help Registered Investment Advisors ("RIAs") and broker-dealers to understand where examinations may be headed, so they can improve their compliance program and target any weaknesses that currently exist.

Gensler's testimony demonstrates the magnitude of the SEC's mission, which is to:

- Protect investors;
- Maintain fair, orderly, and efficient markets; and
- Facilitate capital formation.

Roughly half of the SEC's staff members work in the Enforcement and Examinations divisions. The Division of Examinations serves as the eyes and ears of the SEC and conducts about 3,000 exams per year. Gensler testified that about 15 percent of SEC-registered advisors were examined in Fiscal Year 2020 and Fiscal Year 2021.

According to Gensler, the productivity of the Division of Examinations can be attributed in part to the use of remote exams during the pandemic. Gensler noted, however, that there is no substitute for on-site exams, and the SEC requires additional funding to accomplish that objective. Gensler expects the demands upon the Division of Examinations to escalate due to evolving markets, a heightened geopolitical environment, and increased attention paid to cyber risks.

Expect more examinations of broker-dealers for compliance with Regulation Best Interest

Gensler testified that the Division of Examinations needs to increase its capacity to examine broker-dealers, particularly when it comes to compliance with Regulation Best Interest ("Reg BI"). Gensler's shout-out to Reg BI is not surprising in view of the SEC's Staff Bulletin, which was published on March 30, 2022. In that bulletin, the SEC answered a number of questions to reiterate the standards of conduct owed by broker-dealers and investment advisors when they are making account recommendations to retail investors.

The goal of the Staff Bulletin is to help broker-dealers, RIAs, and their associated persons satisfy their obligations to retail investors when making account recommendations. Selecting an account type is a crucial decision for retail investors. Furthermore, the selection process raises potentially significant conflicts of interest, especially for dually licensed financial professionals.

Although the specific application of Reg BI and the fiduciary standard owed by investment advisors differ in some ways and are triggered at different times, they often produce substantially similar results in terms of the ultimate responsibilities owed to retail investors. Reg BI and the investment advisor fiduciary standard are built upon the duty to act in investors' best interest. Financial professionals must obtain and evaluate sufficient information about the retail investor, so they are able to form a reasonable basis to believe account recommendations are in the retail investor's interest. Without that information, financial professionals do not have the ability to form a reasonable basis to determine if account recommendations are in the retail investor's best interest. The Staff Bulletin makes it very clear that although financial professionals should consider the retail investor's preferred account type, that preference by itself does not satisfy Reg BI.

The guidance found in the Staff Bulletin will be very useful to broker-dealers if more examinations focused on their adherence to Reg BI are forthcoming. The Staff Bulletin is available at https://www.sec.gov/tm/iabd-staff-bulletin.

Gensler makes the case for more resources for oversight of RIAs and investment companies

The Division of Investment Management oversees the investment companies and advisors stewarding the nest eggs for millions of American investors. It now oversees the life savings of more than 106 million American investors. The number of RIAs has grown from 12,000 in 2016 to 15,000. The number of RIA clients has also increased 70 percent from 32 million in 2016 to 55 million in 2021. Gensler attributed this growth to the dramatic increase in robo-advisors and other firms utilizing algorithms and models to provide investment advice directly to investors through separately managed accounts.

The Division of Investment Management also oversees ETFs and private fund advisors. The number of private funds managed by RIAs has risen to 50,000. To justify his request for additional resources, Gensler also pointed to the increasingly complex filings in innovative areas such as crypto, thematic index funds, and Environmental, Social, and Governance.

Conclusion

Aside from requesting funding for additional staffing and other resources, Gensler requested budget increases to improve the SEC’s technology. Additional funding will give the SEC more capacity to investigate misconduct and accelerate enforcement actions. It will also strengthen the SEC’s litigation support and bolster the capabilities of the Crypto Assets and Cyber Unit. The funding is also needed, so the SEC can investigate the tens of thousands of tips, complaints, and referrals received from the public.

The SEC is not the only one needing more funding. Chief compliance officers of RIAs and broker-dealers should look at their own budgets to determine if they are allocating sufficient resources to address the regulatory challenges on the horizon.

Gensler’s testimony can be reviewed at https://www.sec.gov/news/testimony/gensler-testimony-fsgg-subcommittee.