

**FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2019**

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**TUESDAY, JUNE 5, 2018**

U.S. SENATE,  
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,  
*Washington, DC.*

The subcommittee met at 3:33 p.m., in Room SD-138, Dirksen Senate Office Building, Hon. James Lankford (Chairman) presiding.

Present: Senators Lankford, Boozman, Kennedy, and Van Hollen.

**SECURITIES AND EXCHANGE COMMISSION**

**STATEMENT OF HON. JAY CLAYTON, CHAIRMAN**

OPENING STATEMENT OF SENATOR JAMES LANKFORD

Senator LANKFORD. Good afternoon, everyone. The subcommittee will come to order.

Welcome to today's hearing on the fiscal year 2019 budget request for the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Today we have SEC Chairman Jay Clayton, CFTC Chairman Christopher Giancarlo. Thank you both for being here today, by the way, and for the extensive preparation that you did.

SEC's mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. To accomplish these objectives, SEC requests \$1.658 billion for fiscal year 2019, a \$6 million increase over the fiscal year 2018 enacted amount. SEC's funding is derived from fees paid by national securities exchanges and associations and results in no direct appropriations. However, these fees are ultimately passed on to U.S. investors, retirement savers, market participants, and the subcommittee has the responsibility to ensure that they are all spent wisely.

Chairman Clayton, your leadership of the SEC coincides with the rapidly changing environment for investors. The Commission is formulating responses to new threats, including cybersecurity, misconduct affecting retail investors, as well as new opportunities including innovative platforms and promoting investor access to information.

This hearing is timely as I continue working with my colleagues on additional reforms to facilitate capital formation. I look forward to working with you and hearing your thoughts on legislative

changes that would be most helpful to small and mid-sized businesses.

CFTC's mission is to foster open, transparent, competitive, and financially sound markets. To facilitate oversight of the Nation's swaps futures and options markets, CFTC requests \$281.5 million for fiscal year 2019, a \$32.5 million increase over the fiscal year 2018 enacted amount.

Chairman Giancarlo is at the helm with global reform efforts towards swaps data reporting and significant developments in financial technology.

SEC and CFTC as Federal market regulators are charged with establishing a regulatory environment for investors and market participants that fosters innovation, market integrity, and ultimately confidence. And that is not simple to do all three of those. So I appreciate your trying to keep the balance.

We are interested in hearing more about your efforts to defend against cyber threats to investors and financial market infrastructure, as well as to ease regulatory burdens. Your jobs have become even more challenging in the rise of automated trading, constant technological innovation, including areas such as financial technology, or fintech, and the need to operate in markets undergoing digital transformation.

I appreciate both of you being here and your preparation.

Mr. Clayton, your written statement was slightly shorter than "War and Peace," but not much shorter than that. You gave us a tremendous amount of information, and I appreciate you laying all of that out. It was very, very helpful.

Mr. Giancarlo, yours read more like a fiction novel. You had so many great illustrations and ideas in it.

So I appreciate the two pieces of fine literature in your written statements and look forward to the oral testimony in the moments ahead. I thank you both for doing this.

I would turn to my colleague, Senator Van Hollen, for his opening remarks.

#### STATEMENT OF SENATOR CHRIS VAN HOLLEN

Senator VAN HOLLEN. Thank you, Mr. Chairman, and thank you for your leadership, Chairman Lankford.

As you can see, our Ranking Member, Senator Coons, was unable to make it today, but he wanted to extend his best wishes to both of you and his thanks to both of you.

And I share lots of the concerns about issues that were raised by the Chairman.

I thank both of you for being here, look forward to hearing more about your budgets. Both of you have very important responsibilities in your different oversight capacities, and we want to make sure we have the resources available for you both to do your jobs. And so I will have some questions related to your oversight responsibilities, but in terms of an opening statement, just welcome and I look forward to hearing from both of you.

Senator LANKFORD. Thank you.

I was going to mention actually Ranking Member Coons on this as well is under the weather, and I can assure you he would much rather be here than where he is, as far as feeling miserable right

now. But thank you both for being here and we will follow up. He will have questions for the record. Then we will do some follow-up on it in the moments ahead.

Mr. Clayton, why do you not go ahead and begin first with your testimony? We will be glad to be able to receive your testimony now.

SUMMARY STATEMENT OF HON. JAY CLAYTON

Mr. CLAYTON. Thank you, and I will try and give the abridged version.

Chairman Lankford, Senator Van Hollen, Senator Kennedy, thank you for the opportunity to testify before you today about the President's fiscal year 2019 budget request for the SEC.

I am also pleased to be joined by my colleague, CFTC Chairman Giancarlo. We have worked closely together over the past year on a number of issues to improve and strengthen our markets.

On behalf of my fellow commissioners and the 4,500 women and men at the SEC, I would like to thank this subcommittee for its support. Congress' recent fiscal year 2018 funding for the agency will enable the SEC to make significant investments in furtherance of our efforts to modernize our information technology infrastructure and improve our cybersecurity risk profile. I recognize the vote of confidence that you have shown in the SEC, as does our staff. I am committed to ensuring that the agency is a prudent steward of this appropriation.

In my interactions with our staff, it is always clear that they recognize and are motivated by the fact that tens of millions of Americans are invested in our securities markets. The daily touchstone for the SEC staff is the long-term interests of these Americans. In turn, we believe serving these interests furthers America's interests.

Our fiscal year 2019 request of \$1.658 billion for SEC operations will enable the SEC to continue its work in a number of areas with a focus on five important components that I will highlight in a moment.

I will start with a few threshold matters.

First, the request will enable us to start lifting our hiring freeze and support approximately 100 new hires to address current priorities.

Second, the budget request relies on the SEC having continued access to the reserve fund to invest in information technology.

Third, the SEC's funding is deficit neutral, and any amounts appropriated to the agency will be offset by transaction fees.

Let me focus on the five components.

First, information technology (IT) and cybersecurity. With regard to technology and cybersecurity, Congress' enacted fiscal year 2018 appropriation, and our fiscal year 2019 request, will allow the SEC to make improvements to modernize our information technology infrastructure and improve our cybersecurity risk profile. In short, we will use the fiscal year 2018 and fiscal year 2019 funding to advance the implementation of our multiyear IT strategic road map.

Second, capital formation. In facilitating capital formation, we have made progress, but I believe the SEC can and should do more to enhance capital formation in our public and private capital mar-

kets and particularly for mid-sized, small, and emerging companies. Please be assured that as we develop initiatives aimed at promoting access to capital markets, we will also seek to maintain and enhance investor protection. The request will also provide additional resources for staffing of the new Office of the Advocate for Small Business Capital Formation.

Third, protecting Main Street investors. Protecting Main Street investors and preserving their access to investments and opportunities is at the heart of the work of numerous divisions and offices at the Commission. In April, the Commission voted to issue for public comment a comprehensive package of rule making and interpretation designed to address retail investor confusion and improve their relationships with investment professionals. Our rulemaking package would significantly enhance retail investor protection by preserving access in terms of both availability and cost to a variety of types of investment services and investment products. Our rulemaking is designed to serve our Main Street investors, and I hope that we will hear from them during the comment process.

Just yesterday, I had the opportunity to speak with Main Street investors in Houston, Texas, and gained additional valuable insight into what they expect from their relationships with investment professionals. These interactions, along with our experience applying and enforcing our securities laws, are essential to crafting a final rule that, one, aligns investor expectations with legal standards and, two, provides Main Street investors with access to a variety of investment services at a reasonable cost.

Fourth, enforcement, compliance, and inspections. Over 50 percent of our workforce is devoted to enforcement, compliance, and inspections, and our 11 regional offices are primarily devoted to these areas. Our Enforcement Division is committed to protecting our markets and investors, especially from fraud that impacts the most vulnerable. Our budget request will allow for critical investments in our ability to protect investors by supporting key enforcement priorities, including expanding the work of our new Cyber Unit and our new Retail Strategy Task Force. The budget request will also allow for further advances in our examinations of market participants, including investment advisors. We increased our examination of investment advisors by more than 40 percent in fiscal year 2017 to approximately 15 percent of all SEC-registered investment advisors. But we are always seeking improvements in this area.

Fifth and finally, trading and markets. Our trading markets are constantly evolving, expanding, and demanding continuous effort to identify emerging issues and risks. And we strive to ensure that as technology changes, our regulations drive efficiency, integrity, and resilience. Our request will allow our Division of Trading and Markets to expand the agency's depth of expertise in vital areas such as equity and fixed income market surveillance, analysis, clearing agency oversight, broker-dealer operations, cybersecurity, and electronic trading.

Finally, our request supports our participation in the GSA's competitive procurement process for a successor lease for our New York regional office.

In closing, I would like to again thank the subcommittee for its continued support of the SEC, its mission, and its staff.

I look forward to answering any questions you may have.  
[The statement follows:]

PREPARED STATEMENT OF HON. JAY CLAYTON

Chairman Lankford, Ranking Member Coons and Senators of the subcommittee, thank you for the opportunity to testify today on the President's fiscal year 2019 budget request for the U.S. Securities and Exchange Commission (SEC).<sup>1</sup>

It is an honor to appear before this Committee again with my colleague, Commodity Futures Trading Commission (CFTC) Chairman Christopher Giancarlo. Over the past year, we and the staff of our agencies have collaborated on a number of issues to strengthen our markets, including improving our swaps and security-based swap markets. We also are coordinating our efforts to address issues raised by cryptocurrencies, initial coin offerings and related products.<sup>2</sup>

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

These statistics are significant on their face. They are even more significant when viewed in comparison to world markets and demonstrate the importance of our capital markets to America and the American people. Of the world's 100 largest publicly traded companies, 53 are U.S. companies, representing 62 percent of the total market capitalization of those top 100 companies. The U.S. population is approximately 4.4 percent of global population. Our relative contribution to global economy is a remarkable, long-term achievement that has been driven, to a significant extent, by our capital markets. More importantly, at least 51 percent of U.S. households are invested directly or indirectly in our capital markets.<sup>3</sup> This level of retail

<sup>1</sup>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.

<sup>2</sup>See Jay Clayton and J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency*, Wall St. J. (Jan. 24, 2018), available at <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363?mod=searchresults&page=1&pos=2>.

<sup>3</sup>See Jesse Bricker et al (2017), "Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, vol. 103 (September), available at <https://www.Federalreserve.gov/publications/files/scf17.pdf>; see also Rel. No. 34–

investor participation stands out against other large industrialized countries. They want to replicate it because such broad investor participation in our capital markets is a significant competitive advantage for our economy, and our capital markets have made many Americans' lives better. But this level of investor participation should not be taken for granted and has been a decades-long endeavor between the SEC and market participants.

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.

Earlier this year, 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.”<sup>4</sup> 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. 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. 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.<sup>5</sup>

Recently, we launched a new tool designed to enable investors to research whether their financial professional or others offering them investments have a judgment or order entered against them in an enforcement action.<sup>6</sup> The SEC Action Lookup for Individuals—or SALI—provides Main Street investors with additional information they can use to protect themselves from being victims of fraud and other misconduct.

My fellow Commissioners and I also participate in investor education and outreach efforts with military servicewomen and men, seniors and other retail investors. Next week, all five of us, along with staff from across the agency, will be in Atlanta for an investor town hall where Main Street investors can hear directly from, and share feedback with, the Commission on issues important to them.<sup>7</sup>

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.<sup>8</sup> 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

83063, *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles* (Apr. 18, 2018) (for statistics except the mutual fund data); 2017 Investment Company Fact Book (ICI, 57th ed. 2017) (mutual fund statistics).

<sup>4</sup>Presidential Message on National Financial Capability Month (Mar. 30, 2018), available at <https://www.whitehouse.gov/briefings-statements/presidential-message-national-financial-capability-month/>.

<sup>5</sup>See Press Release 2018–88, *The SEC Has an Opportunity You Won't Want to Miss: Act Now!* (May 16, 2018), available at <https://www.sec.gov/news/press-release/2018-88>.

<sup>6</sup>See Press Release 2018–78, *SEC Launches Additional Investor Protection Search Tool* (May 2, 2018), available at <https://www.sec.gov/news/press-release/2018-78>.

<sup>7</sup>See Investing in America: The SEC Comes to You, available at <https://www.sec.gov/investing-america>.

<sup>8</sup>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.

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 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.<sup>9</sup>

#### OUR FISCAL YEAR 2019 BUDGET REQUEST

Our fiscal year 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 fiscal year 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 fiscal year 2019 would enable us to start lifting the hiring freeze that has been in place since late in fiscal year 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, including the Division of Enforcement (17), the Office of Compliance Inspections and Examinations (24), the Division of Trading and Markets (16), the Division of Investment Management (7), the Division of Economic and Risk Analysis (4), the Office of Information Technology (16) and the Advocate for Small Business Capital Formation (5), among others. These 100 positions would result in SEC staffing at approximately the same level as in fiscal year 2014. The fiscal year 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 one cent 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 fiscal year 2019, the fee rate will be set at a level sufficient to collect \$660 million. A portion of these collections will be put into the Reserve Fund, which the agency devotes to information technology improvements, while the remaining funds will be deposited in the general fund of the U.S. Treasury.

#### LEVERAGING TECHNOLOGY, CYBERSECURITY AND RISK MANAGEMENT

Congress's enacted fiscal year 2018 appropriation and our fiscal year 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 fiscal year 2018 and fiscal year 2019 resources to 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 fiscal year 2018 and fiscal year 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.

<sup>9</sup>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 percent of the rules were adopted in each year.

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 coordinate the SEC's efforts to identify, monitor and mitigate risks across our divisions and offices. Last week, we announced an Acting Chief Risk Officer as part of our efforts to maintain a robust program for identifying and addressing risks to the agency's mission while we continue our search to fill this new position on a permanent basis.<sup>10</sup> 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.

While our investigations are not complete, we have taken various steps to reinforce the security of our EDGAR system, 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 fiscal year 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

<sup>10</sup>See Press Release 2018-98, *SEC Names Julie A. Erhardt Acting Chief Risk Officer* (May 31, 2018), available at <https://www.sec.gov/news/press-release/2018-98>.

would also enable funding of multi-year investments to transition legacy information technology systems to modern platforms with improved embedded security features. The fiscal year 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 fiscal year 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 1 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 fiscal year 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 fiscal year 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 fiscal year 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 hire the Advocate, whose mission is to be a resource and voice for small businesses and their investors by pro-

viding 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.

In April, 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.<sup>11</sup> 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

<sup>11</sup>See also *The Evolving Market for Retail Investment Services and Forward-Looking Regulation—Adding Clarity and Investor Protection while Ensuring Access and Choice* (May 2, 2018), available at <https://www.sec.gov/news/speech/speech-clayton-2018-05-02>.

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 who they are dealing with (e.g., what category their investment professional falls into) and, then, what that means and why it matters (e.g., how their investment professional is 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 during the 90 day comment period. In order to provide as much opportunity for that engagement as possible, I also announced several investor roundtables, including in Atlanta, Houston, Denver, and Miami, to hear directly from those the rule is designed to serve—Main Street investors.<sup>12</sup>

The fiscal year 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.<sup>13</sup> 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 re-

<sup>12</sup>See Statement on Public Engagement Regarding Standards of Conduct for Investment Professionals Rulemaking (Apr. 24, 2018), available at <https://www.sec.gov/news/public-statement/public-engagement-standards-conduct-investment-professionals-rulemaking>.

<sup>13</sup>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>.

tail brokerage accounts; and (6) cyber-related threats to trading platforms and other critical market infrastructure.

Our fiscal year 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 advisers, 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 efficiencies, OCIE increased its examination of investment advisers by more than 40 percent in fiscal year 2017 over fiscal year 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 fiscal year 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 5 years running.<sup>14</sup> In 2016, there were nearly 1,400 issues, amounting to \$1.5 trillion, of corporate bonds, and there was over \$8.5 trillion of corporate bonds outstanding.<sup>15</sup> By comparison, in 2006 there was over \$4.8 trillion of corporate bonds outstanding.<sup>16</sup>
- 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.<sup>17</sup>

<sup>14</sup>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>.

<sup>15</sup>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>.

<sup>16</sup>See *id.* at 31.

<sup>17</sup>See *id.* at 58.

—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.<sup>18</sup>

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. In April, 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 fiscal year 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 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 fiscal years 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 fiscal year 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 fiscal year 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 fiscal year 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.

<sup>18</sup>See *id.* at 31.

## Public Statement

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# 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

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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.**<sup>[1]</sup> 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:

- **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 who they are dealing with, i.e., what category — IA, BD, or dual-hatted— their investment professional falls into and, then, what that means and why 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.<sup>[2]</sup>**

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.**

#### 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

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

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

### Related Materials

**§ 240.15l-1 Regulation Best Interest.**

- (a) Best Interest Obligation.
- (1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.
- (2) The best interest obligation in paragraph (a)(1) shall be satisfied if:
- (i) Disclosure Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of such recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest that are associated with the recommendation.
- (ii) Care Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation exercises 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, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.
- (iii) Conflict of Interest Obligations.
- (A) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a

minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations.

- (B) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

(b) *Definitions.* Unless otherwise provided, all terms used in this rule shall have the same meaning as in the [Securities Exchange Act of 1934]. In addition, the following definitions shall apply:

- (1) *Retail Customer* means a person, or the legal representative of such person, who:
  - (A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and
  - (B) Uses the recommendation primarily for personal, family, or household purposes.
- (2) *Retail Customer Investment Profile* includes, but is not limited to, the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.

*Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer  
Prepared By SEC Staff – For Illustrative Purposes Only*

**Which Type of Account is Right for You — Brokerage, Investment Advisory or Both?**

There are different ways you can get help with your investments. You should carefully consider which types of accounts and services are right for you.

Depending on your needs and investment objectives, we can provide you with services in a brokerage account, investment advisory account, or both at the same time. This document gives you a summary of the types of services we provide and how you pay. Please ask us for more information. There are some suggested questions on page 4.

<i>Broker-Dealer Services Brokerage Accounts</i>	<i>Investment Adviser Services Advisory Accounts</i>
<b>Types of Relationships and Services.</b> <i>Our accounts and services fall into two categories.</i>	
<ul style="list-style-type: none"> <li>If you open a brokerage account, you will pay us a <b>transaction-based fee</b>, generally referred to as a commission, every time you buy or sell an investment.</li> <li>You may select investments or we may recommend investments for your account, but the ultimate investment decision for your investment strategy and the purchase or sale of investments will be yours.</li> <li>We can offer you additional services to assist you in developing and executing your investment strategy and monitoring the performance of your account but you might pay more. We will deliver account statements to you each quarter in paper or electronically.</li> <li>We offer a limited selection of investments. Other firms could offer a wider range of choices, some of which might have lower costs.</li> </ul>	<ul style="list-style-type: none"> <li>If you open an advisory account, you will pay an on-going <b>asset-based fee</b> for our services.</li> <li>We will offer you advice on a regular basis. We will discuss your investment goals design with you a strategy to achieve your investment goals, and regularly monitor your account. We will contact you (by phone or e-mail) at least quarterly to discuss your portfolio.</li> <li>You can choose an account that allows us to buy and sell investments in your account without asking you in advance (a <b>“discretionary account”</b>) or we may give you advice and you decide what investments to buy and sell (a <b>“non-discretionary account”</b>).</li> <li>Our investment advice will cover a limited selection of investments. Other firms could provide advice on a wider range of choices, some of which might have lower costs.</li> </ul>
<b>Our Obligations to You.</b> <i>We must abide by certain laws and regulations in our interactions with you.</i>	
<ul style="list-style-type: none"> <li>We must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities. When we provide any service to you, we must treat you fairly and comply with a number of specific obligations. Unless we agree otherwise, we are not required to</li> </ul>	<ul style="list-style-type: none"> <li>We are held to a fiduciary standard that covers our entire investment advisory relationship with you. For example, we are required to monitor your portfolio, investment strategy and investments on an ongoing basis.</li> <li>Our interests can conflict with your interests. We must eliminate these conflicts or tell you</li> </ul>

- SAMPLE FIRM, broker-dealer and investment adviser registered with the Securities and Exchange Commission, April 1, 2018 -

*Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer  
Prepared By SEC Staff – For Illustrative Purposes Only*

<b>Broker-Dealer Services Brokerage Accounts</b>	<b>Investment Adviser Services Advisory Accounts</b>
<p>monitor your portfolio or investments on an ongoing basis.</p> <ul style="list-style-type: none"> <li>• Our interests can conflict with your interests. When we provide recommendations, we must eliminate these conflicts or tell you about them and in some cases reduce them.</li> </ul>	<p>about them in a way you can understand, so that you can decide whether or not to agree to them.</p>
<p><b>Fees and Costs.</b> <i>Fees and costs affect the value of your account over time. Please ask your financial professional to give you personalized information on the fees and costs that you will pay.</i></p>	
<ul style="list-style-type: none"> <li>• <b>Transaction-based fees.</b> You will pay us a fee every time you buy or sell an investment. This fee, commonly referred to as a commission, is based on the specific transaction and not the value of your account.  With stocks or exchange-traded funds, this fee is usually a separate commission. With other investments, such as bonds, this fee might be part of the price you pay for the investment (called a “<b>mark-up</b>” or “<b>mark down</b>”). With mutual funds, this fee (typically called a “<b>load</b>”) reduces the value of your investment.</li> <li>• Some investments (such as mutual funds and variable annuities) impose additional fees that will reduce the value of your investment over time. Also, with certain investments such as variable annuities, you may have to pay fees such as “<b>surrender charges</b>” to sell the investment.</li> <li>• Our fees vary and are negotiable. The amount you pay will depend, for example, on how much you buy or sell, what type of investment you buy or sell, and what kind of account you have with us.</li> <li>• We charge you additional fees, such as custodian fees, account maintenance fees, and account inactivity fees.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Asset-based fees.</b> You will pay an on-going fee at the end of each quarter based on the value of the cash and investments in your advisory account.  The amount paid to our firm and your financial professional generally does not vary based on the type of investments we select on your behalf. The asset-based fee reduces the value of your account and will be deducted from your account.  For some advisory accounts, called <b>wrap fee programs</b>, the asset-based fee will include most transaction costs and custody services, and as a result wrap fees are typically higher than non-wrap advisory fees.</li> <li>• Some investments (such as mutual funds and variable annuities) impose additional fees that will reduce the value of your investment over time. Also, with certain investments such as variable annuities, you may have to pay fees such as “<b>surrender charges</b>” to sell the investment.</li> <li>• Our fees vary and are negotiable. The amount you pay will depend, for example, on the services you receive and the amount of assets in your account.</li> <li>• For accounts not part of the wrap fee program, you will pay a transaction fee when</li> </ul>

*Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer  
Prepared By SEC Staff – For Illustrative Purposes Only*

<b>Broker-Dealer Services Brokerage Accounts</b>	<b>Investment Adviser Services Advisory Accounts</b>
<ul style="list-style-type: none"> <li>• The more transactions in your account, the more fees we charge you. We therefore have an incentive to encourage you to engage in transactions.</li> <li>• From a cost perspective, you may prefer a transaction-based fee if you do not trade often or if you plan to buy and hold investments for longer periods of time.</li> </ul>	<p>we buy and sell an investment for you. You will also pay fees to a broker-dealer or bank that will hold your assets (called “<i>custody</i>”).</p> <p>Although transaction fees are usually included in the wrap program fee, sometimes you will pay an additional transaction fee (for investments bought and sold outside the wrap fee program).</p> <ul style="list-style-type: none"> <li>• The more assets you have in the advisory account, including cash, the more you will pay us. We therefore have an incentive to increase the assets in your account in order to increase our fees. You pay our fee quarterly even if you do not buy or sell.</li> <li>• Paying for a wrap fee program could cost more than separately paying for advice and for transactions if there are infrequent trades in your account.</li> <li>• An asset-based fee may cost more than a transaction-based fee, but you may prefer an asset-based fee if you want continuing advice or want someone to make investment decisions for you. You may prefer a wrap fee program if you prefer the certainty of a quarterly fee regardless of the number of transactions you have.</li> </ul>
<p><b>Conflicts of Interest.</b> <i>We benefit from the services we provide to you.</i></p>	
<ul style="list-style-type: none"> <li>• We can make extra money by selling you certain investments, such as [ ], either because they are managed by someone related to our firm or because they are offered by companies that pay our firm to offer their investments. Your financial professional also receives more money if you buy these investments.</li> <li>• We have an incentive to offer or recommend certain investments, such as [ ], because the manager or sponsor of those investments shares with us revenue it earns on those</li> </ul>	<ul style="list-style-type: none"> <li>• We can make extra money by advising you to invest in certain investments, such as [ ], because they are managed by someone related to our firm. Your financial professional also receives more money if you buy these investments.</li> <li>• We have an incentive to advise you to invest in certain investments, such as [ ], because the manager or sponsor of those investments shares with us revenue it earns on those investments.</li> </ul>

- SAMPLE FIRM, broker-dealer and investment adviser registered with the Securities and Exchange Commission, April 1, 2018 -

*Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer  
Prepared By SEC Staff – For Illustrative Purposes Only*

<b>Broker-Dealer Services Brokerage Accounts</b>	<b>Investment Adviser Services Advisory Accounts</b>
<p>investments.</p> <ul style="list-style-type: none"> <li>We can buy investments from you, and sell investments to you, from our own accounts (called “<i>acting as principal</i>”). We can earn a profit on these trades, so we have an incentive to encourage you to trade with us.</li> </ul>	<ul style="list-style-type: none"> <li>We can buy investments from you, and sell investments to you, from our own accounts (called “<i>acting as principal</i>”), <b>but only with your specific approval on each transaction.</b> We can earn a profit on these trades, so we have an incentive to encourage you to trade with us.</li> </ul>
<p><b>Additional Information.</b> We encourage you to seek out additional information.</p>	
<ul style="list-style-type: none"> <li>We have legal and disciplinary events. Visit <a href="http://Investor.gov">Investor.gov</a> for a free and simple search tool to research our firm and our financial professionals.</li> <li>For additional information about our brokers and services, visit <a href="http://Investor.gov">Investor.gov</a> or <a href="http://BrokerCheck(BrokerCheck.Finra.org)">BrokerCheck (BrokerCheck.Finra.org)</a>, our website (<a href="http://SampleFirm.com">SampleFirm.com</a>), and your account agreement. For additional information on advisory services, see our Form ADV brochure on IAPD, on <a href="http://Investor.gov">Investor.gov</a>, or on our website (<a href="http://SAMPLEFirm.com/FormADV">SAMPLEFirm.com/FormADV</a>) and any brochure supplement your financial professional provides.</li> <li>To report a problem to the SEC, visit <a href="http://Investor.gov">Investor.gov</a> or call the SEC’s toll-free investor assistance line at (800) 732-0330. To report a problem to FINRA, [ ]. If you have a problem with your investments, account or financial professional, contact us in writing at [ ].</li> </ul>	
<p><b>Key Questions to Ask.</b> Ask our financial professionals these key questions about our investment services and accounts.</p>	
<ol style="list-style-type: none"> <li>Given my financial situation, why should I choose an advisory account? Why should I choose a brokerage account?</li> <li>Do the math for me. How much would I expect to pay per year for an advisory account? How much for a typical brokerage account? What would make those fees more or less? What services will I receive for those fees?</li> <li>What additional costs should I expect in connection with my account?</li> <li>Tell me how you and your firm make money in connection with my account. Do you or your firm receive any payments from anyone besides me in connection with my investments?</li> <li>What are the most common conflicts of interest in your advisory and brokerage accounts? Explain how you will address those conflicts when providing services to my account.</li> <li>How will you choose investments to recommend for my account?</li> <li>How often will you monitor my account’s performance and offer investment advice?</li> <li>Do you or your firm have a disciplinary history? For what type of conduct?</li> <li>What is your relevant experience, including your licenses, education, and other qualifications? Please explain what the abbreviations in your licenses are and what they mean.</li> <li>Who is the primary contact person for my account, and is he or she a representative of an investment adviser or a broker-dealer? What can you tell me about his or her legal obligations to me? If I have concerns about how this person is treating me, who can I talk to?</li> </ol>	

*Hypothetical Relationship Summary for a Registered Broker-Dealer  
Prepared By SEC Staff – For Illustrative Purposes Only*

### **Is A Brokerage Account Right For You?**

There are different ways you can get help with your investments. You should carefully consider which types of accounts and services are right for you.

**We are a broker-dealer and provide brokerage accounts and services rather than advisory accounts and services.** This document gives you a summary of the types of services we provide and how you pay. Please ask us for more information. There are some suggested questions on page 4.

<p><b>Relationships and Services.</b></p> <ul style="list-style-type: none"> <li>• If you open a brokerage account, you will pay us a <b>transaction-based fee</b>, generally referred to as a commission, every time you buy or sell an investment.</li> <li>• You may select investments or we may recommend investments for your account, but the ultimate investment decision as to your investment strategy and the purchase or sale of investments will be yours.</li> <li>• We can offer you additional services to assist you in developing and executing your investment strategy and monitoring the performance of your account but you might pay more. We will deliver account statements to you each quarter in paper or electronically.</li> <li>• We offer a limited selection of investments. Other firms could offer a wider range of choices, some of which might have lower costs.</li> </ul>
<p><b>Our Obligations to You.</b> <i>We must abide by certain laws and regulations in our interactions with you.</i></p> <ul style="list-style-type: none"> <li>• We must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities. When we provide any service to you, we must treat you fairly and comply with a number of specific obligations. Unless we agree otherwise, we are not required to monitor your portfolio or investments on an ongoing basis.</li> <li>• Our interests can conflict with your interests. When we provide recommendations, we must eliminate these conflicts or tell you about them and in some cases reduce them.</li> </ul>

- SAMPLE FIRM, a broker-dealer registered with the Securities and Exchange Commission,

April 1, 2018 -

**Fees and Costs.** *Fees and costs affect the value of your account over time. Please ask your financial professional to give you personalized information on the fees and costs that you will pay.*

- The fee you pay is based on the specific transaction and not the value of your account.
- With stocks or exchange-traded funds, this fee is usually a separate commission. With other investments, such as bonds, this fee might be part of the price you pay for the investment (called a “**mark-up**” or “**mark down**”). With mutual funds, this fee (typically called a “**load**”) reduces the value of your investment.
- Some investments (such as mutual funds and variable annuities) impose additional fees that will reduce the value of your investment over time. Also, with certain investments such as variable annuities, you may have to pay fees such as “**surrender charges**” to sell the investment.
- Our fees vary and are negotiable. The amount you pay will depend, for example, on how much you buy or sell, what type of investment you buy or sell, and what kind of account you have with us.
- We charge you additional fees, such as custodian fees, account maintenance fees, and account inactivity fees.
- The more transactions in your account, the more fees we charge you. We therefore have an incentive to encourage you to engage in transactions.

**Compare with Typical Advisory Accounts.**

You could also open an advisory account with an *investment adviser*, where you will pay an ongoing **asset-based fee** that is based on the value of the cash and investments in your advisory account. Features of a typical advisory account include:

- Advisers provide advice on a regular basis. They discuss your investment goals, design with you a strategy to achieve your investment goals, and regularly monitor your account.
- You can choose an account that allows the adviser to buy and sell investments in your account without asking you in advance (a “**discretionary account**”) or the adviser may give you advice and you decide what investments to buy and sell (a “**non-discretionary account**”).
- Advisers are held to a fiduciary standard that covers the entire investment advisory relationship. For example, advisers are required to monitor your portfolio, investment strategy and investments on an ongoing basis.

- If you were to pay an asset-based fee in an advisory account, you would pay the fee periodically even if you do not buy or sell. You may also choose to work with an investment adviser who provides investment advice for an hourly fee, or provides a financial plan for a one-time fee.
- For an adviser that charges an asset-based fee, the more assets you have in an advisory account, including cash, the more you will pay the adviser. So the adviser has an incentive to increase the assets in your account in order to increase its fees.
- You can receive advice in either type of account, but you may prefer paying:

<p><i>an asset-based fee</i> if you want continuing advice or want someone to make investment decisions for you, even though it may cost more than a transaction-based fee.</p>	<p><i>a transaction-based fee</i> from a cost perspective, if you do not trade often or if you plan to buy and hold investments for longer periods of time.</p>
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**Conflicts of Interest.** *We benefit from our recommendations to you.*

- We can make extra money by selling you certain investments, such as [ ], either because they are managed by someone related to our firm or because they are offered by companies that pay our firm to sell their investments. Your financial professional also receives more money if you buy these investments.
- We have an incentive to offer or recommend certain investments, such as [ ], because the manager or sponsor of those investments shares with us revenue it earns on those investments.
- We can buy investments from you, and sell investments to you, from our own accounts (called "*acting as principal*"). We can earn a profit on these trades, so we have an incentive to encourage you to trade with us.

**Additional Information.** *We encourage you to seek additional information.*

- We have legal and disciplinary events. Visit Investor.gov for a free and simple search tool to research our firm and our financial professionals.
- For additional information about our brokers and services, visit Investor.gov, BrokerCheck (BrokerCheck.Finra.org), our web site (SampleFirm.com), and your account agreement.
- To report a problem to the SEC, visit Investor.gov or call the SEC's toll-free investor

assistance line at (800) 732-0330. To report a problem to FINRA, [ ]. If you have a problem with your investments, account or financial professional, contact us in writing at [ ].

**Key Questions to Ask.** *Ask our financial professionals these key questions about our investment services and accounts.*

1. Given my financial situation, why should I choose a brokerage account?
2. Do the math for me. How much would I pay per year for a typical brokerage account? What would make those fees more or less? What services will I receive for those fees?
3. What additional costs should I expect in connection with my account?
4. Tell me how you and your firm make money in connection with my account. Do you or your firm receive any payments from anyone besides me in connection with my investments?
5. What are the most common conflicts of interest in your brokerage accounts? Explain how you will address those conflicts when providing services to my account.
6. How will you choose investments to recommend for my account?
7. How often will you monitor my account's performance and offer investment advice?
8. Do you or your firm have a disciplinary history? For what type of conduct?
9. What is your relevant experience, including your licenses, education, and other qualifications? Please explain what the abbreviations in your licenses are and what they mean.
10. Who is the primary contact person for my account? What can you tell me about his or her legal obligations to me? If I have concerns about how this person is treating me, who can I talk to?

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### **Is An Investment Advisory Account Right For You?**

There are different ways you can get help with your investments. You should carefully consider which types of accounts and services are right for you.

**We are an investment adviser and provide advisory accounts and services rather than brokerage accounts and services.** This document gives you a summary of the types of services we provide and how you pay. Please ask us for more information. There are some suggested questions on page 3.

<p><b>Relationships and Services.</b></p> <ul style="list-style-type: none"> <li>• If you open an advisory account, you will pay an on-going <i>asset-based fee</i> at the end of each quarter for our services, based on the value of the cash and investments in your advisory account.</li> <li>• We will offer you advice on a regular basis. We will discuss your investment goals, design with you a strategy to achieve your investment goals, and regularly monitor your account. We will contact you (by phone or e-mail) at least quarterly to discuss your portfolio.</li> <li>• You can choose an account that allows us to buy and sell investments in your account without asking you in advance (a “<i>discretionary account</i>”) or we may give you advice and you decide what investments to buy and sell (a “<i>non-discretionary account</i>”).</li> <li>• Our investment advice will cover a limited selection of investments. Other firms could provide advice on a wider range of choices, some of which might have lower costs.</li> </ul>
<p><b>Our Obligations to You.</b> <i>We must abide by certain laws and regulations in our interactions with you.</i></p> <ul style="list-style-type: none"> <li>• We are held to a fiduciary standard that covers our entire investment advisory relationship with you. For example, we are required to monitor your portfolio, investment strategy, and investments on an ongoing basis.</li> <li>• Our interests can conflict with your interests. We must eliminate these conflicts or tell you about them in a way you can understand, so that you can decide whether or not to agree to them.</li> </ul>

- SAMPLE FIRM, an investment adviser registered with the Securities and Exchange Commission, April 1, 2018 -

**Fees and Costs.** *Fees and costs affect the value of your account over time. Please ask your financial professional to give you personalized information on the fees and costs that you will pay.*

- The amount paid to our firm and your financial professional generally does not vary based on the type of investments we select on your behalf. The asset-based fee reduces the value of your account and will be deducted from your account.
- Some investments (such as mutual funds and variable annuities) impose additional fees that will reduce the value of your investment over time. Also, with certain investments such as variable annuities, you may have to pay fees such as “*surrender charges*” to sell the investment.
- Our fees vary and are negotiable. The amount you pay will depend, for example, on the services you receive and the amount of assets in your account.
- You will pay a transaction fee when we buy and sell an investment for you. You will also pay fees to a broker-dealer or bank that will hold your assets (called “*custody*”).
- The more assets you have in the advisory account, including cash, the more you will pay us. We therefore have an incentive to increase the assets in your account in order to increase our fees. You pay our fee quarterly even if you do not buy or sell.

**Compare with Typical Brokerage Accounts.**

You could also open a brokerage account with a *broker-dealer*, where you will pay a *transaction-based fee*, generally referred to as a commission, when the broker-dealer buys or sells an investment for you. Features of a typical brokerage account include:

- With a broker-dealer, you may select investments or the broker-dealer may recommend investments for your account, but the ultimate decision for your investment strategy and the purchase and sale of investments will be yours.
- A broker-dealer must act in your best interest and not place its interests ahead of yours when the broker-dealer recommends an investment or an investment strategy involving securities. When a broker-dealer provides any service to you, the broker-dealer must treat you fairly and comply with a number of specific obligations. Unless you and the broker-dealer agree otherwise, the broker-dealer is not required to monitor your portfolio or investments on an ongoing basis.
- If you were to pay a transaction-based fee in a brokerage account, the more trades in your account, the more fees the broker-dealer charges you. So it has an incentive to encourage you to trade often.
- You can receive advice in either type of account, but you may prefer paying:

<p><b>a transaction-based fee</b> from a cost perspective, if you do not trade often or if you plan to buy and hold investments for longer periods of time.</p>	<p><b>an asset-based fee</b> if you want continuing advice or want someone to make investment decisions for you, even though it may cost more than a transaction-based fee.</p>
<p><b>Conflicts of Interest.</b> <i>We benefit from the advisory services we provide to you.</i></p>	
<ul style="list-style-type: none"> <li>• We can make extra money by advising you to invest in certain investments, such as [ ], because they are managed by someone related to our firm. Your financial professional also receives more money if you buy these investments.</li> <li>• We have an incentive to advise you to invest in certain investments, such as [ ], because the manager or sponsor of those investments shares with us revenue it earns on those investments.</li> <li>• We can buy investments from you, and sell investments to you, from our own accounts (called "<b>acting as principal</b>"), <b>but only with your specific approval on each transaction.</b> We can earn a profit on these trades, so we have an incentive to encourage you to trade with us.</li> </ul>	
<p><b>Additional Information.</b> <i>We encourage you to seek additional information.</i></p>	
<ul style="list-style-type: none"> <li>• We have legal and disciplinary events. Visit Investor.gov for a free and simple search tool to research our firm and our financial professionals.</li> <li>• For additional information on our advisory services, see our Form ADV brochure on IAPD on Investor.gov or on our website (SampleFirm.com/FormADV) and any brochure supplement your financial professional provides.</li> <li>• To report a problem to the SEC, visit Investor.gov or call the SEC's toll-free investor assistance line at (800) 732-0330. If you have a problem with your investments, account or financial professional, contact us in writing at [ ].</li> </ul>	
<p><b>Key Questions to Ask.</b> <i>Ask our financial professionals these key questions about our investment services and accounts.</i></p>	
<ol style="list-style-type: none"> <li>1. Given my financial situation, why should I choose an advisory account?</li> <li>2. Do the math for me. How much would I pay per year for an advisory account? What would make those fees more or less? What services will I receive for those fees?</li> <li>3. What additional costs should I expect in connection with my account?</li> <li>4. Tell me how you and your firm make money in connection with my account. Do you or your firm receive any payments from anyone besides me in connection with my</li> </ol>	

investments?

5. What are the most common conflicts of interest in your advisory accounts? Explain how you will address those conflicts when providing services to my account.
6. How will you choose investments to recommend for my account?
7. How often will you monitor my account's performance and offer investment advice?
8. Do you or your firm have a disciplinary history? For what type of conduct?
9. What is your relevant experience, including your licenses, education, and other qualifications? Please explain what the abbreviations in your licenses are and what they mean.
10. Who is the primary contact person for my account? What can you tell me about his or her legal obligations to me? If I have concerns about how this person is treating me, who can I talk to?

Senator LANKFORD. Thank you.  
Mr. Giancarlo.

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#### COMMODITY FUTURES TRADING COMMISSION

##### STATEMENT OF HON. J. CHRISTOPHER GIANCARLO, CHAIRMAN

Mr. GIANCARLO. Thank you, Chairman Lankford, Senator Van Hollen, Senator Kennedy, and Members of the subcommittee. I appreciate the opportunity to appear today along with SEC Chairman Jay Clayton who has become an important regulatory counterpart to us at the CFTC.

For more than a century, Americans have relied on U.S. derivative markets to stabilize the cost of living. These markets allow farmers and ranchers to hedge production costs and delivery prices. They are the reason shoppers enjoy stable prices not only in the supermarket but in all matter of consumer finance from auto loans to household purchases. Derivative markets influence and set the price of availability of heating in homes, energy used in factories, interest rates borrowers pay on home mortgages, and returns workers earn on retirement savings.

And not just consumers. More than 90 percent of Fortune 500 companies use derivatives to manage commercial or market risk in their worldwide business operations. Derivatives allow the risks of variable production costs such as the price of raw materials, energy, foreign currency, and interest rates to be transferred from those who cannot afford them to those who can.

In short, derivatives serve the needs of society to help moderate price, supply, and other commercial risks to free up capital for economic growth, job creation, and prosperity. While often derided in the tabloid press as risky, derivatives, when used properly, are tools for efficient price discovery and risk transfer and risk reduction. It has been estimated that the use of commercial derivatives added 1.1 percent to the size of the U.S. economy between 2003 and 2012.

American derivative markets are the world's largest, most developed, and most influential. Many key agricultural, mineral, and energy commodities are priced in U.S. derivative markets. So are key

financial products like interest rates and foreign exchange that take friction out of the global economy's system of floating exchange rates.

The United States is the only major economy to have a regulatory agency specifically dedicated to derivative market regulation, and that is the CFTC. And the agency is recognized around the world for its depth of expertise and breadth of capability.

This regulatory competency is one of the reasons why U.S. derivative markets continue to serve the needs of participants all around the globe. Well regulated U.S. derivative markets give the American economy a competitive advantage, and that is dollar pricing of the most important global commodities. And these markets underpin the U.S. dollar as the world's primary reserve currency.

Now, this advantage is well recognized by competing economies around the world. Earlier this year, the Shanghai International Energy Exchange allowed non-Chinese market participants to trade its yuan-denominated crude oil contract for the first time. A few weeks later, China opened its yuan-denominated iron ore contract to international traders, and there is also talk about allowing international market participants to trade Chinese futures contracts in fuel oil, copper, and even soybeans.

The opening of Chinese futures markets to international participation is part of a long-term strategy to expand China's influence over the pricing of key industrial, agricultural, and other commodities. This has competitive implications for the United States. We can be complacent no longer about the historical primacy of our derivative markets. We must make sure that U.S. markets are unrivaled in their openness, orderliness, and liquidity.

And to do so, they must continue to be well regulated by an adequately funded U.S. regulator. Good regulation is our competitive advantage. The CFTC must have suitable resources to continue to supervise the world's most open, transparent, competitive, innovative, and financially sound derivative markets in the world. Full funding of the CFTC's budget request will support its mission to serve this vital national interest.

Our fiscal year 2019 budget, which I promise you, Chairman, is not fiction, reflects the true needs of a policy-setting and civil law enforcement agency. It is bare bones, no waste, fiscally conservative, and mindful of taxpayer dollars. It is based on a rigorous review of the agency's functions and expenditures. It broadly assesses key areas of market innovation and financial technology, cybersecurity, cryptocurrencies and assets, econometric capability, clearinghouse supervision, monitoring of systemic risk, and vigorous enforcement.

I humbly ask, Senators, for the tools to do our job to oversee the markets that Americans rely on each day. With the proper balance of sound policy, regulatory oversight, and hard work, America's deep, liquid, and sensibly regulated derivative markets will continue to meet the challenges of increased global competition in a new digital world to ensure a healthy U.S. economy where our citizens can flourish.

Thank you.

[The statement follows:]

## PREPARED STATEMENT OF HON. J. CHRISTOPHER GIANCARLO

## INTRODUCTION

Thank you, Chairman Lankford, Ranking Member Coons, and Members of the subcommittee. I appreciate the opportunity to appear before you today, along with my fellow colleague from the Securities and Exchange Commission (SEC), Chairman Jay Clayton.

For more than a century, Americans have relied on U.S. derivatives markets to stabilize the cost of living. These markets allow farmers and ranchers to hedge production costs and delivery prices so that consumers can always find plenty of food on grocery store shelves. They are the reason why American consumers enjoy stable prices, not only in the supermarket, but in all manner of consumer finance from auto loans to household purchases. Derivatives markets influence the price and availability of heating in American homes, the energy used in factories, the interest rates borrowers pay on home mortgages, and the returns workers earn on their retirement savings.

And not just consumers. More than 90 percent of Fortune 500 companies use derivatives to manage commercial or market risk in their worldwide business operations.<sup>1</sup> These markets allow the risks of variable production costs, such as the price of raw materials, energy, foreign currency, and interest rates, to be transferred from those who cannot afford them to those who can.

Even Americans not actively participating in commodity derivatives markets are affected by the prices generated by them. Commodity derivatives markets provide a critical source of information about future harvest prices. For example, a grain elevator uses the futures market as the basis for the price it offers local farmers at harvest. In return, farmers look to exchange prices to determine for themselves whether they are getting fair value for their crop. The U.S. Department of Agriculture (USDA) uses that same information to make price projections, determine volatility measures, and make payouts on crop insurance.<sup>2</sup>

In short, derivatives serve the needs of American society to help moderate price, supply and other commercial risks to free up capital for economic growth, job creation and prosperity. While often derided in the tabloid press as “risky,” derivatives—when used properly—are tools for efficient risk transfer and mitigation. It has been estimated that the use of commercial derivatives added 1.1 percent to the size of the U.S. economy between 2003 and 2012.<sup>3</sup>

American derivatives markets are the world’s largest, most developed, and most influential. Many of the world’s most important agricultural, mineral, and energy commodities are priced in U.S. dollars in the U.S. derivatives markets. Dollar pricing of the world’s commodities provides a tremendous advantage to American producers in global commerce, an advantage well recognized by competing economies abroad.

American derivatives markets are also the world’s best regulated. The United States is the only major country in the Organization for Economic Co-operation and Development to have a regulatory agency specifically dedicated to derivatives market regulation: the Commodity Futures Trading Commission (CFTC). The CFTC has overseen the U.S. exchange-traded derivatives markets for over 40 years. The agency is recognized for its principles-based regulatory framework and econometrically-driven analysis. The CFTC is recognized around the world for its depth of expertise and breadth of capability.

<sup>1</sup>See International Swaps and Derivatives Association, *2009 ISDA Derivatives Usage Survey*, ISDA Research Notes, No. 2 (Spring 2009), at 1–5, available at <https://www.isda.org/a/SSiDE/isda-research-notes2.pdf>.

<sup>2</sup>*E.g.*, USDA, Informational Memorandum: PM–17–012, *2017 Crop Year (CY) Common Crop Insurance Policy and Area Risk Protection Insurance Projected Prices and Volatility Factors; Malting Barley Endorsement Projected Price Component and Volatility Factor; and Hybrid Seed Price Endorsement—Hybrid Seed Corn Prices* (Mar. 1, 2017), available at <https://www.rma.usda.gov/bulletins/pm/2017/17-012.pdf>.

<sup>3</sup>The Milken Institute found the following economic benefits to the U.S. economy from derivatives: “[b]anks’ use of derivatives, by permitting greater extension of credit to the private sector, increased U.S. quarterly real GDP by about \$2.7 billion each quarter from Q1 2003 to Q3 2012; [d]erivatives use by non-financial firms increased U.S. quarterly real GDP by about \$1 billion during the same period by improving their ability to undertake capital investments; [c]ombined, derivatives expanded U.S. real GDP by about \$3.7 billion each quarter; [t]he total increase in economic activity was 1.1 percent (\$149.5 billion) between 2003 and 2012; [b]y the end of 2012, employment had been boosted by 530,400 (0.6 percent) and industrial production 2.1 percent.” See Apanard Prabha *et al.*, *Deriving the Economic Impact of Derivatives*, Milken Institute, at 1 (Mar. 2014), available at <http://assets1b.milkeninstitute.org/assets/Publication/ResearchReport/PDF/Derivatives-Report.pdf>.

This combination of regulatory expertise and competency is one of the reasons why U.S. derivatives markets continue to serve the needs of participants around the globe to hedge price and supply risk safely and efficiently. It is why well-regulated U.S. derivatives markets continue to serve a vital national interest—Dollar pricing of important global commodities.

In short, America's well-regulated derivatives markets are a national advantage in global economic competition. However, we must not take this advantage for granted. In order for U.S. derivatives markets to remain the world's best, U.S. markets must remain the world's best regulated. To be the best regulated, U.S. derivatives markets must have an adequately funded regulator. The CFTC must have adequate resources to continue to serve its mission to foster open, transparent, competitive, and financially sound U.S. derivatives markets that remain the envy of the world.

Today, I look forward to discussing the CFTC's resource requirements.

#### BUDGET REQUEST

The fiscal year 2019 budget submitted by the Commission reflects the true needs of a policy setting and civil law enforcement agency that has the duty to ensure the derivatives markets operate effectively and the public is protected from harm. As the workload of the CFTC has increased dramatically—exponentially—and globally—over the last 4 years, we have been flat-lined in our budget—at \$250 million in three of those years—and actually experienced a budget reduction of \$1 million this year. Even with the cuts to our budget, it is still incumbent upon us to evolve into a 21st century regulator because the demands on our agency from the markets don't stop as a result of budget cuts. In fact, those demands constantly increase.

In order for the CFTC to fulfill its duty to oversee these vital derivatives markets in fiscal year 2019, the Commission is requesting \$281.5 million and 716 full-time equivalents (FTE). This is an increase of \$32.5 million and 46 FTE over the resources provided in the fiscal year 2018 enacted budget<sup>4</sup> and is the same level of funding that the Commission requested in fiscal year 2018.

The Commission's budget request for fiscal year 2019 reflects and builds on the efforts commenced in 2018. The budget request of \$281.5 million is the level of funding necessary to fulfill the CFTC's statutory mission.

The CFTC budget request is bare-bones, no waste, fiscally conservative, and mindful of taxpayer dollars. It is based on a rigorous analysis of each of the agency's functions and expenditures. As with fiscal year 2018, we built the 2019 budget based upon the real needs of the Commission. Each dollar of this budget serves a specific purpose in pursuit of the agency's mission.

During the budgeting process, we identified ways that the agency could be more efficient. Today, we are implementing changes necessary to realize those efficiencies. Departments are being reorganized and streamlined to increase productivity and provide long-term cost savings. We have also successfully negotiated the return of an entire floor of vacant office space in Kansas City back to our landlord. It will result in significant savings over the remaining life of the Kansas City lease. Going forward, we are committed to working with the General Services Administration in connection with all of the CFTC's regional office leases upon their expiration.

In all matters of agency budgeting and expenditure, we seek to carry out the mission to foster open, transparent, competitive and financially sound markets, free from fraud and manipulation, in a way that best fosters broad-based economic growth and prosperity while respecting the American taxpayer through careful management of our agency resources.

There are areas where the modest increase in the agency's budget that has been requested is necessary to fulfill the CFTC's statutory mission.

#### 21ST CENTURY FINANCIAL MARKETS

Today, we meet at a tipping point. The future is devouring the past, forging a new agenda, and threatening to move ahead of regulators, financial institutions, and government. That is why we need 21st century regulation for a 21st century world.

Technology is leading us into a world that is much different than the world we knew 5 or 10 years ago, much less when the Commission was created in 1975. Much of our world today—from information to journalism to music to manufacturing to transportation to commerce to agriculture, even legal services—is undergoing a digital transformation. It therefore should be no surprise then that our financial markets are going through the same digital revolution.

<sup>4</sup> Consolidated Appropriations Act, 2018, Public Law 115–141.

Technology is impacting trading, markets, and the entire financial landscape with far-ranging implications for capital formation and risk transfer. These technologies include machine learning and artificial intelligence, algorithm-based trading, data analytics, “smart” contracts valuing themselves and calculating payments in real-time and distributed ledger technologies, which over time may come to challenge traditional market infrastructure.

It is no surprise that these technologies are having an equally transformative impact on U.S. derivatives markets. One thing is certain: ignoring these changes in the market would be profoundly imprudent. They will not go away. Rather, the rate of change will accelerate.<sup>5</sup> Nor is ignorance a responsible regulatory strategy. We cannot respond in a reactive way—chasing to catch up with technology. We must be proactive with a regulatory and statutory framework that is ahead of the curve, gives clarity and coherence to this often complex technology, and anticipates its evolution. The same technology can give us advantages in market regulation.

Our task, as market regulators, is to set and enforce rules that foster innovation while promoting market integrity and confidence. To do so, we must have the resources and tools to keep pace with rapid evolution of the markets we oversee. Our budget request provides those resources and tools.

Among other things, our requested budget will also allow us to address market-enhancing innovation and financial technology (FinTech). LabCFTC is the focal point of the CFTC’s efforts to engage with FinTech innovation for the benefit of the American public. It helps us keep pace with changes in our markets, and proactively identify emerging regulatory opportunities, challenges and risks. We have situated LabCFTC within the CFTC’s Office of the General Counsel. This allows LabCFTC to leverage the expertise of the CFTC’s legal team to manage the interface between technological innovation, regulatory modernization, and existing rules and regulations.

LabCFTC has hosted innovators across the Nation, ranging from startups to established financial institutions to leading technology companies. These outreach efforts are designed to make the CFTC more accessible to FinTech innovators, and to serve as a platform for informing the Commission’s understanding of emerging technologies. The information gathered in these meetings also provides important insights to CFTC staff on market innovations that may influence policy development.

In fact, through its engagement with—and study of—innovative technologies, LabCFTC was recently able to recommend new virtual currency surveillance tools to our Enforcement division. Our Enforcement team has been able to avail itself of this new technology and is now able to enhance certain surveillance and enforcement activities. This important development helps underscore the value of LabCFTC, and its effort to ensure that we are prepared to be a 21st century digital regulator.

In addition to LabCFTC’s domestic activities, the Commission continues to proactively work with international regulators on FinTech applications to coordinate approaches and to share best practices. In February of this year the CFTC and the UK’s Financial Conduct Authority (FCA) entered into an arrangement to collaborate and support innovative firms through each other’s FinTech initiatives—LabCFTC and FCA Innovate. This is the first FinTech innovation arrangement for the CFTC with a non-U.S. counterpart. We believe that by collaborating with the best-in-class FCA FinTech team, the CFTC can contribute to the growing awareness of the critical role of regulators in 21st century digital markets.

#### CYBER SECURITY

Cyber security is critically important to protecting infrastructure and financial markets around the world. In fact, it may well be the most important single issue facing our markets today in terms of market integrity and financial stability.

As market leaders and regulators, we must take every step possible to thwart cyber-attacks that have become a continuous threat to U.S. financial markets. Responding to this threat must take priority requiring more of our resources in fiscal year 2019. Our understanding of the cyber threat must develop in pace with the constant evolution of the threat itself. As we learn, we must engage in discussions with the DCOs about their cyber defenses and threat resiliency and recovery. It is through the oversight and examination of systems safeguards that the Commission

<sup>5</sup>See, e.g., Tyler Wells Lynch, *Moore’s Law and the Future of Information Technology*, REVIEWED, Sept. 3, 2013 (Moore’s Law claims that the number of transistors that can fit into a single microchip, or integrated circuit, doubles roughly every 18 months), available at <http://www.reviewed.com/features/moore-s-law-and-the-future-of-information-technology>.

helps to ensure that DCOs are prioritizing cyber security activities. With this budget request, the CFTC will be able to better undertake its duties to oversee cyber defense capabilities in the markets we regulate.

The same vulnerabilities hold true in the case of futures commission merchants where customer accounts hold records and information that requires protection. We as an agency will work hard to ensure that regulated entities live up to their responsibility to ensure their IT systems are adequately protected from attacks and customers are protected.

As an agency, the Commission is faced with growing pressure to protect terabytes of data and maintain compliance with the Federal Information Security Modernization Act and Office of Management and Budget mandates. Protecting our information comes with a price. Some of the requested funding will enable us to enhance our internal cyber security including implementing additional cyber attack sensors and defenses to further protect the market data we collect.

#### OVERSIGHT OF VIRTUAL CURRENCIES

In fiscal year 2018, certain exchanges self-certified several new contracts for futures products for virtual currencies. These innovations impact the regulatory landscape and with this budget request, the Commission will invest more in new technologies and tools that support important surveillance and enforcement efforts.

Under the CEA, Commission regulations, and related guidance, exchanges have the responsibility to ensure that their Bitcoin futures products and their cash-settlement process are not readily susceptible to manipulation, and DCOs have the responsibility of risk management to ensure that the products are sufficiently margined. The CFTC has the authority to ensure compliance with both. In addition, the CFTC has legal authority over virtual currency derivatives in support of anti-fraud and manipulation including enforcement authority in the underlying markets.

Recently, CFTC staff issued an advisory<sup>6</sup> giving registered exchanges and clearinghouses guidance for listing virtual currency derivative products. The guidance will help ensure that market participants follow appropriate governance processes with respect to the launch of these products. It clarifies CFTC staff's priorities and expectations in its review of new virtual currency derivatives to be listed on a designated contract market or swap execution facility, or to be cleared by a DCO. The advisory should help exchanges and clearinghouses effectively and efficiently discharge their statutory and self-regulatory responsibilities, while keeping pace with the unique challenges of emerging virtual currency derivatives.

The CFTC has been in close communication with the SEC with respect to policy and jurisdictional considerations, and in connection with our recent enforcement cases. We have also been working with the U.S. Treasury and the Financial Stability Oversight Council. In addition, we have been in communication with our foreign counterparts through bilateral discussions and through international bodies like the International Organization of Securities Commissions.

#### ECONOMIC MODELING AND ECONOMETRIC CAPABILITIES

The budget request, if met, would boost the CFTC's ability to monitor systemic risk in the derivatives markets by increasing both its analytical expertise and its capacity to process and study the voluminous data provided by market participants since the passage of the Dodd-Frank Act. These investments will allow for the expansion of sophisticated quantitative and econometric analyses that are necessary for risk modeling, stress tests, and other stability-related evaluations, especially with respect to central counterparty clearinghouses. These analyses will, in addition, enhance the quality of CFTC policy development, rulemaking and cost-benefit considerations.

#### AGENCY REFORM AND THE KISS PROJECT

Since becoming Chairman, I have made efforts to normalize operations and practices, and found opportunities to reinvest and maximize current resources. That means a return to greater care and precision in rule drafting; more thorough econometric analysis; and a reduced docket of new rules and regulations to be absorbed by market participants.

The KISS initiative launched last March included a review of rules and processes, and the invitation for public comment to collect ideas on how the CFTC can be a more effective regulator. The effort has produced a tiered list of significant actions

<sup>6</sup>CFTC Staff Issues Advisory for Virtual Currency Products, May 21, 2018.

that will lessen regulatory burdens.<sup>7</sup> Recently, the agency unanimously approved an amendment replacing the complex and confusing lettering for defined terms with a simple alphabetical list.<sup>8</sup> The replacement will remove unnecessary complexity from our rules and should help make regulatory compliance less burdensome.

Internally, we have embraced the administration's Reform Plan concept and have implemented in-depth organizational reviews to ensure that the agency is staffed to provide the most effective services to the American taxpayer. This ongoing effort has already borne results. We are now leveraging knowledge gained from enforcement actions and surveillance efforts to enable the provision of more efficient and timely consumer education materials to the public. The Primer on Virtual Currency, Bitcoin webpage, and podcasts are just a few of the initiatives resulting from these efforts.

#### SWAPS REFORM

We now have more than 4 years of U.S. experience with the current CFTC regulatory framework for swaps and have learned from its varied strengths and shortcomings. Four years provides a significant sample size to evaluate the effects of these reforms and their implementation. Based on a careful analysis of that data and experience, we are in position to address flaws, recalibrate imprecision and optimize measures in the CFTC's initial implementation of swaps market reform.

At the end of April, I released a White Paper on swaps reform called "Swaps Regulation Version 2.0." The White Paper was co-authored with Bruce Tuckman, the CFTC's Chief Economist. This White Paper analyzes the range of academic research, market activity, and regulatory experience with the CFTC's current implementation of swaps reform. It explores and considers a range of improvements to the current reform implementation that is pro-reform, aligned to legislative intent, and better balances systemic risk mitigation with healthy swaps market activity in support of broad-based economic growth.

#### INCREASED EXAMINATIONS OF CLEARINGHOUSES

The Commission expects the number of derivatives clearing organizations (DCOs) to continue to increase in fiscal year 2019, with many expanding their business to other products and other jurisdictions around the world. As the number of DCOs increase, the complexity of the oversight program will increase. It is imperative that the Commission strengthen its examination capability to enable it to keep pace with the growth in the amount of swaps cleared by DCOs pursuant to global regulatory reform implementation. As the size and scope of DCOs have increased, so too has the complexity of DCO's risk management programs and liquidity risk management procedures. In addition, increased funding will enable the Commission to enhance its financial analysis tools used to aggregate data and evaluate risk across all DCOs.

#### ENFORCEMENT

The day after the White House announced its intention to nominate me as CFTC Chairman, I spoke to hundreds of industry executives at the annual Futures Industry Association Conference. I issued a warning to those who may seek to cheat or manipulate America's derivatives markets. I said, "[t]here will be no pause, let up or reduction in our duty to enforce the law and punish wrongdoing in our derivatives markets. The American people are counting on us."<sup>9</sup> Through robust enforcement of our laws and regulation, we will continue to send a clear signal to the marketplace about our seriousness in punishing bad behavior and compensating victims.

In the past several months the CFTC has filed a series of civil enforcement actions against perpetrators of fraud and market abuse involving virtual currency. These actions and others to follow confirm that the CFTC, working closely with the SEC and other fellow financial enforcement agencies, as well as with criminal enforcement agencies, will aggressively prosecute those who engage in fraud and manipulation of U.S. markets for virtual currency.

<sup>7</sup>Michael Gill, Chief of Staff, U.S. Comm. Fut. Trading Comm'n, Remarks at the National Press Club, CFTC KISS Policy Forum, Washington, D.C. (Feb. 12, 2018), *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagill2>.

<sup>8</sup>J. Christopher Giancarlo, Chairman, U.S. Comm. Fut. Trading Comm'n, *We're Making Government Function More Efficiently for Taxpayers and Market Participants* (Feb. 15, 2018), *available at* <https://www.cftc.gov/PressRoom/PressReleases/pr7696-18>.

<sup>9</sup>J. Christopher Giancarlo, Chairman, U.S. Comm. Fut. Trading Comm'n, CFTC: A New Direction Forward, Remarks of Acting Chairman J. Christopher Giancarlo before the 42nd Annual International Futures Industry Conference in Boca Raton, Florida (Mar. 15, 2017), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20>.

In the fiscal year that ended September 30, 2017, the CFTC brought numerous significant actions to root out manipulation and spoofing and to protect retail investors from fraud. The CFTC also pursued significant and complex litigation, including cases charging manipulation, spoofing, and unlawful use of customer funds.

As of this morning, the Commission has filed 13 manipulative conduct cases in 2018—the most manipulation cases the CFTC has ever filed in a single year, which was last year (12 cases).

But it is not just about the numbers; it is about making our markets safer and removing bad actors from the marketplace. We believe that to adequately deter future misconduct, we must prosecute not just the companies responsible, but also the individuals involved in the wrongdoing. We also believe that, to maximize deterrence, we must work with our criminal law enforcement partners to ensure that wrongdoers face not just civil liability, but also the prospect of criminal prosecution and time in jail.

In January 2018, the CFTC filed manipulation and spoofing cases against six individuals in coordination with the Department of Justice (DOJ) and the Federal Bureau of Investigation, which brought criminal charges against the same individuals. This constitutes the largest coordinated prosecution with the criminal authorities in the history of the CFTC. These prosecutions were equally significant for DOJ: in a press statement, the Assistant Attorney General characterized it as “the largest futures market criminal enforcement action in Department history.”<sup>10</sup>

I also pledged last year that the agency would look to benefit from cooperation with civil and criminal capabilities of other Federal and State regulators and enforcement agencies. We have been making good on that pledge. Two weeks ago, I signed an important agreement, marking a milestone in the area of U.S. Federal and State financial fraud detection and prosecution. That was a memorandum of understanding (MOU) between the CFTC and individual State securities commissions will focus our collective resources to better uphold the law.<sup>11</sup>

This MOU establishes protocols and procedures, for the access, use, and confidentiality of information and treatment of non-public information in the course of law enforcement. It creates a framework for cooperation that will result in:

- Leveraging State and Federal resources to support enforcement actions;
- Enhancing the impact of enforcement efforts and their deterrent effect;
- Encouraging the development of consistent and clear governmental responses to violations of the Commodity Exchange Act;
- Preventing the duplication of efforts by multiple authorities; and
- Facilitating vital exchanges of information and communications between the Commission and State Securities Administrators.

Complementing its enforcement efforts, the CFTC has also strengthened its Whistleblower Program, and provided whistleblowers additional incentives to report wrongdoing to the CFTC. In May 2017, to further protect whistleblowers, the CFTC added protections prohibiting employers from retaliating against whistleblowers and from taking steps that would impede would-be whistleblowers from communicating with the CFTC about possible misconduct. In the near future, the CFTC also anticipates issuing its largest ever whistleblower awards. These incentives are working. In fiscal year 2017, the Commission received a record number of whistleblower reports—nearly twice as many as in any other year, and fiscal year 2018 is on track to receive nearly twice as many as in fiscal year 2017.

The Commission takes its enforcement efforts very seriously and prides itself on being a premier Federal civil enforcement agency dedicated to deterring and preventing manipulation and other disruptions of market integrity.

Full funding of our budget request will allow us to continue to carry out our mission in the area of enforcement.

#### RULE HARMONIZATION

Soon after Chairman Clayton was sworn in as SEC Chairman, we began discussing ways to ensure that our respective agencies are working together in areas where our regulatory interests are complimentary or overlapping. Now, almost 8 years after the Dodd-Frank Act officially required the CFTC and SEC to “consult

<sup>10</sup> Acting Assistant Attorney General John P. Cronan Announces Futures Markets Spoofing Takedown (Jan. 29, 2018), *available at* <https://www.justice.gov/opa/speech/acting-assistant-attorney-general-john-p-cronan-announces-futures-markets-spoofing>.

<sup>11</sup> CFTC, NASAA Sign Agreement for Greater Information Sharing Between Federal Commodities Regulator and State Securities Regulators.

and coordinate . . . for the purposes of assuring regulatory consistency,”<sup>12</sup> I am pleased to say that both agencies are undertaking an active and cooperative review of our Dodd-Frank regulations. With the helpful assistance of Commissioner Quintenz, CFTC staff has been actively engaging with our SEC counterparts—and jointly with outside stakeholders—to identify areas ripe for further alignment. Our agencies are also working to finalize an updated information-sharing agreement that will help us further our collaborative efforts in the swaps and FinTech age. I believe that Congress and the American people expect regulators to communicate and coordinate closely on issues where our regulatory interests are complementary or overlapping. I am optimistic this review process will lead to regulatory changes that will enhance our oversight efforts while reducing unnecessary complexities and lessening costs for both regulators and our shared market participants.

#### FOREIGN COMPETITION

As you may know, in the first quarter of this year, the Shanghai International Energy Exchange launched a yuan-denominated crude oil contract allowing non-Chinese market participants to trade for the first time in Chinese commodity markets. Early in the second quarter, China opened a yuan-denominated iron ore contract to international traders. There is also talk of China allowing international market participants to trade Chinese futures contracts in fuel oil, copper and even soybeans.

China is the world’s largest consumer of oil and fuel and a major global purchaser of iron ore for its world leading steel production. The opening up of China’s domestic futures markets to international participation is part of a long term strategy by the Chinese government to expand China’s influence over the pricing of key industrial commodities.

The development of Chinese commodity futures markets as viable regional price benchmarks for key industrial commodities has competitive implications for the United States. We cannot be complacent about the historical primacy of our derivatives markets. Our best response for U.S. commodity market participants and, indeed, for global markets, is to ensure that derivatives markets in the United States are unrivaled in their openness, orderliness, and liquidity. This requires, of course, that the regulation of U.S. markets continue to be of the highest quality.

To achieve this regulatory objective, U.S. derivatives markets must have an adequately funded regulator. The CFTC must have suitable resources to continue to serve its mission to foster open, transparent, competitive, and financially sound U.S. derivatives markets that remain the envy of the world. Full funding of the CFTC’s budget request will allow it to fulfill its mission to serve this vital national interest.

#### CONCLUSION

Members of the subcommittee, we meet one day after the anniversary of the “miracle at Dunkirk,” the rescue of the British and French forces trapped and then improbably evacuated in 1940. That may be the single most important event of the Second World War, enabling Europe to hold on until America entered the war.

Like many of you, I was struck by the recent movie about Winston Churchill, “Darkest Hour.” Faced with the threat of catastrophe, Churchill told the nation, “We shall not fail or falter; we shall not weaken or tire . . . Give us the tools, and we will finish the job.” When those tools came (and they did come), they were American tools that got the job done.

We need the tools to do our job of protecting the markets that Americans rely on each day. With the proper balance of sound policy, regulatory oversight, and hard work, America’s deep, liquid, and sensibly regulated derivatives markets will allow us to meet the challenges of the future and ensure a healthy U.S. economy where our citizens can flourish.

Thank you.

Senator LANKFORD. Thank you both very much on this.

I am going to defer my questions to the end to give time for other Members to be able to step in earlier on this. So, Senator Van Hollen.

Senator VAN HOLLEN. Thank you, Mr. Chairman.

Again, welcome to both of you.

<sup>12</sup>Section 712(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 (July 21, 2010).

Mr. Commissioner Clayton—Chairman Clayton, I have got a question related to conduct and appropriate conduct by members of the SEC because there were some recent alarming reports with respect to an exchange between one of the commissioners, Commissioner Piwowar, and Citibank.

And my first question to you is, would you agree that it would be inappropriate for a member of the SEC to suggest that the way a regulated entity was treated depended on the position that entity took on a business decision outside the purview of the SEC?

Mr. CLAYTON. Senator, we interact with a number of market participants. What I can tell you is how I approach those interactions and that is in a very open, fair, and transparent way.

Senator VAN HOLLEN. I am not suggesting otherwise, Mr. Chairman, with respect to any conduct.

I will cut right to the chase. There were reports. Senator Kennedy and I are both in the Banking Committee. As you know, Citigroup as a matter of policy said to its retailers that they should not be using Citigroup services to sell weapons that had not gone through a criminal background check, where the buyer was under 21. And it has been reported—I assume you have read the reports—that one of the commissioners, Commissioner Piwowar, met with Citigroup at their request on a derivatives regulation issue, and in the course of that conversation, Commissioner Piwowar chewed them out for the position Citigroup had taken on this issue outside the purview of the SEC.

And so my question to you is, are you aware of those reports? Do they concern you? And have you asked the Inspector General to determine whether or not that was a violation of SEC conduct and rules?

Mr. CLAYTON. Senator, I am aware of those reports. I have not asked the Inspector General to investigate those reports, and I do not think that this is the appropriate forum to get into that. But I understand your comments and your concerns.

Senator VAN HOLLEN. I appreciate that. My concerns are shared by a number of our colleagues, and I think you will be receiving a letter in your capacity as chairman. But we are also going to be asking the IG to take a look at this because regulatory bodies should not be using their authority to try to assert the personal opinions of the members. And I think we share that view. I just want to give you a heads-up on that issue. This has nothing to do with anything you did or said in your personal capacity, but I just wanted to raise it with you because the integrity of the process, whether it is CFTC, SEC, any regulatory commission, is that they should not be using the power they have over regulated entities on issues outside their jurisdiction. We may all disagree with the policy position Citigroup took, but I do not think we should disagree on using that leverage.

#### CYBERSECURITY

Let me ask you a question on cybersecurity. And we have had this exchange in the Banking Committee. I know you are concerned about the issue of timely disclosure by entities under the jurisdiction of the SEC that have been hacked. We have talked about Equifax in the Banking Committee.

As I am sure you are aware, a report from the White House Council of Economic Advisors back in February actually identified concerns at the SEC specifically. I just want to read from their report. Quote: The effectiveness of the SEC's 2011 guidance is frequently questioned. There are concerns that companies under-report events due to alternative interpretations of the definition of "materiality."

This is a concern I share. I was somewhat disappointed to see the regulations coming out from the SEC I think in April after this February report that simply sort of adopted the 2011 recommendations that were criticized in the SEC report. And I wonder if you would be willing to take another look at this with us because the Equifax example is one that I think shows that there is a problem when materiality can be so loosely defined that different folks under your regulatory purview have vastly different interpretations.

Mr. CLAYTON. I understand everything you have said. It is a complex issue. Let me try and address a few things.

First, you will note that we brought a very significant enforcement action in this regard against the company formerly known as Yahoo for their failure to disclose in this area. It was clear that the information that they had was material and should have been disclosed.

Second, I think an issue that we have talked about in the past is trading during the period of time that a company identifies an issue, it is clearly important—let us use the word "material" for sake of argument—and then it is disclosed. I am very willing to work with you on that issue because, as I have testified in the past, I think it is good corporate hygiene that during that period, senior officers should not be trading in securities whether they themselves know or do not know of this event. In that area, I am willing to work with you.

Senator VAN HOLLEN. I appreciate that. Forgive me, Mr. Chairman. That is after the company itself has already determined materiality between that time and disclosure. But there is still a lot of ambiguity over what constitutes materiality.

I would only point out that with respect to OMB, a Federal agency, there are clear guidelines for their timeline for reporting hacks, for example, into the Office of Personnel Management system that we saw a couple years ago.

So I think we should have a little clearer definition of what constitutes materiality in the context of these cyber breaches.

Senator LANKFORD. Great.

Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman.

Chairman, Chairman, welcome.

Chairman Clayton, when an American corporation, including but not limited to a broker-dealer, violates the securities laws of another country, are we made aware of that? Do they have to report their violation to you?

Mr. CLAYTON. Generally those other countries do not have statutes that would require their enforcement authorities to notify the Commission.

Senator KENNEDY. What about the American corporation that violated the foreign law? Do they have to tell you?

Mr. CLAYTON. Is there an absolute obligation to tell us? I do not believe so. Are there disclosure obligations that they have that would trigger a requirement to make a disclosure? Yes. And as a matter of policy, do American public companies that have a foreign enforcement problem contact us to let us know? They generally do and they should.

Senator KENNEDY. Have you heard of a company called Real Gold Mining, Limited that was suspended from trading on the Hong Kong Stock Exchange? Does that ring a bell?

Mr. CLAYTON. Senator, that company does not ring a bell, and I want to be careful not to talk about any pending enforcement actions.

Senator KENNEDY. Well, Hong Kong fined an American corporation, Citigroup, \$7.26 million for misleading statements during the IPO of Real Gold Mining, Limited. And Real Gold Mining, Limited ended up being suspended from trading on the Hong Kong Stock Exchange. Do we know if any American investors were hurt?

Mr. CLAYTON. Senator Kennedy, I do not know about that specific situation. But I can tell you that if there was fraud on a large foreign stock exchange, it is likely that directly or indirectly an American investor has been harmed.

Senator KENNEDY. Well, would you look into this? I mean, \$7.26 million is quite a fine. And I do not know the facts of the case. I read about it in the "Wall Street Journal." But I would be interested to know that if Citigroup or other corporations violate the securities laws of another country, how we go about determining in a global economy whether American investors were injured as well.

Mr. CLAYTON. Your question, including as a policy matter, is a very good one. American investors, estimates vary, have at least \$9 trillion invested outside the United States. One of the things that is important to me is what are we doing at the SEC to ensure that when that money goes outside the United States, investors are getting protections that are similar to what they expect at home. I can tell you that the SEC and the CFTC work closely together mostly through the International Organization of Securities Commissions (IOSCO) but also through the Financial Stability Board (FSB) with that in mind because American investors send a lot of money outside the United States.

Senator KENNEDY. Well, if your Inspector General goes to work on the issues that the distinguished Senator talked about, I would also like him to look into why, because of the greed of a handful of companies, in 2008 it caused the entire banking system and almost the world economy to crash. Not a single solitary member of senior management went to jail. You might ask him to take a look at that too.

I would like the thoughts of both of you about the Volcker Rule. I will hush. We got 34 seconds. If you could just tell me—I know there are changes being made. We have not had a recession since 2008. Are we making changes too quickly? I am not saying we are. I am just asking your opinion. Mr. chairman.

## VOLCKER RULE

Mr. GIANCARLO. Thank you for the question. We monitor markets very, very carefully. Just last week, when Italian bonds went into a mini-crisis, we saw a real strain in those markets. In February, when the VIX, Volatility Index, when interest rates had the prospect of rising in that index, we saw a strain in the markets. And what we observe is not an abundance of high-level market-making. Banks have moved out of the market. And one of the reasons is the Volcker Rule. And one of the reasons is a presumption, not in the way it is written in the law, but the way it has been adopted by the agencies, a presumption that activity is proprietary trading unless proven to be market-making. And that is an odd presumption.

The change that our agencies proposed are to remove some of the bias against market-making. I think that is healthy for markets. The core principle, however, remains.

Senator KENNEDY. Because there is a blurred line between proprietary trading and market-making.

Mr. GIANCARLO. Right.

You know, I spoke to Paul Volcker about this a year and a half ago, and he admitted. He said, look, the Volcker Rule is an easy concept but it is hard to do in practice. In other words, let us separate proprietary trading, which banks should not do with depositors' money, from market-making, which is a legitimate function. But he admitted that getting the separation right is a challenge.

What was done in the first crack here was to put in a presumption that things are impermissible proprietary trading. By removing the presumption, we are still keeping the prohibition on impermissible proprietary trading using depositors' funds. And I think that is the right thing.

So it will be said that what has been proposed is a rollback and going back to the crisis days, but it is really not. It is really a very measured moderate response, and I take it as a good sign that Marty Gruenberg from the FDIC supports the proposal that was put forward by at least our agency yesterday.

Senator KENNEDY. Thank you, Mr. Chairman.

Senator LANKFORD. Before I move to Senator Boozman, Chairman Clayton, would you respond on the Volcker Rule as well? Both of you have been asked about it. I know that will be a question. Then I am going to come straight to Senator Boozman.

Mr. CLAYTON. Sure. Let me just supplement what Chairman Giancarlo said, which is this is a very complex area, important area, but an area with a great diversity of firms involved. What I am very happy with is that we are taking the small and medium-sized financial institutions which are—tell me if I have this right—less than 5 percent of trading activity, in fact, and we are taking a tiered approach instead of a one-size-fits-all approach. I think that is wholly appropriate in this area. I think that the compliance burden that fell on those institutions that are the small and mid-sized banks was greatly out of proportion with their trading activity. Other than that, I am fine with everything Chairman Giancarlo said.

Senator LANKFORD. Thank you.

Senator Boozman.

Senator BOOZMAN. Thank you, Mr. Chairman.  
And thank both of you all for being here. We really do appreciate your hard work and your guidance in these areas.

## RULE 30E-3

Before I get into my questions, Chairman Clayton, I understand the SEC adopted the rule 30e-3 earlier this morning. I appreciate the Commission taking into account real concerns that my constituents and stakeholders not only in Arkansas but across the country had with the rule and your efforts to address some of the issues.

However, I still have concerns that the 30e-3 rule that was approved today, an opt in rather than an opt out for paper reports, will have far-reaching consequences for many of my constituents that are elderly, many that do not have reliable access to broadband Internet or simply want hassle-free paper reports. I think that the technology is getting there, but as you travel through rural America, it is still a huge problem for some.

Mr. CLAYTON. I recognize those concerns. Our staff recognized those concerns. And the rule that was approved is, I would say, a substantial departure from what had originally been proposed. We have a 2-year phase-in period. The earliest that a fund complex or company could switch to an opt in to paper is 2021, and that is only after they have provided extensive notice and opportunity for their investors to choose. This is also part of an overall assessment of investor experience that we are going through. So we think that this is the right move, but we do not think it is one that should be done hastily. And we think that we should be providing the very constituents that you mentioned every opportunity to continue to receive reports as they receive them today in paper.

## WELL-REGULATED DERIVATIVES MARKETS

Senator BOOZMAN. Thank you very much.

Mr. Giancarlo, in your testimony, you mentioned the Shanghai International Energy Exchange launched yuan-dominated crude oil and iron ore contracts allowing non-Chinese market participants to trade in Chinese commodity markets for the first time. Can you talk to us a little more about the importance for farmers and end users for the commodities that they trade to be priced in U.S. dollars and not other currencies?

Mr. GIANCARLO. Indeed. You know, I have spent a lot of my past 4 years on the Commission meeting with the farmers that use our products. And I will often point out to them. I say, do you understand that compared to farmers all over the world, you have one advantage that you probably do not think about, but it is an enormous advantage? And that is, most of your production is priced in U.S. dollars. When you compete against an Argentinean wheat grower or an Australian wheat grower, their production is priced in dollars, not in their native currency. That is a tremendous advantage.

We are the world's largest food producer. We are becoming the world's largest energy producer. The largest consumer, however, is China, the largest consumer of energy products, the largest consumer of iron ore for purposes of their world-leading steel produc-

tion, the largest consumer of soybeans. I understand China consumes 60 percent of the world's soybeans.

So they are sitting there saying we are the largest consumer. Why are we paying in dollars for these core commodities? And so it is part of their grand strategy to become the world's leading economic power to see the transfer of the pricing mechanism of these core materials, these core commodities that they consume from dollars into their currency. Now, that may be decades away, but these steps that they are taking in the last few weeks are very much part of that strategy. We should no longer take for granted that for now and for all time, these commodities that we produce and lead the world in production will remain priced in dollars for all eternity. There is nothing in that.

The one advantage we have, I believe, is not only being a large producer, we have the best regulated markets. The price mechanism that is set in Chicago and New York for these commodities is overseen by our agency. And I truly believe we are the world's best regulator at this. There are real deficiencies in the way other regimes go about regulation, including in China. And we saw, when there were problems in their market a year or so ago, their very heavy-handed approach to addressing those problems was not the approach we take. We take a much more well-informed and appropriate, principle-based approach. And I think that is one of the reasons why the pricing mechanism is here, one of the reason why the world looks to U.S. markets to price these core commodities.

Senator BOOZMAN. So in not taking this for granted, you mentioned the ability that we have to run a very orderly system. Are there other things that we need to be doing along that line?

Mr. GIANCARLO. Look, I do not think we can stop China from offering these products around the world. I do not think we can do anything to stop the amazing growth of their economy. It is their right to do that, and they are doing some brilliant things.

What we can do is just what we do but even better. And I think one of those advantages—and I said in my opening testimony good regulation is a national competitive advantage. And I think that is why I humbly ask that our budget request be fulfilled so that we can continue to do what we do but do it even better.

Senator BOOZMAN. Very good. You make a good point. Thank you, sir.

#### FISCAL YEAR 2019 BUDGET REQUEST

Senator LANKFORD. Thank you.

Let me keep going with that theme of your budget request, a \$32.5 million increase on it. Do you consider this bringing up to the level that you think it should be and is this sustainable? Is this a 1-year bump? Is this bringing it up to a new level? What are your expectations for the next several years on budgeting?

Mr. GIANCARLO. Thank you for that.

As you know, Chairman, we have been flat-funded—

Senator LANKFORD. You have for several years.

Mr. GIANCARLO [continuing]. For several years, and in fact, decreased last year.

This increase of roughly 13–14 percent will bring us to a level that had we seen incremental increases during that time, we would

be there. Should you see fit to fund our full request, I do not see similar requests of that magnitude going forward. I see incremental increases going forward. So our request is really to address some of the challenges we have had over the last few years and some of the cuts we have had to make in technology, in supervisors. We have some real, quite mission-critical shortfalls in cyber examiners, in technologists, areas where we really should not be falling behind, and where we have been. We are effectively in a hiring freeze and have been for several years, and as attrition works its way through the Agency, you know it is very uneven. In some critical areas, we have not been able to backfill, and we need to do that. So this funding will bump us up to where we need to be, and then I see incremental increases thereafter.

Senator LANKFORD. Do you see the increased funding—let us just take the technology side of it—on equipment in technology or in personnel in technology?

Mr. GIANCARLO. Both. So technological skills are in short supply, and the people you need for cyber—the going bid for their services is enormous. So to fill those positions is critically important. It is a combination of skilled people and competent technology. Again, once we catch up, then our needs going forward should be incremental.

Senator LANKFORD. For the SEC, the same issue on technology. What do you expect as far as modernization efforts?

Mr. CLAYTON. Well, as I mentioned, I thank you for the additional funding that we needed to lift not only our cybersecurity game but effectively our advancement or, if you want to say it in the negative way, our retirement of legacy systems. Part of cybersecurity and good cyber hygiene is not only what is my cybersecurity protection, but it is also rolling off your legacy systems that were built with less protections and replacing them. And we are able to do that. I think we are in a good place, but I want to be clear. When I say we are in a good place, we are in a good place from funding because I know where to put the dollars. We are improving our cybersecurity risk profile, but we have work to do and I expect it to be a continuing journey.

Senator LANKFORD. So one of the things that you and I have talked about is not just cybersecurity and the right software, right hardware, right personnel and process, but also how much information do you really need to be able to hold. That becomes the threat on it. Obviously, with the breach of the Edgar system before, it raises new questions.

So where are you as far as what information you really need to have accessible at that point?

Mr. CLAYTON. Let me put that into two categories.

Senator LANKFORD. Sure.

Mr. CLAYTON. Personally identifiable information, PII. Following the breach, we did a review of the PII that we take in, and we have eliminated taking it in in areas where we do not need it. And we continue to approach that issue, and I expect to continue to approach that issue in the same way. We are not going to take that kind of retail investor information in unless we need it to fulfill our mission.

More general market information, the same approach. Like we discussed, why would the Commission create a risk unless we need it to fulfill our mission. So we are looking at the market information and the company information that we take in that is non-public. Does the Commission need it? Do we need it at the time we are taking it? Because over time, the value of that information to, for lack of a better term, "bad guys" diminishes. So we are looking at those issues as well.

Senator LANKFORD. Let us talk a little bit about staffing changes. You mentioned quite a bit as far as staffing changes in different key areas. Which area or office, as you look at the priorities of adding 100 different positions basically back in, becomes the top priority for you? So when you are talking about we have got a lot of priorities, this one goes first, where does that land for you?

Mr. CLAYTON. Let me give you four, if you do not mind, four top priorities.

First, we talked about IT. There are a few positions there that we want to fill.

Let me go to the programmatic ones. Enforcement and inspections.

In enforcement, we have probably had the most significant attrition. I know that we can add value there.

Inspections, the number of investment advisers that are operating has increased. Therefore, our obligation to continue to inspect them has increased. The Commission is doing a lot with risk-based inspections, but we also need smart, competent people to do it.

Lastly is in trading and markets. As I have talked about, our markets have evolved a great deal. I want to make sure that we have the people in place. I will give you an example. Fixed income is moving from what I will call human oral trading to a great deal more of electronic trading. I want to make sure that we have the people who can cover that transition. It is a transition that is akin to what has happened in the equity markets but it is not going to be the same. And we need some expertise in that area as well.

Senator LANKFORD. So the challenges you have is the IG went back and evaluated, a very not-fun evaluation on human capital management and pressed on SEC. This was the quote. SEC lacks assurance that its hiring specialists have the necessary skills to hire and promote the most qualified applicants in accordance with key principles of an effective control system.

I know you have seen that and this has already been a work in process. But with adding an additional 100 people, especially in high-end areas like that, how do you feel at this point about hiring specialists and those individuals that are managing human capital?

Mr. CLAYTON. I am going to give you what may sound like a simplistic answer but it is one that I really believe in. Good people hire good people.

Senator LANKFORD. I would agree. That is not overly simplistic. That is good common sense.

Mr. CLAYTON. I think we have good people in place in those programmatic divisions that I mentioned.

Senator LANKFORD. Is that a transition from what the IG was concerned about before?

Mr. CLAYTON. Chairman, I do not know if that is a transition, but I have a great deal of confidence that the people who are now heading those divisions know how to identify talent, and I am going to leave them to do it.

Senator LANKFORD. Fair enough.

Let me if there are other Senators who have a second round of questions. Senator Kennedy? All right.

I have got a stack of a second round here that I want to go ahead and jump into.

#### PERSONNEL NEEDS

Mr. GIANCARLO. Senator Lankford, may I just actually answer the question you asked my colleague, Jay Clayton, about personnel—

Senator LANKFORD. Sure.

Mr. GIANCARLO [continuing]. Where we are looking for it?

In our request, we request 46 FTEs, and I would just like to break those down for you to help you understand how we think about staffing.

I put our needs into three buckets: a third, a third, a third.

The first third are personnel for what I call prevention. Senator Kennedy talked about the last crisis. We think about what a future crisis might look like and think about how we can do something about prevention so it does not happen, not that we have a crystal ball. But when we think about prevention, we think about it in two areas. One is cyber and one is in our clearinghouses. You know, one of the effects of Dodd-Frank was to supersize our clearinghouses with swaps clearing. How do we get ahead in that? And it is vitally important we have the examiners to do the exams and to go into the detail. So maybe we find a problem before it becomes a crisis. In the areas of cyber, we desperately need to add additional personnel to do quality cyber exams of cyber defenses in our global clearinghouses and our futures exchanges and observe what their other defenses are as well.

And then a second bucket is how do we be more forward-looking. And that is where we really need more technologists to understand the way our markets are going digital by the minute and economists to understand the dynamics of algo trading and other impacts on the marketplace.

And then the last third is to just fill in gaps that have emerged over the last 4 years of flat funding and a hiring freeze. Just to give you an example, we have not had a full Commission for 4 years now, but we face the prospect very soon of having a full Commission, once two new commissioners arrive. Those commissioners will need to be staffed. Those staffs will come out of our budget. Just as our budget has gone down for fiscal year 2018, we may have two new commissioners arrive that we will need to staff up. So just filling in the gaps there, and there are other areas as well.

So that is our 46 FTE budget proposal. Thank you for giving me the opportunity to explain it.

Senator LANKFORD. No, no. Glad to. Thanks for the insight on that.

## SWAPS REGULATION VERSION 2.0

Help me understand a little bit. You put out a white paper on swaps regulation and swaps reforms that is pretty sweeping to be able to take a look at and say where could we go and what does this really mean in implementing issues and margins and all kinds of things. Walk us through that and what would be the financial needs as far as staffing around that as well?

Mr. GIANCARLO. Thank you for that.

You know, I am maybe a bit of a rare breed. When Dodd-Frank was passed, I actually publicly stated I thought Title VII worked. I said Congress got that part right, the swaps reforms. And I said that after 14 years in the swaps industry. I knew firsthand the shortcomings in the market structure. I also knew how the market worked and I knew what worked well. And so I was a keen observer of how the CFTC and other Federal agencies implemented Title VII. And at the time, I wrote a white paper in 2015 laying out areas where I thought the agency got it right and areas where—and I thought now coming in as chairman, it was time to update that and reflect on what I have now seen. We have got 4 years of experience with our swaps reforms at the CFTC.

Again, I still believe Congress got it right, and I think in some cases, the agency has been extraordinarily successful in its work. So the clearing mandate, implemented by my predecessor by two, Gary Gensler, has worked extraordinarily well. But that has led to second order impacts. We have supersized some of the world's clearinghouses. What are the impacts of supersizing those clearinghouses? How do we oversee them? How, in the event of a crisis, do we make sure they are able to recover, or if they are not able to recover, how are they then resolved and how are all their accounts put back into good order? So we address that in this white paper.

The swaps reporting mandate, was I think actually the most important mandate to come out of Dodd-Frank, and yet 10 years after the crisis, 8 years after Dodd-Frank was passed, we still do not have a clear and composite picture of the counter-party credit risk of one financial institution to another because of its swaps book. How can we make that swaps reporting a reality so we can actually use it to signal whether risk is building up in the system? And I lay out ideas for that as well.

In the area of swap dealer capital, one of the big problems I believe in the swaps reforms—they are actually biased against swaps. And part of the problem there is that we continue to rely on the notional amount of swaps, which is why when people talk about the swaps market, they talk about it in hundreds of trillions. We recently introduced some research through our Office of Chief Economist that says when you actually net that down, the swaps world looks a lot like other large markets like the U.S. Treasury market and not like some gargantuan marketplace. It actually falls into a logical proportion to other key global markets. And once it is put into proportion, maybe then we can have regulations that reflect its actual size and not fears about it overwhelming the global economy. So that is what we tried to do in this.

It is very much a forward-looking work. It does not lay out things to be implemented next month or next week, but it lays a forward

path to what I think is a balanced and healthy approach to swaps regulation, one that is not biased against derivatives which, as I explained in my opening remarks, are very important to the U.S. economy. I think our leadership in the global swaps market underpins the U.S. dollar as the world's reserve currency, and I think we need to maintain that edge, but we need to do it in a balanced, thoughtful, intelligent, and well regulated fashion.

## DE MINIMIS

Senator LANKFORD. So you have also put out a recent conversation on registration as a swaps dealer to an \$8 billion notional value rather than a \$3 billion. Walk us through the why and the what and what do you think is the effect of that?

Mr. GIANCARLO. When this original rubric was set in place, the \$8 billion, then falling to \$3 billion, there was actually very little data. I would say it was an educated guess by the agency. Now we have years of data, and have done a very, very thorough analysis. And what we have found is that if the \$8 billion were to fall to \$3 billion, we would only gather less than 1 percent more swap dealing activity. The fact of the matter is that we probably would not gather it because that dealing activity is done by small, local power utilities, agricultural co-ops, small regional banks. And in the last 4 years, I have met with many of them, and they all tell me if that level drops down to \$3 billion, they will drop their dealing activity from 7.9 to 2.9 because they cannot bear the cost of becoming a swap dealer. It was estimated recently that the cost of being a swap dealer is over \$300 million per entity, and these small power utilities cannot do that. And so the cost-benefit analysis of capturing potentially another less than 1 percent and imposing those costs just did not make sense. All we would be doing is rewarding the large Wall Street banks that can afford that \$300 million to be a swap dealer. We would be hurting these small, local liquidity providers and helping the large banks.

Senator LANKFORD. So how often does that \$8 billion amount need to be revisited?

Mr. GIANCARLO. So what we adopted yesterday on a two-to-one vote of the Commission is a proposed rule to keep the level at the \$8 billion and not drop it down to \$3 billion. And as I said yesterday, I believe that is right. I think it is right for the U.S. economy. I think it is the right level. We will still be registering the Wall Street banks, and at the end of the day, it was the Wall Street Reform Act. It was not the Small Business Reform Act.

Senator LANKFORD. My question is if we do not revisit that on a regular cycle, then as time goes on, you are capturing more and more small businesses that do not need to be engaged in that.

Mr. GIANCARLO. We should, indeed, revisit that on a regular cycle using up-to-date data.

Senator LANKFORD. Do you have a plan on how that should be or a recommendation on how often that should be revisited?

Mr. GIANCARLO. We did it after 4 years. I think that gave us a good outcome. Now, we have not set that as a regulatory objective, but I think something like that, maybe every 5 years, might be the right time period.

Senator LANKFORD. Thank you.

## CRYPTOCURRENCY

Let me ask you something simple for both of you. What are we going to do on cryptocurrencies? This is not complicated at all. What is the plan? What is the direction? What is the staffing need that you have and the regulatory authority that is needed?

Mr. CLAYTON. Let me divide it into two buckets: cryptocurrency as—or crypto-asset—we will call it a currency as a replacement or substitute for the dollar, the yen, and then what we call ICOs, initial coin offerings, a crypto-asset that is a security.

The ones that are the substitutes—the SEC does not regulate. We regulate securities transactions and persons who issue and trade in securities. Both of us have mentioned that that space is a space where there is no direct regulation of those cryptocurrencies. And it makes sense that there is not because these were all sovereign-backed. Now we have a purported substitute for the sovereign-backed currencies. There is not a specific regulatory framework in place. There is anti-money laundering. There are a number of other statutes that would touch on this, but no comprehensive body of regulation. We need to watch this space for that and many other reasons.

Mr. GIANCARLO. I will tell you the last 18 months for Chairman Clayton and I in the area of cryptocurrencies has been what the Grateful Dead called a “Long Strange Trip.” We had to come up to speed awfully quick in this area that was developing very fast in Chairman Clayton’s case, in the SEC’s case, to make the world understand that unregistered ICOs would not be tolerated. And I think that message has been delivered loud and clear. In the case of the CFTC we will work within our unique statute which allows for self-certification by our self-regulatory organizations of cryptocurrency derivatives which have been launched. We have now put out recent guidance on the standards that we will look at when we review those self-certifications. We have had to get up to speed very quickly, but I do think as we sit here today, within the CFTC’s area and its jurisdiction, within our jurisdiction, we now have our principles expressed and understood.

But there is that area that Chairman Clayton mentions that I think is the area of concern and that is the cash exchanges. The cash exchanges for these cryptocurrencies is an area where we do not have direct regulatory oversight. And that is an area where there is a lot of talk right now as to what is the right way forward. There is potentially a Federal role. The States are exploring what their role is. Certainly some States like New York have developed a cryptocurrency license. Others are looking at this. And I think a general conversation should be had as to whether a 50-State approach or a Federal regulatory approach is the right way to go. But I think we do need to bring our best minds together around the issue of where and how do we go forward. As we see more and more of them. What do they look like, and what is the right role for regulation and at what level of our Federal and State regulatory regime.

Senator LANKFORD. So what do you need from us? Because you all still have a connection on whether it is initial coin offerings or whether it is fraud or whether it is money laundering or any num-

ber of things that are in that space. What is it that you need at this point as far as legislatively?

Mr. GIANCARLO. We need our budget fulfilled, Senator.

Senator LANKFORD. That would be helpful.

Mr. GIANCARLO. Part of our budget is for technologists, and one of the areas—when we are approached with a self-certification, the resources we devote to make sure we are ready when they are ready to launch is a real strain on our resources. And we do not have a choice. We cannot say to a self-certification this meets our requirements but we do not have the budget, therefore it cannot go forward. That is not a basis on which we can deny it. We have to do what we have to do. So the budget allocation is critically important for the CFTC.

Senator LANKFORD. Okay.

Chairman Clayton, anything you want to add?

Mr. CLAYTON. I will just say—and thank you, Chairman Giancarlo—that in the securities space where we are talking about crypto-assets that are securities, ICOs, our laws are clear. You either conduct a good private placement following the private placement rules that are well established or you register with the SEC and conduct a public offering, including with financial statements and all the requirements of a public offering. We have allocated resources to ensuring that people do that, and we will enforce those laws. It is an area that I watch in terms of assets that we need. I think we are good for now, but I am watching that space.

Senator LANKFORD. Fair enough.

#### INITIAL PUBLIC OFFERINGS (IPOS)

Let me flip topics on you real quick as well, Chairman Clayton, and that is dealing with IPOs and trying to encourage more opportunities for more people to be able to get at the market. My concern that I watch is the smaller number of IPOs, let us say, in the last 10 years, the growth of the activist investor, and is that encouraging or discouraging public opportunities to be able to enter into the market, or does that continue to limit dollars in smaller and smaller hands because if you have activist investors and other complexity in the market, then it is easier to go get private capital than it is to go out in the public, which again centralizes wealth again?

So the question really for you is where are we on some of the rules on dealing with activist investors, what power that they have, the percentages and the rules? Is there anything that you are starting to be able to examine to say is this the right model, the right look to be able to consider?

Mr. CLAYTON. Chairman, I share your concern about the relative size of our public equity markets and therefore the relative size that our retail investors have to participate in. Are we reducing the opportunities for retail investment? And as you said, if all of the good investment opportunities—that is an exaggeration. If many of the good investment opportunities are in the private space, the people who have access to the private space are generally our most wealthy, not the middle class. That troubles me. I want to encourage the growth of our public capital markets.

Your specific question around activists and governance. In the last decade, the governance dynamic of our public companies has changed significantly as a result of a number of factors. The result is—I am not saying it is a good thing or a bad thing—shareholders have more direct access and more immediate effect on the governance of public companies. Items that were reserved for the board of directors are now more greatly influenced by shareholders. That has effects.

Senator LANKFORD. Is that based on just a new functioning of an older rule or a new rule?

Mr. CLAYTON. New rules, new market dynamics, concentrations of holdings, as well as direct access to governance by shareholders, which has increased the ability of shareholders to affect decision-making. My view is we should recognize that, take a pause, and ask ourselves—things have changed—have they changed for the better? There are arguments on both sides, but we should recognize that things have changed.

Senator LANKFORD. Right. And that is something that you are currently evaluating to be able to see, gather data to be able to help make a decision on our proposed rule.

Mr. CLAYTON. Yes. That is our job.

#### STANDARDS OF CONDUCT FOR INVESTMENT PROFESSIONALS

Senator LANKFORD. Let me ask about another rule that is sitting out there, the Standards of Conduct for Investment Professionals, a nice little thousand pages that is out there, shorter than your written testimony, by the way.

[Laughter.]

Senator LANKFORD. That is a big piece of it.

Mr. CLAYTON. And to think my mother could not get me to write a paper.

[Laughter.]

Senator LANKFORD. Listen, all of your folks—it was extremely not only well written but a lot of great information there.

So this whole issue about trying to protect small savers and families that are trying to get started, this is a big issue because again it goes back to the middle class and people that are just starting out to try to invest. This is no simple rule because this affects how people will be able to save for their own retirement or try to invest when they are just getting started out, when they are setting aside \$10 a month rather than people that are aside \$10,000 a month on the other end of the spectrum. Give us a feel of where this goes right now from this proposed rule.

Mr. CLAYTON. It is no simple rule. But what we are trying to do is for the type of person you talked about, make it simpler. There are two types of relationships with investment professionals we have in this country. There is an investment advisor type relationship, which is a portfolio-based I will say longer-term, more general relationship. Then there is a broker-dealer relationship which is a transaction-based, more episodic, in-the-moment relationship.

We believe that in both cases the investment professional cannot put their interests ahead of the client. But that means different things in those contexts because we should recognize that, one, you are having a longer-term relationship over a greater aspect of

someone's investment. In the other, it is shorter-term. Both of these models have served us well. They can be improved and they can be clarified. So we want to keep them, improve them, and clarify them, and that is what we are trying to do.

Specifically, we want our retail investors to be able to have a candid conversation with their broker-dealer or their investment advisor about how they are getting paid, what their incentives are, and what that encourages them to do so that they can make more informed choices and they can be better protected. That is what we are trying to do.

Senator LANKFORD. Give us a guess on the timing.

Mr. CLAYTON. We have allowed for a 90-day comment period. I am sure we will take that full comment period. We are doing investor testing. We are doing investor town halls. Let me just take this opportunity to say we want to hear from investors as to what they want because my objective is to align the law and the practice with investor expectations. What does a reasonable investor expect, and let us see if we can align the law and practice with that. So we are going to take at least the 90 days. But you know what? I am not going to take forever because this issue has been out there a long time, and I think it is time to bring a focal point for the many regulators in this space.

Senator LANKFORD. Thank you.

Mr. Giancarlo, any final comments, anything you want to add?

#### MARKET INTEGRITY

Mr. GIANCARLO. Well, we have a different area. But what I hear from Chairman Clayton is this focus on where the rubber meets the road of people's retirements and how they allocate money, how they speak to their professionals, what they expect in return in terms of their needs being put first. And in very many ways, our approach to markets, although again we do have different approaches historically in the approach of our agencies—our approach, though, is still the same thing, is what is the experience of America's producers when they are going to find—price discovery, to find out what their crop—what they should be getting for it at the elevator. Do they trust the price coming out of the Chicago Merc or NYMEX or others? Do they know that that price is going to be a fair price when it is reasonably settled? The reason why the world relies on prices coming out of our markets is because they believe they are deep, they are liquid, they are efficient. We must never take that for granted.

Then the final thought is I hear Chairman Clayton talk about that marketplace that we took for granted for years of how enterprises were financed first through private equity and eventually into the public markets. It worked so well. It was the envy of the world. And it built the great companies like Apple and Sysco and others, all these great firms that dot the landscape that we rely on. They all came to fruition through that process. Did we take it for granted? Have we allowed it to be gummed up? Do we need to fix something?

And I worry about taking for granted our own price discovery markets that set the world price for commodities. We must not take those for granted as well because other countries see them,

and they want them for themselves. We must not take them for granted. We must do everything possible all the time to keep refreshing. What are we good at? How do we keep being good at that? Those are vital national interests. We need to retain them.

Senator LANKFORD. I would agree.

By the way, I did jokingly talk about your opening statement earlier. It is an inspiring piece of literature. You start out with a great American story and telling the story, and it ended with Dunkirk, if I recall correctly. And so the information that you provided and the inspiration was helpful.

Mr. GIANCARLO. As we celebrate the anniversary of World War II, a great uncle of mine, my mother's cousin, died at the Battle of Bastogne. And I think about that all the time. When people give their service to their country, they give the ultimate service. We in public service—we do not face that type of peril, but it is vitally important that we take it as seriously as they did and deliver for our fellow citizens, as they did as well.

Senator LANKFORD. I would concur.

Chairman Clayton, any final statements?

Mr. CLAYTON. I want to thank Chairman Giancarlo and my other fellow Federal regulators, not just our coordination around the Volcker Rule but the coordination over the past year in trying to assess where markets are going, where the vulnerabilities are, and just make us better. I really appreciate the cooperation we have, and I appreciate the cooperation we have with the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. So thank you.

Senator LANKFORD. I would tell you the American economy is benefiting from good leadership at this point as well. We have one of the lowest unemployment rates that we have had in decades now. So the job market is accelerating. The stories that we hear frequently right now from my home are trying to look for employees rather than employees looking for work. It is a very different story than where we were 10 years ago. And both of you have a tremendous responsibility within our economy, being able to keep a good, balanced, stable economy that continues to be able to provide jobs to people in the days ahead. So thank you for the continuing work. There is much still to be done in this process to make sure we have some regulatory certainty that maintains a growing, vibrant economy.

If there are no further questions and comments from either of you gentlemen, the hearing record will remain open until next Tuesday, June 12, for the subcommittee Members to submit statements or questions for the record for either of the witnesses.

#### CONCLUSION OF HEARINGS

Thank you both for being here.

The subcommittee hearing is adjourned.

[Whereupon, at 4:40 p.m., Tuesday, June 5, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]