Securities Regulation Daily Wrap Up, EXCHANGES AND MARKET REGULATION—Chair Gensler makes case for SEC's first $2 billion plus appropriation, (May 18, 2022)

Securities Regulation Daily Wrap Up

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In prepared remarks, SEC Chair Gary Gensler asserted that the agency's staff had shrunk even though the markets it oversees have grown significantly; meanwhile, the agency's formal FY23 request cited looming appeals cases a partial justification for its requested funding increase.

SEC Chair Gary Gensler's backstory for the agency's FY23 appropriations request is one that he could have delivered when he was chair of the CFTC—the agency is under-resourced for the size of the markets it is tasked with regulating. In absolute terms, the SEC receives a far larger appropriation than does the CFTC and the SEC often sees more significant and frequent increases in its appropriations than does the CFTC. Yet despite the SEC's $1.989 billion appropriation in FY22, Gensler asserted to members of the House Appropriations Committee's Subcommittee on Financial Services and General Government that over a period of several years the SEC's size had actually shrunk. The SEC's $2.149 billion FY23 request, Gensler suggested, would put the agency on track to maintain the federal securities laws' "gold standard" status.

Gensler opened his remarks by outlining some of the recent events in markets that call for increased staffing at financial regulators like the SEC. "Further, market participant incentives, economic cycles, and the nature of finance itself will constantly challenge even a gold standard," said Gensler. "In recent years, we've seen as much —whether the market events of March 2020, the meme stock-related volatility in early 2021, the speculative crypto markets, the boom of special purpose acquisition companies (SPACs), or the collapse of Archegos Capital Management, which we recently charged with fraud and market manipulation."

Gensler also suggested that the regulatory landscape both domestically and globally was changing due to recent geopolitical events and central banks' shift to tighter monetary policy. "Given these trends, I think we should do everything we can to maintain and enhance that gold standard of the markets," said Gensler.

CorpFin shrunk the most. Gensler testified that almost all of the SEC's divisions had shrunk their staffs between FY16 and FY21. The staff of the Division of Corporation Finance in particular, said Gensler, had fallen 19 percent since FY16 and that even the FY23 request would leave a gap of 8 percent versus pre-FY16 staffing levels.

The story was similar, but somewhat more nuanced, regarding the 50 percent of SEC staff who work for the Division of Enforcement and the Division of Examinations. While the Enforcement Division's staff fell by 5 percent between FY16 and FY21, Gensler said the Division of Examinations' staff rose by 4 percent since FY16 and would see its staffing rise an additional 4 percent versus FY21 if the FY23 request is approved. The only other division to see staffing growth over the same period was the Division of Investment Management, but Gensler attributed that growth to the creation of an analytics office within the division.

The Division of Trading and Markets and the Division of Economic and Risk Analysis, said Gensler, both saw decreases in staffing since FY16 (1 percent and 7 percent, respectively). Each division would see staffing grow by between 12 and 15 percent versus FY16, respectively, if the SEC's FY23 request is approved.

SEC's formal request: SPACS and appellate cases. For FY23, the SEC has requested an appropriation of $2.149 billion. The SEC is deficit neutral so its appropriation is offset by transaction fees. The agency was recently funded for the remainder of FY22 under the Consolidated appropriation Act, 2022 (H.R. 2471) at just under the $2 billion level, receiving $1.989 billion.

The SEC said the key drivers of its FY23 request include the recent increase in non-traditional IPOs by special purpose acquisition companies (SPACs), expansion of the private funds market, and digital assets. Other SEC needs focus on developing the agency's artificial intelligence (AI) capabilities to match AI-based funds and AI-driven high frequency trading (HFT) platforms. Moreover, the SEC seeks an extra $20 million to further upgrade its IT systems to leverage cloud computing and to comply with an executive order mandating that federal agencies adopt a "zero trust" approach to cybersecurity.

The SEC's specific funding needs are also reflected in staffing estimates for several of its divisions. Within CorpFin, the bulk of the positions requested would be devoted to disclosure reviews of registrations submitted by SPACs. The executive summary to the SEC's request, using fiscal year period data on company filings, said the following regarding SPACs: "The staff have observed IPO activity increase from over 700 IPOs in FY 2020 to over 2,000 IPOs in FY 2021, a 177 percent increase. Many of these IPOs involved SPACs, so it is reasonable to expect a high volume of de-SPAC transactions for review in the coming years, and as many as 500 SPACs are currently searching for a target" (footnote omitted).

With respect to SPACs, recent data suggest a significant decline in SPAC IPOs. For example, data compiled by IPO Vital Signs, a Wolters Kluwer Legal & Regulatory U.S. database that includes all SEC registered IPOs (including REITs and those non-U.S. IPO filers seeking to list in the U.S. markets), suggested that, as of mid-May, SPAC withdrawals outnumbered completed SPAC IPOs thus far in 2022. Although de-SPAC activity may remain elevated for a time because of an existing backlog of activity, it remains to be seen if SPAC IPOs will again reach the lofty numbers they achieved during the last two years.

The SEC's request also said that a significant number of positions within the Division of Enforcement would be devoted to that Division's Cyber Unit. Positions requested for the Division of Examinations would be split between staff who focus on investment advisers, Regulation Best Interest compliance, and new security-based swaps registrants. Many of the positions requested for the Division of Trading and Markets would emphasize issues related to the Dodd-Frank Act swaps reforms. The SEC's Office of General Counsel also would receive more funds to better handle what the request described as a "significant increase" in cases and appeals.

As an example of high profile appeals involving the SEC, the Supreme Court this week decided to hear a case raising the question of whether a respondent in an SEC administrative enforcement matter can seek immediate review of an alleged constitutional defect in the proceeding in a federal district court rather than waiting to bring a petition for review in a federal appeals court should they become aggrieved by a final order of the Commission. The court took the case despite the U.S. Solicitor General's urging that the petition for certiorari be held pending the outcome of another case the court will hear involving a different federal agency. Previously, the Supreme Court has declined to hear similar cases involving the SEC, although unlike the current case, it was the respondents in the SEC proceedings seeking Supreme Court review. If the court were to reach an outcome allowing early access to the district court in the SEC matter, a majority of the justices would likely have to overturn or significantly distinguish four precedential opinions that create the existing framework for determining if an administrative matter can be challenged in a district court before a federal agency has decided the matter according to that agency's statutory scheme.

In what could be another high profile SEC appeal, a majority of the Fifth Circuit today largely held the SEC's administrative enforcement powers unconstitutional. Specifically, the majority held: "(1) the SEC's in-house adjudication of Petitioners' case violated their Seventh Amendment right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which the SEC would exercise the delegated power, in violation of Article I's vesting of 'all' legislative power in Congress; and (3) statutory removal restrictions on SEC ALJs violate the Take Care Clause of Article II." An SEC decision to seek rehearing *en banc* and/or an eventual appeal of the decision to the Supreme Court would likely turn on the SEC's assessment of the strength of the Fifth Circuit majority's reasoning and a judgment about the likelihood of success before either the full Fifth Circuit or the Supreme Court.

Moreover, with the SEC having just proposed new climate risk disclosures, the topic of climate change rulemakings was cited multiple times by the SEC in its formal budget request as a partial justification for the agency's proposed FY23 appropriation.

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